Japan - December 2020

SPOTLIGHT
Savills Research

2020 Review and 2021 Prospects

Japanese property remains attractive, despite the uncertainty

INTRODUCTION

Whilst the consumption tax hike enacted in October created some unease during the final months of 2019, there was plenty of encouragement heading into the new decade. Indeed, with the Tokyo Olympics on the horizon, property sectors exposed to inbound tourism were particularly upbeat. All the while, the relative stability of Japan's political and economic landscape continued to appeal to investors. This optimism quickly faded amid the onset of COVID-19, however, and one of Japan's longest post-war economic expansions was stopped in its tracks. Whilst the country has managed the virus relatively well, a somewhat long road to recovery is expected given its modest potential GDP growth rate.

As for sector performance, the suspension of international travel has completely reversed the fortunes of the previously encouraging retail and hospitality sectors. In contrast, the structural changes brought on by the proliferation of e-commerce has thrust the logistics sector into the spotlight. Both the residential and office sectors, meanwhile, are going through some significant changes, and these varying reactions to the pandemic are also echoed in the J-REIT markets. Specifically, a recent correction in logistics focused J-REITs notwithstanding, likely in response to the sector overheating, premiums remain significantly higher than its peers. Concurrently, the stark contrast between hard assets and listed vehicles, may reflect different views on sector prospects or give arbitrage opportunities to shrewd investors.

(Please refer to our Spotlight Report "Savills 2020 Year Book" for further analysis on the J-REIT market.)

The onset of COVID-19 has completely altered how we go about our business. The acceleration of workplace reform, and especially teleworking, has amped up the uncertainty facing the office sector, and offices have now come to be regarded with more caution. For employees, flexibility at the workplace is no longer a rarity, and the subsequent benefits to welfare are becoming apparent.

Still, the extent of this reform remains to be seen. For one, structural barriers exist. Namely, the average residential unit size in the capital has been on a downtrend since the start of the millennium, turning the home into a sub-optimal location for fostering productivity. At the same time, changing entrenched behaviours will not be easy. For example, the median age of those living in central areas, which at present stands at the mid 40's, continues to rise, highlighting the challenge ahead.

In this environment, satellite offices could emerge as a viable alternative. Whilst many of these facilities are currently located in Tokyo's central five wards (C5W), it would not be a surprise to see them rapidly start to appear in more peripheral areas such as Omiya and Yokohama. Indeed, this "hub-and-spoke" model, whereby workers can commute to facilities that are close to residential areas, should satisfy employee needs, whilst also enhance productivity.

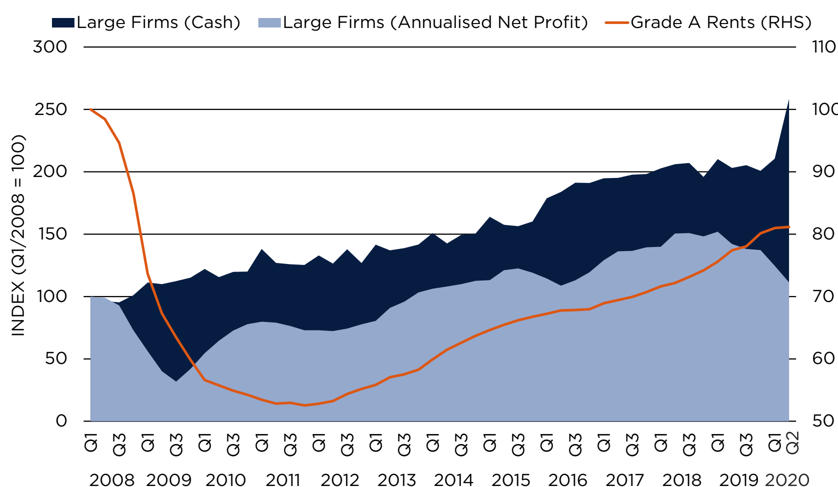
In future, therefore, these centrally located hubs could become a place designed with a specific purpose in mind, be it fostering creativity or providing a sense of belonging. No longer will the office be solely used to house employees regardless of their functions, and so, the location and quality of the asset will be vital. As a consequence, this is likely to create a growing disparity between offices that do satisfy these conditions and those that do not. In fact, signs of this trend have already emerged in submarkets such as Shibuya and Minato where fundamentals have softened, for instance. Even in these submarkets, however, changes remain idiosyncratic to certain buildings.

Nonetheless, the office market remains tight, and the weakening of fundamentals has been manageable – a trend partly underpinned by the frugality of Japanese corporates. To be sure, for the time being, the sound balance sheets of these large companies have allowed a wait-and-see approach (Graph 1). In return, a sudden deterioration in the market has been avoided. However, with forecasts for the next fiscal year looking uncertain, and given that office strategy considerations are also due during the spring, further turbulence is expected. With that in mind, 1H/2021 will certainly be worth keeping an eye on.

The residential sector, meanwhile, has demonstrated more resilience, and it was boosted by the news that the population of Tokyo had hit the milestone of 14 million residents in May 2020. Yet, since then, this figure has been hard to breach. Here, the ban on international travel has once again had an impact. To wit, whereas the number of Japanese residents had increased by around 30,000 year-on-year (YoY) as of October 2020, the sum of foreign residents had decreased by a similar amount. One would assume, therefore, that once the borders are reopened, some positive momentum should return, and the population is likely to remain high.

In line with the aforementioned workplace reform, changes are also afoot within the residential sector. Without the need to frequently commute to the office, the location and convenience of a condo has started to

GRAPH 1: Annualised Net Profits & Cash Holdings Of Large Corporations* And Tokyo Grade A Rental Growth, 2008 to Q2/2020



Source Ministry of Finance, Savills Research & Consultancy
*Large corporations are those with more than JPY1 billion of capital.

become superseded by space. Accordingly, the pricey rents in the C5W are appearing somewhat hard to justify, and some residents may even consider moving into peripheral regions in seek of larger units. This transition, however, is likely to be modest and gradual. All things considered, therefore, it is understandable to see market fundamentals slightly soften, though, in truth, the residential sector remains a defensive play amid these tumultuous times.

Right now, we are facing an unprecedented level of uncertainty. Despite some positivity surrounding the development of a viable vaccine, without a clear end in sight, market sentiment remains understandably gloomy. In the meantime, the geopolitical risks that had taken centre stage late last year could re-emerge. Amidst all this, however, the Japanese economy, including the domestic property market, remains relatively stable compared to its peers. Thus, whilst the present is filled with trepidation, there are surely better days ahead.

With Japan continuing to exude stability amid the global pandemic, the country should continue to attract international capital going forward. In the meantime, domestic corporates are likely to offer opportunities through real estate dispositions aimed at offsetting the impact of COVID-19 and improving capital efficiency.

INVESTMENT TRENDS

Despite being surrounded by uncertainty, in-house cap rates have remained fairly stable, with sellers notably remaining calm. For instance, rates for prime Tokyo offices and retail assets have stayed at around 2.7%.

As of Q3/2020, total investment in Japanese real estate amounted to approximately JPY3.0 trillion year-to-date (YTD) according to Real Capital Analytics (RCA) – a near 28% haircut compared to the same period last year (Graph 2). Predictably, the defensive nature of residential assets during these testing times has led to a marked increase of 71% YoY in flows.

