SPOTLIGHT
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ESG in Japan Real Estate

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ESG sees rapid proliferation in Japanese real estate

Summary

- ESG has gained traction in the real estate industry as both investors and prospective tenants have recognised the growing importance of ESG integration.
- Existing properties, especially older ones, have a narrower range of feasible actions that can incorporate ESG initiatives, and investors need to understand what options are realistically available.
- Major initiatives in offices, the largest commercial sector, include incorporating renewable energy systems and using timber as the primary structural material.
- The residential sector has seen net zero energy house (ZEH) condos increase in popularity. Some investors have also turned to more niche sectors such as healthcare facilities and student housing for socially responsible investments.
- The retail sector has pursued ESG goals like implementing energy and water conversion systems, and creating social spaces that support local communities.
- In addition to initiatives involving the usage and generation of renewable energy, large brand new logistics facility campuses are being designed as towns to be integrated into the community that provide a range of services.
- Although many hotels are still suffering from the pandemic, some have seen environmental and social initiatives on a manageable scale. HR related initiatives are also likely to accelerate as many hotels start to recruit new staff.
- Going forward, the dichotomy between "green" and "non-green" assets will likely become more apparent, impacting valuation and pricing within a few years.

INTRODUCTION

ESG has commanded a growing amount of attention as governments and companies seek to embrace worldwide expectations pertaining to environmental, social, and corporate governance issues. At a national level, Japan has announced plans to achieve net-zero carbon emissions by 2050. The Japanese real estate sector has also seen increasing demand for properties that have an ESG focus. While major listed vehicles have been years ahead on ESG initiatives because of the growing pressures from institutional investors, many other players in the industry, particularly those involved in the private and hard assets sectors, are rapidly catching up.

Before the pandemic began, ESG was a secondary consideration in the real estate industry, especially within the investment community. This is partly because the scope of ESG initiatives is rather limited for existing buildings, especially at the typical ages of buildings that are often traded, given the fact that the expected costs to implement them outweigh the economic benefits in many cases. However, it has since gained traction and has become an essential component to be integrated into a holistic real estate strategy.

Currently, most new ESG initiatives focus on environmental aspects, specifically reducing carbon footprints by lowering energy consumption and using renewable energy. Major developers with their own ESG goals have been very active in these initiatives and have built energy efficient facilities across different sectors. As such, the stock of environmentally-friendly buildings has been gradually increasing. Some initiatives on social aspects have also been observed in the market with notable examples in the logistics sector. For instance, some logistics facilities feature amenities such as child-care services, open parks, and wellness areas. Since the logistics sector faces fierce competition for labour, having these amenities will help to improve the competitiveness of properties.

Indeed, both investors and prospective tenants have realised the importance of becoming ESG-focused in today's economy. Real estate that performs well on ESG metrics is likely to be valued at a premium within a few years as systems in the industry are being revised to reflect ESG metrics. For instance, RICS has issued new guidance about how sustainability should be taken into account when valuing commercial property, which could result in real estate assets that emit more carbon having a lower valuation. However, ESG metrics do not presently appear to be fully reflected from an economic standpoint. The opportunity for prescient asset managers and investors is to look for opportunities to rebalance their portfolios with these factors.

At the same time, given the increased scrutiny on company ESG policies, prospective tenants are likely to become increasingly selective and look for facilities that will help reduce their carbon footprint and energy consumption, especially in the case of high-grade buildings. In response to this heightened demand, and to ensure that portfolios remain future-proof, a number of expedited initiatives and development

activities related to ESG from developers across multiple sectors have seen progress.

This report will discuss these initiatives and projects, in addition to how investors can incorporate ESG into their existing and new investments.

ESG initiatives have rapidly gained traction, and new features and practices are emerging across all sectors. However, ESG metrics do not presently appear to be fully reflected from an economic standpoint yet. Hence, prescient asset managers and investors may be looking for opportunities to rebalance their portfolios with these factors in consideration.

