2023 demonstrated stability and resilience, with prospects for an improved 2024

INTRODUCTION
2023 has been another challenging year for the global economy. Ongoing conflicts in Ukraine and the Middle East, as well as persistently high inflation and interest rates across the globe have contributed to a global economic slowdown, which has negatively affected real estate markets and sentiment in most countries. Japan has fully transitioned to a post-pandemic state of affairs in 2023, and the release of pent-up demand has heralded positive economic growth. Corporate Japan has performed notably well in 2023, with the equity market booming, and many observers are more optimistic about Japan’s mid-term economic outlook.

Inflation has been a prominent feature in post-pandemic Japan, which may transform the situation moving forward. Female and elderly labour participation rates have already reached high levels, and with persistent labour shortages, as well as the general consensus of accepting price increases, wage growth is likely to continue for the meantime. As such, 2024 growth looks set to be even stronger.

This may be the harbinger of continuous “nominal” growth as priced in equity markets. In this scenario, sustained rental growth appears to be a distinct possibility across the asset class, which should attract further investment into Japanese real estate. Even if this ideal situation does not come to fruition, Japan would likely return to the familiar stable, albeit stagnant, status quo at worst.

Inflation appears to have already peaked out in Japan, and the US interest rate environment has calmed down. Hence, upward pressure on Japanese interest rates will be limited. Regardless, the Bank of Japan will likely further normalise its monetary policy, with its policy rate moving away from negative territory, while investors appear to have already factored in these modest interest rate increments, anticipating a new phase in the Japanese economy.

That said, Japan may face economic challenges during the monetary policy normalisation process, with the Bank of Japan holding around half of the massive government debt. Meanwhile, US-China relations may become more tense, particularly taking into account the normalization process, with the Bank of Japan.

Investor sentiment remains positive in Japan, and transaction volumes managed to hold well while many other countries saw deal volumes plummet to less than half this year. Japan’s economy has experienced encouraging growth, which has supported sound recovery in respective real estate sectors. Japan is well regarded for its political, economic, and social stability, especially amid various global upheavals over the past year. In addition, low interest rates and the persistent weak yen have encouraged strong interest from overseas players, as well as contributing to improved prospects in certain sectors, such as hospitality and retail, which benefit from spending by inbound tourists to an outsized extent.

According to MSCI, as of Q3/2023, total investment in Japanese real estate amounted to approximately JPY3.8 trillion year-to-date (YTD), with overseas investors and J-REITs particularly active over the past year. In-house cap rates for most select sectors were largely unchanged over the past year. In-house cap rates in the mid-market residential sector loosened by 10 basis points (bps) to 3.4%, and some observers may anticipate further moderate adjustments in other sectors moving forward. Furthermore, elevated dry powder and limited opportunities may keep acquisitions competitive for prospective investors over the coming year.

Broad economic growth and the robust recovery of inbound tourism, in addition to attractive funding available have buoyed real estate activity in 2023, and several significant transactions took place across all asset classes. The largest transaction that was announced over the past year was Yodobashi Holdings’ acquisition of land and a portion of the Sogo and Seibu department stores from Fortress Investment Group.

**TABLE 1: Major Transactions in 2023**

<table>
<thead>
<tr>
<th>PROPERTY</th>
<th>TIMING</th>
<th>LOCATION</th>
<th>PRICE (JPY BILLION)</th>
<th>BUYER</th>
<th>USAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land and part of Seibu Ikebukuro, Sogo Chiba, and Seibu Shibuya Portfolios (27 properties)</td>
<td>Sep</td>
<td>Various</td>
<td>300</td>
<td>Yodobashi Holdings</td>
<td>Retail</td>
</tr>
<tr>
<td>Daiwa Resort Hotel Portfolio (27 properties)</td>
<td>Jul</td>
<td>Various</td>
<td>US$900 million (134)</td>
<td>SC Capita, ADIA, Goldman Sachs</td>
<td>Hotel</td>
</tr>
<tr>
<td>Tokyu Plaza Ginza</td>
<td>Mar</td>
<td>Tokyo</td>
<td>130</td>
<td>Mitsui Sumitomo Trust Panasonic Finance</td>
<td>Retail</td>
</tr>
<tr>
<td>Blackstone Logistics Portfolio (6 properties)</td>
<td>Apr</td>
<td>Various</td>
<td>US$800 million (114)</td>
<td>GIC</td>
<td>Logistics</td>
</tr>
<tr>
<td>Residential Portfolios (48 properties)</td>
<td>Jan</td>
<td>Tokyo, Osaka, Aichi</td>
<td>80</td>
<td>AXA IM Alts</td>
<td>Residential, Health Care</td>
</tr>
<tr>
<td>Odakyu Dai-ichi Seimei Building</td>
<td>Mar</td>
<td>Tokyo</td>
<td>71</td>
<td>Dai-ichi Life Insurance</td>
<td>Office</td>
</tr>
<tr>
<td>Gotenyama SH Building</td>
<td>Apr</td>
<td>Tokyo</td>
<td>70</td>
<td>TIS Inc.</td>
<td>Office</td>
</tr>
<tr>
<td>CBRE IM Logistics Portfolio (6 properties)</td>
<td>Mar</td>
<td>Various</td>
<td>64</td>
<td>Mapletree Logistics Trust</td>
<td>Logistics</td>
</tr>
<tr>
<td>The Imperial Hotel Tower (35% land ownership)</td>
<td>Sep</td>
<td>Tokyo</td>
<td>62</td>
<td>Mitsui Fudosan</td>
<td>Hotel, Office, Retail</td>
</tr>
<tr>
<td>J.P. Morgan Residential Portfolio (33 properties)</td>
<td>Feb</td>
<td>Tokyo, Osaka, Aichi</td>
<td>59</td>
<td>AXA IM Alts</td>
<td>Residential</td>
</tr>
</tbody>
</table>

Source: Nikkei RE, Mingtiandi, Savills Research & Consultancy

savills.co.jp/insight-and-opinion/
In the midst of a challenging global economy, Japan has proven to be a stable and resilient market. The delayed reopening has led to a significant release of pent-up demand, driving growth in various real estate sectors and the overall economy. This has attracted both existing and new investors eager to expand their presence in Japan. Despite potential challenges like expected interest rate hikes and limited opportunities, the country’s nominal growth prospects and overall stability are anticipated to maintain stronger transaction volumes in 2024.