This striking decline in overall investment volumes notwithstanding, there were still some notable transactions over the year. In fact, an increasing proportion of them have involved overseas investors. Specifically, whilst developers have traditionally sold assets to the REITs that they sponsor, the global pandemic may have seen this trend shift slightly for two reasons. Firstly, with the need to shore up balance sheets, some appear more open to dealing with international investors, particularly where elevated prices are involved. Secondly, some J-REITs may also no longer be active buyers given weak unit prices. In this regard, the significant level of dry powder ready to be deployed – an excess of USD300 billion at the start of 2020 according to Preqin Pro – goes some way in driving this dynamic. What's more, the negligible nominal interest rates on offer around the world are likely to push pension funds to increase allocations to real estate, further accelerating this trend.

As for transactions involving a J-REIT and its sponsor, Nippon Building Fund's recent acquisition of over JPY200 billion stands out. It would appear that its sponsor, Mitsui Fudosan, is already looking to put this added liquidity to work, with the firm reportedly making a JPY100 billion bid to acquire Tokyo Dome.

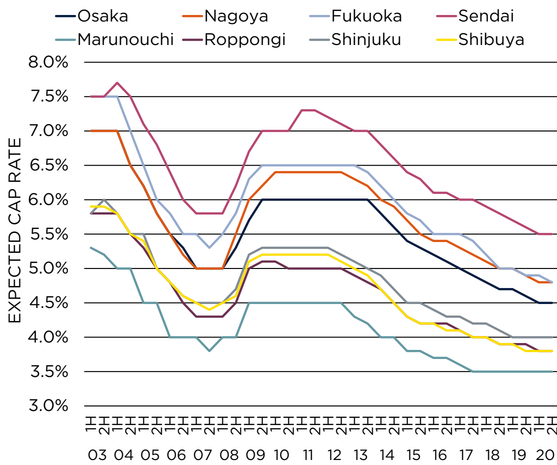
Another potential trend comes in the form of acquisitions with leaseback arrangements. Here, with firms such as Nitori (an IKEA equivalent) investing around JPY200 billion in order to develop their own logistics facilities over the next five years, deep-pocketed investors may in time decide to take on some of the risks, allowing the developers to reinvest the proceeds.

Looking ahead, the likes of PAG and BentallGreenOak have already announced their intentions to invest around USD8 billion and USD10 billion, respectively, within the next few years, endorsing the prospects of the Japanese property market, and by extension, the relative stability of the Japanese economy.

GRAPH 2: Investment Volumes And Cross-border Share, 2007 to Q3/2020

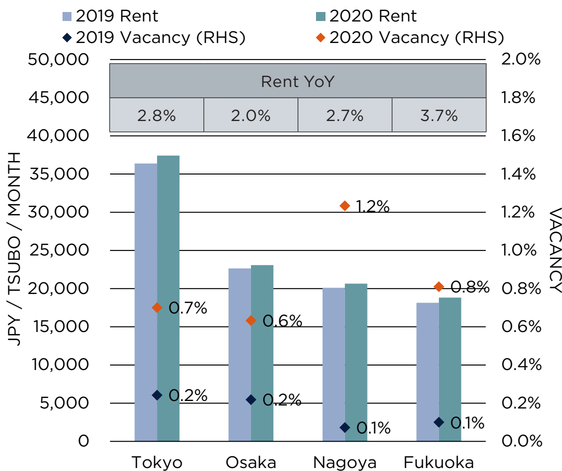
Source RCA, Savills Research & Consultancy

GRAPH 3: JREI Expected Prime Office Cap Rates By City, 2003 to 2020



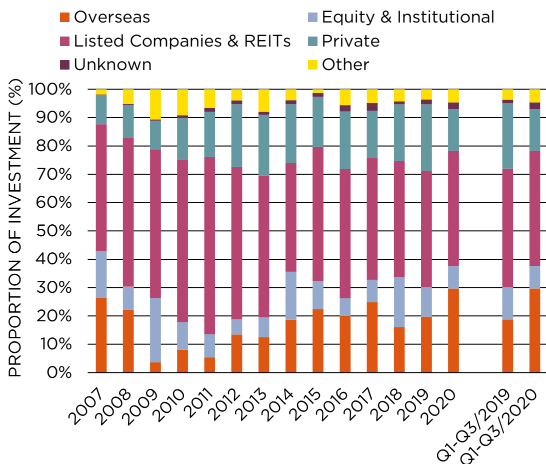
Source JREI, Savills Research & Consultancy

GRAPH 4: Investment-grade Office YoY Rental Growth And Vacancy Rates, Autumn 2020



Source Savills Research & Consultancy

GRAPH 5: Office Investment Volumes, 2007 to Q3/2020



Source RCA, Savills Research & Consultancy

OFFICE

Investment Trends

As the top core asset type in Japanese real estate, and with fundamentals remaining sound, pricing for prime office assets has remained stable despite the pandemic. As such, Savills' in-house cap rates for Grade A offices in Tokyo have held at 2.7% through 2020. The October 2020 Japan Real Estate Institute (JREI)[1] survey reiterated this view in Tokyo, though Osaka, Nagoya, and Fukuoka have seen 10bps compressions YoY. As for Grade B office assets in the capital, some appear to be trading at a slight discount to pre-COVID levels.

Following a robust first quarter, office investment volumes fell off during the year amidst border closures and a domestic soft lockdown in April and May. As a result, office deal flow fell 32% YTD to Q3/2020. On the other hand, YTD overseas investment is up 7% from the same time last year, as cross-border funds with Japan platforms have remained active. In this environment, diligent and flexible investors should continue to find attractive opportunities in the office sector.

Review and Prospects

Despite historically high levels of new supply, airtight market conditions resulted in nearly all of the year's supply being filled or pre-leased. During Q2/2020, however, the economic shock of the pandemic and soft lockdown, as well as the sudden adoption of remote working, ground leasing activity to a halt. Given that six-month notice periods are standard for terminating lease contracts, though many leases are fixed-term, the first signs of market vulnerability emerged in Q3/2020, with average Grade A rents in Tokyo's C5W contracting for the first time in almost a decade.

Vacancy rates have also expanded, led mostly by adjustments in Shibuya and Minato, with the former especially hurt by a higher exposure to technology firms and start-ups. Elsewhere, with an even greater proportion of start-ups and small-to-medium sized enterprises (SMEs) in their tenant base, Grade B offices have borne the brunt of this shift.

Whilst minor at this stage, future concerns over vacancy may be justified considering that Japanese companies by and large have yet to take decisive action on their leases. Even so, the next wave of Tokyo office supply is set for 2023 – providing a much-needed two-year buffer. Encouragingly, over 80% of 2021 supply is reportedly pre-leased.

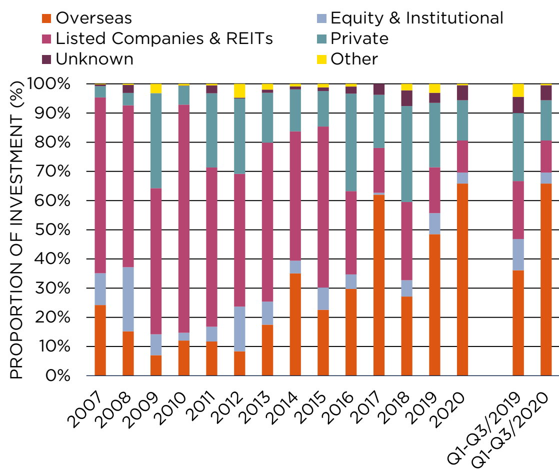
In the regional markets, rents have been higher than last year though, as in Tokyo, vacancy is slowly but steadily loosening. SMEs are more prevalent outside of the capital, with those in the travel and hospitality industries being particularly hard hit, leading to some floor space being returned. The global economic slowdown and ongoing ban on international travel remain firm headwinds for regional economies, which are somewhat more dependent on exports and inbound tourism.