CURRENT ON-THE-GROUND WORK FOR EXISTING BUILDINGS

While newer and upcoming properties are able to take advantage of the newer technologies available and can ensure that initial designs to adhere to ESG standards, owners of existing buildings will find it much harder to incorporate ESG initiatives. Some buildings, especially older ones, might be perfectly functional from a leasing point of view, but concurrently run the risk becoming increasingly obsolete or face expensive retrofits. Such buildings may have a limited pool of potential buyers, consequently capping their property value at the time of disposal. It is important for investors to understand the range of options that can help them keep up with the new ESG norm, as meeting more sustainability criteria should equate to more opportunities, especially for funding.

As a first step, property owners could commission a comprehensive energy audit or seek green building certifications, such as the Global Real Estate Sustainability Benchmark (GRESB), or upgrade existing ones to improve the building's standings. There are also several Japanese certifications, such as the Comprehensive Assessment System for Built Environment Efficiency (CASBEE), which may be more beneficial in some cases. While obtaining such certifications would be a step in the right direction, a large number of costs may be involved. For instance, understanding the feasibility of such projects alone might incur expensive consulting fees, not to mention the costs of making upgrades to the property itself.

Once energy-use data has been collected and analysed, owners can consider what improvements can be prioritised. Some physical improvements that could be made to the property from an energy-consumption point of view include installing LED lighting, or upgrading heating, ventilation, and air-conditioning systems. Owners should closely analyse energy utilisation as well as their income statements and observe how efficiently energy is consumed to see what improvements would make sense from a financial standpoint in the long run. In addition, a monitoring system could also be installed as a way to keep track of energy consumption from different functions. Professional advice could be sought to help understand the

Table 1: Major Japanese Real Estate ESG Certifications

CERTIFICATION NAME	ABBREVIATION	YEAR OF ESTABLISHMENT	CRITERIA	RATING SYSTEM
Development Bank of Japan Green Building	DBJ Green Building	2011	Evaluation in accordance with five ESG perspectives	Ratings range from one to five
Comprehensive Assessment System for Built Environment Efficiency	CASBEE	2001	Evaluation of environmental performance and built environment	Ratings range from one star (C rank) to five stars (S rank)
Building-Housing Energy-efficiency Labeling System	BELS	2013	Evaluation of energy consumption efficiency	Ratings range from one star to five stars

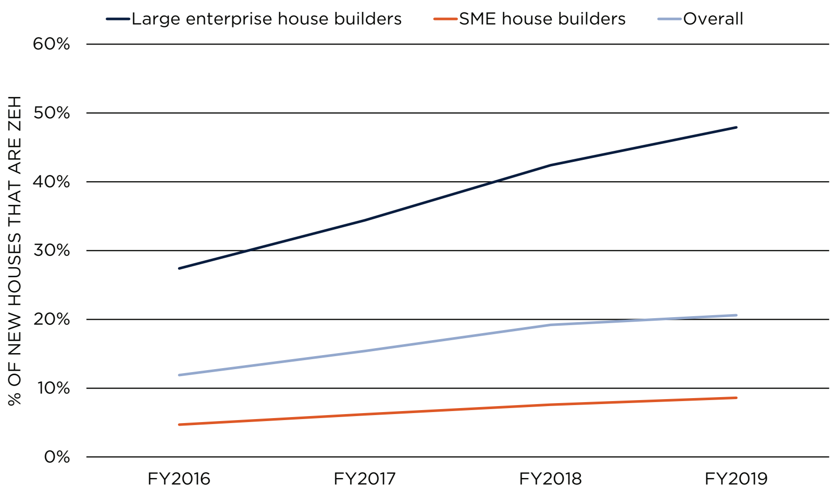
Source Development Bank of Japan, Institute for Building Environment and Energy Conservation, Jutaku Seino Hyouka Hyouji-Kyoukai, Savills Research & Consultancy

Table 2: Overview of ZEH

WHAT IS ZEH	Net zero energy house
DEFINITION	A house with an annual net energy consumption of around zero
AUTHORITY	Agency for Natural Resources and Energy (part of METI)
TARGETS	All newly built houses to be ZEH on average by 2030
NUMBER OF REGISTRATIONS	Around 7,600 (As of November 2020)

Source Ministry of Economy, Trade and Industry, Savills Research & Consultancy

Graph 1: Percentage of New Houses Constructed that are ZEH, FY2016 to FY2019



Source Ministry of Economy, Trade and Industry, Savills Research & Consultancy

potential to increase the property's overall value and make it easier to sell to ESG-conscious investors.

