Japan - March 2021

SPOTLIGHT

Savills Research

Regional Residential Markets

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Positive demographic trends provide sound fundamentals for some markets

Summary

- The Japanese residential market has been attracting the interest of overseas investors as the global economy has been disrupted by several events, including the pandemic.
- Greater Tokyo is undoubtedly the most popular market due to strong fundamentals supported by social and economic trends.
- Regional hubs such as Osaka, Nagoya, and Fukuoka also pose opportunities as there is steady intra-regional migration flow to major regional cities.
- The COVID-19 pandemic has changed lifestyles and preferences for residences, possibly creating some long-lasting impact on the market.
- Unlike the logistics market, it may be worth considering why domestic investors, who possess market insight and plenty of capital, are not as enthusiastic about the residential market.

INTRODUCTION

Whilst the global pandemic and the subsequent recession have thrown the real estate market into turmoil, the Japanese residential market on the other hand, known for its defensive nature, has been gaining strong interest from global investors, especially in Tokyo.

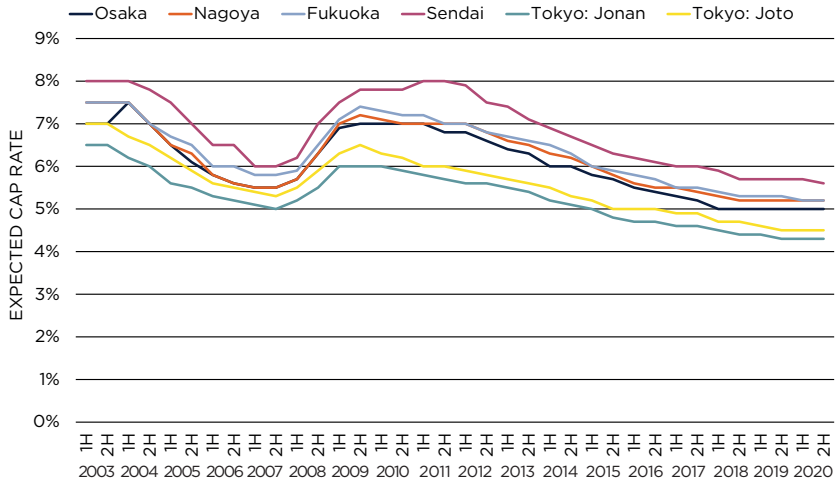
The attractiveness of the market is based on favourable funding conditions, as well as its stable political and economic fundamentals. These factors have stood out especially in recent years as social disruptions, including COVID-19, were experienced around the globe. As the world economy remains clouded by uncertainty, and abundant liquidity seeks investment opportunities, the Japanese residential market will likely continue to gain traction.

That being said, competition for quality assets remains fierce. Compressed yields for residential properties in the nation's capital as well as limited opportunities will encourage more investors to seek opportunities beyond Tokyo and venture into regional markets to achieve their yield targets.

In this report, we focus our discussion on macro and micro demographic trends. In Japan, over 5 million people move from one city to another every year[1], more than

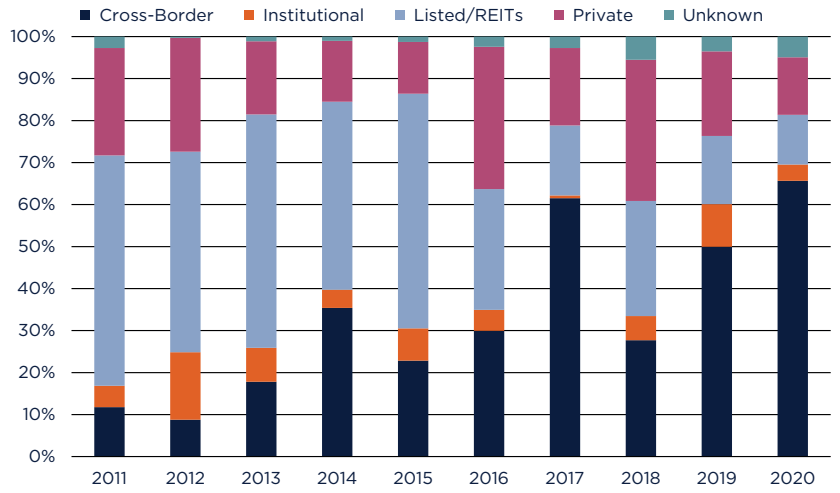
1 This figure includes migration of non-Japanese. However, we have used demographic statistics of Japanese throughout the report, unless otherwise noted.

