Japan - September 2022

SPOTLIGHT
Savills Research

Regional Residential Markets

Regional residential markets remain stable

Summary

- Throughout the pandemic, the regional residential markets, including Osaka, Nagoya, and Fukuoka, have performed better than Tokyo, which experienced larger corrections after years of stronger rental growth.
- Due to shorter commute times, as well as lower population densities compared to Tokyo, remote work in regional markets has not become as prevalent as Tokyo, which could have limited the impact from the pandemic.
- Osaka's residential market has remained relatively stable during the pandemic, although rental growth has slowed down.
- Nagoya's residential market has also been relatively stable with occupancy improving and rents continuing to increase.
- Fukuoka's residential market has outperformed others, supported by favourable demographic trends. However, recent signs of a slowdown may indicate that the growth seen thus far might have been too rapid.
- There have been noticeable portfolio transactions that included residential properties in the regional markets.

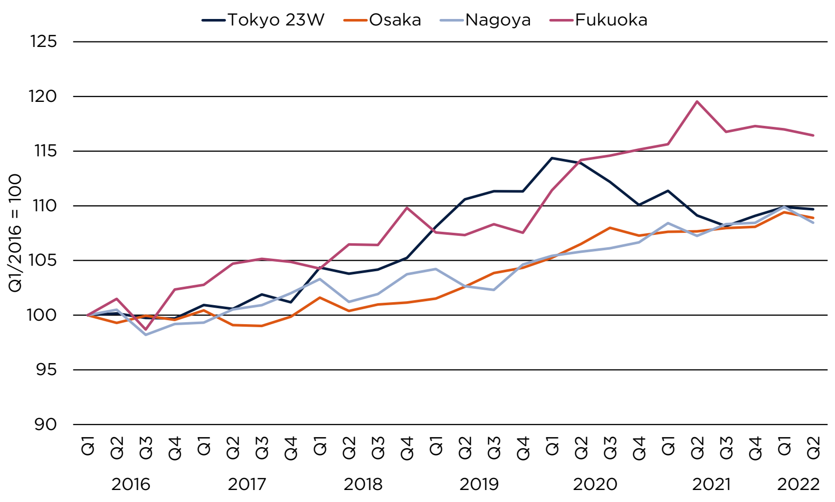
INTRODUCTION

As discussed in our [A Deep Dive into the Tokyo Residential Market August 2022], Tokyo's residential market has somewhat weakened since the onset of the pandemic. In recent quarters, signs of bottoming out have been observed, but the recovery is expected to be gradual given that economic uncertainty remains, and hybrid work arrangements might soften demand in Tokyo.

In contrast, major regional markets such as Osaka, Nagoya, and Fukuoka have not been affected by the pandemic as much as the capital (Graph 1). Fukuoka in particular has seen considerably stronger growth, and its average rent is over 15% higher compared to the level seen in Q1/2016. Elsewhere, although rental growth in Osaka and Nagoya has been more moderate than in Fukuoka, rental levels in these two markets have also continued to grow throughout the pandemic without experiencing notable corrections like Tokyo.

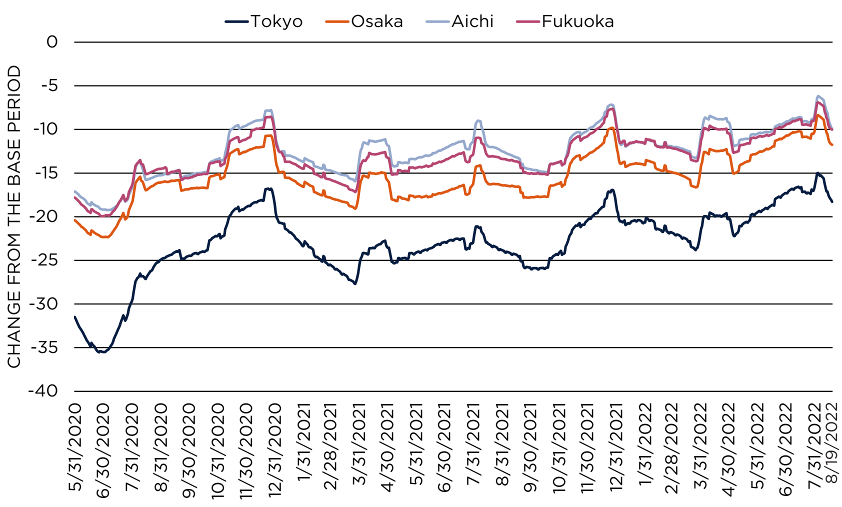
One explanation for the dichotomy between Tokyo and these major regional cities, especially Osaka and Nagoya, is Tokyo's strong growth leading up to the pandemic. As Graph 1 illustrates, Tokyo's rental level surged from Q1/2018 to Q1/2020, moving away from those of Osaka and Nagoya. However, the pandemic halted its growth streak, and the rental level

GRAPH 1: Residential Rental Index by Market, Q1/2016 to Q2/2022



Source Savills Research & Consultancy

GRAPH 2: Workplace Mobility (90-day average), 31 May 2020 to 19 August 2022



Source Google LLC "Google COVID-19 Community Mobility Reports" as of 23 Aug 2022, Savills Research & Consultancy appears to have settled as it merged with Osaka and Nagoya. As such, the corrections that the capital has experienced seem to be a rebound from its rental growth that might have been too rapid.

Another explanation for the dichotomy is underlying demographic trends. As discussed later in this report, the decreases in net-migration[1] experienced in these regional cities were not as substantial as in Tokyo. Particularly, Fukuoka, which enjoys a higher percentage of relatively young workers and has been outpacing other cities in terms of population growth, has only experienced minor rental corrections even though its rental growth was strong prior to the pandemic just like Tokyo.

Overall, the fundamentals of the regional residential markets appear sound. Furthermore, Japan is steadily transitioning toward normalcy, and regional areas have been leading Tokyo in recovery (Graph 2). Additionally, the further lifting of border controls is positive news for markets that benefited from inbound tourism prior to the pandemic. In the following sections, we will further analyse recent trends and provide an overview of each regional market.