Buildings typically undergo large-scale renovations to maintain and upgrade overall conditions around every decade, or post-acquisition. During these renovations, owners could use the opportunity to implement initiatives like using recycled material to improve the exterior and interior. Other areas that could see improvement include the creation of green spaces, especially if the floor area ratio of the building is low. The installation of solar panels could be a good initiative even if it does not make economic sense on a stand-alone basis. Indeed, such initiatives would check certain green boxes, which might help in obtaining funding for similar projects. Introducing sharing services such as bicycles to improve micro-mobility and increasingly integrate the community could also be considered. Overall, existing buildings still have options to implement ESG-related initiatives that could potentially increase the value of the property, although the difficulty and costs may be higher for older properties, particularly those significantly more than 20 years old.

INITIATIVES FOR OFFICES

Offices represent the largest commercial sector, and serve as a front for developers to demonstrate their ESG initiatives due to the prominence of office buildings in city centres and the amount of traffic they see. For instance, Mitsubishi Estates announced that they will have installed renewable energy systems in more than 40 of their office buildings by FY2022. In doing so, 50% of its electricity will be generated using renewable power. Another example is the Tekko Building that became the first large-scale office building to run on 100% renewable energy at the start of 2021.

In Minato, Mori Building, a long-time proponent of sustainable design, has been incorporating it from the initial design phase in many of their buildings since the late 1980s. For example, its previous projects such as Toranomon Hills Business Tower, Toranomon Hills Mori Tower, and ARK Hills Sengokuyama Mori Tower all have energy conversation systems and solar power generation built into their façade. Their urban planning designs that incorporate "vertical garden cities" also allow for significantly reduced carbon output, more amenities, and space for museums, cultural exhibits, community workshops and events to promote the importance of sustainability. These features have not only allowed nine of their buildings to acquire the S-rank CASBEE Certificate, but also serve as a lure to tenants and visitors, increasing the demand for such buildings.

Another initiative is the introduction of office buildings that are built using timber as the primary structural material. Over the past few years, many hybrid-wood buildings utilising domestic timber and recycled wood have been announced, further emphasising the importance of sustainability and supply-side accountability. For instance, Mitsui Fudosan is planning to build a 17-story wood-frame office in the Nihonbashi area with Takenaka Corporation, forecast to be completed in 2025 and will be the tallest wooden building in Japan. In 2018, Sumitomo Forestry unveiled a proposal for what is expected to become the tallest wooden skyscraper, at 350m, scheduled for 2041. The increased use of sustainable timber as an environmentally friendlier refurbishment option may become increasingly prevalent and more widely used in existing properties for large renovations.

Overall, the office sector has seen a myriad of initiatives pertaining to carbon reduction and creating community spaces led by major developers and players. The innovative measures implemented have garnered interest and prospective tenants. Such initiatives may also be seen from other players before long as such practices become a norm in the industry.

INITIATIVES FOR RESIDENTIAL

The residential sector was one of the earliest to observe ESG-related initiatives. In 1992, photovoltaic cells that could be practically installed on individual homes and a system that allowed the surplus electricity produced to be sold back to energy companies were introduced. Presently, the Ministry of Land, Infrastructure, Transport, and Tourism (MLIT) aims to have all new residential housing meet ZEH[1] standards by 2030, driving many developers to shift their focus to such condos. The heighted levels of environmental consciousness amongst younger buyers and the potential energy savings are likely to gradually increase the interest levels toward ZEH condos.

