SPOTLIGHT

*Savills Research*

Japan - December 2022

# 2022 Review and 2023 Prospects

# Japan's stability appeals amidst global uncertainty

## INTRODUCTION

2022 has been characterised by turbulence in global geopolitical and economic landscapes. Factors such as the conflict in Ukraine, energy crisis, and inflation as well as interest rate hikes have all weighed on the global economy. Japan, a country known for its stability, was not immune to this uncertainty, and particularly felt the impacts of a historically weak yen.

That said, the Japanese real estate market looks and has overall been stable. While a small number of investors currently take a wait-and-see attitude, most investors continue to pursue investment opportunities. Indeed, many investors struggled to acquire assets in the extremely competitive acquisition markets last year, which suggests they are busy catching up now. Hence, signs of re-pricing have not been observed yet. Indeed, Tokyo and Osaka rank high in the recent investor survey by the Urban Land Institute. Amidst this uncertainty, investors are looking for stable investment destinations.

Furthermore, global inflation has likely peaked out, and interest rate hikes in the US appear like they will slow down going forward. Hence, the worst might have passed for the Japanese yen, which has rapidly rebounded to more moderate levels equivalent to this summer.

So far, the Bank of Japan (BOJ) has been hesitant to tighten its monetary policy and currently appears to be feeling little immediate pressure to do so. Instead, it has adopted a wait-and-see approach until the markets are calmer and will likely then consider making revisions. Indeed, witnessing the near collapse of pension funds in the UK following a sudden dramatic rise in interest rates, the BOJ is keenly aware of the importance of subtle and measured decision making. As the term of Governor Kuroda ends in April 2023, the BOJ may revise the current monetary policy by capitalising on the market calmness after the dust settles. We believe interest rate increments will likely be modest, as we have previously written, since inflation in Japan is modest.

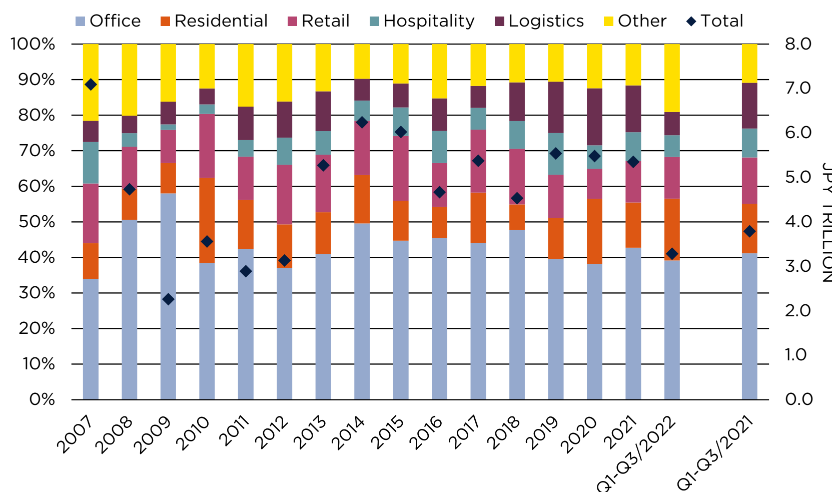
Recovery in 2023 looks like it will be relatively stronger in Japan than other countries, and given Japan's belated reopening from the pandemic, pent-up demand is high. The government has also made proactive efforts with supportive policies. Furthermore, the situation in China might be a boon for Japan, and Japan will be a likely destination for some of the outgoing foreign capital from China, which was accelerated due to the recent political developments and the ongoing strict COVID restrictions.

With the optimism going forward, the Japanese real estate market is facing elevated prices across all sectors. Fortunately, the Japanese market appears to welcome some new players and more transactions will likely take place. In 2022, several new names came to Japan from overseas. Also, investors using security tokens (ST) have emerged in Japan. We witnessed the first ST investor as recently as in July 2021. As of December 2022, the underlying assets of ST investors grew to a total of JPY40 billion. In 2023, several foreign ST investors are expected to enter the Japanese market, and the ST market size is forecast to reach a total of JPY2.5 trillion by 2030. The largest transaction by a ST investor amounted to JPY14.6 billion, which suggests they could buy any asset class now. Indeed, matured markets like Japan require a more diversified pool of investors.

Nevertheless, risks are plentiful. Global inflation and elevated interest rates may persist longer than expected. Economic slowdowns have already started in some countries and this is likely to cause some deterioration in the Japanese economy. High levels of uncertainty may heighten regional tension, although positive developments at the G20 summit in Indonesia may offer some hopes of easing global tensions. Indeed, Japan's stability shines amidst global uncertainty.

Overall, the outlook for Japan real estate looks stable, especially in relative terms. With new investors and players in sight, the market will become more liquid and show greater potential for growth.

**GRAPH 1: Investment Volumes, 2007 to Q3/2022**




**Source** RCA, Savills Research & Consultancy

**Although the pandemic has faded into the background, 2022 was still a tumultuous year highlighted by events such as the war in Ukraine, the subsequent energy crisis, and persistent inflation leading to interest rate hikes. A global recession is likely, but the Japanese economy looks to fare better due to its belated reopening. The majority of investors in Japan are still pursuing new investment opportunities, and 2023 will see more participants. The matured Japan market will welcome a more diversified pool of investors, which will give the market more liquidity and greater potential for growth.**

## INVESTMENT TRENDS

While property-level performances have started showing signs of improvement, investor sentiment is mixed, reflecting uncertain macroeconomic conditions. Although several major portfolio transactions were recorded and investor interest in Japanese real estate appears sound, some investors are taking a wait-and-see attitude.

The logistics sector is still the most sought-after with demand driven by e-commerce and third-party logistics companies steadily filling the large supply. The residential sector has been popular due to its defensive nature, and has continued to draw investor interest. Although the office sector has not started a recovery in earnest, prime offices or select properties with upside potential remain sought after. More investors have begun exploring opportunities in the retail and hospitality sectors as well.

In-house cap rates for select sectors have seen some changes over the year: cap rates for Grade A office and residential have compressed by 10 basis points (bps) to 2.6% and 3.3%, respectively. Cap rates for other sectors remain unchanged.

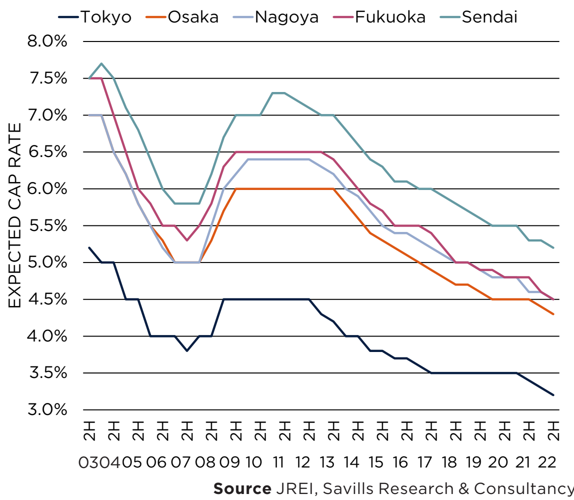
According to Real Capital Analytics (RCA), as of Q3/2022, total investments in Japanese real estate amounted to approximately JPY3.3 trillion year-to-date (YTD) – around a 13% decline compared to the same period last year. While most sectors recorded contractions, the transaction volume in the residential sector increased by 8% compared to the same period in 2021, highlighting its continuing popularity.