The regional residential markets remain steady supported by stable demographic trends. Unlike Tokyo, the pandemic has not substantially affected demand in those markets, and rents have generally continued to grow moderately. With urbanisation expected to continue, the fundamentals of these regional markets appear sound.

OSAKA

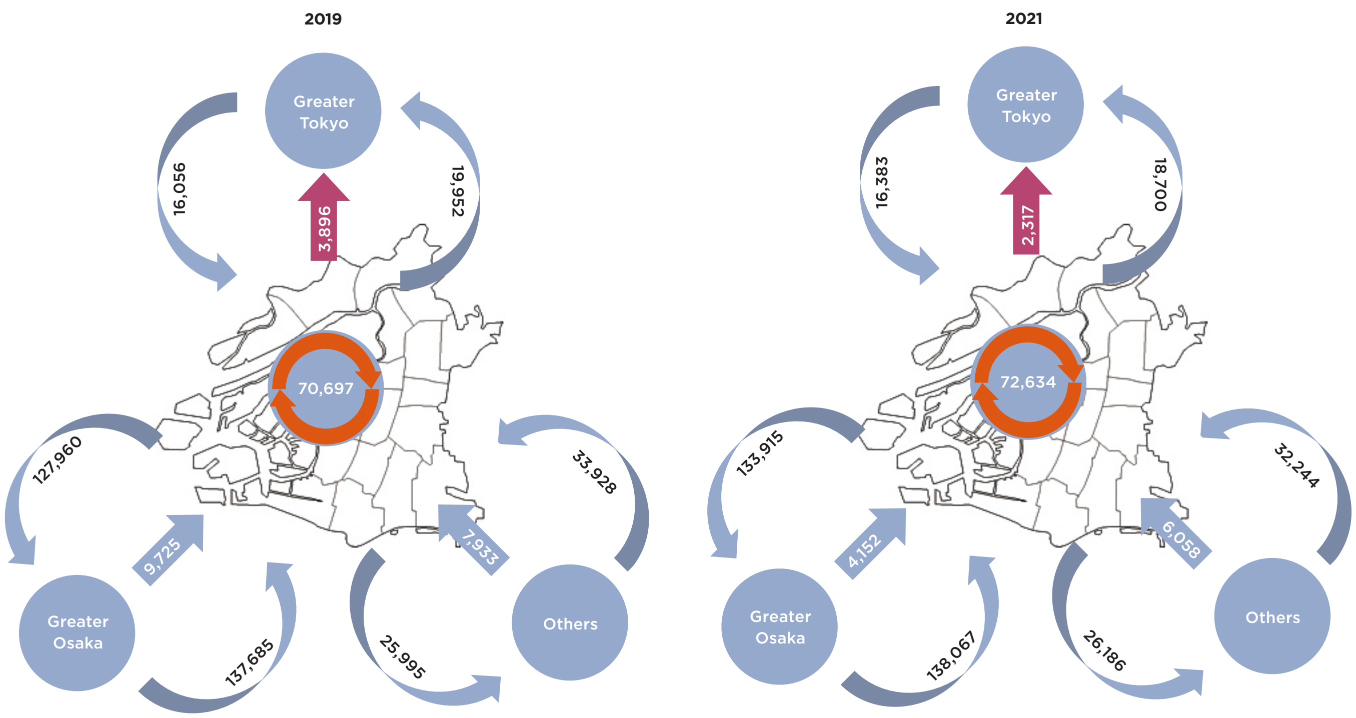
Osaka is a regional centre in the Kansai region and attracts people from both within and outside Greater Osaka[2]. However, compared to 2019, prior to the onset of the pandemic, total net-migration to Osaka City decreased from 14,000 to 8,000 in 2021. Specifically, net-migration between other parts of Greater Osaka more than halved to about 4,000 in 2021, while the net-migration between Others (all prefectures excluding the ones in Greater Osaka and Greater Tokyo[3]) declined by 2,000 (Graph 3). These declines during the pandemic halted the gradual

1 Net-migration is defined as the inflows into the subject city minus the outflows from respective counterparts. Negative net-migration would indicate that the population has decreased.

2 Greater Osaka is defined as the region which consists of Osaka, Kyoto, Hyogo, and Nara.

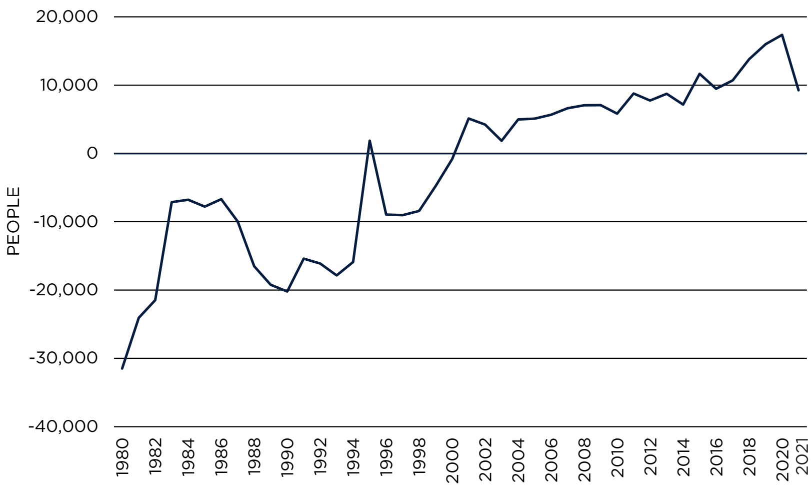
3 Greater Tokyo is defined as the region which consists of Tokyo, Kanagawa, Chiba, and Saitama.