For JPY300 billion. The retail sector has undergone fundamental transformations, due to changes in consumer behaviour induced by the pandemic. Elsewhere, the acquisition of a resort hotel portfolio from Daiwa House for US$900 million by a consortium led by SC Capital was another noteworthy deal with the aim of capturing robust inbound demand.

Logistics assets remain a highly prized jewel in investors’ portfolios due to the mid-term growth outlook, and the sector attracted a significant uptick in interest in 2023 despite lukewarm leasing and sharp pricing. For instance, GIC acquired six logistics facilities from Blackstone for an estimated US$800 million, while Mapletree Logistics Trust also expanded their presence in Japan, with their acquisition of six logistics assets from CBRE Investment Management for US$500 million.

The residential sector retains its popularity among both domestic and overseas investors seeking stable returns moving into the post-pandemic era. The most significant residential acquisitions were carried out by AXA Investment Managers for two residential portfolios for JPY80 billion and JPY60 billion, and smaller portfolios appear to be in high demand now. Moderate population growth in Japan’s major urban areas looks to sustain firm demand in the rental residential market and raises the prospects of further rental growth.

Although Japan’s office market has received mixed opinion this year due to the uncertainty of the sector and dampened global sentiment, some notable transactions took place in 2023. Most notably, Dai-ichi Life Insurance acquired the Odakyu Daichi Seimei Building and the Odakyu Century Building for over JPY70 billion and JPY57 billion, respectively. TIS Inc., a domestic IT company, acquired the Gotenyama SH Building for JPY70 billion for its own use, effectively as a data centre. Observers should note that premium assets remain scarce and coveted, and demand should remain firm in the sector moving ahead.

Japan is one of the exceptional countries to record moderately strong transactional volumes this year, and both its relative stability and prospects for nominal growth in the medium-term bode well for prospective investors. Domestic and cross-border transactions should continue to hold strong, with more new and established players likely looking to make forays into the Japanese market over the coming year. Attractive funding options should support this trend. As such, we hold an optimistic view of Japan’s real estate capital markets going forward, and anticipate greater transaction volumes in 2024.
OFFICE

Investment Trends

Although the office market has historically been the largest asset class in Japanese real estate, we have witnessed many investors turn their attention to other asset classes amid somewhat dampened sentiment in the sector, especially amongst western investors. Nonetheless, Savills in-house cap rates for Grade A offices in Tokyo remain unchanged YoY at the tight level of 2.6% in 2023. The October 2023 Japan Real Estate Institute (JREI) survey indicates that expected cap rates remain largely stable, with the exception of a few regional markets like Osaka and Sendai, which showed a slight compression of 10 bps, demonstrating the stability of office assets.

Investment volumes in the office sector as of Q3/2023 contracted for a second consecutive year by around 31% compared to the same period in 2022, although it should be noted that figures are still preliminary and should increase as more deals are confirmed. Office assets have received moderately less interest than in previous years, yet some noteworthy transactions took place in Q2/2023. The largest transactions include the Odakyu Dai-ichi Seimei Building acquired by Dai-ichi Life Insurance for roughly JPY70 billion. Meanwhile, a handful of other transactions took place for over JPY20 billion throughout the year, and prime office assets remain scarce and highly sought after.

Review and Prospects

Notable improvements have been made in the office market overall in 2023, and Japan appears to have completely transitioned to a post-pandemic state of affairs. Indeed, office attendance rates among workers have increased, while full remote work policies have become scarcer. That said, some hybrid work arrangements remain in place as a corporate perk, especially among major companies in large urban areas, and many companies have revised their office needs and functions accordingly.

The Tokyo office market has largely stabilised, and the situation into 2024 can be best described as cautiously optimistic. Rental corrections softened throughout the year among Grade A and Grade B offices, and the market experienced some modest quarterly increments later in the year. Indeed, Tokyo's Grade A rents declined by 1.1% YTD as of Q3/2023, which were notably more modest than the decline over the same period in 2022. Meanwhile, Grade A vacancy remains tight overall at 3.4%, having decreased by 0.5 percentage points (ppt) over the same period. The Japanese economy has been on a recovery track in 2023, and demand for office space appears to be firm among tenants, especially modern offices that are located near public transport hubs. Vacancy rates still remain relatively loose compared to the ultra-tight vacancy observed in the pre-pandemic era, and some companies are seizing opportunities to consolidate offices and carry out overdue office upgrades and layout adjustments while leasing conditions remain favourable for tenants.

However, competition for tenants has contributed to greater bifurcation in terms of leasing performance between modern, well-located offices and older, poorly located offices. Vacancies remain elevated in areas with inconvenient access, given that the red-hot labour market has forced companies to prioritise more desirable and convenient areas for their offices in order to attract workers. As such, some building owners have continued resorting to rental corrections and longer free-rent periods to attract tenants.