GRAPH 1: Expected Cap Rates for Residential Investment, 2003 to 2020



Source JREI, Savills Research & Consultancy

GRAPH 2: Residential Investment Share by Investor, 2011 to 2020



Source RCA, Savills Research & Consultancy

the entire population of New Zealand. The migration of such a large amount of people has significant implications for Japanese real estate markets, especially in residential markets where population movements directly affect demand.

By carefully analysing a multitude of social and economic data, we have identified drivers of major demographic trends and markets that have benefited from them. Indeed, some regional cities show positive demographic trends and pose investment opportunities.

RESIDENTIAL TRANSACTION TREND

The transaction volume of residential properties in Japan has been increasing especially since 2018, and geographically, Tokyo is by far the most popular market in Japan, followed by regional cities such as Osaka, Nagoya, and Fukuoka.

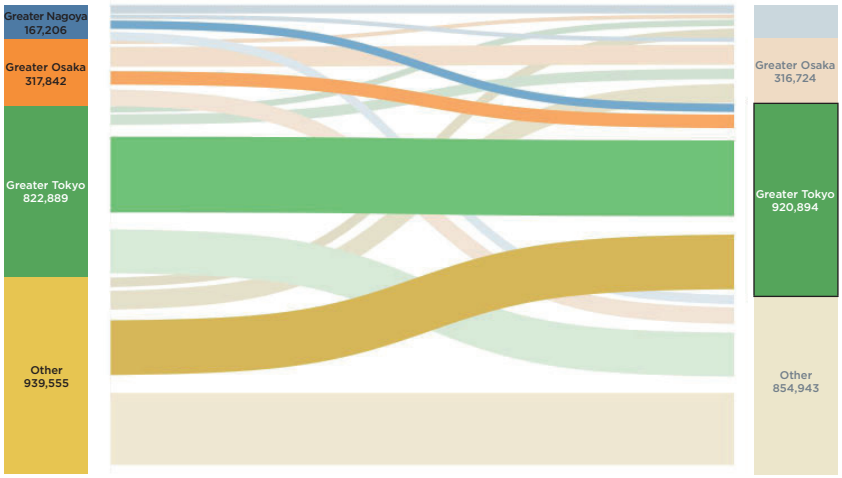
In 2020, Tokyo accounted for 42% of total residential transaction volume while Osaka, Nagoya, and Fukuoka together accounted for 31%. This contrast highlights Tokyo's dominating position as the social and economic powerhouse of the country.

That said, yields have been compressing in the Tokyo residential market and our in-house cap rates for mid-market residential property are 3.4% as of Q1/2021. With increasing interest in this market, the rates could compress further going forward. Meanwhile, Japan Real Estate Institute's (JREI) latest investor survey indicates that regional cities have yield premiums of about 50 to 100 basis points compared to Tokyo, which makes venturing into regional markets an alternative for many investors.

As the COVID-19 pandemic has disrupted the real estate markets globally, Japan's residential sector is drawing the interest of investors due to its stable and defensive nature. While Tokyo remains the most popular market in the country, major regional cities that have exhibited sound demographic trends should present opportunities especially to those who seek higher yields.

In terms of the investor profile, overseas investors are increasingly active in this market. Total transaction volume in this sector reached about JPY740 billion and over 60% of that was acquired by overseas investors in 2020. According to Real Capital Analytics (RCA), Blackstone was the top player in terms of acquisition volume between January 2019 and December 2020, followed by overseas institutional investors such as Allianz, AXA Group, and Nuveen Real Estate.