GRAPH 3: Osaka's Migration Flows, 2019 vs 2021



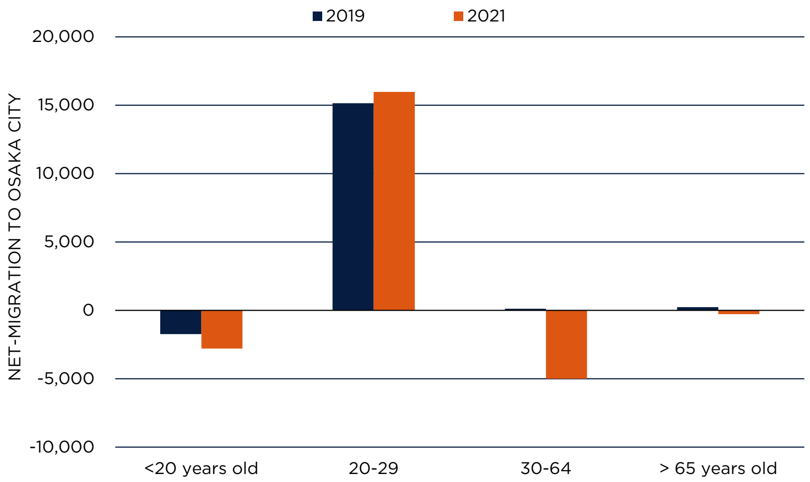
Source Ministry of Internal Affairs and Communications, Savills Research & Consultancy

GRAPH 4: Japanese Net-migration to Osaka City, 1980 to 2021



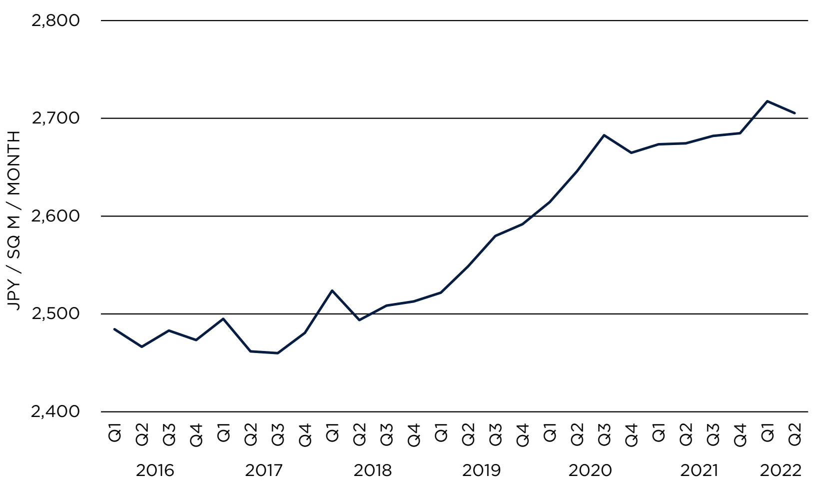
Source Ministry of Internal Affairs and Communications, Savills Research & Consultancy

GRAPH 5: Net-migration to Osaka City by Age Group, 2019 vs 2021



Source Ministry of Internal Affairs and Communications, Savills Research & Consultancy

GRAPH 6: Osaka City Rents, 2016 to Q2/2022



Source Savills Research & Consultancy

increases of net-migration that the city saw over the past two decades (Graph 4).

The overall decline in net-migration was primarily caused by an increase in the number of people moving from Osaka City to other parts of Greater Osaka. To wit, the outflow from Osaka City increased by 5,000 between 2019 and 2021, and the outflow to other parts of Greater Osaka was clearly the primary cause of this change (6,000). Meanwhile, the total inflow amount has not changed significantly (about 1,000) during the same period.

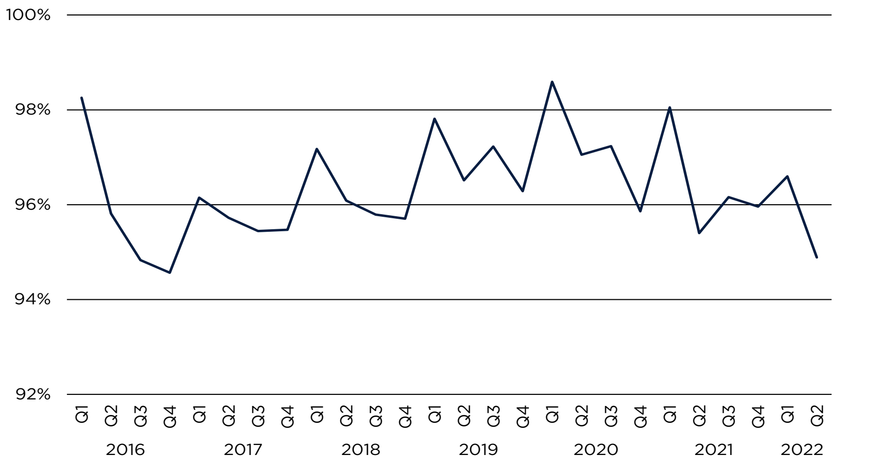
In order to shed some light on the profiles of these people who have left Osaka, we compare net-migration patterns by age between 2019 and 2021. Based on this analysis, it is clear the 30-to-64-years-old age group saw the largest decline in net-migration while changes were relatively minor in other age groups. Interestingly, net-migration of the 20-to-29-year-old age bracket recorded a moderate increase, offsetting some declines in other age groups.

Given the above, Osaka seems to still retain its allure among young workers. However, remote or flexible work arrangements that have become more common, although not as prevalent as in Tokyo, might have encouraged working-age populations to move to neighbouring areas.

These mixed demographic trends appear to have continued, resulting in slowed rental growth in Osaka. As of Q2/2022, the average rent in Osaka registered at JPY2,700 per month, up 2.2% from Q2/2020. However, the pace of growth has substantially slowed considering that the growth between Q2/2018 and Q2/2020 was 6.1%. Simultaneously, average occupancy rates have dipped since the onset of the pandemic, although they have generally remained above 95%.