Although total transaction volumes were down, there were several major transactions recorded in 2022. Most noticeably, it has been announced that a consortium led by Hulic will acquire the Japanese government's portion of Otemachi Place for JPY436 billion, the largest transaction ever in Japan. Reportedly, overseas institutional investors also showed strong interest.

Moreover, Brookfield Asset Management is said to be in talks regarding the acquisition of Meguro Gajoen from China Investment Corporation for an estimated JPY190 billion. Also, Kohlberg Kravis Roberts (KKR) is reported to have obtained the right of first refusal on the acquisition of Hyatt Regency Tokyo along with an adjacent office building, which is also likely to be over JPY100 billion. Earlier this year, GIC also acquired a portfolio of 30 properties including Prince brand hotels from Seibu Holdings for JPY150 billion.

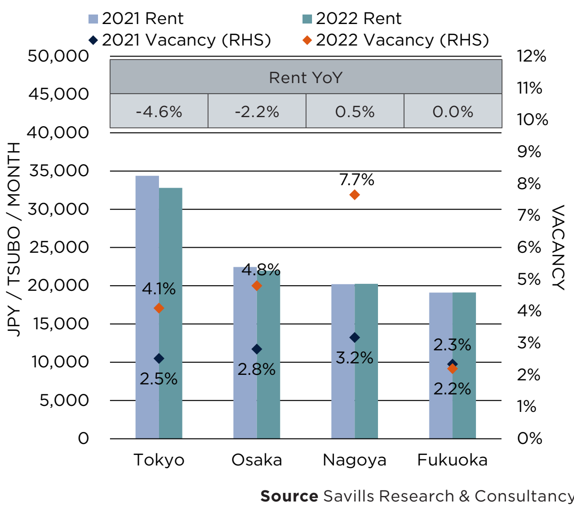
As such, although the outlook of the global economy is shrouded with uncertainty, investor interest in the Japan real estate market appears sound. Indeed, Gaw Capital announced in summer that it would invest an additional US$3.5 to US$4.0 billion over the next 1.5 to 2 years by leveraging the weak yen.

**GRAPH 2: JREI Expected Prime Office Cap Rates by City, 2H/2003 to 2022**



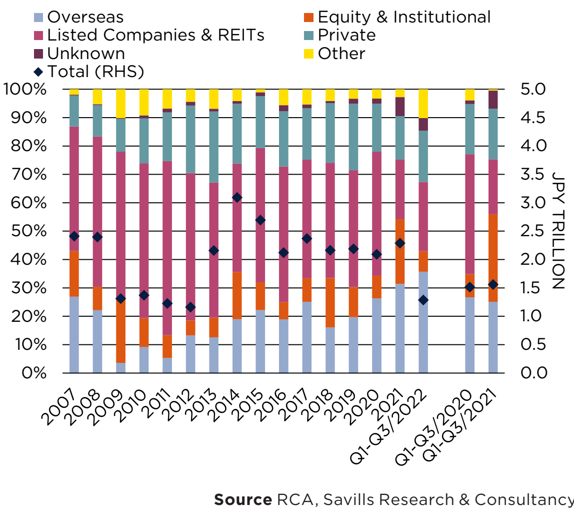

**Source** JREI, Savills Research & Consultancy

**GRAPH 3: Investment-grade Office YoY Rental Growth and Vacancy Rates, 2H/2022**




**Source** Savills Research & Consultancy

**GRAPH 4: Office Investment Volumes, 2007 to Q3/2022**




**Source** RCA, Savills Research & Consultancy

## OFFICE

### Investment Trends

The office sector is still the largest asset class in Japanese real estate, and has seen greater confidence in 2022 with the pandemic having transitioned into an endemic state. Savills in-house cap rates for Grade A offices in Tokyo have compressed by 10bps to 2.6% through 2022. Meanwhile, the October 2022 Japan Real Estate Institute (JREI)[1] survey also shows that expected cap rates in Tokyo have compressed by 10bps YoY. Fukuoka and Osaka have seen cap rates tighten by 20bps YoY, while Nagoya's cap rates have tightened 10bps YoY.

Investment volumes in the office sector YTD as of Q3/2022 are around 18% lower than volumes over the same period in 2021 and 2020, although it should be noted that figures are still preliminary and will likely increase as more deals are confirmed. Indeed, the transaction of Otemachi Place by a consortium led by Hulic, estimated to be at JPY436 billion, the largest transaction ever in Japan, has not yet been included in these figures.

The market has overall seen substantial interest from overseas investors as well; cross-border transactions comprised around 35% of YTD Q3/2022 volumes. One major transaction was an undisclosed overseas investor purchasing Ariake Central Tower for over JPY40 billion (estimated).

### Review and Prospects

The pandemic transitioned to an endemic state in 2022, and office attendance has remained mostly stable throughout the year. Remote work policies are still prevalent, and it appears that many companies have adopted some form of hybrid work.

While the Tokyo office market has continued to weaken in 2022, rental declines have slowed significantly - Tokyo's Grade A market rents have only contracted 2.6% YTD as of Q3/2022. Rents appear to be bottoming out and could see some recovery. In fact, some popular buildings have even started to gradually raise rents.

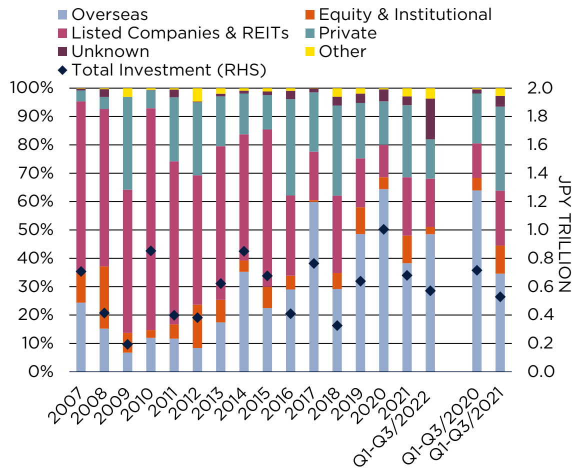
At the same time, vacancy rates have loosened 1.4 percentage points (ppts) over the same period. However, a majority of offices are close to full occupancy, whereas a handful of poorly located and older offices have high vacancy rates, and are the main contributors to this increment. Indeed, the pandemic has created some bifurcation in the market, with older offices that have poor accessibility suffering disproportionately. Elsewhere, Grade B offices appear to have been prompted to lower rents due to the diminished relative affordability when compared to declining Grade A rents. As such, the Grade B market has overall moved in tandem with the Grade A market.

Rental trends in regional markets have outperformed Tokyo, with most markets either remaining stable or only seeing a moderate decline. However, there is some disparity between markets when it comes to vacancy. Osaka has seen a similar rate of vacancy increment as Tokyo. Meanwhile, Fukuoka's vacancy has remained almost flat, while Nagoya saw a large increase in vacancy of 4.5ppts YoY. Although the vacancy increment in Nagoya was noteworthy, this mainly stemmed from a few buildings, mostly new ones, with a striking amount of vacant space, likely due to the ownership structure, whereas a majority of buildings in the market are actually performing well.