Regional office markets have achieved moderate recovery in 2023, supported by regional economic growth and rising office participation rates. All-grade rents increased moderately YoY across all regional submarkets, which outpaced Tokyo for a second consecutive year. Although mild divergence was witnessed in terms of all-grade vacancy rates throughout the year, regional markets remain tight overall, and a majority of newly completed office developments have been absorbed with limited issues. Overall, we anticipate further moderate growth in Japan’s regional office markets moving forward.

A large amount of new supply has arrived to the Tokyo market in 2023, the majority of which was delivered in Toranomon and Shibuya, while 2024 is also set to be another year for large incoming supply. Meanwhile, Osaka and Fukuoka are also set to welcome large amounts of new supply in 2024 and beyond, which may cause some temporary disruptions due to lukewarm demand for office space at bullish rental levels. However, a number of factors, including rising construction costs have forced some developers to delay or reconsider their office projects, which should ease some concerns and provide some breathing room to absorb the backlog of office supply.

Overall, the market has seen moderate improvements over the past year as Japan returned to a state of normalcy and economic recovery has taken hold. Although there will likely be some temporary fluctuations due to the large incoming supply, many developments will be large and mixed-use, and should transform their respective markets and contribute to generating wider economic and social benefits for decades to come. These new developments are being developed with the highest ESG specifications, and will continue to improve the competitiveness of Japan’s major cities. In addition, given the uncertainty as well as evolving tenant demand, office assets are likely to be considered more “operational” assets moving forward. Landlords will need to collaborate with tenants in terms of floor utilisation and carbon dioxide emissions measurement. Furthermore, this may be an appropriate timing to consider office conversions.
**2023 Review and 2024 Prospects**

**RESIDENTIAL**

**Investment Trends**

Savills in-house cap rates for mid-market residential properties loosened moderately over the year by 10bps to 3.4%, although remaining tight overall. The asset class has generally remained popular with investors, but interest rate increments and global uncertainty have impeded further cap rate compression as investors have become slightly pickier when choosing assets. Residential assets remain highly valued among investors looking for stable returns, and expected cap rates for residential properties in Japan have tightened further by 10bps YoY to 3.8%, according to JREI. That said, the previously ubiquitous portfolio premium has dissipated, while smaller portfolios appear to gain more popularity.

Residential investment volumes as of Q3/2023 were around 28% lower than the figure observed over the same period in 2022. The beginning of 2023 saw considerable interest among institutional investors in the residential market. Specifically, AXA Investment Managers made a substantial announcement regarding the acquisition of two residential portfolios for JPY80 billion and JPY60 billion. Another notable transaction was Mitsui & Co. Digital Asset Management’s acquisition of a portfolio valued at over JPY30 billion. Several market players have disposed of residential portfolios, due to funds having reached the end of their lives, among other reasons. Meanwhile, many new names have also entered the Japanese residential market, demonstrating high liquidity and strong demand from investors globally.

**Review and Prospects**

With society’s overall return to normalcy, the Tokyo 23W market continues to witness consistent recovery, and average rents in Q3/2023 have largely rebounded to pre-pandemic levels. Furthermore, average occupancy rates have also largely recovered, having increased by 0.79pts YoY and standing at just 0.39pts shy of the pre-pandemic level in 2019.

Tokyo continues to enjoy moderate population growth. As of November 2023, YTD net migration in the 23W has surpassed pre-pandemic migration levels, with an influx of 96,000 people, distributed roughly equally between Japanese and foreign nationals. In comparison with pre-pandemic levels, Japanese net migration declined by 35%, while that of foreign nationals increased by approximately 2.5 times. The asset class has generally remained popular with investors, but interest rate increments and global uncertainty have impeded further cap rate compression as investors have become slightly pickier when choosing assets. Residential assets remain highly valued among investors looking for stable returns, and expected cap rates for residential properties in Japan have tightened further by 10bps YoY to 3.8%, according to JREI. That said, the previously ubiquitous portfolio premium has dissipated, while smaller portfolios appear to gain more popularity.

Residential investment volumes as of Q3/2023 were around 28% lower than the figure observed over the same period in 2022. The beginning of 2023 saw considerable interest among institutional investors in the residential market. Specifically, AXA Investment Managers made a substantial announcement regarding the acquisition of two residential portfolios for JPY80 billion and JPY60 billion. Another notable transaction was Mitsui & Co. Digital Asset Management’s acquisition of a portfolio valued at over JPY30 billion. Several market players have disposed of residential portfolios, due to funds having reached the end of their lives, among other reasons. Meanwhile, many new names have also entered the Japanese residential market, demonstrating high liquidity and strong demand from investors globally.

**Residential Investment Volumes, 2007 to Q3/2023**

<table>
<thead>
<tr>
<th>Year</th>
<th>Overseas</th>
<th>Listed Companies &amp; REITs</th>
<th>Private</th>
<th>Unknown</th>
<th>Total Investment (RHS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>10%</td>
<td>30%</td>
<td>20%</td>
<td>40%</td>
<td>0.0</td>
</tr>
<tr>
<td>2022</td>
<td>10%</td>
<td>30%</td>
<td>20%</td>
<td>40%</td>
<td>0.0</td>
</tr>
</tbody>
</table>

**Graph 6: Rents by Unit Size, CSW, 2014 to Q3/2023**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>15-30 sq m</td>
<td>3,000</td>
<td>3,200</td>
<td>3,400</td>
<td>3,600</td>
<td>3,800</td>
<td>4,000</td>
<td>4,200</td>
<td>4,400</td>
<td>4,600</td>
</tr>
<tr>
<td>30-45 sq m</td>
<td>3,500</td>
<td>3,700</td>
<td>3,900</td>
<td>4,100</td>
<td>4,300</td>
<td>4,500</td>
<td>4,700</td>
<td>4,900</td>
<td>5,100</td>
</tr>
<tr>
<td>45-60 sq m</td>
<td>4,000</td>
<td>4,200</td>
<td>4,400</td>
<td>4,600</td>
<td>4,800</td>
<td>5,000</td>
<td>5,200</td>
<td>5,400</td>
<td>5,600</td>
</tr>
</tbody>
</table>