Despite the challenges outlined above, the gravity of change remains manageable in both Tokyo and regional office markets, and much of the impact has been concentrated in specific areas. Going forward, flattish or slightly soft rental movement is expected to continue as both tenants and landlords maintain their wait-and-see approach. Vacancy rates are likely to inch upward, though unless the economic situation were to deteriorate significantly, occupancy should remain relatively high for the time being.

Flexible work arrangements are likely to continue, and some firms may choose to complement centrally-located primary offices with satellite locations in peripheral hubs. Overall, we expect office location and quality to play a more significant role in determining rental prospects, with the gap in rents for lower-quality, less-conveniently located offices likely to widen even more.

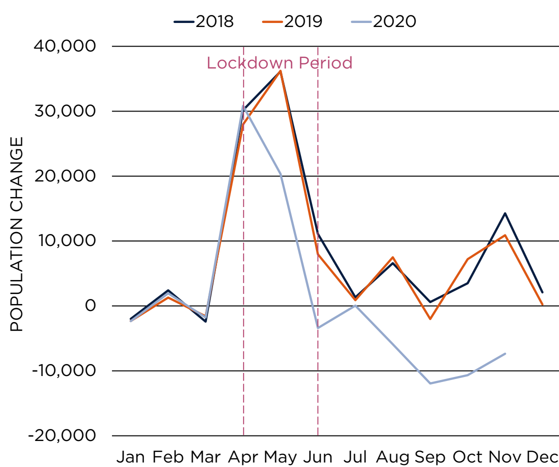
1 Expected cap rates reported by JREI tend to be looser than market cap rates.

GRAPH 6: Residential Investment Volumes, 2007 to Q3/2020



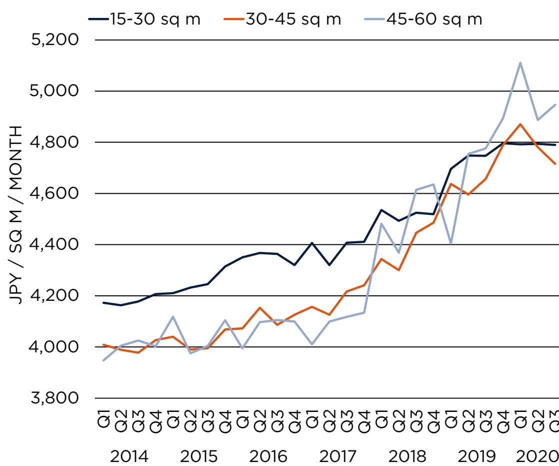
Source RCA, Savills Research & Consultancy

GRAPH 7: Tokyo Monthly Population Change, 2018 to November 2020



Source Tokyo Metropolitan Government, Savills Research & Consultancy

GRAPH 8: Rents By Unit Size, C5W, Q1/2014 to Q3/2020



Source Savills Research & Consultancy

RESIDENTIAL

Investment Trends

In house cap rates for mid-market residential property have remained steady at 3.4%. Being one of the most popular investment targets, competition has been fierce in an already narrow field with limited prime opportunities. According to JREI, expected cap rates for residential property in Jonan and Joto have fallen to 4.2% and 4.4%, respectively.

As documented by RCA as of Q3/2020, YTD investment volumes were around 71% larger than the transaction activity recorded during the same period last year, and 5% above the total volume in 2019. Buyers appear undaunted by market routs, particularly overseas investors who accounted for two thirds of total investments (Graph 6), highlighting Japan's continuing safe haven status and the residential market's defensive appeal. Big ticket deals such as Blackstone's JPY300 billion repurchase of the Anbang Portfolio in Q2/2020 have been significant contributors to this trend.

Review and Prospects

In the face of persistent headwinds, the residential sector has emerged with resiliency, particularly when compared to other core asset types such as office and retail. The market has fought with a slowing of corporate activity, low wage growth and job security all applying pressure to personal incomes. Suffice to say, labour demand in the capital has fallen, with the job to-applicant ratio dropping from 2.08x in December 2019 to 1.19x as of October.

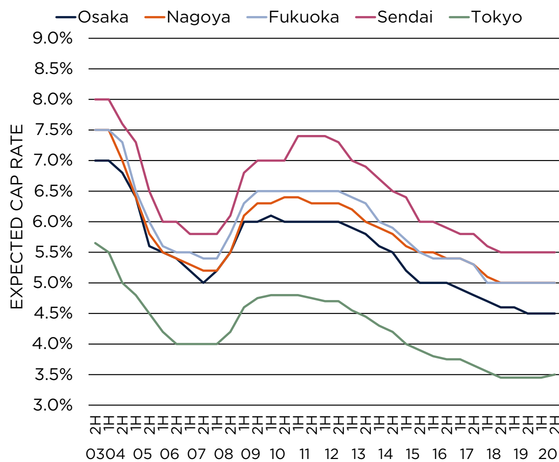
Admittedly, quarterly rental contractions have started to manifest following a period of back-to-back growth in the multi-family sector. This reaction was as sturdy as expected, however, despite ongoing global circumstances. In fact, it wasn't until Q3/2020 that rents across Tokyo's 23 wards (23W) and C5W fell below their four-period moving averages, and still, occupancy rates managed to remain steady.

Indeed, whilst the sector is certainly not immune, core fundamentals have helped weather the storm thus far. For instance, Japanese corporates' substantial cash reserves provide additional firepower to mitigate layoffs. At the same time, Tokyo's population remains close to its recent historic high of 14 million – recorded in May this year. To be sure, this high watermark has proved tough to break through as any increases in Japanese residents have been offset by the shrinking number of foreign residents – likely a fleeting trend caused by the ban on international travel (Graph 7). Yet, the capital is still the economic driver of the nation, and as such, it will continue to attract a continuous stream of youth seeking education and employment opportunities over the long-term, albeit more moderate than before.

Given the many unknowns, one trend that has started to gain traction concerns changes in residential unit preferences. Namely, the need to spend more time at home may prompt residents to prioritise larger spaces with better amenities as opposed to proximity to train stations – a feature that is highly-valued outside of Tokyo's C5W. To that end, average rents for units ranging from 30 to 45 sq m have softened over the previous six months, whilst those for units ranging from 45 to 60 sq m have seen an increase over the same period (Graph 8). The sudden implementation of work-from home arrangements has likely contributed to this dynamic, encouraging these demographics to require more space and layouts with an additional room. Without question, some may want to leave the capital, and the pandemic has undoubtedly added some impetus to this line of thought. Yet, the majority would probably prefer to stay in Tokyo given the many career and educational opportunities. Indeed, giving up the benefits of an urban lifestyle may be easier said than done.

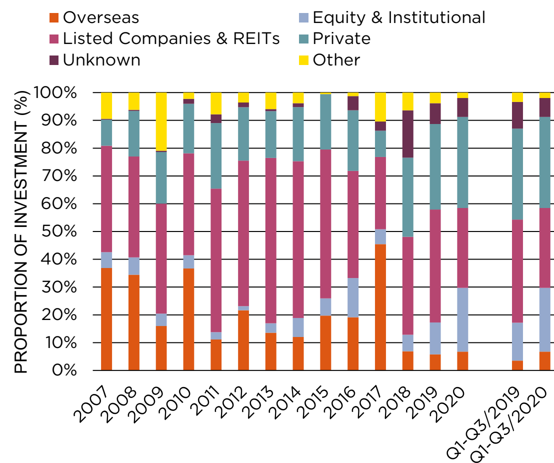
Japan's economy is now laying firmly in recession territory. As such, short-term rental growth will likely be outweighed by the financial squeeze being faced by residents. Vacancy rates are also likely to remain weakish. However, promising news on a successful vaccine, a relaxation of visa restrictions and latent demand will all contribute towards a recovery. In this environment, Japan's multi-family sector offers a comfortable degree of certainty for those deploying capital in an increasingly uncertain world.