Overall, the Japanese market has been fairly stable and has shown signs of bottoming out, with some properties seeing rents stabilise or even edge up in recent quarters. Nonetheless, poorly located, and older offices will likely suffer for some time. While the large supply in 2023 has seen sound pre-leasing activity, the global economic slowdown could introduce hurdles to the market, and demand might take longer to recover. In this scenario, the gap between outperforming and underperforming offices may widen even more.

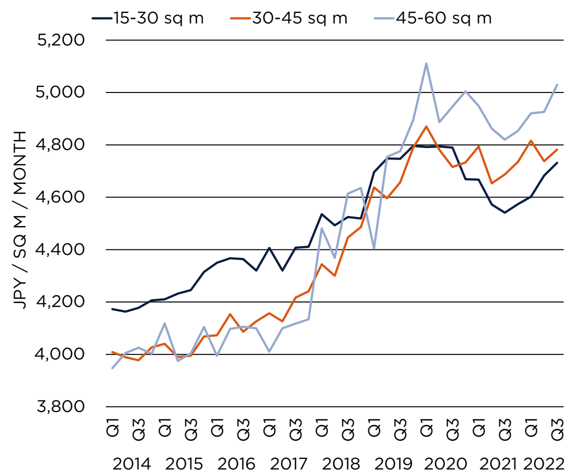
1 Expected cap rates reported by JREI tend to be wider than market cap rates.

**GRAPH 5: Residential Investment Volumes, 2007 to Q3/2022**



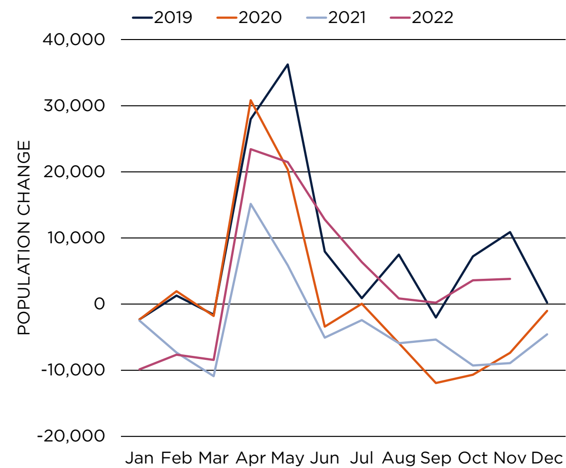

**Source** RCA, Savills Research & Consultancy

**GRAPH 6: Rents by Unit Size, C5W, 2014 to Q3/2022**




**Source** Savills Research & Consultancy

**GRAPH 7: Tokyo Monthly Population Change, 2019 to November 2022**




**Source** Tokyo Metropolitan Government, Savills Research & Consultancy

## RESIDENTIAL

### Investment Trends

Savills in-house cap rates for mid-market residential properties have tightened to 3.3%, decreasing 10bps over the year. The stability of this asset class has heightened the competition for acquisitions, and residential properties remain popular in the market. According to JREI, expected cap rates for residential properties in Jonan have tightened 10bps YoY to 3.9%, showing the continued interest in the sector.

As of Q3/2022, YTD residential investment volumes were around 8% higher than the figure observed over the same period in 2021, although they were lower than the extremely large transaction volumes over the same period in 2020. Nonetheless, a number of major portfolio transactions have taken place in 2022, including an acquisition of 32 residential properties by Gaw Capital Partners and Qatar Investment Authority for an estimated US$450 million. This high level of activity is likely to continue into 2023.

### Review and Prospects

The Tokyo 23W market has experienced noticeable recovery over the past year as society transitioned to an endemic state. Average asking rents have trended upwards, and have neared pre-pandemic levels. Meanwhile, average occupancy rates have also recovered, although they appear to remain around 1.0ppts lower than the pre-pandemic highs.

Although moderate, inflation has hit Japanese households due to the spike in energy prices and imports due to the weakened yen. This comes against a backdrop of modest wage growth, and has overall eroded the average household's purchasing power. Consequently, some people could be hesitant to return to the relatively expensive 23W market, and may slow growth in the Tokyo residential leasing market for the meantime.

As of October 2022, the population of the 23W is still slightly lower than pre-pandemic times. In contrast, many outer cities within Tokyo prefecture, and next to Tokyo prefecture actually saw a net increment in their population over the past two years. This was likely primarily due to the relative affordability and larger living spaces that could be found in these locations, especially while working from home arrangements were commonplace. Indeed, migration trends in 2021 show that the largest population outflows from the 23W were to surrounding regions in Greater Tokyo.

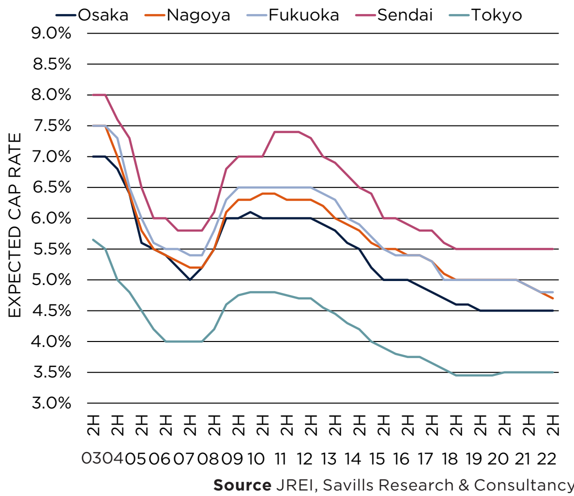
Nevertheless, while net population growth has been slow throughout 2022, there are signs of changing fortunes for Tokyo's demographic situation. The 2022 spring moving season saw a net-influx of 43,000 people into Tokyo prefecture, compared to 15,000 in 2021. The easing of border restrictions and return of many foreign nationals to Tokyo significantly contributed to this recovery, as this demographic constituted a large proportion of the net population increment, even well after the spring moving season. Furthermore, the net influx of people in the desirable 20-to-29-year-old age band remains high, which is a testament to Tokyo's continuing status as an economic powerhouse.

Hybrid work arrangements are still common, meaning that larger units have retained their popularity among renters looking for units that feature space for remote work. As such, larger units have continued to maintain their premium over small units in 2022. The relative scarcity of such units within the 23W has also contributed to this upward trend.

The population of the 23W will likely be supported by the return of foreign nationals in the short-term. However, with the heightened costs of living due to inflation, combined with prevailing hybrid workstyles, areas that are more affordable such as outer wards and cities outside the 23W will likely remain popular for the time being. In contrast, the C5W may perform well, since residents of these submarkets typically have high incomes and are affected less by inflation.

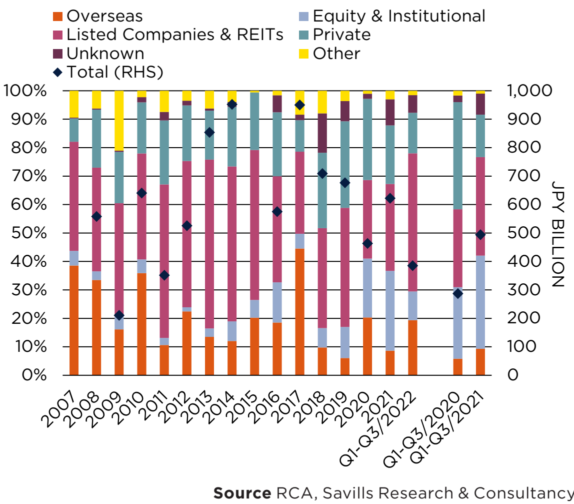
Overall, the global economic slowdown should dampen the recovery of the 23W residential market somewhat. Going forward, further growth and recovery will be contingent on both economic conditions, wage growth and the extent that companies continue hybrid work. In general, more companies appear to have requested greater attendance in the office, although remote work policies are still in place. Similar to a year ago, residents will still need to find a balance between distance from the office and larger space at home for remote work.

