Japan - August 2022

SPOTLIGHT
Savills Research

A Deep Dive into the Tokyo Residential Market

savills

Tokyo's residential market is stable, but warrants caution

Summary

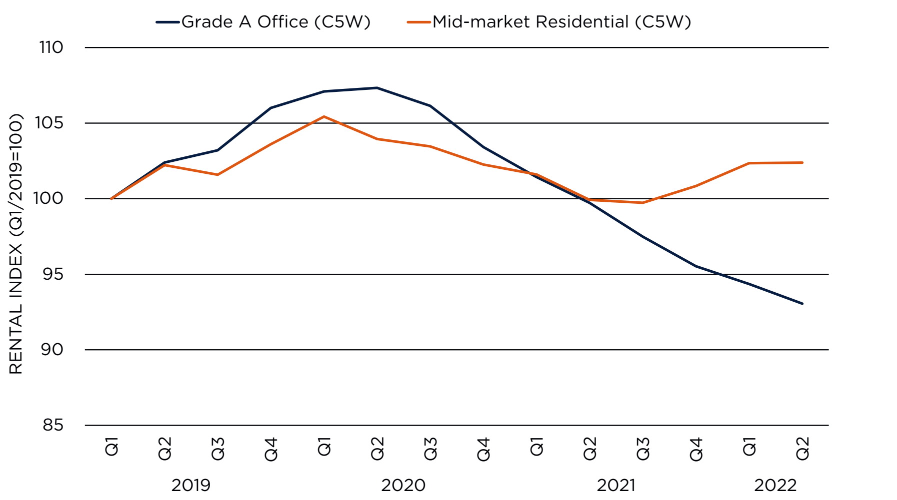
- Tokyo's residential market has been resilient during the pandemic and has started exhibiting recovery in recent quarters.
- Although the pandemic has changed demographic trends in Tokyo, the capital's population will likely resume its long-term growth trend, albeit gradually.
- While the residential market is supported by stable market fundamentals, investors should be cautious about the limitations and risks inherent in the residential sector, as well as potential interest rate increases.
- There is heightened competition for residential properties, and some overseas investors appear particularly keen on this sector.
- As concerns over interest increases grow, some investors may reconsider the sustainability of the compressed cap rates currently present in this sector, although overall fundamentals should remain stable.

INTRODUCTION

Japan's residential market remains popular due to its defensive nature that was demonstrated again during the pandemic. Although average residential rents in Tokyo's central five wards (C5W) declined by a moderate 5% between Q1/2020 and Q3/2021, they have already bounced back in recent quarters, offsetting half the rental decline seen during the pandemic. As Japan's economy continues its gradual recovery and the population inflow to the capital (both from other domestic regions and overseas) returns, Tokyo's residential market is expected to resume its steady growth trajectory.

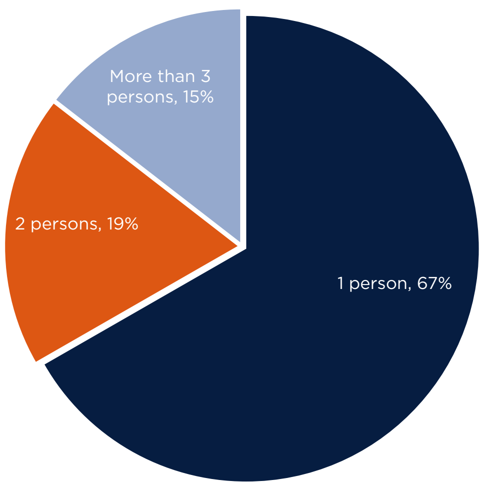
Nonetheless, new risks are emerging in this stable sector. The first risk factor is a result of fierce competition for residential assets. According to Savills in-house surveys, transaction cap rates for mid-market residential properties in Tokyo have narrowed to 3.3% as of Q2/2022, and winning bids of prime assets could certainly be much tighter in reality. Furthermore, while the sector's cap rate is still 70 basis points (bps) higher than that of Grade A offices, it may be tight considering the global pressure to increase interest rates, as well as the inflationary environment even in Japan. If Japan sees interest rate increases, which are expected to be moderate at most, currently