GRAPH 9: JREI Expected Retail Cap Rates By City, 2H/2003 to 2020



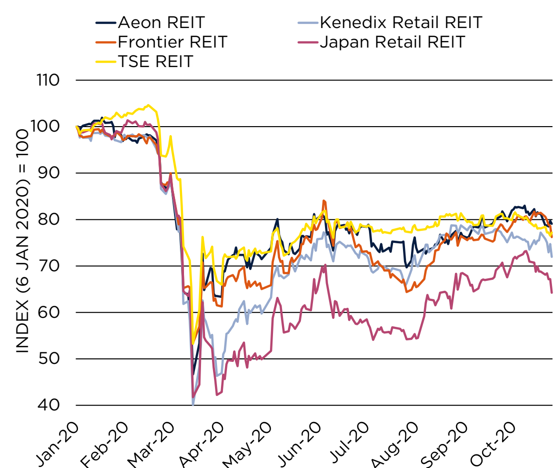
Source JREI, Savills Research & Consultancy

GRAPH 10: Retail Investment Volumes, 2007 to Q3/2020



Source RCA, Savills Research & Consultancy

GRAPH 11: Retail J-REIT Performance Vs TSE REIT Index, As Of October 2020



Source J-REIT Disclosures, Japanese Exchange Group, Savills Research & Consultancy

RETAIL

Investment Trends

Based on our in-house survey, cap rates for high-street retail in Tokyo have held firm at 2.7% as of Q4/2020. Expected cap rates for prime retail property in Ginza and Omotesando according to JREI, meanwhile, have also remained somewhat unchanged at 3.5%. Osaka was the same, with a rate of 4.5%.

Looking ahead, deal flow should pick up slightly as high street properties, for example, remain popular given their high land value. Elsewhere, sellers of conveniently located suburban properties in metropolitan areas may be more willing to negotiate, as a result of their ongoing struggles through the pandemic, presenting some upside upon recovery.

Review and Prospects

Whilst 2019 ended with the fallout from the consumption tax hike, this concern was swiftly overshadowed by the global pandemic in 2020. As such, the already downbeat outlook for the retail sector has worsened. Adding insult to injury, the complete suspension of international travel has left a painful mark in major retail hubs.

The sector's suffering is yet to be reflected in retail rents, however. For instance, listed rents in Tokyo continued to rise in 1H/2020, with average 1F rents increasing by around 8% YoY. In the regional markets, meanwhile, the story was very much the same. Even so, much of this uplift was driven by the availability of previously unattainable prime assets – paradoxically boosting listed rents. In reality, there have been cases of drugstore tenants – a favourite of inbound visitors – vacating spaces in the likes of Shinsaibashi, Osaka, for example, and these are unlikely to be filled anytime soon, subsequently weighing on rents going forward.

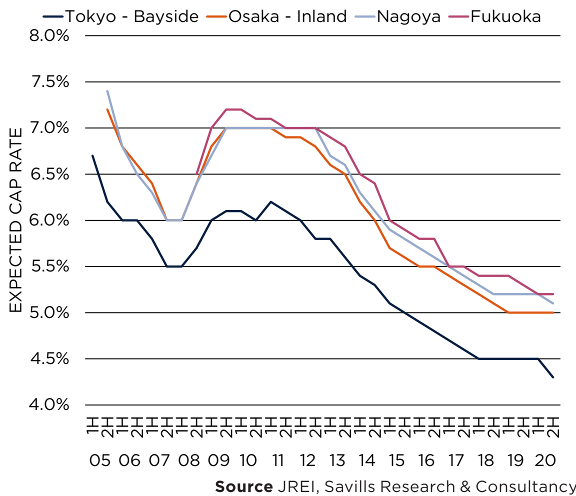
The prospects for the retail sector appear slightly more upbeat when turning to the J-REIT markets. For starters, the performance of most retail focused J-REITs has matched the TSE REIT index (Graph 11). Aeon REIT in particular stands out in this regard thanks to its master-lease arrangements with fairly creditworthy tenants (including Aeon itself). In contrast, investors appear to have some concerns regarding Japan Retail Fund given the above-average exposure to urban high street retail. Yet, this is probably an overcorrection considering that the J-REIT has maintained its dividend payments thus far, likely in part because of the solid long-term relationships with tenants. Moreover, as mentioned, high-street assets remain highly sought after due to the high land values attached. As such, this stark contrast between investors of hard assets and J-REITs implies there should be some opportunities ahead for hard-working and flexible investors.

Meanwhile, the inclusion of Tokyo in the "Go To" campaign in October should stimulate retail sales across the nation, paving the way for an improvement in consumer confidence – vital to drive pent-up demand. This will, however, be tested if another wave materialises. For now, signs of a recovery in confidence have emerged with retail sales increasing by 6.4% YoY according to data for October 2020. Whilst this was partly as a result of consumers kerbing their spending after the tax hike last year, the return of consumer confidence is welcome, nonetheless.

The complexities facing the retail sector are unique. They have arisen, not from an economic downturn – which has often been the case with previous recessions – but rather, the fight against the pandemic. Thus, the pace of recovery will vary significantly amongst market participants, and as such, asset location will be critical going forward. Furthermore, in this "new normal", consumers' appetites for experiences over goods are likely to accelerate. In anticipation of this phenomenon, therefore, retailers will have to incorporate unique ways to enhance the retail experience such as showrooms and pop-ups.

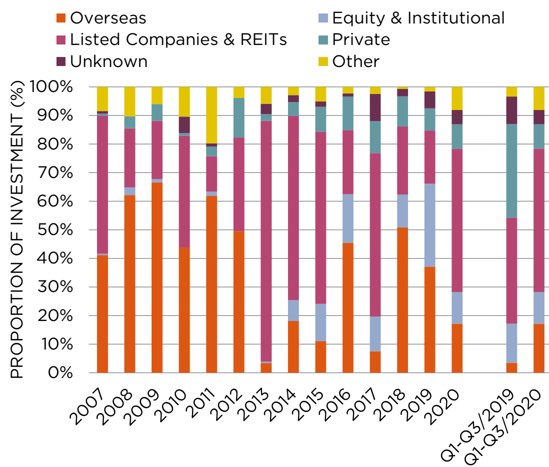
With that in mind, there remains optimism for the sector going forward, especially considering the pleasantness of the retail experience in Japan for domestic and inbound customers alike. This fondness for the high-street may even help slow the growth of e-commerce, adding to the sector's potential.

GRAPH 12: JREI Expected Logistics Cap Rates By City, 2005 to 2020



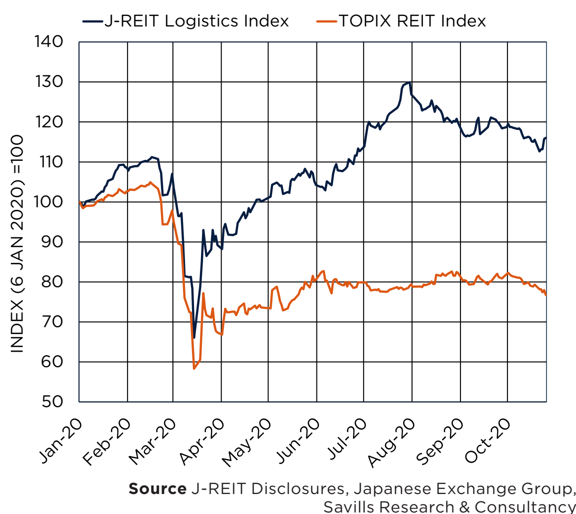
Source JREI, Savills Research & Consultancy

GRAPH 13: Logistics Investment Volumes, 2007 to Q3/2020



Source RCA, Savills Research & Consultancy

GRAPH 14: Average Logistics REIT Performance, As Of October 2020



Source J-REIT Disclosures, Japanese Exchange Group, Savills Research & Consultancy

LOGISTICS

Investment Trends

With one of the most compelling demand stories in the COVID-19 environment, the logistics sector has drawn a flood of investment volume and investor interest. As a result, it has seen the sharpest cap rate compression over the course of the year. According to JREI's October 2020 survey, expected cap rates compressed in most major markets over the year, with the Tokyo bay side area marking a 10-20bps fall to 4.3%.

