COVID-19 and Japan Property

Savills Research

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MARKETS ON HOLD
With the world gripped by the COVID-19 pandemic, governments are scrambling to assess disease prevalence and apply stringent containment measures that limit physical interaction – essential for saving lives, but catastrophic for the economy as global business activity is effectively put on pause. The international investment community has naturally responded with a massive selloff of all liquid assets, and Japanese markets have been no exception, with sentiment being further dampened following the postponement of the 2020 Olympics. Given the nature of hard assets, property performance and the resulting valuations have yet to reflect the COVID-19 shock – but market players are bracing themselves for impact.

Indeed, as a black swan event for which few in the investment community might have accounted, investors must now revisit their assumptions and assess their global positions. Within the Japanese property market, at present, nearly all rumoured transactions appear to have been suspended or postponed. Unlike the previous crisis, sellers and owners have, for the most part, a solid financial standing. As such, excluding holders of hard-hit hotels and retail assets that may breach covenants, owners have no need for a fire sale.

Summary
• With the economy already under pressure following the consumption tax hike of October 2019, the COVID-19 crisis has created a perfect storm for Japan. The one-year postponement of the Tokyo Olympics has further dampened market sentiment for 2020, though it is far more welcome than an outright cancellation.

• Cap rates across sectors other than hospitality and retail should hold in place for the time being as transaction activity comes to a halt.

• Compared to other nations, Japan has less exposure to overseas demand including trade and inbound tourism, lending some insulation from border closures.

• Listed Japanese firms hold JPY500 trillion in cash and cash equivalents, whilst households are less indebted than during the lead up to the global financial crisis, and less so compared to international peers.

• The sectors with the most resilience to the COVID-19 pandemic, in order, are 1) residential, 2) logistics, 3) office, 4) retail, and 5) hospitality.
With the Tokyo Olympics in sight, Japan entered 2020 with high hopes and sound fundamentals. Sadly, the COVID-19 pandemic has dashed these hopes and presents a major challenge to the domestic property market. Certain sectors are better positioned to weather the storm, however, and frugality among Japanese corporates and households should offer an additional buffer to the domestic market.

Certain investors, particularly domestic ones, still appear interested in acquisitions; however, they appear to be seeking deeply discounted opportunities, for instance, with a 15% wider cap rate than before. This has led to a lack of compromise on pricing, as most owners have no urgency to sell. International investors, on the other hand, have put overseas transactions on hold. Indeed, worldwide travel restrictions are preventing them from physically inspecting assets, halting the due diligence process in its tracks. This trend is unlikely to shift anytime soon and is not inconceivable to persist months after the pandemic has started to recede.

While travel restrictions might present a physical roadblock to investment, the shock to the capital markets could shift the buyer landscape and open more opportunities to overseas investors. The J-REIT market saw a significant correction after mid-February, with the TSE REIT Index plummeting almost by half towards mid-March. Although the index has since recovered somewhat, it remains over 30% lower than before the COVID-19 shock.

Unit price/NAV and property purchasing power have been reduced accordingly, likely putting a damper on acquisition activity this year.

Given that J-REITs have recently been active buyers, accounting for approximately 30% of market transactions, their now limited purchasing power should pave way for much-awaited opportunities for other investors who have previously struggled to acquire properties in a very competitive acquisition market. Indeed, private real estate, pension, and sovereign wealth funds still hold a historically high level of dry powder to deploy. For that reason, these investors are likely to grow their clout this year as cash reclaims its throne in the COVID-19 world.

CAP RATES FREEZE...FOR NOW

With essentially no transactions being closed, there are no real benchmarks by which market players can judge “actual” property values in the current environment. As a result, cap rates are, for the moment, frozen in place. Moving forward, appraisal reports are likely to show cap rates that are somewhat looser, though not to the extent that property values decline so drastically as to cause breaches in lending covenants.

Lending attitudes have become more reserved, but windows are still open for certain assets and asset types, especially in the residential, logistics, and office sectors. Assumptions on rent increases and leverage have been adjusted to a more conservative level, however. With Japan’s fiscal year commencing in April, lenders may use this opportunity to adopt more conservative strategies.