GRAPH 3: Inter-prefectural Migration of Japanese by Region, 2020



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

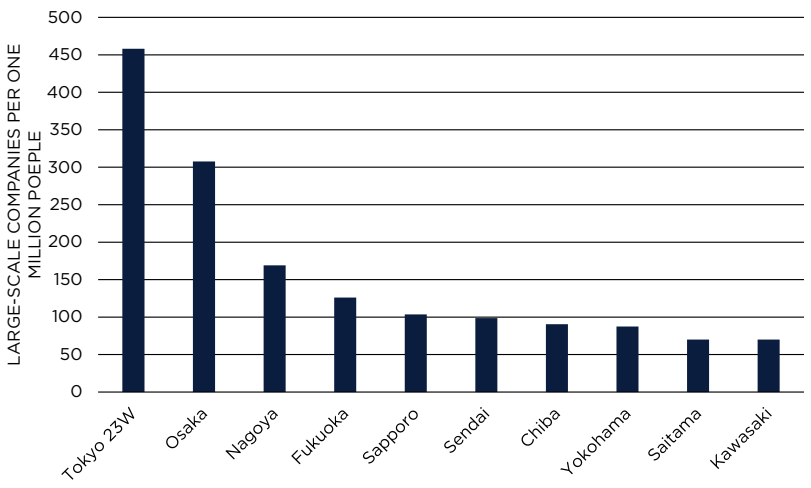
MACRO DEMOGRAPHIC TRENDS

In a high-level summary, Greater Tokyo[2] is the clear winner as the population inflow to the market (921,000 in 2020) exceeds the outflow from the market (823,000 in 2020) while, in all other markets, outflows outweigh inflows (Graph 3). As such, it is no surprise that most investment in Japan is targeting Tokyo, as discussed. In fact, with the exception of 1994 and 1995, Greater Tokyo has maintained positive net-migration since 1954, highlighting the region's strong gravitational pull.

One pull factor to Greater Tokyo is a high concentration of major companies in the capital. As illustrated in Graph 4, Tokyo has an overwhelming share of large-scale companies. In terms of nominal GDP, Tokyo alone recorded JPY108 trillion in FY2019, accounting for approximately 20% of the country's GDP despite comprising only 10% of the country's population. This relation between migration and economic strength is also clear in Graph 5, which illustrates that net-migration to Greater Tokyo fluctuates in sync with corporate profits. This correlation is likely because when economic conditions weaken and companies reduce hiring, fewer job seekers move to Greater Tokyo.

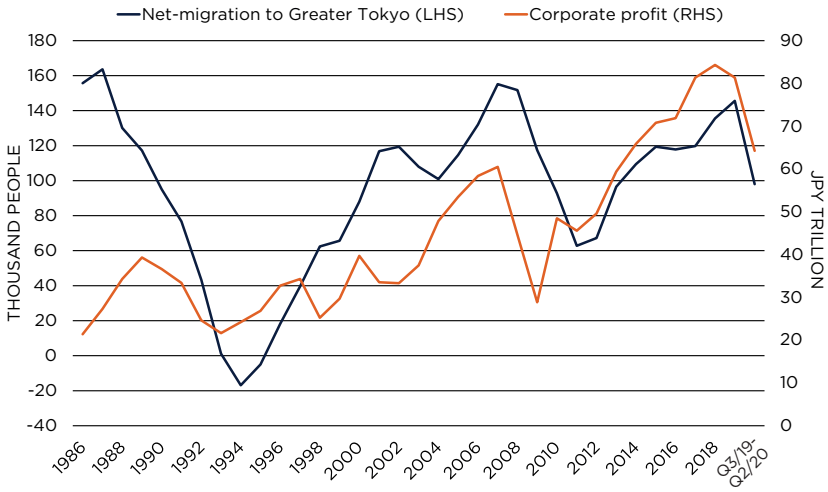
2 In this report, Greater Tokyo includes Tokyo, Kanagawa, Chiba, and Saitama.