GRAPH 1: Residential Rent vs. Grade A Office Rent in the C5W, Q1/2019 to Q2/2022



Source Savills Research & Consultancy

GRAPH 2: Household Size Breakdown of Occupiers of Privately Run Rental Units in Tokyo 23W, 2018



Source Statistics Bureau of Japan, Savills Research & Consultancy aggressive international investors may need to revaluate their strategies in this sector. The second risk factor is the uncertainty of how new work styles will affect the residential market in the long-term. As discussed in our Tokyo Office Supply June 2022, companies will likely continue hybrid work arrangements, which could impede overall population inflows to the capital compared to pre-pandemic levels.

Overall, Tokyo's residential sector is on a stable footing with the prospects of continuous recovery. However, with these risk factors present, investors may need to exercise caution. In the following sections, we will highlight factors and trends that investors may want to pay attention to in making well-informed decisions.

Tokyo's residential market has demonstrated its defensive nature, supported by the capital's stable residential demand. With the pandemic transitioning to an endemic state and the economy regaining its footing, the residential market is likely to continue steadily recovering. However, there are signs of caution with some overseas investors looking particularly more keen than others. Concerns over interest hikes may cause some investors to assume a more cautious market outlook.

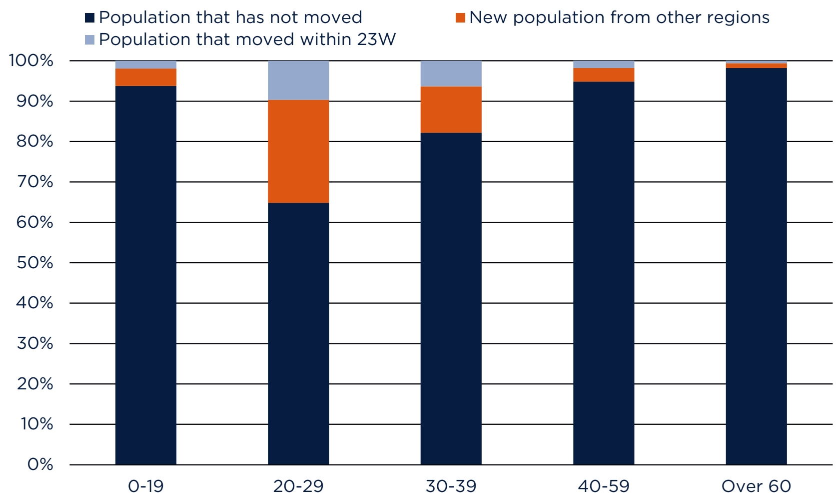
RESIDENTIAL LEASING MARKET IN TOKYO

Based on the House and Land Survey of Japan, the number of households that rent housing in Tokyo's 23 wards (23W) was about 2.5 million as of 2018. Out of that number, about 2.1 million of them rented privately-run rental units, with the remainder renting public housing and corporate housing. Additionally, based on the same survey, close to 70% of the renters were single households and approximately 20% were two-person households. Because of this high percentage of single and two-person households, average rental units in the 23W are typically about 40 sq m in size with two rooms that cater to small households.

Based on the statistics above, it is clear that the large proportion of the tenant pool is a cohort of relatively young workers without children. In fact, based on data of population movements, the population in the 20-to-29-year-old age band has a high propensity to move, both between prefectures as well as within the 23W (Graph 3). Due to the higher mobility seen in this age band, we can assume that they are more likely to rent than buy their own properties, therby driving demand in the residential leasing market.