As of Q3/2020, YTD investment in industrial property amounted to JPY415 billion, around 18% below that of the same period last year. It is worth noting, however, that this gap is likely to close as more of this year's transaction activity is made public. The sector is becoming increasingly competitive and overseas investors certainly face an uphill battle against deep-pocketed domestic developers and their associated J-REITs (Graph 13). This does not mean that overseas investors are completely priced out, however, with some notable successes seen during the year.

Review and Prospects

Greater Tokyo continues to be the focal point for logistics development and investment. With high levels of supply in 2018 and 2019, market players unsurprisingly exhibited caution as they weighed up the levels of demand. Some fears were justified, and market conditions softened somewhat in the first half of 2019, with rents falling to a recent low of JPY4,120 per tsubo in July. However, conditions flipped immediately afterward, as Q3/2019 alone saw over 950,000 sq m of new supply met by new demand of nearly 1.1 million sq m.

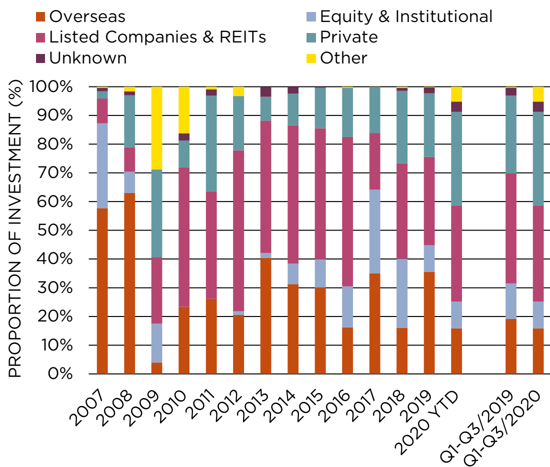
The story for 2020 has been similar, as around 1.8 million sq m of new supply has been easily swept up by demand nearing 2.1 million sq m YTD. Vacancy in turn fell to a historic low of 0.4% in July, and held at that level through to October. Rents have grown 2.8% YoY to sit at JPY4,400 per tsubo, though growth has been flat over the course of 2020. Going forward, the expectation amongst most players is that the supply and demand balance will remain stable for the time being, despite nearly 3 million sq m of new supply coming online in 2021.

Greater Osaka has experienced a remarkable recovery following the massive supply boom in 2016 and 2017. Indeed, vacancy rates fell 9.8ppts from their 2017 peak to land at 2.0% in April 2020, and rents have risen a record 12.4% YoY, standing at JPY4,000 per tsubo as of October – the highest level to date. Vacancy saw an uptick to 3.0% in July as a result of a high level of supply coming online during Q2/2020, including the 380,000 sq m ESR Amagasaki Distribution Center. However, this supply is being steadily absorbed, leading vacancy rates to contract 0.5ppts QoQ to 2.5% as of October.

Market conditions should remain favourable barring a significant deterioration in the macroeconomy. There are, however, some indications that the sector is overheated as competition for development land is reportedly fierce, driving up industrial land prices, enough to challenge the feasibility of certain development projects. Also, on the demand side, COVID-19 has resulted in a slowdown in 3PL revenue growth, with some major firms that have more global exposure, such as Nippon Express, experiencing a decline in sales in 2020. End-users in some hard-hit industries have likewise struggled, somewhat dampening the previously promising rental growth prospects.

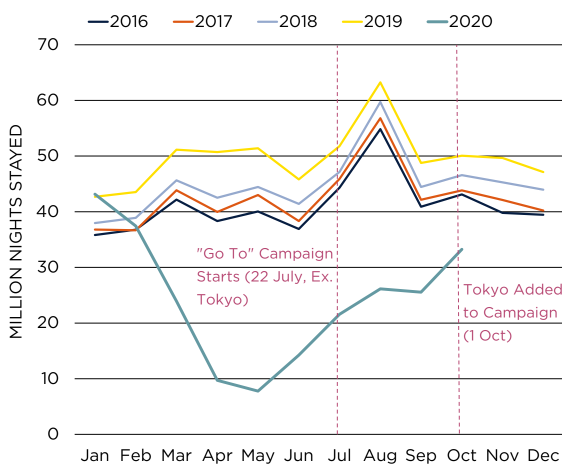
With BtoC e-commerce as the most notable exception, few segments of the economy have been immune to the pandemic-induced slowdown. Even so, the investment enthusiasm in the logistics sector remains robust, as demonstrated by the sharp compressing of cap rates this year. This trend looks likely to continue with multiple investors looking desperate to acquire logistics assets while overall fundamentals appear strong. That said, a cautious approach in this popular sector appears more sensible going forward.

GRAPH 15: Hotel Investment Volumes, 2007 to Q3/2020



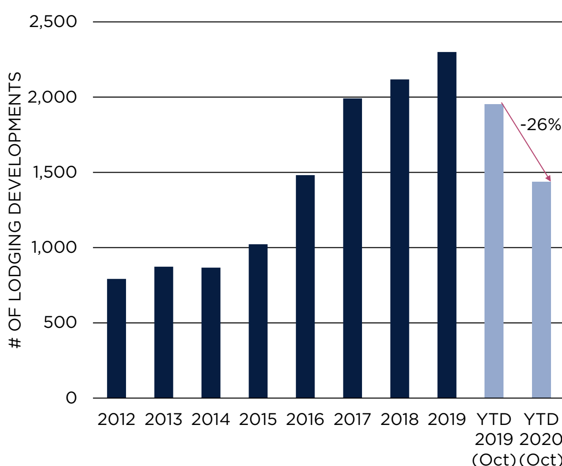
Source RCA, Savills Research & Consultancy

GRAPH 16: Hotel Nights Stayed By Month, 2016 – 2020YTD



Source Japan National Tourism Organization, Savills Research & Consultancy

GRAPH 17: Lodging Developments, 2012 to October 2020



Source Ministry of Land, Infrastructure, Transport and Tourism, Savills Research & Consultancy

HOTEL

Investment Trends

The hospitality sector has borne the brunt of the pandemic and hotel investment has naturally faltered as a result. For instance, limited-service hotels in urban areas that have come to market are reportedly transacting at significant discounts to pre-COVID pricing. According to JREI, expected cap rates of these assets in Tokyo softened by 20bps to 4.6% in October as a result. This trend was also observed in several regional markets. Even so, widespread distress has yet to manifest, keeping overall pricing in the sector relatively stable.

With fewer properties coming to market, and those that do seeing discounts, investment volumes into the hotel sector fell by around 37% YTD as of Q3/2020. Transaction activity has been further supressed by the hesitancy of Japanese banks to finance hospitality deals, except, for instance, in cases involving very high land values or an owner-operator with a proven track record. So long as these pressures continue, the hotel investment market will likely be limited to a select few assets, with mainly strategic buyers being able to capitalise.