**Graph 7: Rental Premiums/discounts* vs 23W Average, 2018 to 2023**

<table>
<thead>
<tr>
<th>Year</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
<th>2022</th>
<th>2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium / Discount to 23W Average</td>
<td>-20%</td>
<td>-15%</td>
<td>-10%</td>
<td>0%</td>
<td>5%</td>
<td>10%</td>
</tr>
</tbody>
</table>

*The above represents the average premium/discount over the respective year.
RETAIN

Investment Trends
Savills in-house cap rates for high-street retail in Tokyo continue to stand at 2.7%, unchanged since 2020. Furthermore, expected cap rates for prime retail property in Ginza compressed by 10bps to 3.4% over the past year, according to JREI. Overall, interest has been shifting to the Japanese retail sector among investors, who anticipate stronger returns in the post-pandemic era.

Preliminary data from MSCI suggests that retail transaction volumes as of Q3/2023 were 15% greater than the same period in 2022, amounting to around JPY680 billion. Furthermore, it is important to note that a number of transactions have likely yet to be factored into this figure, and overall retail transaction figures for 2023 will likely increase moving forward. There have been several considerable transactions in the retail sector in 2023. For instance, Yodobashi Holdings announced its acquisition of the the land and part of the iconic department stores, Sogo and Seibu from Fortress Investment Group for JPY300 billion. Another prominent transaction was the sale of Sun Square, a mixed-use leisure facility, by Nippon Paper Industries for an undisclosed price, but with the seller reportedly achieving a capital gain of JPY25 billion.

In a post-pandemic state, both domestic and inbound footfall continues to recover and grow. However, some risk factors persist in the sector, namely tenants are struggling with increased energy and materials costs, which may constrain further rental growth for the meantime. Nonetheless, the growing domestic economy and inbound tourism, in addition to the necessity to repurpose facilities in response to behavioural shifts, will likely support growth in the sector and encourage major transactions going forward.

RETAIL

Review and Prospects
The retail sector has experienced a notable resurgence, and the performance of prime shopping streets has gone from strength to strength. As such, average 1F rents in Tokyo’s prime retail submarkets exceed the pre-pandemic peak level in 2019 (Graph 10). This has largely been supported by the large-scale recovery of inbound tourism in 2023, and areas catering to inbound tourists have performed well, with retail properties in these areas attracting increased attention among potential tenants for new store openings.

The luxury sector in particular has thrived. Indeed, elevated flight and accommodation costs have led to relatively high-income visitors comprising a majority of inbound tourists visiting Japan in 2023. Propelled further by their heightened spending power due to the depreciated yen, this profile of inbound traveller has fuelled high spending in the luxury sector in 2023. Conversely, these factors have also encouraged local wealthy residents to spend more domestically. As such, prime streets in Ginza, Omotesando, and other premier shopping areas have performed notably well this year, and the sentiment of the sector remains positive going forward.

Elsewhere, upper floor units, which have struggled due to low foot traffic during the pandemic, are re-emerging, driven by increased demand in the service sector, especially beauty-related services, and clinics. In addition, food and beverage (F&B), as well as inbound tourism-dependent industries have seen a notable resurgence in 2023, which should support stable growth in the retail sector overall. Non-prime streets still exhibit moderately high vacancies and have some room for improvement, but should gradually recover as footfall continues to pick up.

Regional cities have also attained a greater sense of stability in the post-pandemic era. Both 1F and non-1F retail units have experienced encouraging rental growth on average, and vacancies have been gradually falling. Indeed, most regional cities have significant revitalisation plans in the pipeline, which look to transform central urban areas through large mixed-use developments, and contribute to long-term growth in their respective retail markets.

Japan’s retail industry has undergone a noticeable transformation in recent years. Most notably, the proliferation of e-commerce continues to chip away the role and market share of traditional brick-and-mortar stores, with the pandemic further propagating this trend, deepening the changes in consumer behaviour. Retail operators will need to adapt to satisfy the needs and preferences of consumers, such as by providing unique in-person experiences and services that are complimentary to online shopping. Mixed-use establishments such as Tokyu Kubukicho Tower, a 47F entertainment high-rise building in Shinjuku, will be well positioned in this regard.

In addition, the sector must grapple with a handful of risk factors that may delay future growth somewhat. Elevated energy and materials costs, in addition to labour shortages pose difficulties for some tenants that already operate on thin margins, especially those in the F&B industry. These factors may constrain further rental growth looking ahead.

Overall, sentiment is favourable in the retail sector, and investors will likely continue looking for opportunities in the market. Businesses that suffered during the pandemic have caught their second wind in the post-pandemic era, and the retail sector should continue a path of broad recovery going into 2024, with the pace of growth largely depending on the industry and location.
LOGISTICS

Investment Trends
The logistics sector continues to capture strong interest among investors in 2023. Our in-house survey indicates that cap rates for prime logistics properties held steady at 3.3%. Meanwhile, expected cap rates compressed in all major markets for a second consecutive year, with the Tokyo bayside area marking a 20bps fall to 3.8%, according to JREI's October 2023 survey. Investment activity in the logistics sector witnessed an uptick in 2023, with preliminary transaction volumes as of Q3/2023 having more than doubled compared to the same period in 2022, especially as international investors with deep pockets have shifted their attention from the office sector. Momentum has also been sound among J-REITs. The most prominent transaction of 2023 was GIC's acquisition of six logistics facilities from Blackstone for an estimated price of JPY4,230 million. In addition, Mapletree Logistics Trust bought six logistics facilities from CBRE Investment Management for US$500 million.