Major players can be seen responding to this trend. Sumitomo Realty and Development, which accounted for over 7% of the condo supply in 2020, announced that condos developed in the future will all have a ZEH-oriented standard. Nomura Real Estate, which accounted for 6%, also has ZEH condos in the pipeline and will introduce initiatives such as the installation of fast electric vehicle chargers in condo parking lots. These initiatives will go a long way in ensuring that the supply that these companies provide is ahead of MLIT's 2030 target.

Loans on ZEH condos come with tax rebates, and this has contributed to an increase in demand for such properties. For example, Sohgoh Real Estate sold all 80 ZEH units in its development Lune Ageo within four months of going on sale in April 2021. While ZEH rental properties have not seen the same increase in popularity because tenants still appear unwilling to pay the premium for such units, some solutions for this predicament have surfaced. For instance, Orix Bank is providing lower interest rates loans to investors who purchase ZEH condominiums from Urbanet Corporation within Tokyo.

1 ZEH stands for net zero energy house

Developers have also turned to value-add options like refurbishing their existing stock. For instance, Comforia Residential REIT (CRR), sponsored by Tokyu Real Estate, has obtained Development Bank of Japan Green Certifications for five of their properties (approximately 20% of total GFA), and plans to continue acquiring one or two certifications per year. CRR has also issued Green Bonds with the intent to refurbish buildings and effectively expand their inventory of ESG-oriented properties.

Some investors have also turned to healthcare facilities and student housing that provide social benefits and contribute to the overall economic health of the region, although they are still niche sectors that are fragmented. Overall, ESG-focused players may have the upper hand in acquiring assets because some sellers, especially owner operators who are typically well-known within local communities, might feel more comfortable selling their assets to socially responsible investors. Increasing levels of consolidation might be observed in the healthcare sector once this trend gains momentum.

These movements by developers to stay ahead of future regulations will help raise greater awareness of the importance of ESG, and transform it into a norm in the market. A growing supply of residential units with similar ESG specifications can be expected.

INITIATIVES FOR RETAIL

Retail developers have made progress in promoting social aspects of their properties and to reduce their carbon footprint against the backdrop of growing environmental consciousness from consumers and tenants. There have also been notable investments to upgrade current retail stock, adding value and reducing energy costs. These initiatives to retail spaces have garnered visible support from local governments because such spaces play an important role in creating a hub where people can gather and foster the local community.

One of Japan's largest retailers, Aeon, has been active in pursuing ESG goals. It has committed to powering its more than 160 shopping malls with 100% renewable energy by FY2040 through directly purchasing from clean-energy producers, generating solar power, and is also considering offsite solutions such as acquiring land to produce other forms of renewable energy like wind and biomass. Aeon has also integrated this initiative into the community by allowing nearby residents to receive shopping points in return for supplying surplus electricity generated from residential solar power systems. From a social aspect, Aeon has begun introducing the AEON Yume-mirai Nursery School, which provides 365-day childcare services to Aeon employees, tenants, and the local community during the operating hours of the shopping centres that they are located within. To date 21 of their malls reportedly already have these services. Projects such as these should spark a wider range of initiatives among developers and investors when looking on how to strengthen their ESG progress.

PARCO, a large retail building operator, has also been making investments into their current properties by installing energy conservation systems, water conservation sensors and cooling units that utilise the air from outside instead of air conditioning. Indeed, Chofu PARCO became the first ever shopping centre facility in Japan to obtain the Eco Mark certification in early 2021, and Kichijoji PARCO has been certified as a Musashino City Eco Partner, showing the push being made by local governments to raise the business appeal and environmental standard of their retail space. Social initiatives like incorporating incubation facilities in various malls to promote innovation can also be seen. In addition, Shibuya PARCO has also held events for social causes and community festivals such as the Shibukaru Festival and Shibuya StreetDance week.

These ESG innovations by developers have set a new standard for properties, and other players have started to react. Asset manager Kenedix has been installing LED lighting and solar panels in many of its shopping centres in Japan. In fact, the solar panels installed at three of its properties have a capacity of more than 650 kW, and in one year produced enough energy to power more than 200 homes in Japan for a year. They have also greened many outdoor areas, which serve to both regulate outdoor temperatures as well as provide a relaxing façade.