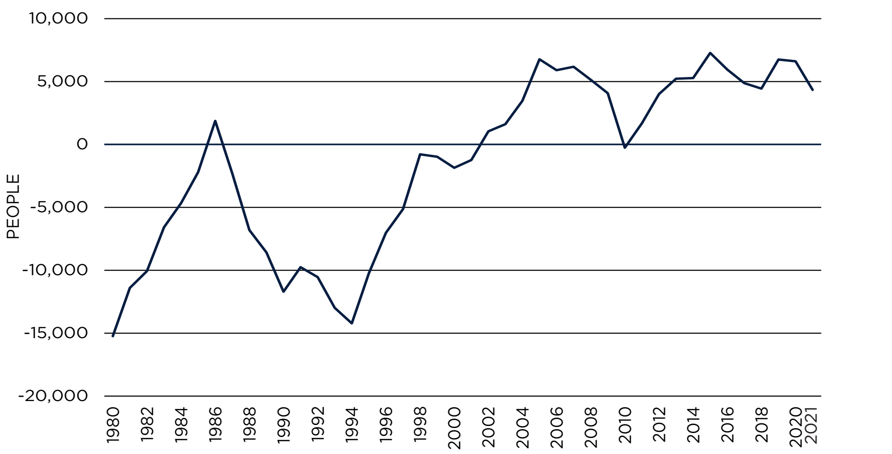
Overall, Osaka's residential market has remained stable, although its market fundamentals appear somewhat weaker compared to the pre-pandemic times. However, it must be noted that the market might have been too strong prior to the pandemic, and it almost seems that it has just returned to a long-term trajectory of moderate growth. With ongoing redevelopment around Umeda, as well as major events such as the 2025 World Expo and the opening of Japan's first integrated resort in the pipelines, the market is expected to maintain its moderate growth trajectory over the long term.

GRAPH 7: Osaka City Occupancy Rate, 2016 to Q2/2022



Source J-REITs, Savills Research & Consultancy

GRAPH 8: Japanese Net-migration to Nagoya City, 1980 to 2021



Source Ministry of Internal Affairs and Communications, Savills Research & Consultancy

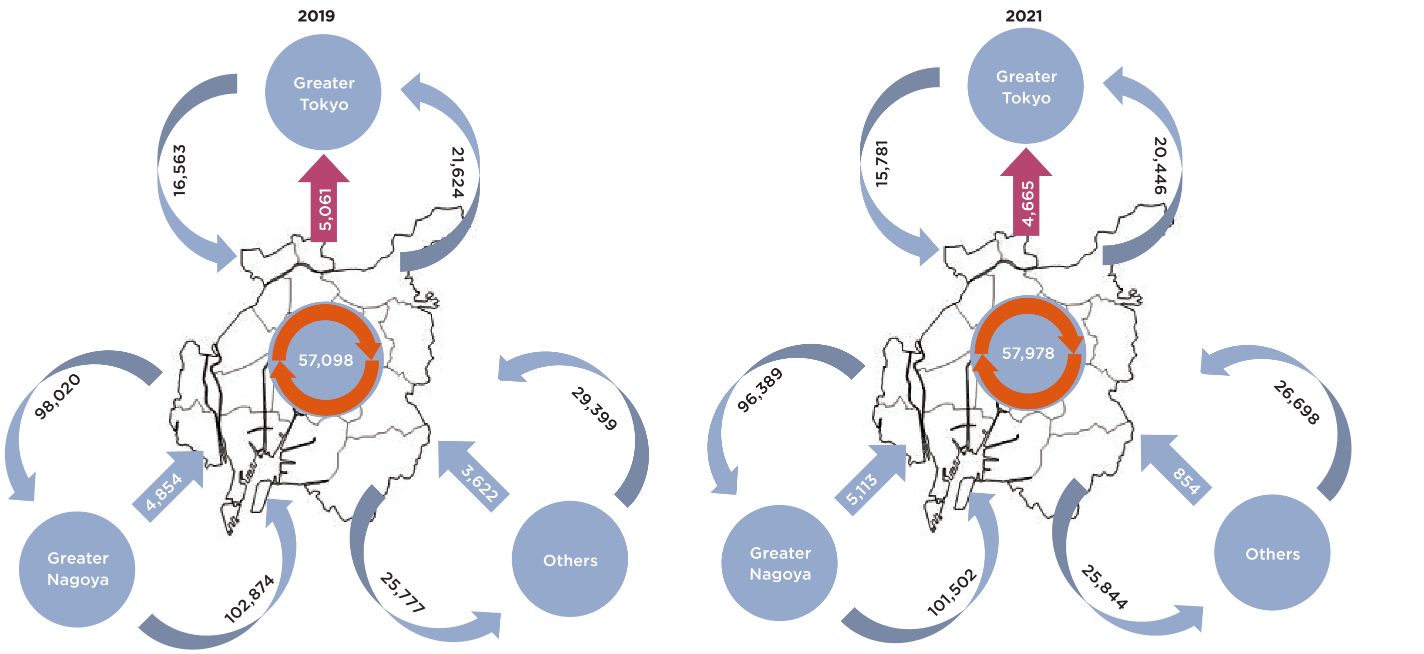
NAGOYA

Nagoya is another major regional market situated between Tokyo and Osaka and typically enjoys positive net-migration from other parts of Japan, mainly from Greater Nagoya[4]. Just like Tokyo and Osaka, the pandemic has affected the overall migration pattern and decreased the net-migration volume to the city in 2021 compared to 2019, although the impact is relatively moderate. In fact, net-migration between other parts of Greater Nagoya has slightly increased between these two periods. Additionally, net-migration between Greater Tokyo has increased, offsetting some of the net-migration decline between Others (all prefectures excluding the ones in Greater Nagoya and Greater Tokyo).