GRAPH 4: Large-scale Companies per One Million People, 2016



Source Ministry of Internal Affairs and Communications, Savills Research & Consultancy
* Large-scale companies are defined by the Small and Medium Enterprise Agency's criteria set for different industries. For instance, in the manufacturing industry, large-scale companies are the ones with more than 300 employees or the ones that are capitalised at more than 300 million yen.

GRAPH 5: Japanese Net-migration to Grater Tokyo and Corporate Profits, 1986 to Q2/2020



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

Another primary migration driver is education. Tokyo has a high concentration of top-rated universities, and high-school graduates will relocate from all over Japan to attend them. Graph 6 illustrates that prefectures in Greater Tokyo tend to have high ratios of high-school graduates attending universities in the same region, and consequently, had positive net-migration figures in the age group of 15 to 19 years old. In other areas, except for regional hubs such as Osaka, Kyoto, Aichi, and Fukuoka, high-school graduates have high tendency to go to universities outside of their regions, resulting in negative net-migration in this age group.

To summarise our discussion thus far, Tokyo has been drawing people from across Japan largely due to employment opportunities and education. These factors are deeply rooted in the Japanese social system and the long-term trend is unlikely to change, though economic cycles will likely cause some ebbs and flows. Additionally, the recent trend of increasing foreign students and residents should somewhat impact the overall demographic trend. This non-Japanese population may further accelerate the trends we have identified.

As such, from a macro demographic perspective, Tokyo and its surrounding prefectures including Kanagawa, Saitama, and Chiba have sound fundamentals that support their residential markets.

MICRO DEMOGRAPHIC TRENDS

While Greater Tokyo is undoubtedly at the centre of Japan's solar system and therefore a primary destination of migration, over 50% of migration actually takes place within the same prefecture. This pattern is apparent in Graph 7 that compares net-migration figures from within and without the same region where the city in question is located.

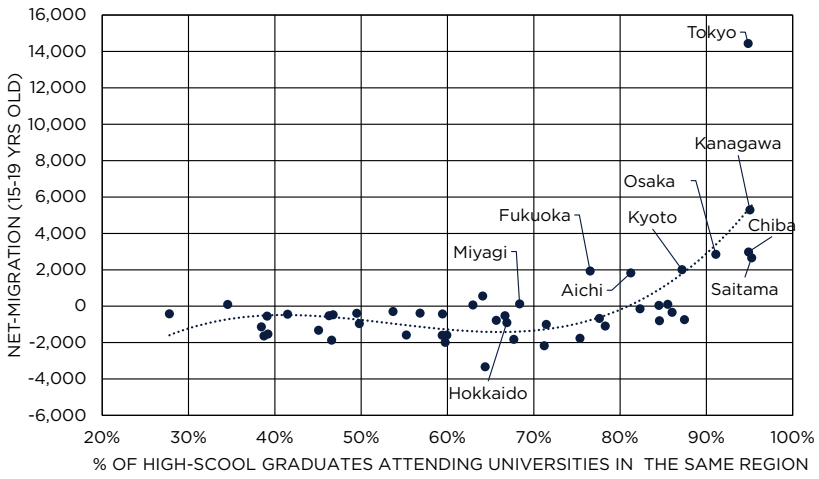
Specifically, cities such as Osaka, Nagoya,

TABLE 1: Japanese Net-migration of 20-39 year-old Population, 2020

		NET-MIGRATION	ORIGIN							
			KANTO	KANSAI	CHUBU	CHUGOKU	HOKKAIDO	KYUSHU/ OKINAWA	SHIKOKU	TOHOKU
DESTINATION	KANTO	84,854	-	19,725	27,967	6,444	3,251	10,280	3,111	14,076
	KANSAI	-8,642	-19,725	-	2,365	3,745	197	1,591	2,794	391
	CHUBU	-29,050	-27,967	-2,365	-	642	-65	-89	274	520
	CHUGOKU	-12,367	-6,444	-3,745	-642	-	34	-1,879	325	-16
	HOKKAIDO	-2,908	-3,251	-197	65	-34	-	37	5	467
	KYUSHU/OKINAWA	-9,727	-10,280	-1,591	89	1,879	-37	-	200	13
	SHIKOKU	-6,683	-3,111	-2,794	-274	-325	-5	-200	-	26
	TOHOKU	-15,477	-14,076	-391	-520	16	-467	-13	-26	-