Meanwhile, most asset owners, other than those with hotels and retail properties, can maintain a wait and see approach while continuing to collect rental income. Hard-hit hotels and retail properties will likely face immediate rent adjustments and thereby see cap rates change more rapidly. Office, logistics, and multi-family rents should stay relatively flat for the time being, as rents are fixed during the contracted period, providing a layer of protection for cash flows. Hence, it is likely that actual property values will not fluctuate much, at least until the end of the year. That said, lower-quality properties may face issues sooner given that the tenants are generally less creditable.

OVERSEAS EXPOSURE MORE LIMITED THAN IT IS PERCEIVED

Although the Japanese economy is far removed from the spectacular growth of the 80s and even from the recent growth of the world economy, it is still one of the most stable in the world. Some still believe that Japan is highly export oriented and, as such, COVID-19’s disruption of global supply chains could damage the Japanese economy disproportionately. Yet, in truth, Japan is more similar to the U.S. in that domestic demand dominates economic activity: trade accounts for only around 35% of GDP, among the lowest in the world. This misconception may come from the Japanese public equity market where, compared with other countries, multiple large manufacturing companies with sizable market caps have an outsized weight among major indices.

Similarly, while inbound tourism has been a major boon to the Japanese economy, serving as an important growth catalyst since 2013, it remains a small part of total economic activity in Japan, with hoteliers and retailers relying primarily on a stable base of domestic demand to support their businesses. Specifically, inbound tourism still accounts for less than 1% of Japan’s GDP and less than 20% of total nights stayed in its accommodations, while inbound retail accounts for a mere 1% of total retail revenue (Graph 3).
WHEN FRUGALITY PAYS DIVIDENDS

Japan’s exceptionally high level of government debt is well known. However, the story is quite different when looking at companies and households.

Listed Japanese firms hold more than JPY 50 trillion in cash and cash equivalents, an amount that is essentially equivalent to the country’s annual GDP. For perspective, U.S. firms hold around USD4 trillion in cash, or around 20% of annual GDP. Japan Inc.’s rampant cash hoarding, marked by modest overseas investors; however, this strategy has enabled Japanese businesses to be well-positioned to weather this crisis. Households have been similarly frugal over the past decade, with the debt-to-GDP ratio among Japanese families generally declining since the global financial crisis (Graph 4).

Despite these financial buffers among companies and households, the timing of the COVID-19 crisis has created a perfect storm for Japan. Indeed, with the nation still reeling from the consumption tax hike enacted in October, the already-fragile Japanese economy looks certain to head into a technical recession - and possibly worse. Further, unlike during the global financial crisis, there appears to be no nation that still has sufficient firepower to drive a global economic recovery.

THE IMPACT TO JAPANESE PROPERTY

In the case of Japan, we believe the sectors with the most resilience to the COVID-19 pandemic, in order, are 3) residential, 2) logistics, 3) office, 4) retail, and 5) hospitality. Considering local market practices, we believe that only the hospitality and retail sectors should experience immediate negative impacts. These sectors are most susceptible to government containment policies, including travel restrictions, and social distancing guidelines, and some hotels and retail property owners have already received rent reduction requests from struggling tenants. Unlike in Western countries, there are at present no legal moratoriums on rent payments. The government has instead requested that real estate owners consider a flexible response to accommodate struggling tenants. That said, some lawmakers are considering legally-binding measures.

Investors should now focus on asset management while assessing the impact of COVID-19 and rethink their investment and portfolio strategies. In the short-term, managing tenant relations and maintaining rents at an appropriate level should be the primary concern of owners. Thereafter, some may want to consider adjusting asset type allocation to a more defensive mix. In these testing times, the quality of the underlying assets as well as the creditworthiness of tenants matters more than ever. Those unable to satisfy these conditions are therefore expected to suffer disproportionately.

The property markets are ultimately linked to economic fundamentals, and current prospects for global economic growth appear daunting. Double-digit quarterly contractions in GDP appear inevitable in many parts of the world, and a short-term recovery scenario is unlikely. Equity and credit markets appear to have calmed somewhat, but the violent volatility observed during March may return. To wit, major economic indicators expected to suffer disproportionately.

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OFFICE

The office market entered 2020 with promising prospects, which will now more than likely prove to be short-lived. Yet, all things considered, Grade A and B office markets in Tokyo both saw impressive rental growth over 2019, whilst maintaining extremely low vacancy. Many regional markets have proven to be similarly robust over the past two years. With office demand largely tracking economic growth, however, office fundamentals are likely to deteriorate as the economy weakens, albeit with a delay of at least a few months to a half year.