Analysing by age, the decline in the 30-to-64-year-old age group had the largest impact on the overall net-migration trend to Nagoya. Within this group, the 30-to-39-year-old age bracket in particular saw decreases in net-migration between other parts of Greater Nagoya, especially Aichi. Although remote work has not become as prevalent in Nagoya as in Tokyo, the pandemic might have prompted relatively young families in this bracket to move to surrounding areas around Nagoya. At the same time, the 20-to-29-year-old age bracket has seen increased net-migration between Greater Nagoya. However, the decline in net-migration between Nagoya

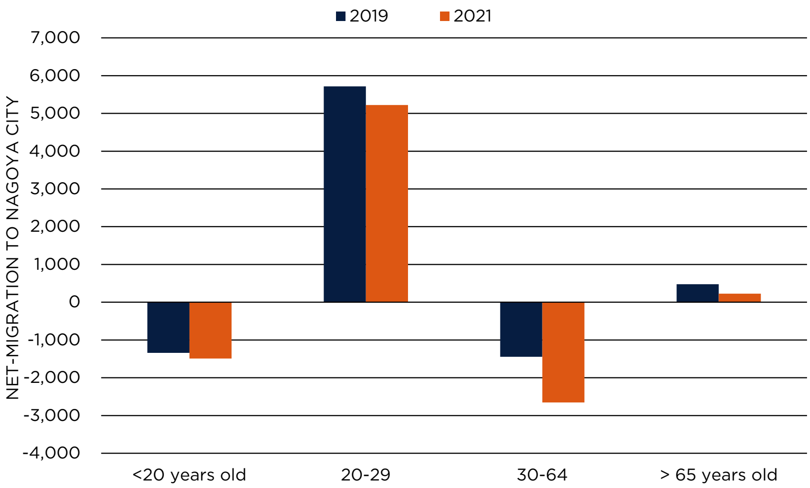
4 Greater Nagoya is defined as the region which consists of Aichi, Mie, and Gifu.

GRAPH 9: Nagoya's Migration Flows, 2019 vs 2021



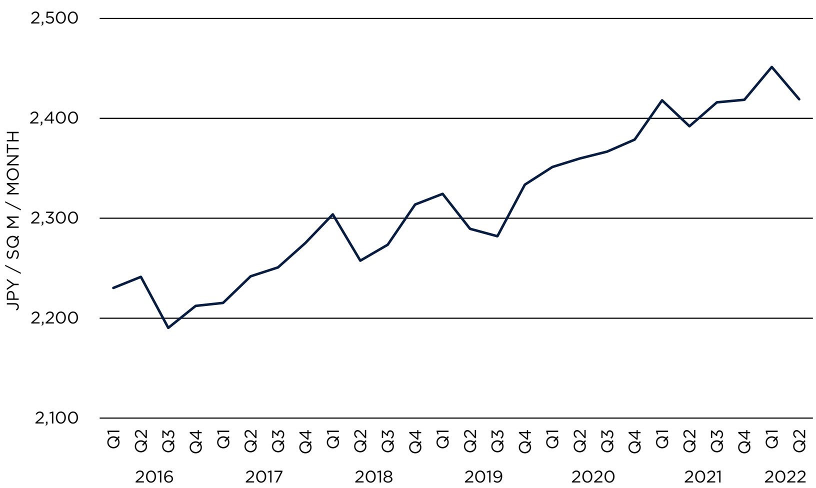
Source Ministry of Internal Affairs and Communications, Savills Research & Consultancy

GRAPH 10: Net-migration to Nagoya City by Age Group, 2019 vs 2021



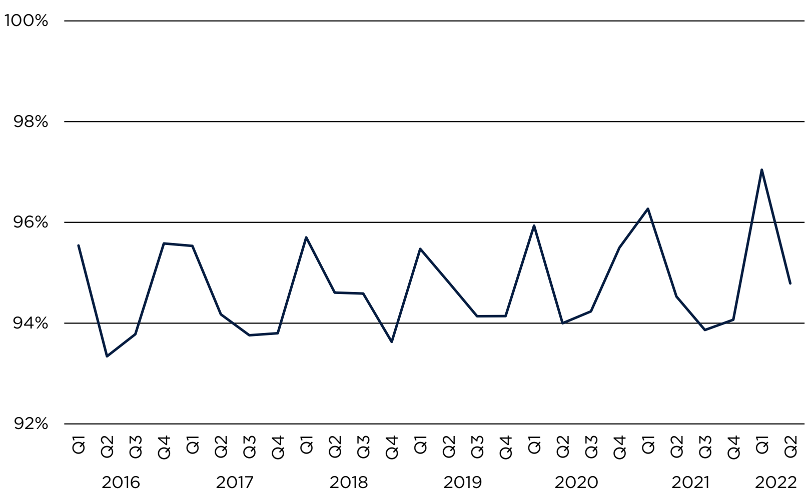
Source Ministry of Internal Affairs and Communications, Savills Research & Consultancy

GRAPH 11: Nagoya City Rents, 2016 to Q2/2022



Source Savills Research & Consultancy

GRAPH 12: Nagoya City Occupancy Rate, 2016 to Q2/2022



Source J-REITs, Savills Research & Consultancy

and other major metropolitan areas, namely Greater Tokyo and Greater Osaka, has more than offset the positive flow from Greater Nagoya, resulting in a moderate decline in net-migration in this age group.

As such, net-migration to the city has declined mildly between 2019 and 2021, but the negative impact appears limited thus far. Against this backdrop, Nagoya's residential market has remained relatively stable. Throughout the pandemic, rents have generally grown, and occupancy has been constantly above 94%. Furthermore, occupancy appears to have improved somewhat in recent quarters. This might be possibly because the market has managed to absorb some large supply built up in the past years (please see our [Nagoya Residential Markets October 2021]).

Overall, Nagoya's market fundamentals are sound, supported by positive economic prospects and demographic trends driven by urbanisation. The central areas in Nagoya, especially Sakae, are seeing redevelopment and should help to sustain demand and, in turn, increase rents.