Review and Prospects

2020 was meant to be a banner year for Japan's tourism and hospitality industries. The onset of the pandemic put an abrupt end to these once high expectations, however, as closed borders halted inbound tourism and a soft lockdown kept domestic travellers at home for the months of April and May. Prompted by soaring inbound tourism and the prospect of hosting the Tokyo Olympics, record room supply had entered the market in 2019 – primarily in the urban, limited-service hotel subsector. As such, the COVID demand shock has arguably come at the worst possible time.

The situation is not entirely bleak, however. Although inbound tourism has been an important catalyst for the growth of Japan's hospitality sector, domestic travellers still claim the lion's share of demand – accounting for 84% of total nights stayed in 2019. The government's "Go To" travel campaign, implemented in late July, meanwhile, appears to have been somewhat effective in encouraging residents to travel domestically. For illustration, total nights stayed have recovered to over 50% of 2019 levels since late July, and after September in particular (Graph 16). The addition of Tokyo to the campaign in October, as well as the government's intention to extend the campaign until the Olympics, likely strengthens this recovery.

Unfortunately, with COVID cases seeing a winter spike throughout the Northern Hemisphere – Japan included – this recovery could be short-lived. Indeed, the national government has now indicated that it will temporarily suspend the "Go To" travel campaign.

While there is no clear timeline for when demand will return to its pre-pandemic growth track, supply, fortunately, looks set to cool significantly in 2020 and beyond. Operators capable of weathering the storm until then may find themselves in a somewhat more advantageous position.

Japan's landmark year may have been disrupted, but this should be seen as more of a temporary setback than as a sign of inherent weakness. The 2019 Rugby World Cup, for instance, was widely hailed as a success, with inbound visitors, a majority of whom visited Japan for the first time, largely indicating that they would want to return to the country. This suggests that the Japan has significant potential to attract more tourists and only requires a stronger platform through which to engage with them.

Unsurprisingly, it will take a few years for performance to recover to 2019 levels. Until then, operators need to capture new demand from domestic individuals and corporate customers. Operational and management/contractual practices are, therefore, changing in response to the new normal. Whilst the government appears to be supportive for the time being, hoteliers need to try and err on their own new strategies.

ALTERNATIVE ASSETS

The pandemic has shifted the alternative asset landscape. Data centres are now the most sought-after, with healthcare and student housing seen as alternative segments of the residential market – drawing interest as multi-family residential yields remain compressed. Indeed, with yield increasingly scarce in traditional sectors, the attraction of these alternative assets is poised to intensify.

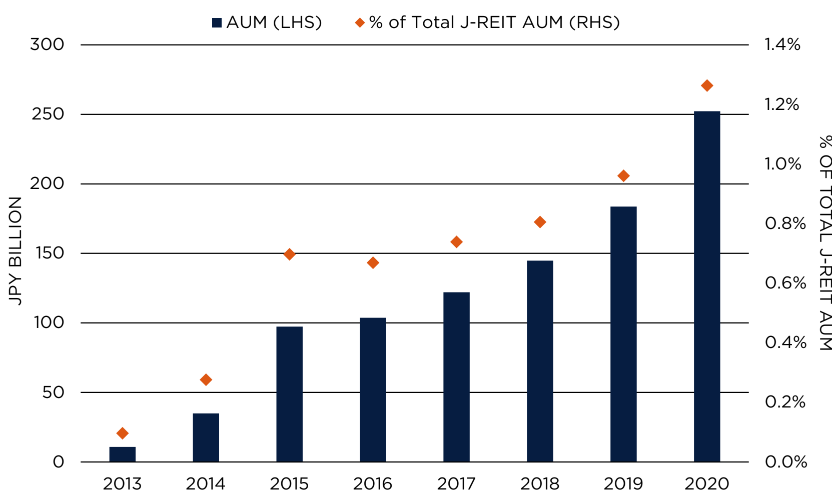
In addition to securing a higher yield, investors are also concerned with deploying capital in relatively safe assets offering, at most, a modest return. There are still very few assets available that meet even this requirement, however. With ample dry powder targeted at the country, investors appear to be on the lookout for alternative asset sectors with a compelling demand story in the current and post-pandemic environment.

Healthcare

As a matter of course, COVID-19 presents significant challenges for the healthcare sector, particularly nursing homes, which house the demographic that is most vulnerable to the virus. Like their counterparts across the globe, Japanese nursing home operators have implemented rigorous measures to prevent the spread of infection within their facilities, and as such, health care facilities are still popular with the elderly.

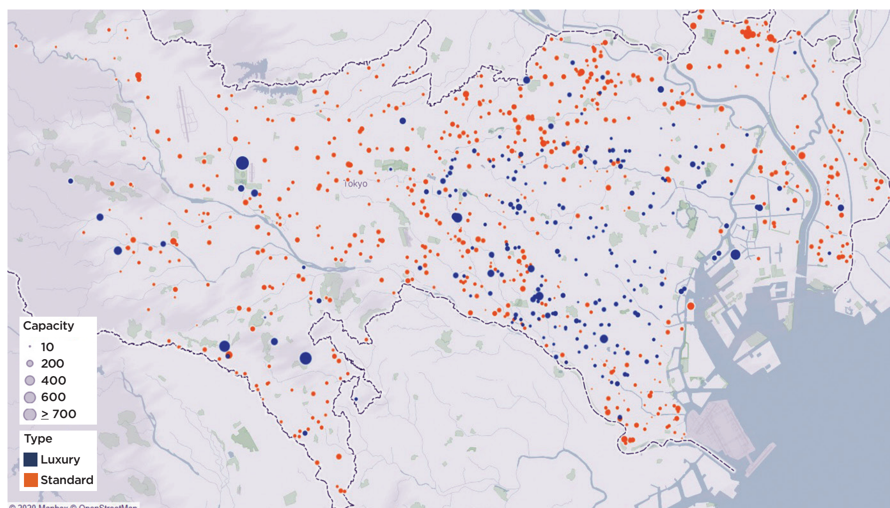
The industry's overall success aside, the outbreak poses a significant risk to the operations and safety of healthcare facilities, and property investors may need to be even more careful in evaluating operators before purchasing a property. Revenues still appear to be trending upward across the sector; however, the cost of implementing virus-prevention measures and increased compensation for employees has weighed on profits.

GRAPH 18: J-REIT Healthcare AUM By Acquisition Value, 2013 to 2020*



Source ARES J-REIT Databook, Savills Research & Consultancy
*2013 – 2019 values are as of 31 December for the respective years. 2020 values are as of 30 September.

Map 1: Fee-based Senior Housing Facilities In Tokyo Prefecture, October 2020



Source Tokyo Metropolitan Government, Savills Research & Consultancy

Though still representing only a very small portion of real estate investment, the AUM of healthcare J-REITs has grown a whopping 37.3% from December 2019 to September 2020, whilst total AUM across all sectors only rose by 4.4% over the same period. As the medical and nursing care industries remain fragmented, achieving appropriate investment scale can be challenging, limiting opportunities for institutional and overseas investors. Some players have still managed to make an entrance, however.

In March 2020, Singapore Press Holdings (SPH) acquired three healthcare facilities across Japan via a newly established healthcare fund. In addition to Singapore's Parkway Life REIT, which is among the earliest entrants to the market, SPH is one of the first few overseas entities to make a significant investment into the Japan healthcare sector. According to the Nikkei, the fund managers plan to continue investing in hospitals, elderly care nursing facilities and medical centres in Japan, with the intention of expanding the fund's scale to JPY50 billion.