Given the looming large incoming supply, observers may have some concerns regarding lukewarm leasing performance. Nevertheless, many investors retain a strong conviction regarding the sector’s robust mid-term fundamentals, and appear to have the mindset of “short-term pain, long-term gain”. As such, deal volume remains high in 2023, and is expected to continue to do so in 2024.

Review and Prospects
Asking rents in Greater Tokyo have witnessed a moderate contraction of 2.1% YoY to JPY4,600 per tsubo as of Q3/2023. In terms of vacancy, the market is facing challenges in absorbing the backlog of supply, which was exacerbated by a large amount of new supply introduced in 2023. This has resulted in a persisting loosening of vacancy for the eleventh consecutive quarter, which increased by 2.4ppts YoY to 6.4%.

The Greater Osaka market remained relatively stable, with limited new completions and firm tenant interest helping to maintain a tight balance between supply and demand in 2023. Specifically, asking rents contracted by 1.6% YoY to JPY4,230 per tsubo, and vacancy saw a moderate increase of 2.1ppts YoY to 3.7% as of Q3/2023.

Going forward, Greater Tokyo is forecast to experience a large influx of approximately 3.4 million sq m of new logistics supply in 2024, and the tepid absorption and elevated levels of vacancy are expected to linger for some time. Meanwhile, the Greater Osaka market is also expected to welcome a large supply of logistics space in the coming years, with a forecast of around 1.0 million sq m and 1.4 million sq m in 2024 and 2025, respectively, and the expansion of the Shin-Meishin Expressway will open up more space for logistics facilities, development, which may lead to further increments in coming years. Nonetheless, the situation appears to remain stable for the time being in Greater Osaka, given the manageable amount of new supply in recent years and firm demand.

Furthermore, macroeconomic factors such as elevated construction and materials costs and land prices may impede future development projects, while instances of investors altering their development plans or selling development land have also been observed. Overall, this influx of supply should only be temporary, which should provide some breathing room for the absorption of the large amount of incoming supply.

Meanwhile, the rapid large supply of logistics facilities, coupled with increasing demand in semiconductor manufacturing and digital security, has spurred a shift in focus towards data centres. Investment opportunities are limited in the sector, but both hyperscale data centres and smaller local data centres have experienced a considerable expansion in demand, given the prevailing need for both cloud-based solutions and other forms of in-house storage.

While the fundamentals of the logistics sector remain robust in the post-pandemic era, the sector faces a number of challenges going forward. Elevated energy costs and labour shortages are having a bearing on tenant performance, on top of new regulations on working hours, which will only increase uncertainty moving forward. Indeed, logistics companies operate on thin margins, and many would unlikely be able to bear the cost of further rental hikes. Hence, these issues will likely inhibit the absorption of new logistics supply and may constrain rental growth moving forward.

As the competition for tenants heightens among logistics facilities, we predict that some further bifurcation in performance will materialize in the market. In addition to new and well-located facilities, there appears to be growing demand for facilities with specialized features, such as cold-storage, and such properties will likely capture significant tenant demand moving forward. On the other hand, older facilities with poor transport access may struggle to secure tenants, and further rental revisions may be necessary in order to sufficiently compete moving forward.
**HOTEL**

**Investment Trends**

2023 has been a standout year for the hospitality sector, having witnessed the reopening of borders and robust recovery to pre-pandemic levels. As such, hotels have experienced magnetic appeal among investors, and a much-anticipated intensification of transaction activity has taken place. Indeed, investment volumes until Q3/2023 have already exceeded those of the same period in 2022 by nearly 50%, according to preliminary data by MSCI.

Furthermore, these figures are preliminary and investment volumes will likely increase as more deals are announced. As such, given the resurgence and popularity of the sector, expected cap rates for hotels have compressed across all major markets in 2023, according to JREI.

Several notable hotel transactions were recorded in 2023, and international investors have been particularly active, comprising over 60% of hotel transactions as of Q3/2023. The largest recorded hotel transaction in 2023 took place by a consortium led by SC Capital, which acquired a resort hotel portfolio from Daiwa House for US$900 million. In addition, KKR acquired the Odakyu Century Building in Shinjuku, which houses the Hyatt Regency in Tokyo, for JPY57 billion, while BentallGreenOak acquired the Rihga Royal Hotel in Osaka for around JPY35 billion.

Domestic players have been similarly active this year. For instance, Mitsui Fudosan acquired a 36% land ownership interest in The Imperial Hotel Tower in Chiyoda for around JPY62 billion, which will undergo extensive redevelopment over the coming years. Furthermore, Invincible REIT acquired six hotels and resorts for JPY57 billion.

Overall, Japan’s hotel sector looks set to remain popular among international and domestic investors. Indeed, the weak yen and Japan’s tourist attractions will facilitate rapid growth of inbound tourism. The luxury hospitality sector will be particularly popular due to the scarcity of prime assets and the makeup of current tourism demand.

**Review and Prospects**

The hotel sector has seen dramatic recovery in 2023. Border restrictions to Japan were completely lifted in May, and the number of inbound tourists has recovered rapidly, aided by the persistent weak yen. Indeed, according to the Japan National Tourism Organization, the monthly number of foreign visitor arrivals has already exceeded the 2019 monthly level in October 2023, even before the meaningful return of Chinese tourists, signalling the large potential for further growth.