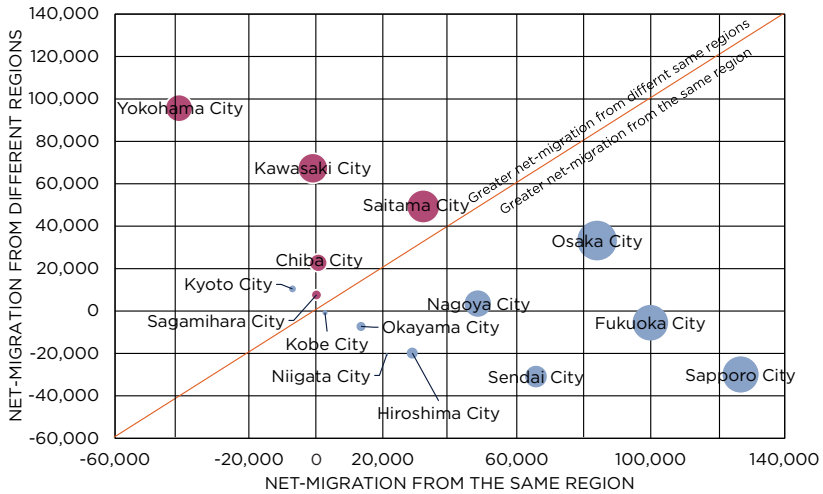
Source Ministry of Internal Affairs and Communications, Ministry of Finance, Savills Research & Consultancy

GRAPH 6: 15-19 Year-Old Japanese Net-migration vs Percentage of High-schools Graduates Attending Universities in The Same Region



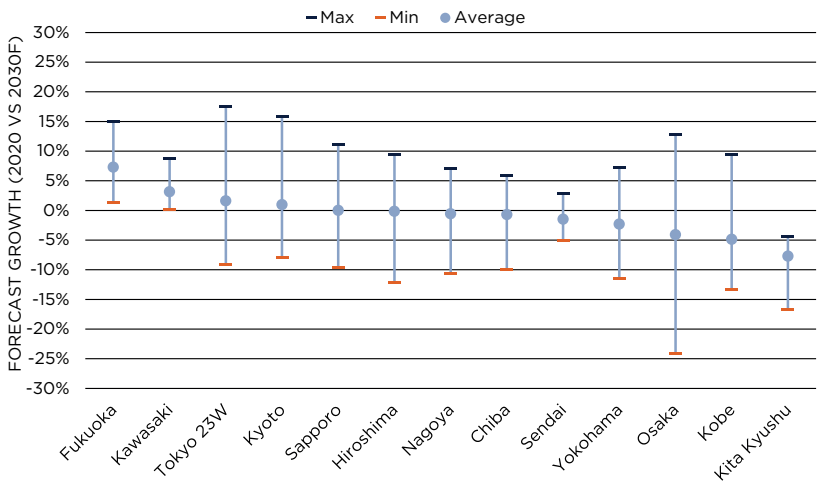
Source Ministry of Internal Affairs and Communications, Ministry of Education, Culture, Sports, Science and Technology, Savills Research & Consultancy

GRAPH 7: Japanese Net-migration by Origins, 2010 to 2020



Source Ministry of Internal Affairs and Communications, Savills Research & Consultancy
*The sizes of the bubbles represent total net-migration.

GRAPH 8: Forecast Population Growth, 2020 to 2030F



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

Fukuoka, Sapporo, and Sendai had overall positive net-migration between 2010 and 2020 mainly due to intra-region migration. On the other hand, cities in Greater Tokyo, such as Yokohama, Kawasaki, Saitama, and Chiba had positive net-migration largely due to migration from outside of the region.