**GRAPH 8: JREI Expected Retail Cap Rates by City, 2H/2003 to 2022**



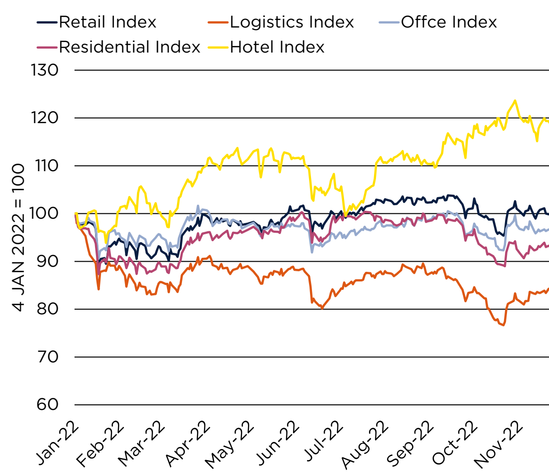

**Source** JREI, Savills Research & Consultancy

**GRAPH 9: Retail Investment Volumes, 2007 to Q3/2022**




**Source** RCA, Savills Research & Consultancy

**GRAPH 10: Sector J-REIT* performance, as of November 2022**




**Source** Japan Exchange Group, Savills Research & Consultancy
*The J-REIT index was constructed from J-REITs of each respective sector with a market capitalisation of greater than JPY100 billion at the start of 2022.

## RETAIL

### Investment Trends

As of Q4/2022, Savills in-house cap rates for high-street retail in Tokyo are at 2.7% and have remained at that level since 2020. According to JREI, expected cap rates for prime retail property in Ginza have been stable at 3.5% - unchanged over the year.

Retail transaction volumes have been slower compared to those in 2021, with transactional volumes as of Q3/2022 (YTD) having fallen around 22% compared to the same period in 2021. However, investment volumes should pick up as the retail situation continues to improve with the resumption of inbound tourism. Indeed, some investors were prescient to this heightened optimism in the market, and a few large-scale transactions were observed in 2022. For instance, Tokyu REIT purchased a portion of the mixed-use retail complex Futako Tamagawa Rise in Tokyo for JPY20.2 billion.

### Review and Prospects

Japan has transitioned towards an endemic state, and footfall has mostly recovered in many areas. However, a stark dichotomy in performance persists between prime and non-prime areas at the submarket level. While prime streets in Tokyo and other regional cities have very few vacancies and are performing well, less prominent peripheral streets continue to struggle, contributing to higher average vacancy rates in several submarkets. Indeed, these locations are often home to F&B and entertainment businesses, which have suffered disproportionally as a result of the pandemic. Hence, recovery for the retail sector has largely depended on the area.

Upper floor units have experienced particularly high levels of vacancy. These units are frequently occupied by F&B establishments, and so were disproportionately affected by lower levels of footfall. While they have seen some reprieve in tenant demand from service providers such as beauty clinics and coworking spaces, it will still take some time before the market sees a full recovery.

Inflated commodities prices, coupled with the weak yen have had knock-on effects for consumer prices, while average households continue to struggle with modest wage growth and inflation. These issues may impede some recovery as consumers are increasingly conscious about spending and eating out.

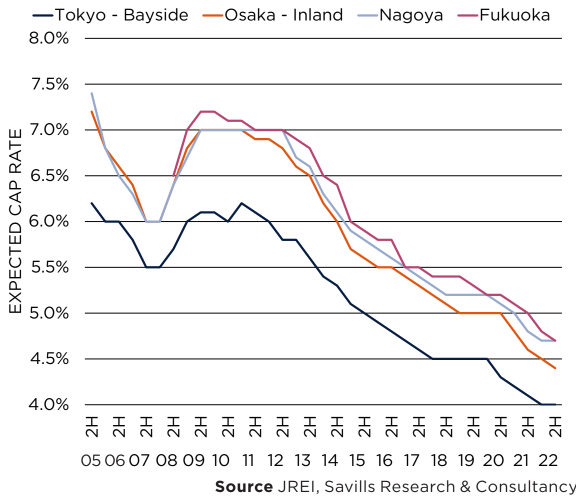
In contrast, the luxury sector has gone from strength to strength, supported by high levels of domestic spending by wealthy residents. Prime streets in Ginza, Omotesando, and other premier shopping areas have seen a revival in fortunes, and there have been several new luxury retail openings and new major redevelopment projects. Sentiment in the luxury sector should continue to grow as inbound tourism picks up in 2023.

While domestic consumption might face a slowdown, the resumption of inbound tourism in October 2022 should be a boon for the retail industry, bolstered further by the weak yen. That said, with typically high-spending Chinese visitors unable to travel due to COVID restrictions in China, the boost from inbound tourism might be limited.

There are a number of large-scale developments in the pipeline that are expected to transform their respective retail landscapes. Many of them will be mixed-use, so as to diversify revenue streams. Furthermore, another growing trend is that developers are increasingly incorporating ESG principles into new retail projects, to embed developments within the surrounding community and reduce any negative externalities that might arise. Secondly, the location of demand and function of physical retail stores have undergone some changes. Namely, the outflow of people from urban centres observed during the pandemic has notably increased suburban retail demand, while the unabated growth of e-commerce has contributed to more retail space being transformed to function as a showroom for retail goods, while actual purchasing is carried out online.

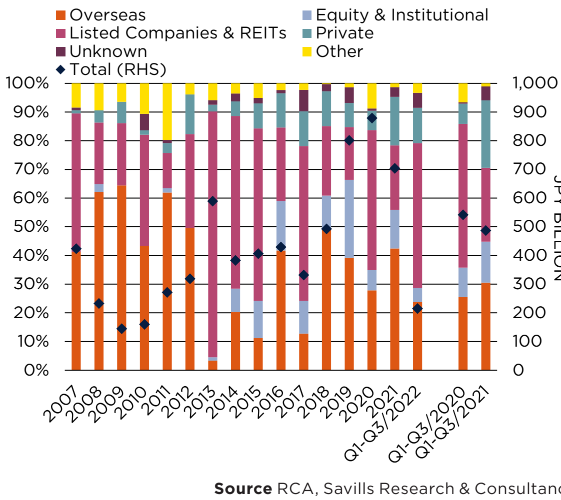
Going forward, the retail sector is likely to continue improving and have stronger prospects. Indeed, retail J-REITs have outperformed other J-REIT sectors in 2022, with exception of the hotel sector. The transition toward an endemic state and the reopening of borders should boost some retail spending from inbound tourists leveraging the weak yen, even without Chinese shoppers. This could attract the attention of more investors, especially as the yield spreads of sectors that were very popular during the pandemic, such as logistics and residential, appear tight, as retail properties still have room for value-add opportunities.