Within the senior housing sector, increasing attention is being drawn to the high end or luxury segment, broadly defined as facilities that require lump-sum payments of at least JPY10 million prior to move-in. In Tokyo, these facilities tend to congregate towards the southern and western wards of the Tokyo 23W, in neighbourhoods that had traditionally been known as upscale residential districts, such as Setagaya.

There are also several high-end facilities located in Western Tokyo Prefecture (Tama Region) in cities such as Musashino, Mitaka, Tachikawa, and Hachioji, with the likely draw being the relative convenience and green spaces offered by these submarkets (Map 1).

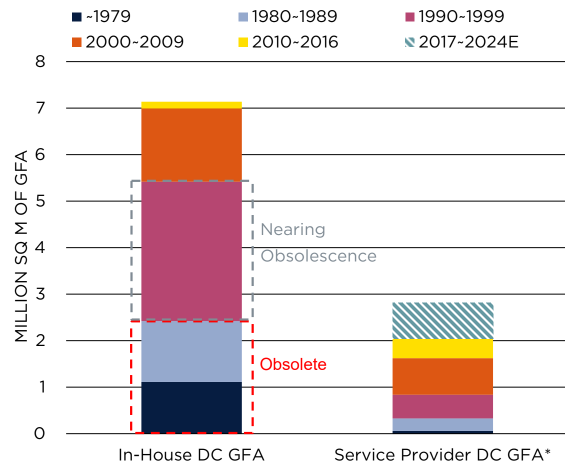
The ongoing outbreak will undoubtedly present risks to the healthcare sector going forward and investors continue to face challenges in identifying assets of a sufficient scale. However, demand for nursing care and medical services only stands to grow over the coming decades. As J-REITs and other players continue to expand their healthcare portfolios, more acquisition opportunities are likely to emerge, while early entrants to the market will see more viable exit opportunities for their investments.

(Please see our November 2018 spotlight, "Japan Healthcare", for a more in-depth analysis of the market.)

Data Centres

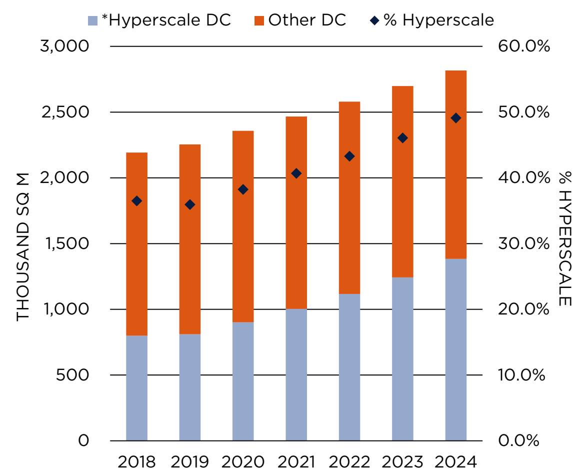
The onset of COVID-19 has led to a dramatic increase in enquiries from institutional investors regarding the Japan data centre market, given that the crisis has accelerated digitisation trends the world over. However, at present, the vast majority of Japan's data centre stock consists of older, owner-occupied stock held by corporates in-house or by major domestic telecoms and systems integrators. Much like the logistics sector nearly two decades prior, overseas specialist groups are attempting to revamp the market with modern, for-lease stock, which will over time create more viable opportunities for property investors.

GRAPH 19: Age Breakdown Of In-House And Service Provider DC Space, 1979 to 2024E



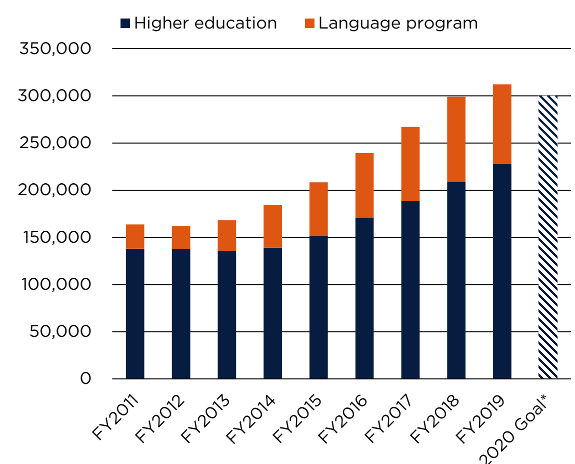
Source IDC Japan, Savills Research & Consultancy
*"Service Provider DC" refers to space managed by data centre service, systems integration, and telecom providers. Most of this space is owned and occupied by domestic telecoms and systems integrators.

GRAPH 20: Estimate Of DC Service Provider Total Stock, 2018 to 2024



Source IDC Japan, Savills Research & Consultancy
*"Hyperscale DC" refers to facilities with over 5,000 sq m of server floor space.

GRAPH 21: Number of International Students in Japan, FY2011 to FY2019 & FY2020 goal



Source Japan Student Services Organisation, Savills Research & Consultancy
*The government's 2020 target was initially set in 2008.

Following Macquarie's majority-stake acquisition of the firm earlier this year, Australia-based AirTrunk has announced its inaugural project in Japan. In collaboration with Daiwa House, AirTrunk will incrementally construct a seven-building complex with up to 330,000 sq m of GFA and offering up to 300 mega-watts of power receiving capacity. The project will be the firm's largest to date, as well as the largest hyperscale facility in Japan, and will be located in Inzai City, Chiba, which has come to serve as Greater Tokyo's top hub for data centres.

While we continue to observe a steady stream of large-scale projects as the above, investment into Japan's data centre market still lags other major developed economies, such as the United States, by a wide margin. For instance, according to NAREIT, data centre REITs accounted for more than 10% of the total US REIT market, whilst in Japan, a few J-REITs have only several data centres partly because of accounting reasons[2]. The fact that limited exit options exist without J-REITs may have partly delayed development in data centres, much like what we have seen with cold storage logistics facilities. Innovative investors may pave the way going forward, however. Regardless, both developers and their partners continue to face significant challenges in sourcing adequate land with access to fibre-optic and power infrastructure.

Still, the demand base for this sector is only set to grow over the coming decade and there is strong indication that the market will be undersupplied. According to data from IDC Japan, 34% of in-house data centre GFA was completed prior to 1990 and another 42% of stock was completed during the dot-com boom of the 90s (Graph 19). Electrical and cooling systems for data centres should generally be replaced after 15 to 30 years. Given that this is a costly process, migrations to co-location centres or to cloud operators should pick up over the coming decade, increasing the need for third-party capacity and services. Whilst a boom in supply is expected over the same period, driven mainly by hyperscale data centres serving cloud providers, current estimates of data centre stock through to 2024 will still fall far short of the amount of space becoming obsolete.

The imminent implementation of 5G networks seems to have mixed implications for the data centre market. Although internet traffic and data transmission rates will increase exponentially, computing power will need to be geographically proximate to the end user. This development will likely bifurcate the market into "core" and "edge" data centre subsectors.

The need for a vast array of centrally located infrastructure, including cellular towers and small-scale edge data centres, could open more opportunities for investment into the sector via mixed-use schemes or direct acquisition of communications infrastructure.

2 In general, J-REIT pays dividend from income net of depreciation. Hence, data centres with large depreciable assets are not favourable for J-REIT scheme.

To be sure, investment into the Japan data centre market has been limited thus far due to a lack of built opportunities for buyers and challenges sourcing land for developers. Still, the nascent AirTrunk's ability to acquire a 130,000 sq m plot of land in the coveted Inzai market shows that persistence can greatly pay off for those who are seriously committed to the sector.