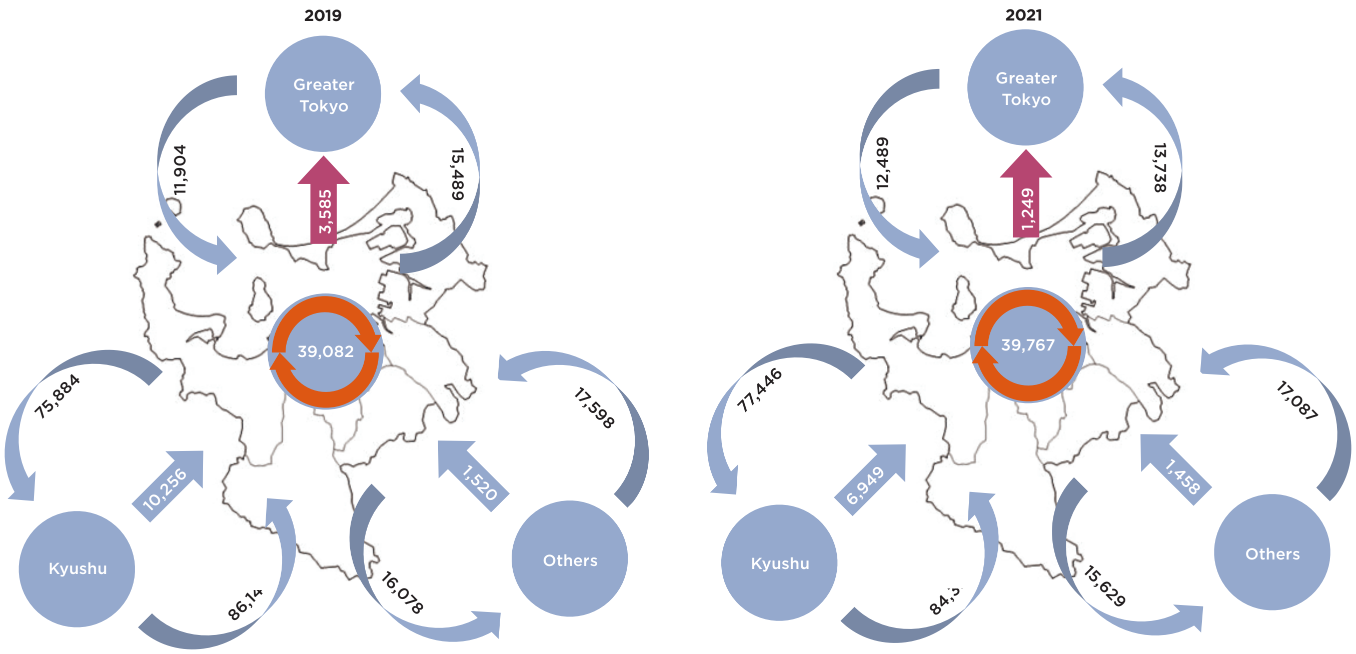
FUKUOKA

Fukuoka is a regional hub in Kyushu and has seen the strongest growth amongst the markets we study in this report. Indeed, the city is gathering momentum as it aspires to become a start-up hub, and redevelopment projects in Tenjin and Hakata are revitalising the city's central areas. Moreover, the ongoing extension of the Nanakuma Line will provide a new connection between these two areas and improve their accessibility within the city, which will likely further increase the value and rental levels of the Tenjin area.

Fukuoka mainly attracts people from other parts of Kyushu, and net-migration between this region was about 7,000 in 2021. In contrast, net-migration was only 1,500 between Others (all prefectures excluding the ones in Kyushu and Greater Tokyo). However, due to the pandemic, net-migration from Kyushu has shrunk moderately by 3,000 from 10,000 in 2019. At the same time, between Fukuoka and Greater Tokyo, the decrease in outflow together with the increase in inflow have increased net-migration, which has partially offset the decline in net-migration between Kyushu. Overall, 2021 net-migration figures to Fukuoka were only 1,000 less than 2019.

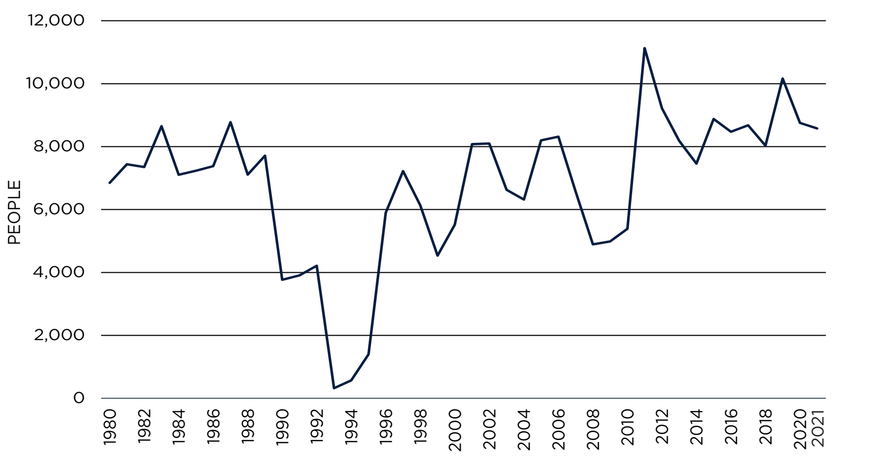
The net-migration patterns by age seen in Fukuoka are quite different from those of Osaka and Nagoya. While it is similar in that the 20-to-29-year-old age bracket is