This indicates that while these regional cities do not have powerful forces to attract people from outside of their own regions, they are still established regional hubs and can attract migrants within the same regions. After all, given the option, many people would choose to remain in the same region where they have their social network or sentimental attachment to their hometowns[3]. As such, for those who seek good employment and education opportunities, but prefer to stay close to their homes, moving to major cities of their regions is a valid option.

One thing to note is that population growth rates vary widely even in the same city, and therefore, investors need careful assessments of submarket-level population movements. For instance, although the population of Osaka City overall is forecast to shrink 4.1% between 2020 and 2030, central wards in the city such as Naniwa, Kita, Tennoji, and Chuo are expected to see double-digit growth during the same period (Graph 8). In general, this urbanization trend can be attributed to the fact that more people prefer to live close to their workplaces located in central business districts, though this trend may somewhat change after the pandemic.

This urbanisation trend will likely continue as redevelopment projects taking in major regional cities will make central areas more convenient and attractive. While construction investment across Japan has started to pick up since 2010, it is far cry from its peak in early 1990s and redevelopment has been happening in relatively limited areas of major cities (even in Tokyo, major redevelopment projects have been focusing on central areas and station fronts). This disparity across regions will likely make central submarkets more attractive and encourage urbanisation trends.

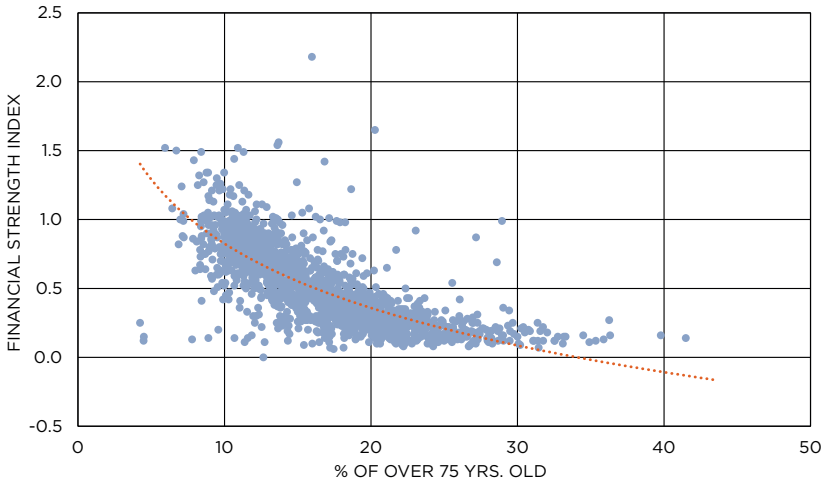
For instance, in our Regional Japanese Office Markets – December 2020, we pointed out that the Noritake project and RAYARD Hisaya-odori Park in Nagoya appear to have increased residential values beyond the station front. The Umekita Second Project in Osaka and the Tenjin Big Bang Project in Fukuoka should have a wide economic impact on the surrounding areas as well. Graph 9 reinforces this by illustrating that cities with higher population growth tend to have higher construction volume per person.

3 According to a survey conducted by the Cabinet Office, only 50% of young migrants moved to Greater Tokyo because they wanted to live there. Others would have chosen other regions if there had been jobs or schools they liked.