Overall, these moves will ensure that their properties will help the sector continue to retain value and grow. While the retail sector has seen its popularity dim somewhat even before the pandemic, ESG initiatives may provide an avenue for investors, especially strategic ones, to seek additional value. Indeed, as long as the pandemic remains manageable, we are likely to see the retail sector recover. In turn, we should see increased activity by potential buyers and tenants looking to capitalize on the recovery and their ESG goals.

INITIATIVES FOR LOGISTICS

In order to keep up with the growing e-commerce industry in Japan, the logistics sector has seen a large influx of supply in recent years, and record levels of supply are forecast for both 2022 and 2023. With the increase in green certifications, this also means that more green-certified properties will be available in the market.

In addition to the environment, the wellness of workers and social engagement is an important theme especially in the logistics sector, which is affected by chronic labour shortages. In order to attract more labour, some developers have designed logistics facilities with a strong social aspect, which may also increase the value of the property from an ESG perspective.

Major developers such as GLP have gone to lengths to design their logistics facilities to resemble a town. For instance, their ALFALINK Nagareyama campus, which has eight logistics facilities planned, features amenities like child-care services, open parks, wellness areas, and event spaces. With these additional services and benefits that the logistics campus provides, it could become a hub for the local community and make its presence more welcomed by residents. Moreover, these features will also make it easier to attract and retain workers. Other developers have also introduced similar initiatives, planning their logistics facilities with an urban design that integrates it into the community. This helps to give their facilities a competitive edge over others and provide added value to their tenants.

Certain environment related ESG initiatives have also seen an increase in popularity as tenants are also keen on the potential energy savings that could reduce operational costs. For instance, the Yatomi Distribution Center being developed by Hines, a new player in the Japan market, will reportedly have renewable on-site power generation, water reclamation, and other energy optimising systems. Mitsui Fudosan Logistics Park has also been making upgrades into their facilities by installing solar panels and LED lights. All these initiatives and improvements help ensure the continued value of these facilities and provide investors greater reassurance.

At the same time, some areas may experience difficulties in attaining ESG goals. For instance, the data centre sector that has gained increasing interest amidst the pandemic. While there have been initiatives to make improve the energy efficiency of data centres, they will still consume extremely high amounts of electricity. As the importance of ESG initiatives permeates the industry, data centres are likely to come under increasingly greater levels of scrutiny. Future data centres may therefore require additional capital invested into research and upgrades to boost the sustainability of such facilities.

The demand for logistics facilities with an ESG-focus will continue growing. Indeed, the social benefits that these facilities can provide to their community and employees will likely help to attract more workers in the tight labour market, effectively killing two birds with one stone. As the supply of logistics facilities continues to grow, both investors and tenants may become increasingly selective and mindful of the ESG-related initiatives.

INITIATIVES FOR HOTELS

The hotel sector has suffered the most during the pandemic due to the plummet in tourism and restrictions that effectively cut off other revenue streams like events and banqueting. Many hotels were struggling to keep afloat, and would not have had the financial leeway to make extensive investments into ESG. It might also be difficult to transfer the costs of such upgrades to customers, especially when there are many other options available for guests to choose from.

Nonetheless, some hotels have made efforts to implement cost-effective environmental initiatives on a manageable scale. For instance, Japan Hotel REIT has made moves to switch to LED lighting, water-saving devices, and has also introduced green lease agreements. Energy data is also requested from its lessees to help decide on what other renovations to make in order to improve energy efficiency. Hankyu Hanshin has also sought to eliminate single use plastics, encouraging customers to reuse linen to save water, and implemented food waste recycling programs. Some hotels are also making progress to further integrate themselves into the community with social initiatives. For instance, Invincible REIT has had some of its hotels designated as tsunami evacuation centres. It has also increased its interaction with communities by using local produce in food procurement, and supports local activities and festivals. Elsewhere, Hoshino Resorts has introduced wellness programs like better work policies and more benefits for those on childcare leave and career comeback programs. Such initiatives should also benefit hotels that had to lay off employees during the pandemic and are now facing a shortage of workers.