GRAPH 13: Fukuoka's Migration Flows, 2019 vs 2021



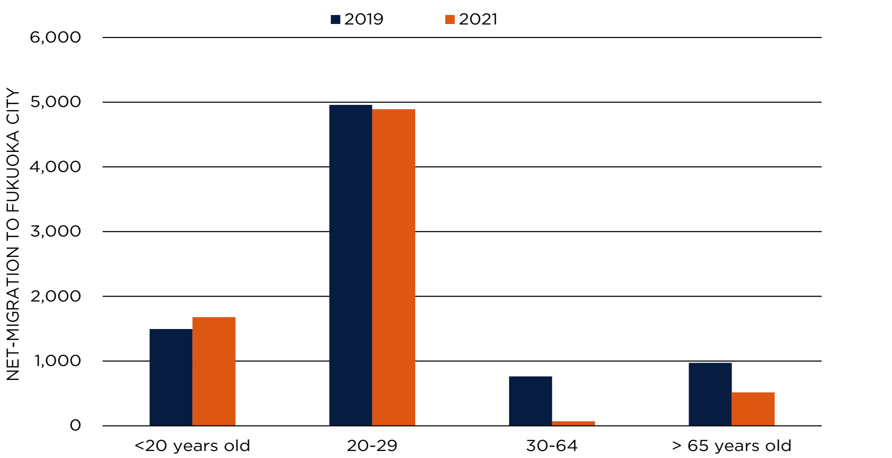
Source Ministry of Internal Affairs and Communications, Savills Research & Consultancy

GRAPH 14: Japanese Net-migration to Fukuoka City, 1980 to 2021



Source Ministry of Internal Affairs and Communications, Savills Research & Consultancy

GRAPH 15: Net-migration to Fukuoka City by Age Group, 2019 vs 2021



Source Ministry of Internal Affairs and Communications, Savills Research & Consultancy

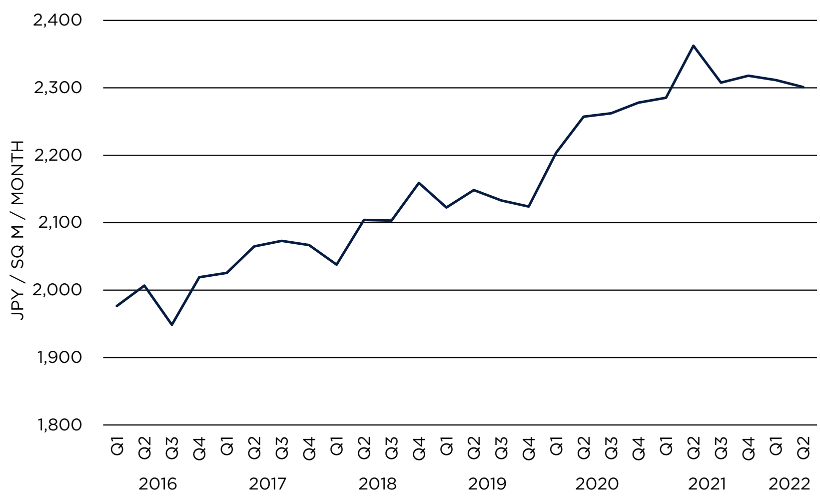
driving demographic movements, Fukuoka also generally sees positive net-migration in the age groups of less than 20 years old and 30-to-64-years-old unlike the cities mentioned above. This power of Fukuoka to retain people within the city has helped it to achieve the largest population growth among the 20 major cities[5] between 2015 and 2020. It is also worth noting that although the pandemic has noticeably reduced net-migration in the age band of those over 30 years old, it has still remained positive in 2021 unlike Osaka and Nagoya.

As for Fukuoka's residential market, its fundamentals remain strong, reflecting stable demographic trends. Occupancy has rarely dipped below 96%, and rents have continued to grow through the pandemic in general. Nonetheless, rental growth appears to have slowed down in recent quarters. Considering the sound occupancy and steady demographic trends, it does not seem that the slowdown is due to a softening in demand. One probable explanation for this change is a rebound from rapid rental growth seen in Fukuoka in previous years. Indeed, as depicted in the introduction, Fukuoka's growth stands out compared to other cities. We will be watching carefully to see if rental growth returns in Fukuoka going forward.

Overall, the Fukuoka market has a strong footing supported by positive demographic trends. A series of developments through

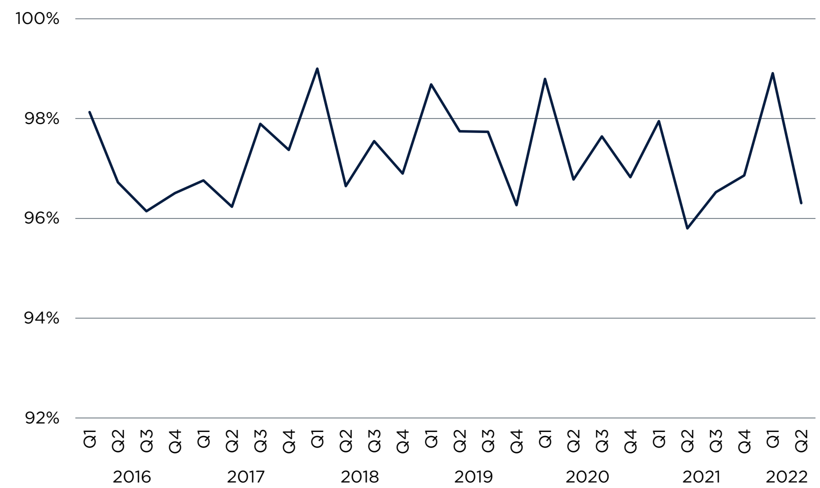
5 20 ordinance-designated cities, which do not include Tokyo's 23 wards where the growth rate was 5.1% between 2015 and 2020.