GRAPH 9: Population Growth (2015-2020) vs Construction Volume Per Person (2015-2019) by Municipality

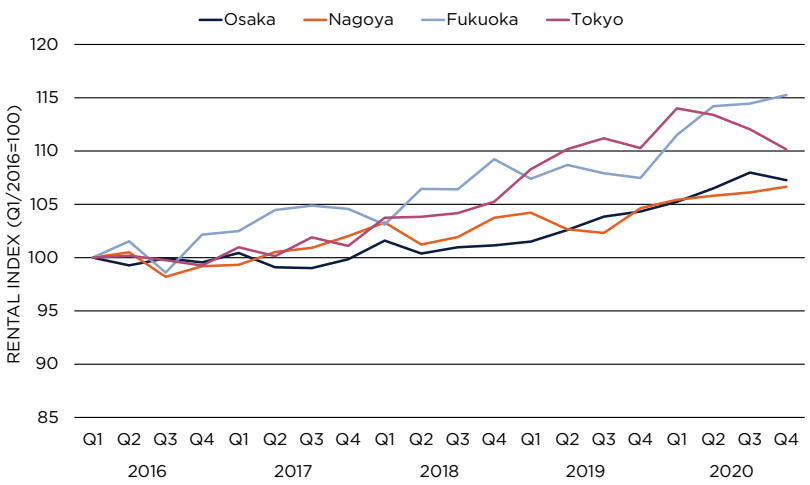
Source Ministry of Internal Affairs and Communications, Ministry of Land, Infrastructure, Transport and Tourism, Savills Research & Consultancy

GRAPH 10: Percentage of Over 75-year Population vs. Municipality Financial Strength



Source NIPSSR, Ministry of Internal Affairs and Communications, Savills Research & Consultancy
*Three-year simple averages calculated by dividing the total value of basic financial revenue by basic financial demand value. Values below 1.0 indicate that municipalities require central government's tax revenue allocation to meet basic financial demand.

GRAPH 11: Rental Index, Q1/2016 to Q4/2020



Source Savills Research & Consultancy

Additionally, the compact city vision[4] promoted by the Japanese government could push the population to major regional cities in the future by incentivising movement to major regional hubs. Compact cities are designed to promote concentration of urban development around key transportation nodes, such as stations, to improve city functions and minimise operational costs. This is critically important because Japan's rapidly ageing population has a major implication for the financial strength of municipalities.

As illustrated in Graph 10, financial strength, measured as a ratio of basic financial revenue and basic financial demand, decreases as the percentage of the 75-year-old population increases. As of FY2018, the average was about 0.5 (meaning that 50% of basic financial demand must be funded through the central government tax allocation). Considering that the median percentage of 75-year-population of municipalities is forecast to increase from 16% in 2015 to 26% in 2035[5], a large portion of municipalities will likely rely on the central government's life support to finance basic needs.

This bleak forecast implies that population flight to major regional cities will likely continue and possibly accelerate in the future. A shrinking local economy will push those of working age to urban areas for job opportunities. However, they may be more likely to move to major cities in the same regions rather than Greater Tokyo.

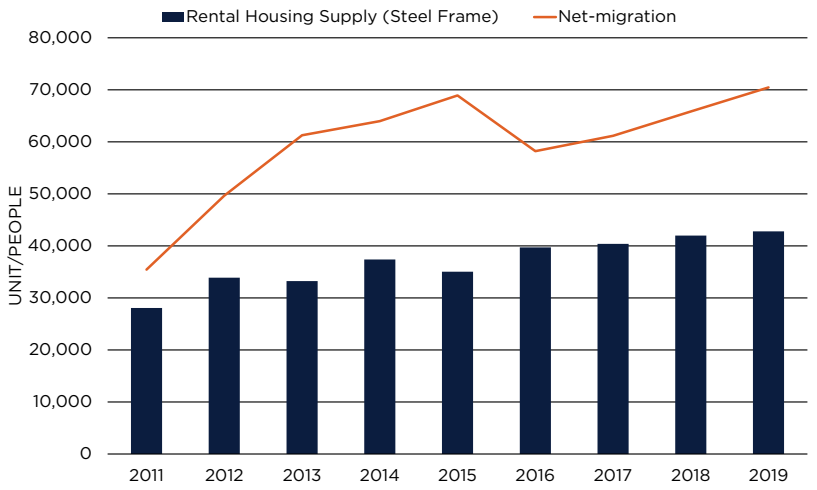
RESIDENTIAL LEASING

Based on the discussion thus far, major regional cities, especially the ones considered as regional hubs such as Osaka, Nagoya, and Fukuoka, as well as cities in Tokyo's neighbouring prefectures, appear to have sound fundamentals as residential markets. Indeed, Savills in-house residential data shows steady rental growth in Osaka, Nagoya, and Fukuoka over the past years. While data is rather limited for Greater Tokyo, overall rental growth in the region, as well as population increases discussed above, indicate that rents have likely increased during the same period.