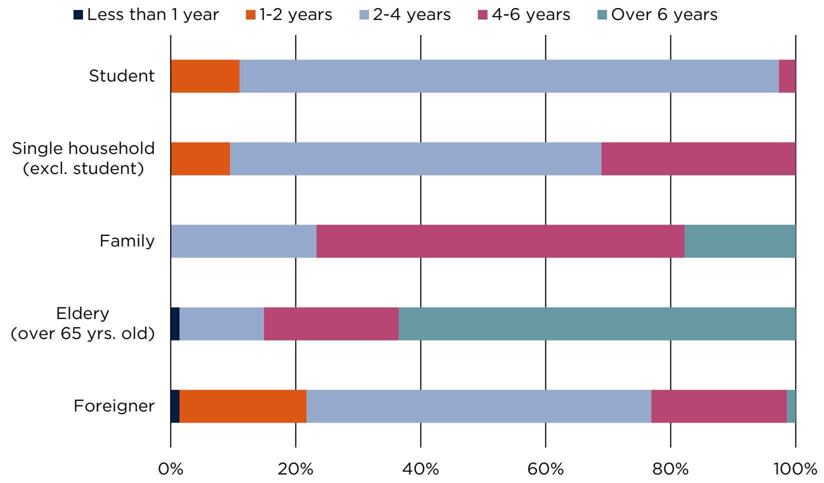
There are several implications that can be deduced from these observations. Firstly, the tenant turnover in an average residential property in Tokyo is likely to be relatively quick because single households have short renting periods on average. According to the Japan Property Management Association, close to 60% of single households rented their housing for a span of two to four years, while about the same percentage of families rented for four to six years in Greater Tokyo (Graph 4).

GRAPH 3: Population Mobility in Tokyo 23W, 2021



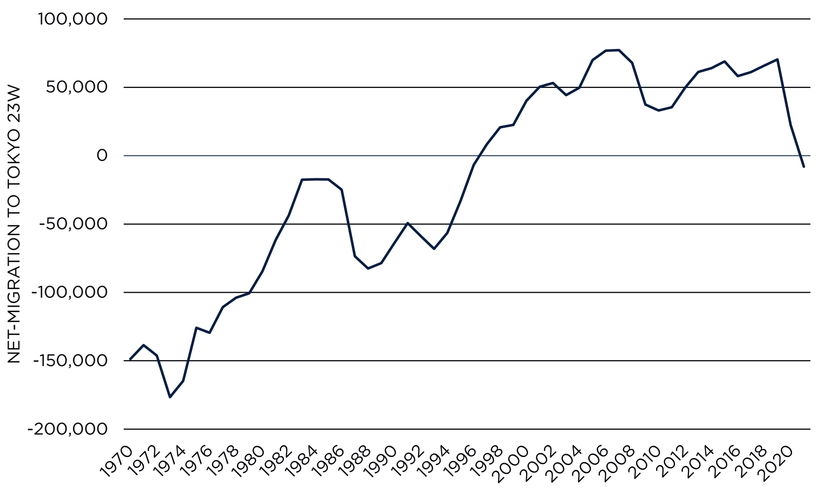
Source Tokyo Metropolitan Government, Ministry of Internal Affairs and Communications, Savills Research & Consultancy
Note: The population that has not moved is calculated by subtracting the new population that moved into the Tokyo 23W and the population that moved within the Tokyo 23W in 2021 from the population as of 1 January 2022.

GRAPH 4: Average Lease Length by Tenant Type, 2H/FY2020



Source Japan Property Management Association, Savills Research & Consultancy

GRAPH 5: Japanese Net-migration to Tokyo 23W, 1970 to 2021



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

Secondly, as discussed in a later section, the extent that rents can increase is largely dependent on the income levels of the population in their 20s and 30s. Despite the encouraging rental growth that Tokyo saw up until the onset of the pandemic, this indicates that there might be a ceiling to how much rents can increase by in Tokyo given young workers' relatively low salaries, especially with stagnant wage growth.