As such, hotels have continued their path of strong growth in 2023. ADNs have increased rapidly, and have often surpassed those of pre-pandemic times. Hotel guestrooms are scarce relative to the burgeoning demand in 2023, and overall new hotel supply is forecast to be relatively low in coming years, which should ensure that ADNs remain elevated for the meantime. In addition, while the rebound in the numbers of typically high-spending Chinese visitors has been slow, further windfalls are expected for Japan’s hotel sector sooner than later. However, occupancy levels remained capped among a majority of establishments due to labour shortages, and this issue looks to persist for the meantime.

The recent growth of the hospitality sector was strongly led by the luxury sector, propelled by inbound tourists as well as wealthy Japanese who have had fewer incentives to travel abroad in recent years due to travel restrictions and the weak yen. Moreover, the profile of inbound tourists has changed significantly in 2023. Per-person spending among overseas visitors is noticeably higher compared to the pre-pandemic, and elevated travel costs effectively mean that only relatively high-income earners have been able to travel to Japan. We expect this trend to accelerate towards the completion of the IR developments.

Within the luxury sector, ryokan have performed extremely well both during the pandemic, and in the post-pandemic era, particularly among inbound tourists looking to gain a more authentic experience while travelling in Japan. Given the abundance of opportunities in the market, many experienced players have already made entries, and we believe that the market has tremendous potential for further growth. For a more in-depth overview, please refer to our “Ryokan Market June 2023” report.

Despite this encouraging situation, the hotel sector faces a number of hurdles moving forward. Besides the notable subdued occupancy rates due to labour shortages, the recovery of revenue streams from MICE events has lagged, which will likely delay the full recovery of full-service hotels, in particular. In addition, mass inbound tourism will likely take some more time to fully recover due to global economic slowdown and inflation, while domestic demand from wealthy Japanese will likely taper off as more look to travel overseas going forward.

The hotel sector has improved dramatically in 2023, and given the segment’s bright prospects, many investors will continue to explore opportunities in the market. Overall, the market should continue this encouraging trajectory moving forward, but individual hotel performance will depend largely on the hotel grade and respective market.
### ALTERNATIVE ASSETS

Data centres have maintained their popularity on the back of rapid digital transformation in Japan increasing the utilisation, and consequently demand for both hyperscale and local data centres. At the same time, the scarcity of suitable land and challenges in procuring power has limited the number of deals in the market. Elsewhere, healthcare and student housing have also seen heightened interest, although further interest rate increments in combination with the fixed term leases typically observed in the healthcare sector might dampen sentiment.

#### Data Centres

The pandemic has expedited demand for digital infrastructure in Japan, which have served as a catalyst for economic growth and investments in the country, with foreign direct investments into communications having seen significant increments over the past few years to more than JPY2 trillion in 2022. Since the government started its focus on semiconductor policies in 2021, investments of more than JPY2 trillion have been recorded, and there have also been many announcements of new production lines and initiatives. Overall, this paradigm shift has signified increasing demand for data centres to serve as a base for digital infrastructure, and there is a large amount of supply in the pipeline to accommodate this.

The data centre market can broadly be categorised into hyperscale and local. While there is no clear definition of what constitutes a hyperscale data centre, they typically refer to very large-scale data centres that are owned and operated by major corporations, and often have more than 5,000 servers, and usually have capacities upward of 20MW. In Japan, many such data centres are located on the outskirts of major urban areas such as Inzai, Chiba, and situated in clusters due to the large amount of land and energy required for operational use.

On the other hand, local data centres are much smaller in scale, and tend to be located in closer proximity to central business districts. However, many older local data centres tend to house outdated, company-tailored IT systems that have become more difficult to maintain. The Japanese government’s digital transformation push has resulted in companies moving away from these legacy enterprise systems, and migrating to cloud-based solutions that hyperscale data centres provide.

Nonetheless, there is still need and demand for local data centres situated closer to central areas. Firstly, some companies like to maintain their IT systems in a hybrid fashion, using both cloud services provided by hyperscale data centres, as well as some form of in-house storage, which could be either in-office or colocation space. Colocation data centres close to central areas have an advantage here as they can provide customers relatively easier access compared to those situated further afield.

The conversion of office buildings to local colocation data centres appears to be a viable strategy, considering that leases for data centres will be longer and can generally generate greater net operating income than a similar office building, due to the specialised nature and scarcity of such properties.

One notable example would be the Gotenyama building located in Shinagawa, Tokyo, which Sekisui House REIT decided to sell to TIS for JPY70 billion in March at a 3.3% cap rate. While it is officially designated as an office building, the buyer TIS is leasing the building in its entirety, using it as a data centre. In addition, Hulic and Digital Edge are reportedly developing a data centre in Nihonbashi, which is likely to have been redeveloped from an office building. Indeed, investors looking to enter into the Japanese data centre market will more likely find opportunities in similar local data centres, as compared to the hyperscale market which is much more competitive. Elsewhere, the broader data centre market keeps seeing large amounts of interest, and some investors have been successful in overcoming challenges in penetrating it. For instance, SC Zeus Data Centers has announced investing JPY50 billion into developing two data centres with a capacity of 50MW in Osaka, with the first slated for opening in 2027, and reportedly plans to lease and eventually sell it.

The data centre market in Japan is rapidly growing and expected to see considerable growth in upcoming years, with multiple large hyperscale developments in the pipeline, particularly in the Greater Tokyo and Greater Osaka area. While the market has potential to grow even beyond that, there are multiple constraints that will likely hinder this, especially in the case of hyperscale data centres. Firstly, land suitable for data centre development is scarce as there are various constraints pertaining to size and location. Next, the availability of power is a significant obstacle to overcome, as obtaining power can take two to three years to secure. Going forward, more investors, especially new ones, are likely paying closer attention to the local data centre market, which is comparatively easier to break into. At the same time, outside of the primary Greater Tokyo and Greater Osaka markets, land and power supplies are comparatively easier to source, possibly presenting development opportunities to investors that are able to partner with the right operator and have the risk appetite to look beyond established markets. Overall, with the expansion in foreign direct investment in digital infrastructure and communications technology, the data centre market will likely continue expanding.