**GRAPH 11: JREI Expected Logistics Cap Rates by City, 2H/2005 to 2022**



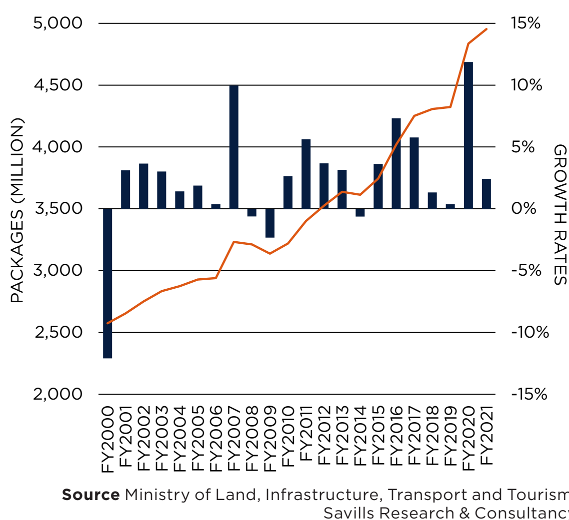

**Source** JREI, Savills Research & Consultancy

**GRAPH 12: Logistics Investment Volumes, 2007 to Q3/2022**




**Source** RCA, Savills Research & Consultancy

**GRAPH 13: Package Delivery Volume, FY2000 to FY2021**




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

## LOGISTICS

### Investment Trends

The popularity of the logistics sector has remained high over the past year. According to JREI's October 2022 survey, expected cap rates compressed in all major markets over the year, with the Tokyo bayside area marking a 10bps fall to 4.0%. At the same time, our in-house survey indicates that cap rates for prime logistics properties remain unchanged and are as low as 3.3%.

Investment activity has been slow across many sectors so far in 2022 and logistics was no exception. Transaction volumes as of Q3/2022 (YTD) were around 55% lower than the same period in 2021 at JPY215 billion. That said, there were a few notable activities in 2022. Most recently, Gaw Capital Partners will reportedly acquire seven logistics facilities from Blackstone for approximately JPY80 billion, Indeed, investor interest in this sector remains strong despite the currently low cap rates.

Despite the logistics sector's continuing popularity, investors should take heed of a number of risk factors, namely the global inflationary environment putting cost-related pressures, especially on logistics tenants typically with thin operating margins, and the potential interest rate increments in the coming year, which might affect the previously popular stable long-term lease model.

### Review and Prospects

In 2022, Greater Tokyo has continued to perform soundly with average rents growing. Specifically, asking rents in the region increased 2.6% YoY to JPY4,700 per tsubo as of Q3/2022. Strong demand from e-commerce operators and 3PL companies appears to continue propping up the market. That said, the average vacancy rate has increased 2.3ppts YoY to 4.0%. Although the market is still tight, the increasing supply has led to some slight loosening.

Meanwhile, Greater Osaka has seen limited vacancy increments in 2022. Compared to 2021, supply in the region was significantly limited and newly completed facilities have been leased at a sound pace. As a result, vacancy increments have been milder at 0.5ppts YoY to 1.6%. Encouraged by the sound market conditions, average asking rents have risen 6.7% YoY to JPY4,300 per tsubo as of Q3/2022.

Going forward, Greater Tokyo is expected to see about 4.0 million sq m of new supply (GFA) in 2023, the same level experienced in 2022. The sound absorption pace in 2022 is an encouraging sign, but there are some indications that certain inland areas are seeing a softening and will take more time to attract tenants. In Greater Osaka, supply in 2023 is expected to be about 75% greater than in 2022. A large portion of the 2023 supply is expected in inland areas of Osaka and Kobe where some softening has been already observed. As such, although there is some concern, the amount of supply forecast for Greater Osaka looks manageable overall.

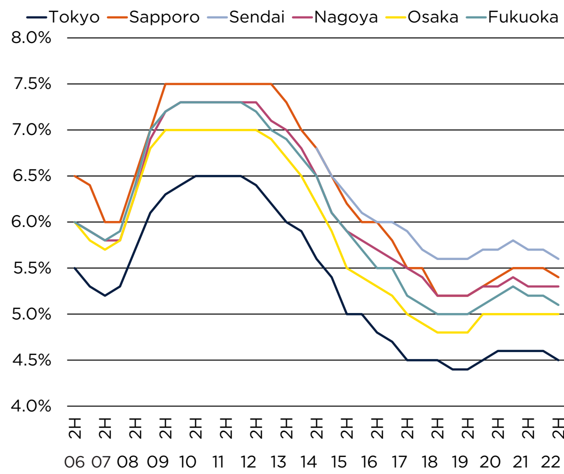
The momentum stemming from the growth in e-commerce might slow down in Japan, at least temporarily, as society progresses toward normalcy. This, in turn, might slow down demand growth from e-commerce operators.

Additionally, as we explored in one of our reports [Japan Logistics – Evidence of caution], the unique characteristics of the logistics sector, such as the low land value, the difficulty of tenant diversification, and chronic labour shortages may weaken market conditions if the logistics market experiences any softening.

Furthermore, the new regulation that will come into effect in April 2024 will cap overtime hours at 960 hours a year and will also force truck companies to pay 50% more wages on overtime hours that exceed 60 hours a month. Based on a survey conducted by the Japan Trucking Association in early 2022, many were not prepared for the change.

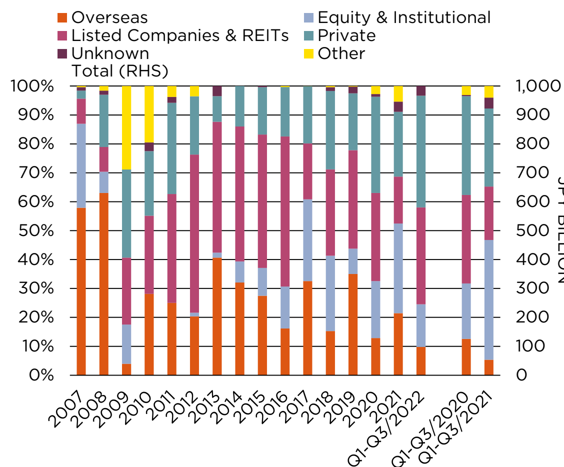
Overall, fundamentals for the logistics sector remain sound, and investors are expected to seek opportunities in this sector. However, there are increasing concerns over inflation and future supply in the pipeline. With the growing competition for tenants, some investors may find it difficult to achieve sufficiently high rents to justify their sharp pricing. With some changes in consumer patterns and regulation expected, potential investors need to assess how the assets will respond in turn to them.