Lastly, we need to understand how the changes in behaviours and preferences of renters caused by the pandemic will affect the market. Specifically, it has been widely observed that larger units have gained popularity during the pandemic as many people have suddenly needed additional space to work remotely, and also due to the increased amount of time spent at home. Furthermore, as discussed in the next section, the net migration of the population between 20 and 29 years old plummeted after the pandemic started. Whether these changes remain in place going forward or not might change the dynamics of supply and demand.

TOKYO'S DEMOGRAPHIC TRENDS

Understanding demographic trends is essential to form a realistic view on the future of Tokyo's residential market, and it is especially important now since the pandemic disrupted the trends that were prevalent before. Indeed, although the net-migration volume to Tokyo was largely positive for over two decades, it fell to a negative territory since the pandemic struck (Graph 5)[1].

Graph 5 illustrates that the amount of net-migration to Tokyo has generally been moving in tandem with economic cycles, with temporary dips seen when the bubble burst and the global financial crisis struck. However, the recent abrupt drop in net-migration is much larger than the one seen during the downturn after the global financial crisis, which indicates that other than the economic slowdown, there are also other factors that have influenced net-migration.

Comparing the net-migration patterns in 2019 and 2021, the channel that saw the largest decline is the one between the 23W and other regions of Greater Tokyo (including other parts of Tokyo). Although net-migration from these regions was negative even in 2019 at -4,000, it decreased even further to -51,000 in 2021, meaning that Tokyo 23W lost 47,000 more people to other regions of Greater Tokyo in 2021 when compared to 2019 (Graph 6).

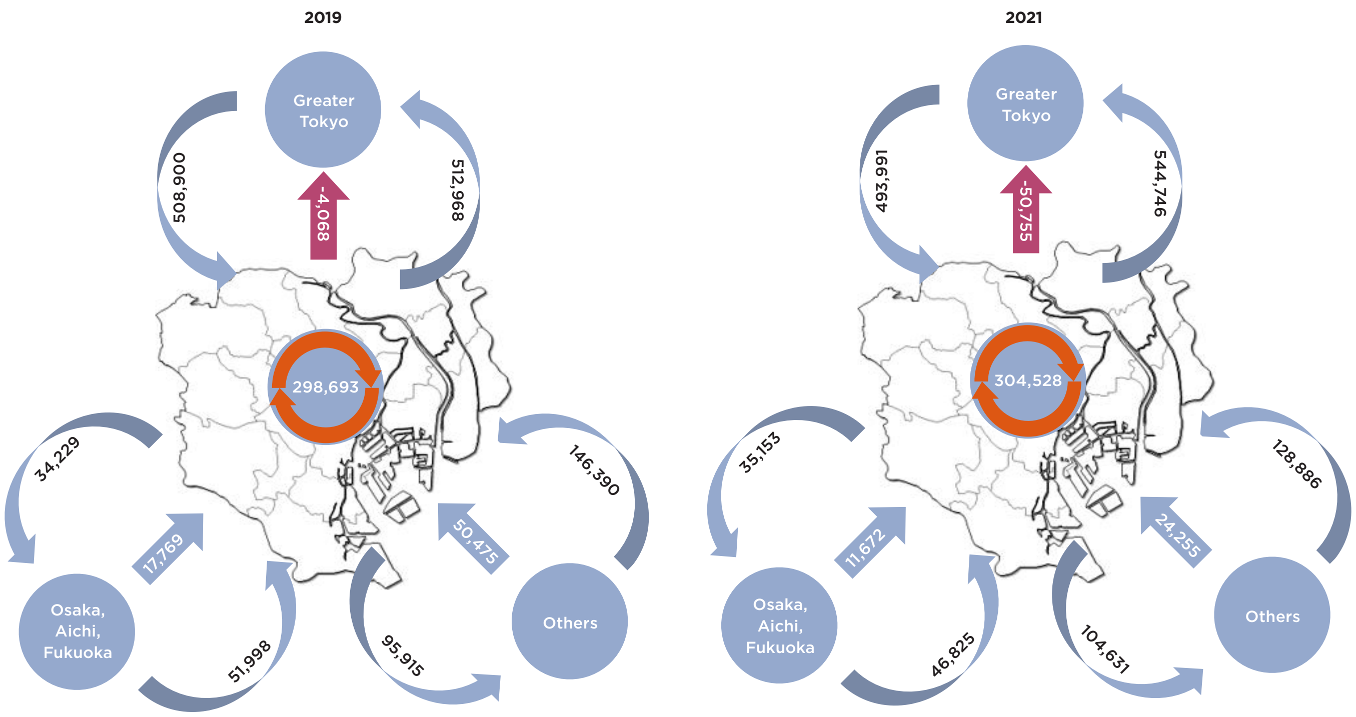
Looking closely, the increased negative net-migration is primarily caused by the increased outflow from Tokyo 23W to the other regions of Greater Tokyo. Between 2019 and 2021, the figure increased by 32,000 from 513,000 to 545,000. While the smaller inflow in 2021 (494,000) compared to that in 2019 (509,000) also contributed to the increase in the negative net-migration volume in 2021, the impact is relatively small, and it is clear that the outflow was the primary cause of the decreased net-migration volume.