#### Healthcare

Healthcare facilities for the elderly can broadly be classified into those that are run by public entities, and the privately owned and operated fee-based homes. However, according to a survey conducted by the Ministry of Health, Labour, and Welfare (MLHW) on social welfare facilities published in 2023, these two categories have seen different trends over the past few years; the number of private facilities (Rojin Fukushi Shisetu) on the decline, while the number of public facilities (Rojiin) has been on an increasing trend (Graph 17).

Indeed, healthcare assets have seen considerable interest from investors as Japan’s ageing demographics project steadily increasing demand, resulting in the rise of private facilities. Behemoth players have entered the playing field, with Nippon Life announcing the acquisition of Nichi Holdings, the owner of Nichigakkan, Japan’s largest nursing care provider. A

---

**GRAPH 16: Forecasted Data Centre Services Market Value by Service, 2023 vs 2027**

![Graph 16](attachment:graph16.png)

**GRAPH 17: Number of Healthcare Facilities in Japan, 2014 to 2022**

![Graph 17](attachment:graph17.png)

---

1 Comprising nursing elderly homes (Youro Rojin Home), low-cost elderly care facility (Keihi Rojin Home), and elderly welfare centres (Rojin Fukushi Centre).
operators are likely to stay profitable, and provide steady returns to investors.

Within the healthcare sector, high-end facilities have gained more traction. For instance, Mitsubishi Fudosan has six properties under its Park WELLSTATE brand, that has entry fees upwards of tens of million yen. There are only a fairly small number of healthcare facilities that can be considered to have luxury units, and the demand for such facilities is likely to increase as wealthy retirees that require healthcare tend to prefer to do so in comfort and amongst peers of similar stature.

Overall, the healthcare sector appears to have garnered high levels of interest from both domestic and international players. Nonetheless, there are hurdles for the sector as a whole. Firstly, the long-term fixed rent leases prevalent in the sector can be a double-edged sword, especially with noticeable inflation, and it may be difficult to raise prices to fully transfer the costs to the elderly that are likely reliant on savings and pensions. Likewise, changes in government policies regarding subsidies, tax incentives, and programs related to elderly facilities must also be taken into account. Furthermore, the performance of healthcare facilities can differ significantly depending on the operator. As of October 2023, public facilities were reportedly 89.3% full, while private facilities (excluding serviced residences) were 84.6% full according to the aforementioned MLHW survey. The ability of operators to overcome challenges such as the shortage of nursing staff and cost management will ultimately affect their business continuity. While the demand for healthcare facilities must continue to increase when considering Japan's ageing population, the number of facilities from a myriad of investors and operators is also likely to increase and heighten competition, meaning that the selection of the right operator will become an increasingly important factor going forward.

Student Housing
Interest in the student housing market has rekindled in the post-pandemic era, as international students return to Japan and more domestic students appear eager to live in places closer to school. This can be seen according to data from Kyoritsu Maintenance, a major student housing operator, which reported that occupancy in their student housing properties in September 2023 was at 98.2%, up 4.7ppts from the previous year. Furthermore, the number of new foreign national students saw a large increase in 2022, and 2023 figures look to surpass those of pre-pandemic times. Another major operator, JSB, has seen its number of rooms increase 5% yearly since 2023, with close to full occupancy, and other large operators have similarly been growing the number of managed rooms. As such, fundamentals for the sector appear strong.

According to a survey by Benesse Educational Research and Development Institute, the number of students living in dormitories appears to have been on the rise over the past decade, with 4.5% of students in 2016, compared to 3.3% in 2018, there was a dip to 3.4% in 2021 due to the pandemic. Student housing facilities face the strongest competition from studio apartments, which a vast majority of students appear to opt for when choosing to live alone. However, this is more likely due to the lack of suitable dormitories located close to campuses than a general preference, as there are strong appealing points for student housing, including lower upfront costs, the comparative ease of moving in and out, and being in a student community. International students in particular are often a target market for student housing facilities because many of them are likely to encounter problems in securing a traditional lease in the general residential market due to communication and or credit concerns.

A few sizable deals have been recorded by domestic investors. For instance, Advance Residence REIT acquired four dormitories for a total of JPY3.3 billion in Tokyo, Kanagawa, and Fukuoka at appraisal direct cap rates between 3.9% and 4.3%. Star Asia REIT acquired 49.9% of preferred equity of an SPC that owns a dormitory in Bunkyo at a 4.0% cap rate. However, the overall market is still relatively small, making deals more difficult to source, although interest remains somewhat heightened. Indeed, similar to healthcare assets, opportunities in the student housing sector are limited, leading to small transaction volumes. The student housing sector will likely see greater attention going forward in the post-pandemic environment, especially as international students returning to Japan provides a stronger backbone for the sector. Demand from domestic students could also rise in the future - Japan has a comparatively lower university participation rate of 62.1% compared to the OECD average of 76.3%, suggesting that there is considerable room for potential, especially with more females choosing to go to university over the past decade. Student housing appears to have some yield spread over general multifamily assets, and also have the defensive nature of the residential sector. However, the location of the property, specifically its proximity to school campuses, will be a crucial factor in determining the success of the property.

Next, the operator of the student housing will also play a big part, especially when catering and marketing to international students. Nonetheless, the sector is likely to continue growing especially as the government continues its push to increase the number of international students at Japanese universities.
OPPORTUNITIES AND RISKS

Opportunities
In the aftermath of the pandemic, all sectors in Japan have displayed signs of recovery in the past year. However, 2023 stands out as the most challenging in the last decade, marked by war, inflation, a high global interest rate environment, and pervasive uncertainty. Many major economies saw deals plummet to less than half from the previous year, though Japan managed to hold relatively well.