**GRAPH 14: JREI Expected Cap Rates for Hotels by City, 2H/2006 to 2022**



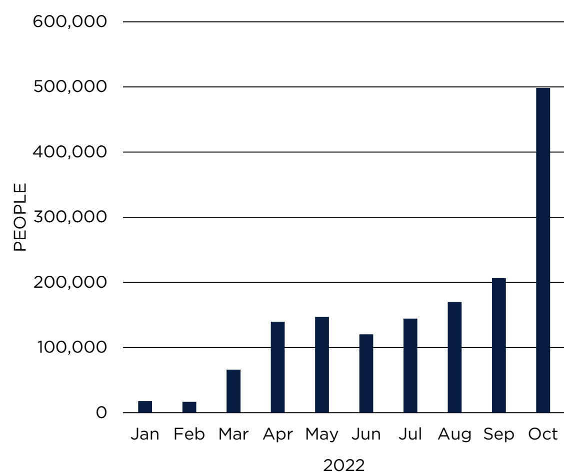

**Source** JREI, Savills Research & Consultancy

**GRAPH 15: Hotel Investment Volumes, 2007 to Q3/2022**




**Source** RCA, Savills Research & Consultancy

**GRAPH 16: Overseas Tourists by Month, January 2022 to October 2022**




**Source** Japan National Tourism Organization, Savills Research & Consultancy

## HOTEL

### Investment Trends

Border controls in Japan have been lifted in 2022, and the hospitality sector is set for a long-waited recovery. Investment volumes in this sector lagged in 2022, falling 35% YTD as of Q3/2022 compared with the same period in the previous year. Indeed, many hotel owners were reluctant to sell during the pandemic. 2023 should see an intensification of transaction activity as more inbound tourists enter Japan, and owners are likely to be able to sell hotels only at acceptable discounts compared to pre-pandemic prices.

There were several notable transactions in 2022. In February 2022, Seibu Holdings announced that it will sell 31 hospitality properties including 15 hotels to GIC for an estimated JPY150 billion.

Elsewhere, Odakyu Electric Railway Company is reportedly planning to sell Hyatt Regency Tokyo to KKR. Although the details are unknown, the price for the hotel and the adjacent office building is estimated to be about JPY140 billion[2]. Daiwa House has also announced that it will sell the Daiwa Resort business to Ebisu Resort, which is managed by Japan Hotel REIT Advisors, for JPY55.6 billion in April 2023. Daiwa Resort is currently operating 24 hotels across Japan.

More recently, it has been reported that China Investment Corporation (CIC) is considering to sell Meguro Gajoen to Brookfield for an estimated JPY190 billion. The property is a multi-purpose facility with hotel, wedding venue, and office functions.

### Review and Prospects

2022 is a watershed year for the hospitality sector as inbound tourists have started to return to Japan with border controls being largely lifted after two years of strict restrictions on international travel.

Considering that inbound tourism was growing at a breakneck pace before the pandemic, recovery is likely to be strong as pent-up demand is released and the weak yen helps to attract tourists. According to the World Economic Forum, Japan took the top spot as a tourist destination for the first time in 2022. While the Japanese government started to reopen its borders to tour groups in June 2022, travel restrictions on individual tourists were not removed at full scale until mid-October 2022. In October, the number of inbound tourists increased from 207,000 in September to 499,000, and the November figure is expected to increase significantly, reflecting the full impact of the border reopening. Moreover, as mainly relatively affluent travelers return to Japan, average ADRs are improving strongly.

Furthermore, domestic tourism is returning in earnest, rapidly approaching pre-pandemic levels. According to the Japan Tourism Agency (JTA), the number of hotel stays by domestic tourists has started to gradually recover toward the end of 2021. Recently, the number in September 2022 was only 5.4% below the level seen in the same month in 2019, a noticeable improvement from double digit declines in most preceding months.

However, the pace of recovery is likely to be capped by China's prolonged COVID restrictions. Indeed, tourists from China made up one third of the total inbound spending in 2019, and it is unlikely that inbound tourist figures will return to pre-pandemic levels without these neighboring regions.

Market participants appear to remain bullish on the luxury sector. A noticeable example is the recently announced opening of a hotel affiliated with Dorchester Collection in Torch Tower. Scheduled to open in FY2028, it is planned to be on the 53rd to 58th floors and will house 110 guestrooms. Elsewhere, the upscale sector should also pose opportunities as the stock/supply is limited. Branding may be key to attracting affluent guests from all over the world.

Overall, the situation surrounding the hospitality industry has been steadily improving and is expected to get significantly better as the strict border measures have been lifted. We expect many hotel transactions in 2023 since owners are now able to sell their hotels at acceptable discounts on pre-pandemic prices.

2 In May 2022, Nikkei reported that Dai-Ichi Life Insurance Company is considering acquiring the office portion.

### ALTERNATIVE ASSETS

Since the onset of the pandemic, data centres have arguably become the most sought-after alternative sector largely due to increasing demand for hyperscale data centres. Although the pandemic has shifted to an endemic state, the popularity has not waned. While student housing and senior housing remain as popular alternative segments for the competitive residential asset class and are expected to benefit from secular demographic changes, the current inflationary environment may weaken the sentiment for the senior housing typically with fixed long-term leasing contract.

#### Data centres

During the pandemic, the data centre sector has gained increasing interest. Particularly, demand for hyperscale data centres is strong due to a confluence of factors such as the absence of dominant domestic players in Japan, the country's strategic location as a network connection and distribution hub, and the increased implementation of digital transformation during the pandemic. The current friend-shoring trend may accelerate the movement.

This is not the first data centre boom in Japan, but is in fact considered the fourth one. The first boom came with the emergence of the internet for commercial use in the 1990's, and needs for data centres have changed significantly since then. For instance, there is a greater need for facilities that can use large amounts of electricity, since the current boom stems from heightened demand for hyperscale data centres with larger computing power. Consequently, more sophisticated cooling systems are necessary to dissipate the heat produced by more powerful servers, and the floor loading capacity must be sufficiently high to hold more densely packed equipment. With companies becoming increasingly ESG conscious, it has become more important for data centres to run efficiently and also to have access to green energy. Against this backdrop, new, state-of-the-art data centres have been built in recent years, and more are currently under construction.

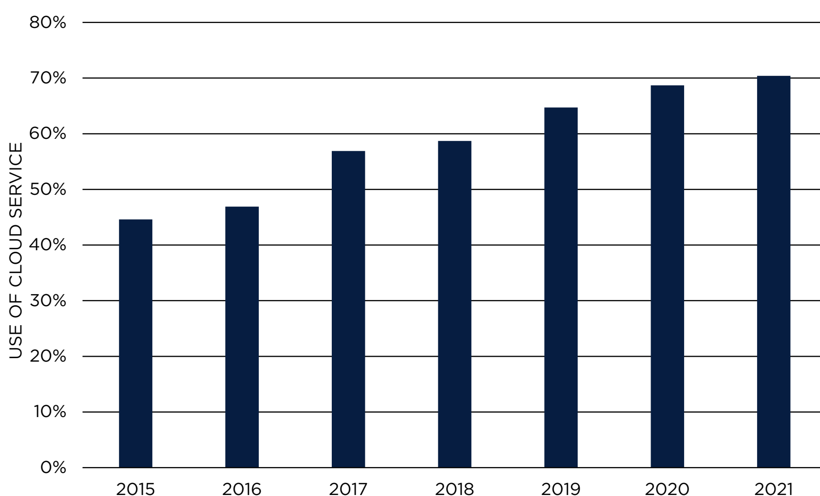
Given the strong growth in data usage expected by various forecasters, as well as Japan's ageing data centre stock, interest in developing new data centres should continue to expand. Indeed, Google has announced that it will open its first data centre in Japan by 2023 as part of its US$730 million investment in infrastructure in Japan. However, as mentioned in our report last year, finding suitable development sites is a challenge. In addition to requirements like having access to a large and stable electricity supply, the availability of large sites for future expansion is important especially for hyperscalers. Furthermore, when taking into account other criteria such as accessibility from cities, proximity to internet exchange and submarine cables, the distance from active fault lines, and safety concerns such as the likelihood of terrorist attacks, ideal sites are few and far between. The scarcity of suitable land is a likely reason why the number of announcements of new data centre developments appear fewer in 2022 than in 2021.