Given the aging in-house stock, we may also see more sale-and-leaseback arrangements, as firms opt to avoid significant capex whilst maintaining in-house DC capacity. Looking ahead, demand for data centre capacity in Japan at large and Tokyo in particular should continue to outstrip supply. As such, regardless of the current hurdles to investment, with cloud operators expanding aggressively in Japan and 5G technology on the horizon, demand fundamentals should remain strong.

Student Housing

Under the present circumstances, the student housing sector undoubtedly faces significant challenges. Closed borders around the world have prevented international students from matriculating at, or physically returning to, their universities. This is a challenging situation for Japan, as international students are a key demand driver for student accommodation.

Japan instituted its broad entry ban, including on foreign students, in March 2020. Naturally, this has been highly disruptive to the student housing sector. However, the national government has permitted foreign students enrolling at Japanese universities to re-enter Japan as of 1 October, providing some much-needed support to the sector.

Considering that the number of international students has grown at an average annual rate of 10.9% since 2013 and, in fact, exceeded the government's 2020 target in FY2019, we can expect that the total number of students will return to a growth track once the pandemic comes under control. Geopolitical tensions could inadvertently prove beneficial. As of FY2019, students from China accounted for 40% of total international students in Japan. Tensions amongst China and the United States, as well as other Western nations, could make Japan a more attractive destination to Chinese students. Given these long-term tailwinds, domestic developers have continued to target the sector.

In the end, the student housing sector overall will take time to recover. Most major universities in Tokyo continue to host semesters either entirely or partially online, prompting many domestic students to remain in their home prefectures or to move back in with their parents, particularly if those students are from other parts of Greater Tokyo. Encouragingly, disclosures from Kyoritsu Maintenance, a major student housing operator, reveal that occupancy in their dormitory business segment was still over 90% as of September 2020, with much of the decline in occupancy being attributed to new buildings.

OPPORTUNITIES AND RISKS

Opportunities

The virus has completely transformed daily life, and at the same time, deepened political uncertainty and social divide across the globe. While both interest rates and inflation have remained historically low in Japan, this has become the new norm for all developed economies. As such, yield is still somewhat hard to come by. Coupled with the continued relative stability of the domestic economy – probably more so now than last year – the Japanese property remains as attractive as ever for investors.

At home, meanwhile, Japanese corporates have increasingly turned to property disposals in an effort to offset the economic damage from the pandemic. Similarly, with market sentiment remaining uncertain, many J-REITs trade at a discount to NAV. They may no longer be active buyers (even from sponsors) in the competitive acquisition market as a result. Hence, investment opportunities are likely to increase going forward.

With this in mind, the below represent some of our views on investment strategies for Japanese real estate.

Core and Core-plus

With the property cycle appearing to be in the latter stages heading into 2020, Core and Core-plus assets were already in high demand given their defensive nature. A year later, with a markedly more downbeat outlook for the economy, this momentum has continued, albeit with some underlying shifts.

One of these changes concerns the logistics sector. Indeed, with the winds of e-commerce firmly in its sails, the sector became the must-have asset class and the subsequent competition for assets was fierce. This exuberance, however, has led to valuations becoming somewhat stretched and the market appears a tad overheated as a result. Although investors are now starting to regard the asset class with more caution, the fundamentals of the logistics sector remain strong. Some have even turned to development to avoid this fierce competition, though this has its own challenges given the skyrocketing land prices.

Meanwhile, the usual suspects, namely high-quality Grade A/B offices and institutional quality multi-family residences, continue to be pursued by investors. The former, for instance, is highly liquid and the volume of assets in Japan is unmatched amongst developed Asian counterparts. At the same time, the latter, continues to be a defensive play, acting as a ballast to investor portfolios. Despite both asset classes facing a softening in their underlying fundamentals amid the changes to the working environment, the longer-term prospects, especially of multi-family facilities, have assuaged concerns. Cap rates have remained stable in both spaces so far to boot. Within the residential sector specifically, investors chasing higher yields seem to have broadened their focus towards more niche sectors such as student housing and elderly care facilities. Both sectors come with specific risks and limited fragmented opportunities, however.

Value Add

It is no secret that the office sector as a whole is perhaps going through the most significant long-term change. As such, it is faced with a commensurate amount of uncertainty. Developers have also faced their own issues. With that in mind, an opportunity may have presented itself for investors with a high capacity for risk. To wit, some developers have indicated a willingness to offload some properties in order to raise liquidity under these testing times, even before pre-leasing activity has begun in earnest. As one can imagine, risks are naturally higher. Yet, investors with the patience and the necessary acumen could see meaningful upside in future.

Elsewhere, similar opportunities may have also emerged in the much-maligned retail sector. Here, temporarily struggling assets located in close proximity to stations have continued to appeal, with their prospects moving in lockstep with the recovery in footfall going forward.

Opportunistic

Thanks to the boom in inbound tourism, the hospitality sector was all that anybody could talk about towards the end of the previous decade. Yet, the onset of the global pandemic, and subsequent postponement of the Tokyo Olympics, has flipped the sector's prospects on its head. Troubled by the ongoing gloom and the build-up of large supply over the last few years, small budget hotels are more likely to be in distress, creating an entry point. Whilst these assets may no longer be fit to remain in the hospitality sector, some of them could, however, be converted. Despite the major hurdles ahead, including the availability of loans and the challenge to estimate yield at investment, this should present great opportunities, especially for owner-operators or strategic buyers with different investment strategies. Also, given the contrasting valuations between hard assets and listed vehicles, corporate transactions are likely to become more common.

Risks

2020 has been a year unlike any other. Indeed, despite the domestic economy appearing somewhat stable for the time being, fears surrounding the pandemic continue to dominate imminent concerns. If the current situation were to worsen, dragging down the world economy as well as the Japanese economy, domestic corporates, which have up till now taken a wait-and-see attitude, may start to tighten the belt. Under this scenario, a reduction in office floor space would be a probable strategy and the direction of the real estate market may change abruptly.

On a more long-term basis, the potentially long-lasting changes to the workplace presents another major risk. To be sure, some changes, such as a more flexible working environment, were perhaps already in progress. It was the sheer speed and scale in which the shift occurred, however, that has caught many by surprise. For now, without knowing whether this transition is here to stay, uncertainties loom large.

Overseas Risks

Being the third largest economy in the world, Japan's destiny is ostensibly tied with the global economy. Thus, whereas domestically the virus has been managed relatively well, the same cannot be said for the west at large. With a global recovery out of sync, therefore, some volatility is to be expected at the expense of the recovery efforts of large Japanese corporates.

Meanwhile, despite the pandemic overshadowing the geopolitical risks that had taken centre stage late last year, they have not disappeared. In truth, the resolution of the recent U.S. presidential elections may have helped to slightly ease concerns. Even so, a thawing of relations between the U.S. and China is doubtful, especially in the near future. With the events in Hong Kong reaching its climax in mid-2020, any further tension in the East Asian region could spell trouble for Japan.

Interest Rates

To be sure, the prospect of interest rates rising in Japan and across the world appears remote at present. Indeed, we even have a tentative roadmap with the Fed, for instance, committed to keeping rates close to zero through 2023, or until inflation reaches the 2% level. In this regard, the Bank of Japan (BoJ) is unlikely to jump the gun considering inflation at home remains stubbornly low.

That said, interest rates cannot remain anchored at historical lows forever. The main concern here comes from the BoJ holdings of Japanese government bonds (JGB), which equated to around 45% at the end of June. As such, given the scale of JGBs on the BoJ's balance sheet, a meaningful uptick in interest rates could be damaging to both the property market and the BoJ itself – the gatekeeper of the yen as a global currency.

Of course, the likelihood of these events unfolding remains very low, especially considering other major central banks face more or less the same issues. Still, it is worth bearing in mind.

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