Interestingly, the channel between Tokyo 23W and overall Japan excluding Greater Tokyo, Osaka, Aichi, and Fukuoka (henceforth referred to as Others) displays an opposite trend. In this channel, the impact from the decrease in inflow to Tokyo 23W (-18,000) is much larger than the impact from the increase in outflow to Others (-9,000). This contrast indicates that there must be multiple explanations as to how the pandemic has reduced the net-migration volume to Tokyo.

As is widely reported, a likely cause of the increased outflow to other Greater Tokyo regions is the prevalence of telework that arose with the pandemic. Telework arrangements have made it easier for workers to live further from their offices, and the increased needs for larger layouts that can accommodate workspace have encouraged people to move to Tokyo's neighbouring regions that are comparatively more affordable and more

1 The figures in Graph 5 exclude the foreign population for the consistency of the time-series data because the government has changed the method to track it.

GRAPH 6: Tokyo 23W's Migration Flows, 2019 vs 2021



Source Ministry of Internal Affairs and Communications, Savills Research & Consultancy
Note: the figures include both Japanese and foreign population movements within the country.

TABLE 1: Demographic Outflow from Tokyo 23W to Other Greater Tokyo Regions, 2019 vs 2021

REGION	2019	2021	CHANGE (PEOPLE)	CHANGE (%)
Other parts of Tokyo	347,637	358,272	10,635	3.1%
Kanagawa	61,830	72,632	10,802	17.5%
Saitama	57,964	63,317	5,353	9.2%
Chiba	45,537	50,525	4,988	11.0%
	512,968	544,746	31,778	6.2%

Source Ministry of Internal Affairs and Communications, Savills Research & Consultancy
Note: the figures include both Japanese and foreign population movements within the country.

suitable for raising children.

Amongst these neighbouring regions, Kanagawa saw the largest increase of outflow from Tokyo 23W between 2019 and 2021 (Table 1) with about 11,000 more people moving from Tokyo 23W to the prefecture. Additionally, other parts of Tokyo also saw a large increase in population outflow of about 11,000 people, though it is relatively small in terms of percentage changes.