Despite these hurdles, new players have surfaced. For instance, GLP has announced its intention to enter the data centre market in February 2022. The company plans to invest more than JPY1.0 trillion and construct more than six data centres with total capacity of 900MW in Greater Tokyo and Greater Osaka by 2028. Reportedly, it has already secured six sites for development and is targeting hyperscalers such as Google and Microsoft as potential tenants. Gaw Capital Partners has also acquired the Fuchu Building located in Fuchu Intelligent Park in Tokyo. Combined with the adjacent site that the fund acquired in April 2021, the total campus size will reach 11,000 sq m and is planned to be a site for a 50MW data centre with about 4,000 racks. Furthermore, Daiwa House has launched its data centre brand, DPDC, in April 2022. The company has been developing data centres in Inzai since October 2020 and plans to construct 14 data centres with 330,000 sq m in GFA under the DPDC brand.

Moreover, the Japanese government has been trying to facilitate the development of data centres in regional cities. In April 2022, the government disclosed 78 potential data centre development sites that were proposed by municipalities, including the information about items such as power infrastructure, network accessibility, and land prices of those sites. Considering that there were unsuccessful cases of data centres in regional cities in previous booms, whether developers can reduce risk with the support from the government might become an important consideration.

Overall, the prospects for the data centre sector are promising. Considering that the demand for data storage should only increase going forward, and Japan's strategic location as a pivotal network hub in the region, the data centre market is expected to expand. With new players making a foray into the market, data centre developments are expected to continue to pick up. However, a scarcity of ideal sites and the difficulty of securing a large supply of stable electricity might limit the pace of development. Especially for new entrants, the ability to collaborate with local partners is likely to be essential.

**GRAPH 17: Percentage of Cloud Service Use by Company*, 2015 to 2021**



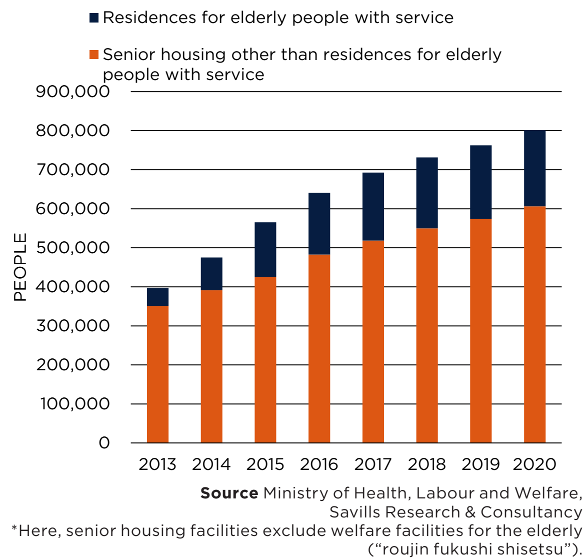

**Source** Ministry of International Affairs and Communications, Savills Research & Consultancy
*Percentages of respondents who answered that their companies used cloud service, at least partially.

#### Healthcare

The operation of healthcare assets was particularly disturbed by the pandemic as operators needed to take extra caution to prevent COVID-19 outbreaks. That said, the pandemic has shifted to an endemic state, and there were several announcements made in 2022.

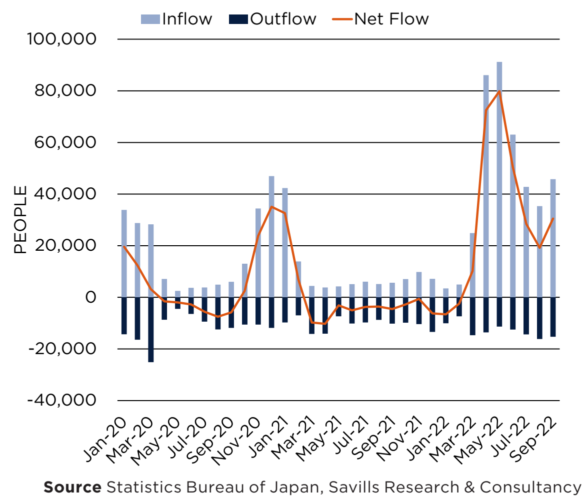
For instance, AXA Investment Managers has recently announced its debut in this sector. Its first investment is JPY21.9 billion portfolio acquisition including 15 facilities. Elsewhere, Nuveen Real Estate has closed its US$100 million Japan Alternative Living Strategy, which has a focus on stablised

**GRAPH 18: Accommodation Capacity for Senior Housing Facilities* in Japan, 2013 to 2020**




**Source** Ministry of Health, Labour and Welfare, Savills Research & Consultancy
*Here, senior housing facilities exclude welfare facilities for the elderly ("roujin fukushi shisetsu").

**GRAPH 19: Inflow, Outflow, and Net-Flow of Foreign Nationals, January 2020 to September 2022**




**Source** Statistics Bureau of Japan, Savills Research & Consultancy

senior housing assets, in July. Both of them have been already active in the multifamily sector.

Elsewhere, Singapore Parkway Life REIT, one of the first entrants in this market, continues to be active and acquired five senior housing properties in 2022. Divided into two separate portfolios, the Singaporean REIT purchased three properties in Hokkaido, including Blue Terrace Kagura, Blue Rise Nopporo, and Blue Terrace Taisetsu, for JPY2.6 billion from Blue Melon Capital and its subsidiary while it also acquired two properties in Tokyo and Chiba from Daiwa House Industry for JPY2.9 billion. Average cap rates of these two portfolios are 6.5% and 5.2%, respectively.

Additionally, another Singaporean REIT, First REIT, acquired two healthcare properties, including Medical Rehabilitation Home Bon Séjour Komaki in Aichi and Loyal Residence Ayase in Kanagawa, in 2022 for JPY2.6 billion in total. These purchases follow its strategic entry into the Japanese market with the acquisition of 12 senior housing properties in 2021. Aiming to diversify its currently Indonesia-centric portfolio, the REIT is expected to continue to make acquisitions in Japan going forward.

Some J-REITs also continued to acquire healthcare assets over the past year. For instance, Healthcare & Medical Investment Corporation acquired 10 properties across Japan for JPY11.4 billion in March and April. More recently, Kenedix Residential Next Investment Corporation announced the acquisition of five senior housing properties for JPY6.8 billion in November.

As such, the healthcare sector appears to be getting a healthy level of investor interest, though challenges remain. Firstly, the current inflationary environment could eat away at the profits of senior housing facilities. Considering that their end tenants are elderlies that rely on their savings, it is hard for operators to transfer heightened operational costs. Furthermore, the long-term fixed rent leases that are common in the sector are disadvantageous in inflationary environments. That said, some investors seem satisfied with extra 50bps+ on top of multi-family cap rates. In the long term, a shortage of nursing and care-giving staff may be a persistent problem. According to the government's estimate released in 2021, the labour shortage of care-giving staff is projected to be 320,000 - around 13% of the necessary staff in the healthcare sector by FY2025. Given the above, the quality of operators will be an increasingly important factor in weighing investment opportunities.