In 2023, substantial transactions have occurred across diverse sectors, encompassing portfolio deals in various parts of the country. The retail and office sector, too, witnessed a handful of significant transactions at approximately JPY70 billion. Amidst this activity, a divide emerges as some adopt a cautious, selective stance, while others perceive it as an opportune moment to seize deals that were previously out of reach. The market dynamic reflects varied strategies among investors in response to the evolving transaction landscape.

In Japan, inflation appears to have peaked, with expectations of stabilising around 1-2% next year. The interest rate environment in the US is calmed down albeit with “high” for longer, suggesting limited upward pressure on Japanese interest rates. We anticipate Japan’s long-term interest rate stabilising at 70-80bps. The Bank of Japan is likely to revise its monetary policy, leading to a modest increase of 20-30bps in short-term interest rates. Assuming this base scenario unfolds, the capital market is poised to digest this paradigm shift, as many investors seem to have already factored in this level of interest rate increment, propelling the market into the next stage.

Despite the likelihood of global economic slowdowns or recessions that could dampen real estate activity, Japan is undergoing transformative economic changes to resume “nominal” growth outlined in our “Japan’s Prospects Towards 2040” report. If these transformations materialise, propelling the Japanese economy to the next stage, there’s potential for renewed optimism in the real estate sector. The current high level of uncertainty contrasts with the prospect of positive shifts on the horizon as reflected in the bullish equity market. With this in mind, the points below represent some of our views on investment strategies for Japanese real estate.

Core and Core-plus
The enduring appeal of multi-family real estate persists, underscored by its resilience in maintaining a steady cash flow even amid the challenging landscape of the pandemic. A plethora of acquisition opportunities has emerged as numerous funds near the end of their lifespans. In the meantime, the continuous influx of fresh capital has snapped up opportunities. Noteworthy sectors such as student housing and healthcare facilities have emerged as desirable alternatives, albeit with significantly smaller scales.

Simultaneously, the logistics sector continues to be a coveted investment destination due to the strong mid-term fundamentals, notwithstanding imminent concerns related to burgeoning supply and escalating vacancy rates. That said, tenants within this sector grapple with wafer-thin profit margins and the looming spectre of inflation, on top of new regulations surrounding labour in 2024. Office attendance has experienced a noteworthy stability in 2023, signalling a positive trend in the business landscape. The substantial increase in office supply during the year has yielded encouraging signs. Notably, prime grade B offices endowed with high specifications continue to command premium rents, affirming their sustained popularity in the market.

Value-add
Urban retail shows promising potential for further expansion, driven by robust inbound demand. Another avenue for unlocking additional growth lies in repositioning these retail spaces to centre around entertainment, a strategic move that is poised to gain increased popularity.

Offices grappling with high vacancy rates could strategically optimise their space utilisation. Proactive approaches should prove themselves by filling more floors through thoughtful capital expenditure and a refined leasing strategy.

In this aspect, an ESG angle may work well: the shift from brown to green conversion, targeting easy wins. For instance, installing solar panels and enhancing insulation quality to improve energy efficiencies.

Opportunistic
The luxury or branded residence segment has emerged as a compelling avenue for exploration. This interest is heightened by the current subdued stock levels in this niche market. Tokyo witnessed the hugely successful debut of its first branded residence in 2023, courtesy of Aman Tokyo Residences. This landmark entry paved the way for additional participants in the market, signalling a potentially lucrative investment opportunity.

The allure of the hotel sector continues to persist for investors. The robust return of inbound tourism as well as the recovery of domestic tourism, have contributed to bettering the strong performances of pre-pandemic times. Especially, high-end tourism and any assets connected to this, as described our “Japan’s Prospects Towards 2040”, will benefit, including hotels, retail, resorts, among others. Ryokan and ski resorts could be strong alternatives.

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

Interest Rate Risks
A potential disruption to our main scenario looms if global inflation resurfaces, leading to a subsequent increase in interest rates. High interest rates may strangle economies, which could also exert additional upward pressure on Japan. Complicating matters, the Bank of Japan presently holds half of the country’s government bonds. While there is pressure to move interest rates freely to stabilise the yen and inflation, the prospect of increased rates poses a significant strain on the government’s budget, given the escalating debt repayments. The sustainability of such high levels of debt and government deficits is a looming concern.

Geopolitical Risks
Amidst escalating tensions in economic and diplomatic relations between the US and China, coupled with concerns over potential hostilities surrounding Taiwan, the global landscape is rife with uncertainty. Concurrently, geopolitical unrest in Ukraine and chaos in the Middle East amplify these concerns, and some may view these events as harbingers of World War III. The high level of uncertainty has the potential to impact even stable nations like Japan.

Natural Disaster/climate Change
Japan is notoriously susceptible to a range of natural disasters, and the increasing influence of climate change on global weather patterns has heightened concerns. Beyond the perennial threats of earthquakes, tsunamis, and volcanic eruptions, Japan faces the added challenges of more frequent and intense typhoons, flooding, and heatwaves, which have become more prolific in recent years.

For more information about this report, please contact us

Savills Japan
Christian Mancini
CEO, Asia Pacific
(Ex. Greater China)
+81 3 4330 3611
cmancini@savills.co.jp

Savills Research
Tetsuya Kaneko
Managing Director, Head of Research & Consultancy, Japan
+81 3 4330 3103
tkaneko@savills.co.jp

Simon Smith
Regional Head of Research
& Consultancy, Asia Pacific
+852 2842 4573
simon.smith@savills.asia