GRAPH 16: Fukuoka City Rents, 2016 to Q2/2022



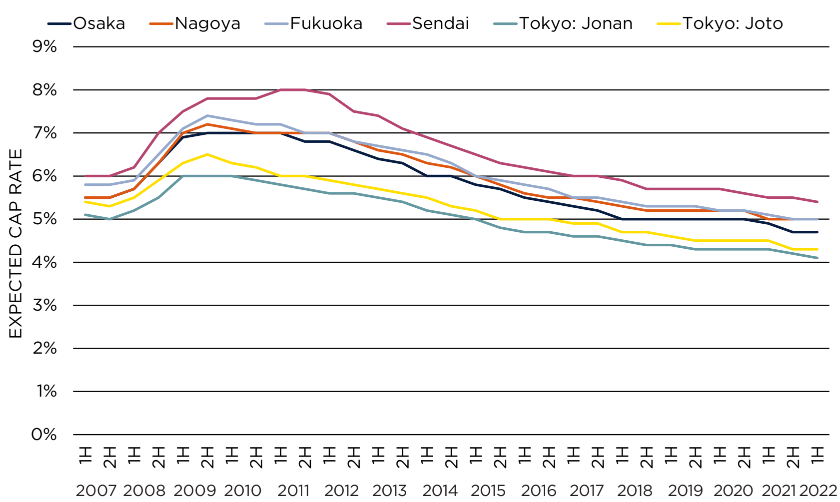
Source Savills Research & Consultancy

GRAPH 17: Fukuoka City Occupancy Rate, 2016 to Q2/2022



Source J-REITs, Savills Research & Consultancy

GRAPH 18: Expected Cap Rates by City, 1H/2007 to 1H/2022



Source Japan Real Estate Institute, Savills Research & Consultancy

Tenjin Big Bang and Hakata Connected should make its central areas more attractive in the long term. Especially, the newly completed Tenjin Business Center Building is the first office building of that scale in Tenjin, and it could trigger a gravitational shift from the Hakata station area. Indeed, Tenjin Business Center has increased its top rents to a level equivalent to that of Osaka and Nagoya, which attracts high income earning corporations and professionals, helping to create a new resident base. With economic conditions expected to improve and border controls being relaxed, prospects for the Fukuoka market are positive.

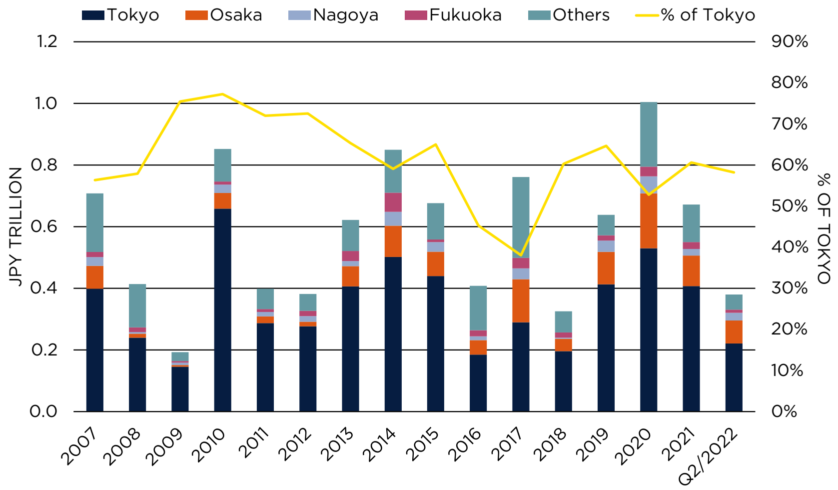
TRANSACTIONS

In the past year, there were several noticeable portfolio transactions that involved residential properties in regional markets. Better yields and limited opportunities in Tokyo, as well as the positive fundamentals of these regional markets appear to have attracted investor interest.

For instance, Gaw Capital/Qatar Investment Authority acquired five residential properties in Osaka and three in Nagoya as part of a 32-property portfolio for JPY60 billion in May 2022. In the same month, it was also announced that Blackstone/Alyssa Partners had acquired a 19-property portfolio in Tokyo, Osaka, Nagoya, and Fukuoka, which is rumoured to be over JPY20 billion. Furthermore, M&G Real Estate acquired 30 residential properties in Japanese cities including Osaka and Nagoya from Blackstone for JPY49.2 billion in March 2020.

While Tokyo remains the most popular market in Japan due to its status as the country's economic centre, regional markets are likely to gain more traction as their performance continues to outpace Tokyo's. That being said, it is challenging for investors to find residential assets available for sale in regional cities. Regarding this point, portfolio transactions are attractive in terms of scale, but the properties acquired from other institutional investors might have little room for improvement, thereby limited value-add opportunities. As such, it will continue to be difficult for investors with higher yield targets to find attractive deals in regional cities.

GRAPH 19: Residential Investment Volumes by City, 2007 to Q2/2022 (YTD)



Source Real Capital Analytics, Savills Research & Consultancy

OUTLOOK

Overall, regional markets have exhibited respectable stability thus far. Although they have inevitably been affected by the pandemic, the impact has been mild compared to what was experienced in Tokyo. Specifically, the net-migration to Osaka, Nagoya, and Fukuoka has declined since the onset of the pandemic, and that appears to have resulted in some softening in leasing demand. Weakened economic conditions have also translated into slowed rental growth. Nonetheless, none of the three regional markets have experienced as large a correction as Tokyo has.

Several major portfolio transactions that involved properties in the regional cities have taken place. Although Tokyo continues to see the largest volume of transactions, regional markets appear to be attractive options especially given their stronger performances throughout the pandemic and better yields. An increasing number of players entering these markets provides additional liquidity as well.

That said, the residential market as a whole shows some signs of overheating, as discussed in the aforementioned A Deep Dive into the Tokyo Residential Market August 2022. Due to residential properties' characteristics, upside potential may be limited, and this might be more true in regional markets whose economic bases are weaker than Tokyo's. For example, the average taxable income by taxpayer grew about 10% in Osaka, Nagoya, and Fukuoka between 2010 and 2021 while Tokyo's growth was close to 20%. Furthermore, as economic uncertainties continue, the world economy is likely to slow down, which will, in turn, negatively affect the Japanese economy including its regional markets. Moreover, inflation is likely to linger everywhere, and Japan is no exception. Although inflation in Japan is likely to be more moderate than in other countries, this may make real wage growth negative, which could result in softer residential markets.

Nonetheless, these regional markets are established economic and cultural hubs in their respective regions, and urbanisation in these markets will continue. Furthermore, ongoing redevelopment projects will revitalise the surrounding areas and should induce more residential demand. As such, these markets are expected to continue growing in the long term.

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