## Student Housing

Without a doubt, the pandemic and subsequent entry ban dimmed the prospects for the student housing sector. However, with the relaxation of border restrictions starting from March 2022, the outlook has significantly improved. According to the data published by the Japanese government, the monthly net migration of foreign nationals to Japan has increased from -6,600 in January 2022 to 30,500 in September 2022. Moreover, Kyoritsu Maintenance, a major student housing operator, revealed that occupancy in its dormitory business segment, which was 92.1% in FY2021, moderately increased to 93.5% in FY2022.

Rental recovery observed in the general multifamily market is also positive for the student housing sector. Granted that facility features and amenities of student housing are different from those of general multifamily properties, Japanese students in particular are likely to compare both types when considering accommodation options. As such, when rents for general multifamily properties increase, all-inclusive, relatively affordable student housing should become more appealing.

There were some recent transactions as well. For instance, AXA Investment Managers acquired four student housing properties along with 29 multifamily properties, which was announced in September 2022. While the details have not been made available, the student housing properties reportedly include 539 studio units near universities in Greater Tokyo. Elsewhere, J-REITs have also transacted a number of student housing properties in 2022, though relatively few. Recently, Comforia Residential REIT has announced that it will acquire Campus Village Akatsuka-Shinmachi in Itabashi for JPY2.3 billion at an appraisal direct cap rate of 4.1% in October. There are also instances of dispositions by J-REITs, such as Tokyo Student-House Wako which was sold by Advance Residence Investment Corporation to its sponsor, ITOCHU Property Development, for JPY800 million at an appraisal direct cap rate of 5.2%.

Overall, it is likely that the student housing sector will regain its momentum as the influx of international students resumes. With yields for general multifamily assets compressed, this is an interesting alternative sector that is equipped with the defensive nature of residential property and growth potential based on secular social trends. As the market grows, more investors will show interest in this sector. If geopolitical tensions rise among some countries, Japan might also increase its popularity as a host country for international students.

## OPPORTUNITIES AND RISKS

### Opportunities

With the pandemic receding, all sectors have seen some recovery over the past year. That said, 2022 has been a year characterised by war, inflation and a high global interest rate environment, which all make the world unstable. Even Japan, a country known for its stability, has experienced a historic weakening of the yen. Given that wage growth remains largely modest in Japan, average households have suffered.

Inflation is currently at acceptable levels and interest rates remain low in Japan. As such, while some are taking a wait-and-see approach due to concerns over a future increase in interest rates, most investors are looking to snap up opportunities. Indeed, 2022 has been another busy year with multiple large transactions. On top of the JPY436 billion deal involving Otemachi Place, the largest transaction ever in Japan, several transactions valued at over JPY100 billion have taken place over the past year.

Interest rate hikes in the US are likely to slow down, and many believe that the upward pressure on interest rates in Japan should be manageable. Investors will likely get a clearer picture of the direction of the market by early 2023 as inflation in the US gradually slows down. J-REITs are notably susceptible to changes in interest rates and their activity level depends on the interest rate environment. Given the relatively high prices of real estate, transactions volumes by J-REITs will likely be affected if interest rates go up.

Nevertheless, some economic slowdown or recessions are likely, which will negatively impact real estate activity. With this high level of uncertainty, investors remain cautious as well as selective in their investments. For instance, although the office sector remains stable, office location appears to be an increasingly decisive factor, especially considering the long-term impact of hybrid work arrangements.

ESG appears to be gaining further ground. According to a survey by the Development Bank of Japan, approximately half of tenants responded that they would accept some level of rental premium for ESG compliant office buildings.

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

### Core and Core-plus

The logistic sector remains sought after, although there are increasing concerns over inflation and large supply. Tenants are struggling with thin profit margins and inflation, and competition for tenants is growing. Some investors may not be able to achieve rents high enough to justify their own sharp pricing.

Multi-family retains its popularity due to its stable cash flow even during the pandemic. There were several large portfolio transactions over 2022, and 2023 is also likely to see a high level of activity. Rental levels have almost recovered to pre-pandemic levels, and meaningful wage growth should come before further rental hikes. Student housing and healthcare facilities appear to be popular targets as well.

Office attendance has improved throughout 2022 and there has been stability in the office market. Investors have been very selective about location – poorly located offices will likely struggle to attract tenants while hybrid work arrangements are common.

### Value-add

Urban retail still appears to have some room for growth. Indeed, brick and mortar demand from domestic consumers has largely recovered in 2022. That said, recovery has been fragmented even in prime submarkets. High-spending inbound tourists should help change the fortunes of urban retail.

Disposals of corporate real estate, especially by the industries hit the hardest by the pandemic, are still likely to continue in 2023.

### Opportunistic

The hotel sector continues to be attractive to investors, given that inbound tourism has resumed and domestic tourism, which comprises roughly 80% of market before the pandemic, has recovered to pre-pandemic levels. Furthermore, investors, anticipating interest rate hikes, are encouraged by the fact that hotel performance is far less linked to interest rates than other sectors. We expect many hotel transactions in 2023 since owners are now able to sell their hotels at acceptable discounts on pre-pandemic prices.

Elsewhere, luxury or branded residences might be interesting opportunities to explore, especially because the stock level remains subdued. Tokyo will see its first branded residence in 2023, provided by Aman Tokyo Residences, which will pave the way and spark new entries from other market participants.

There should be some opportunities in the office sector, particularly among office buildings with high vacancy. This comes with significant risks, but shrewd investors may identify properties with high potential.

### Risks

There are several risk factors in the current global landscape, and the following will be important to consider for real estate investment.

### Interest rate risks

While the Japanese real estate sector has mostly remained stable throughout the pandemic, a noticeable increase in interest rates will likely trigger some corrections, especially for assets that have experienced sharp pricing and compressed cap rates.

If global interest rates continue to increase, and the depreciation of the yen continues, or CPI in Japan remains elevated, the BOJ is more likely to tighten its monetary policy. With a new governor set to be elected by April, the BOJ may revise its policy. This is likely to lead to an increase in interest rates as well as a change in lender sentiment. Nevertheless, we expect only moderate change because inflation in Japan is expected to remain at a manageable level and BOJ has little reason to increase interest rates as long as the exchange rate stays within a preferable range.

### Geopolitical risks

2022 has been a turbulent year, with the crisis in Ukraine, strict COVID restrictions in China, and tensions between the US and China all shaping the global geopolitical and economic landscape. These events have all contributed to a global economic slowdown, especially among Japan's trading partners, which will negatively impact the Japanese economy.

### Pandemic risks

The spread of the highly transmissible omicron strain in early 2022 exposed the prevailing risks of new COVID-19 variants. Another new strong variant may disrupt the global economy again, as well as further change the behaviour of people.

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

**Simon Smith**
Regional Head of Research & Consultancy, Asia Pacific
+852 2842 4573
ssmith@savills.com.hk


Savills plc: Savills plc is a global real estate services provider listed on the London Stock Exchange. We have an international network of more than 600 offices and associates throughout the Americas, the UK, continental Europe, Asia Pacific, Africa and the Middle East, offering a broad range of specialist advisory, management and transactional services to clients all over the world. This report is for general informative purposes only. It may not be published, reproduced or quoted in part or in whole, nor may it be used as a basis for any contract, prospectus, agreement or other document without prior consent. While every effort has been made to ensure its accuracy, Savills accepts no liability whatsoever for any direct or consequential loss arising from its use. The content is strictly copyright and reproduction of the whole or part of it in any form is prohibited without written permission from Savills Research.