Encouragingly, well over 95% of office supply in 2020 has been filled or pre-leased and supply in 2021 and 2022 is low, helping the market remain stable. With vacancy rates already at record lows, tenants have limited options if they did decide to move, and for that reason, landlords would be justified in keeping rents unchanged. Moreover, with the requirement to provide advance notice if they do decide to leave, the tangible impact of tenant relocations could take up to six months to emerge, adding to market stability.

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What’s more, amid a previously buoyant market, with fierce competition for space, financial incentives such as rent-free periods were limited. Landlords therefore would most likely prefer to offer these incentives to prospective tenants before allowing vacancies to rise. Hence, rents should stay flatish before vacancy goes up. On the other hand, this somewhat optimistic scenario may not apply to lower-grade buildings – where our coverage is limited – accommodating lower-grade buildings, some of which may be financially vulnerable and may soon need to seek rent reductions or shrink leased floor areas. With governments across the globe approving or enforcing self-isolation, the

GRAPH 4: Household Debt To GDP Ratio Among Major APAC Markets, 2006 to 2018

![Graph showing Household Debt To GDP Ratio Among Major APAC Markets, 2006 to 2018](source: International Monetary Fund, Savills Research & Consultancy)
requirement to work remotely is likely to shape tenant preferences even after the pandemic recedes. Indeed, those who had indicated a desire to expand leased floor space before the COVID-19 outbreak may change tack as the current turmoil weighs on demand for workforce.

Moving forward, there should be cases of companies shrinking office space by maintaining some remote working practices, or setting up satellite offices closer to residential areas such as Omiya, thereby creating new opportunities for market participants. Centrally located co-working spaces, in contrast, should lose some of their appeal as a result of these demand shifts, but co-working spaces closer to residential areas should be able to capitalise.

RESIDENTIAL

The multi-family residential sector stands as the most resilient in the face of the current crisis. Solid rental growth was observed in most submarkets in Tokyo in Q1/2020 and, so far, fundamentals have appeared sound.

To be sure, the residential sector is certainly not immune to this ongoing uncertainty. Corporate activity has slowed, with labour demand falling as a result. There have even been cases of soon-to-be university graduates having job offers rescinded by smaller companies, emphasising the uncertain market conditions ahead. Coupled with stubbornly low wage growth, as evidenced by the lower salary hikes than demanded in the annual spring negotiations (whereby increases in salaries are negotiated between companies and their respective unions), the affordability of current rent levels will be tested.

Despite the pessimism, it is important to keep in mind the defensive nature of the residential sector through times of stress. For instance, the sector held up relatively well even after the global financial crisis – rents adjusted by approximately 10% and occupancy remained stable in the subsequent years. Furthermore, firms have hitherto faced prolonged labour shortages, and are therefore likely to reduce other expenses before turning to workforce redundancies.

More broadly, the cash reserves of Japanese firms serve as a strong reserve to help weather the COVID-19 storm, and this additional firepower should mitigate layoffs, pay cuts, and bankruptcies, thereby providing another layer of protection to the residential sector. Considering the above, therefore, rental growth, if any, is expected to be moderate, at least until the impact of COVID-19 becomes more apparent.

Looking further ahead, residential unit preferences may change if a substantial number of companies continue some form of remote work and/or flexible working hours after the pandemic subsides. Having impetus to spend more time at home may prompt residents to prioritise larger spaces with better amenities as opposed to proximity to train stations, a feature that is highly-valued outside of Tokyo’s central five wards. Conversely, COVID-19 may deliver a blow to the emerging co-living and share house subsector, as convenient locations and social environments may lose some of their lustre.

RETAIL

Although Japan has yet to implement a strict lockdown, caution among residents has been high since February, with many avoiding crowded commercial centres. According to Google, as of late March, footfall in retail and entertainment properties in Tokyo has fallen by over 60%. These numbers are likely to fall further in April and May as the government steps up restrictions to further limit business activity and the movement of people.

This sharp decline in footfall has unsurprisingly hit retail revenues. For instance, Renown, a major apparel retailer, recorded a drop of over 40% in its March store sales. Meanwhile, Saizeriya, an Italian restaurant chain, marked a 20% decline – the largest decrease in a decade. The break-even point of the food service industry is said to be approximately 90% and, as such, the pandemic is a catastrophic blow to this industry.