One notable trend is that Tokyo, especially in central areas, appears to have lost some traction concurrent with the COVID-19 pandemic, while other cities retained sturdy rental growth. Due to the pandemic, Tokyo's population growth has taken a pause, which appears to be affecting the city's rents. Average rents dipped

4 Compact cities are designed to promote concentration of urban development around key transportation nodes, such as stations, and improve city functions and minimise operational costs. The government is also advocating the benefit of low carbon emission from reduced vehicle transportation in compact cities.
5 This is based on the National Institute of Population and Social Security Research's (NIPSSR) forecast published in 2018.

GRAPH 12: Rental Housing Starts vs Net-Migration to Tokyo, 2011 to 2019



Source Ministry of Land, Infrastructure, Transport and Tourism, Savills Research & Consultancy
* In this chart, rental housing supply includes steel reinforced concrete, steel concrete, and steel structured buildings.

especially in the C5W, while more affordable areas have gained momentum. Additionally, the shift in preferences for larger and more affordable units appears to have persisted thus far and is expected to remain in place for the time being with work-from-home arrangements becoming more established. That said, in the 23W, net-migration has exceeded the number of rental housing starts over the past decade, providing sound supply-demand dynamics for the market (Graph 12). Indeed, occupancy of investment-grade residential properties owned by J-REITs remains tight in Tokyo.

Markets in cities including Osaka, Nagoya, and Fukuoka appear to exhibit steady momentum. The difference from Tokyo can be attributed to the fact that these cities have a much lower population density and shorter commutes, which relatively diminishes the appeal of remote work.

OUTLOOK

As widely publicised, Japan's population started to decline in 2011 and is likely to lead peer countries in its aging trend. Despite this narrative, some cities have growing populations and sound economic fundamentals. These cities tend to be established regional hubs and beneficiaries of positive migration trends. As urbanisation is a trend that will likely last for a long time, population inflow to major cities should continue for the foreseeable future. The pandemic as well as the economic conditions impact on this urbanisation trend, but are unlikely to significantly change the direction of this trend. Social changes such as increasing dual-income households, higher labour participation rates of females, and increasing retirement ages also contribute to local economies.

While current trends are likely to continue on a macroeconomic scale, the COVID-19 pandemic has changed our lifestyle in a profound way and may have permanently changed the course of society. First of all, remote work arrangements are likely to remain, in many cases through a hybrid hub and spoke model. As we have already witnessed, this will slow migration to city centres and increase demand for larger residential units. This trend could be propelled by the digitalisation effort by the government. Secondly, domestic companies shifting from "membership type" employment to "job type" employment can reduce the number of transfers across regional offices. For instance, Mitsubishi Chemical plans to allow employees to request not to be transferred to other prefectures for six years.

With regard to investment trends, the increasing number of overseas investors in the residential market has been noticeable. This is in clear contrast with the logistics market where there are many new local and international entrants to the market. While this trend can be celebrated as validation of its attractive stable nature and increased maturity of the logistics market, it may be worth considering why domestic investors, who possess wide market insight and large capital, are not as enthusiastic about the residential market. The market making in the residential sector is currently being done mostly by aggressive overseas bidders, and occasionally with relatively high leverage. While investors with small portfolios could still find buyers when they exit, those with large numbers of properties might be vexed to divest them, particularly if the pool of potential buyers will not be as abundant in the future.

Nevertheless, favourable funding conditions as well as stable and defensive cashflow will remain attractive. Hence, multi-family residential properties in both Tokyo and regional hubs are likely to keep sought after.

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