International luxury hotel brands have also made steps in expanding ESG initiatives by incorporating them as brand standards. For instance, Marriot and Hilton have plans to ensure that all their properties globally will have a sustainability certification, and have issued yearly reports to investors about the progress of their ESG initiatives. In the case of luxury hotels, ESG initiatives could serve not only as a way to reduce energy and water costs in the long-term, but more importantly, as an important marketing tool that reinforces the hotel's brand with sustainability. While, some guests might be unwilling to pay a premium to stay at "green" hotels, they might also look to avoid environmentally unfriendly ones. The importance and value added by brand standards are likely to grow and become critical in the Japan hotel market.

As more international brands are expanding their footprints in Japan and the hotel market recovers from the pandemic, other initiatives that could be seen include the introduction of human resources (HR) polices that cater to fostering stronger corporate governance as well as change to streamlining the recruitment processes. For instance, the promotion of diversity, equity, and inclusion (DEI) in the workplace has gained international attention, and should also serve to help attract talent in the industry. In addition, robust data management has become increasingly important. Japan has amended its privacy laws to be close to those of the EU's General Data Protection Regulation (GDPR), and the hotels could ensure that their policies are properly in line to provide greater levels of assurance to customers and clients. Overall, hotels should see growing interest toward conforming with ESG practices, especially as the impact of the pandemic fades and the industry recovers.

OUTLOOK AND IMPLICATIONS FOR ESG

ESG has gained traction as an essential consideration when developing and investing into real estate, and the number of ESG initiatives in the industry has proliferated. However, the heterogeneous nature of real estate means that the implications will vary from sector to sector.

While the office sector has seen ESG initiatives such as generating electricity with renewable energy, this is more true for investment grade offices. On the other hand, some lower grade offices, especially older ones beyond Tokyo, may have fewer avenues for similar plans, and thus attract fewer buyers. Indeed, major cities beyond Tokyo, even Osaka, have seen a limited number of newer offices during last two decades, which means that the ESG initiatives that new buyers can consider are likely to be narrower in scope. However, this could also be an opportunity for investors who are more flexible and focus primarily on commercial aspects.

In the residential sector, more investors may engage in development or forward commitment. Acquiring brand-new, ESG-compliant properties is becoming an increasingly valid investment option for ESG-minded investors, and investors could avoid fiercer competition for acquisitions via developments or forward commitments. In addition, more investors may look to overcome hurdles in entering the healthcare facilities market, and owners may thus have a larger pool of buyers that they would feel comfortable disposing the asset to. Consequently, more transactions may be seen because of the increase in the number of socially responsible investors. Currently, the healthcare market is so fragmentated that most assets are owned by well-known families in local communities. ESG initiatives may change this situation and transform the market into one with a stronger institutional presence.

The retail and logistics sectors have seen social initiatives that aim to integrate facilities into their communities. Such properties are likely to attract strategic buyers who are able to value such assets holistically, and may give them an advantage during acquisitions. With this in mind, transaction volumes in quiet retail space may increase.

Many hotels in Japan are of 20 to 30 years of age, suggesting that there is a large pool of hotels that are physically able to conduct upgrades but are lagging behind in ESG implementation. As the hotel sector gradually recovers from the pandemic, many hotels could look to make swift transitions toward investing in ESG. In the meantime, some hotel segments, such as lifestyle, are likely to become increasingly integrated with ESG.

Overall, an increasing number of ESG initiatives can be expected going forward as its importance gains traction amongst investors. However, while newer buildings are more likely to have designs that cater to modern ESG standards, some older buildings may face difficulties in upgrading and consequentially fail to reach ESG requirements. The dichotomy between "green" assets and "non-green" assets is likely to grow, but at present, ESG metrics do not appear to be fully reflected from an economic standpoint. For this reason, forward thinking asset managers and investors may be looking for opportunities to rebalance their portfolios with these factors in consideration.

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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

Sam Crispin
Regional Head of Sustainability & ESG, Asia Pacific
+852 2840 4723
scrispin@savills.com.hk