Department stores, many of which had already been in a fragile state, are among the hardest hit subsectors of the retail market. Major department stores showed a 30-40% decrease in their March sales. Duty free sales – previously the best performing segment – have plummeted by over 90%. On the other hand, supermarkets, convenience stores, and drug stores are faring well thanks to growing demand from people spending more time at home and stocking up on daily essentials.

In this difficult environment, multiple retail property managers have begun to receive rent reduction requests, especially from thinly capitalised subsectors such as food services and event planning. More requests should follow as operating activity is further constrained by social distancing guidelines and closed borders. As a result, we should see some consolidation in this fragile sector, which should be a positive development in the long-term. In the meantime, skilful asset management matters more than ever.

Prime retail sales are also under pressure. For now, however, owners in this subsector have a higher degree of protection as rents are fixed with creditable tenants, whilst the most sought after locations still have the advantage of high land values and strong demand. As such, the prime subsector is perceived to be defensive.

The disparity amongst winners and losers in the retail sector has been stark and this trend is likely to become more pronounced. Those who implemented digital platforms early can continue to leverage these channels during the COVID-19 crisis and beyond, while those who are late to the digital game will continue to struggle. On a longer-term basis, this crisis will likely change shopping behaviour, with retailers now needing to respond to not only e-commerce but post COVID-19 customers.

LOGISTICS

The logistics sector will likely emerge as one of the survivors of this crisis. Despite supply increasing significantly in Greater Tokyo during 2019, vacancy rates tightened and rents rose, highlighting the sector’s solid underlying fundamentals. The Greater Osaka market continued to see a recovery from 2017’s supply glut, with solid rental and occupancy growth. Even so, the sector is not immune to a short-term shock, as supply chains are disrupted and labour shortages may be exacerbated.

New supply in both submarkets is expected to be solid in 2020. Despite demand remaining sound, COVID-19 will undoubtedly weigh on certain subsectors. For example, demand for storage locations from high-street retailers should be curbed, while e-commerce distribution centres and F&B storage facilities for grocers should fare well during the pandemic.

As for investors, the sector’s long-term prospects remain attractive given the structural changes facing the logistics industry. The rise in e-commerce is expected to be a long-term transition, and therefore the sector is somewhat shielded from short-term adjustments. In addition, modern facilities, which have features that mitigate labour shortages and are more resilient to natural disasters, should have sound long-term demand. Also, the nature of the current crisis – prompting people to avoid crowded commercial hubs – will likely facilitate e-commerce by changing consumer behaviour.

HOSPITALITY

The COVID-19 crisis arguably came at the worst possible time for already struggling hotels in Japan. Indeed, the travel restrictions resulting from the pandemic are a catastrophic blow for the fragile sector. Japan Hotel REIT, the largest hotel J-REIT, posted an almost 30% decrease in its February RevPAR, and has mentioned that March RevPAR may decline by 70%. Some operators will likely need to conduct hard negotiations with banks to secure a vital cash reserve to weather the storm. NOI and cap rate adjustments are thus inevitable.

Hospitality is undoubtedly the hardest hit sector. With the virus spreading across the world, international travel should continue to be restricted, and as such, a full recovery is likely to be a protracted process. While this is a
challenging time for the industry, it may also be a great opportunity for cash-rich longer-term investors to pick up attractive assets with high growth potential. Opportunistic investors may similarly be able to pick up distressed assets that perform well under normal circumstances. As such, this could be an opportunity for industry consolidation in order to transform its profitability.

Japan remains an emerging market for inbound tourism and therefore the adverse effects from the pandemic are somewhat more manageable, especially when compared to regional peers. Broadly speaking, inbound tourism accounts for less than 1% of its GDP, though certain areas and hotels are more dependent on these visitors than others.

Although inbound tourism may take a year or longer to recover, domestic travel demand could see a faster recovery as the outbreak is brought under some degree of control. For instance, popular tourist destinations like Kyoto have recently been shunned by some Japanese visitors due to over-crowding. The extreme lull in inbound visitation to Kyoto and other top destinations should help draw domestic visitors once more. Regardless, hoteliers and investors may need to pay more heed to the balance between inbound and domestic demand going forward.