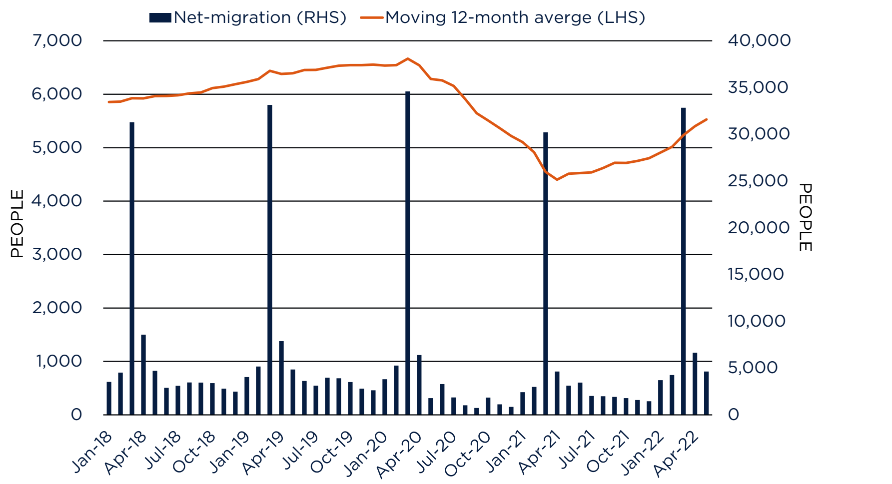
The primary reasons for the large increases in these regions would be their good access to Tokyo, as well as the popularity of cities such as Musashino and Tama. The cities in these regions are often cited as popular residential areas due to their accessibility and livability. While housing prices in Kanagawa and other parts of Tokyo (particularly the Tama region) are usually noticeably higher compared to Saitama and Chiba based on data available from Real Estate Information Network for East Japan (REINS), companies that have implemented telework tend to be larger ones because smaller companies do not have capacity to support telework. As such, the trend possibly indicates that higher-income people who work for larger companies have moved to relatively expensive popular regions with good accessibility such as Kanagawa and other parts of Tokyo.

On the other hand, the decrease of inflows

GRAPH 7: Demographic Inflow from Others to Tokyo 23W vs Number of Jobs Available for New Graduates for the Next Year, 2007 to 2021

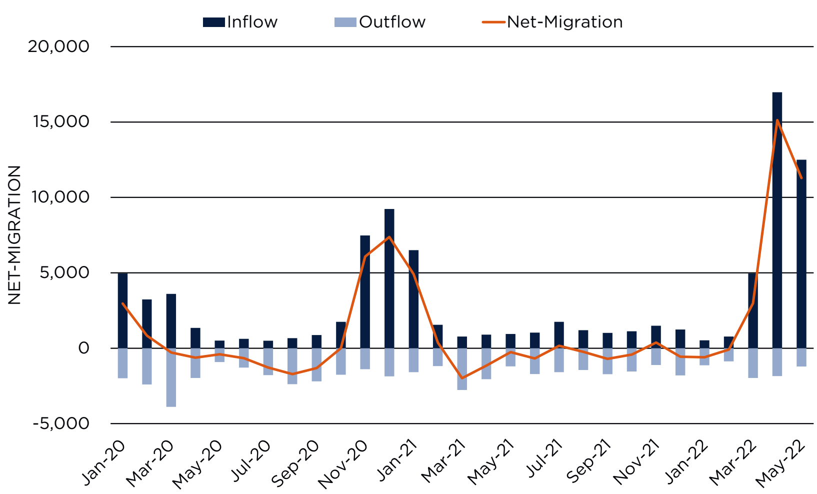
Source Tokyo Metropolitan Government, Recruit, Savills Research & Consultancy
Note: Demographic inflow figures exclude the movements of foreigners for the consistency of the time-series data because the government has changed the tracking methodology.

GRAPH 8: Monthly Net-migration (20 to 29 years old) to Tokyo Prefecture, January 2018 to May 2022



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

GRAPH 9: Tokyo 23W's Foreign Population Flow Between Overseas, Jan 2020 to May 2022



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

from Others to Tokyo 23W appears largely due to economic conditions rather than telework arrangements. As explained in the introduction, net-migration tends to move in sync with economic cycles because many migrants to Tokyo tend to be jobseekers. As such, when economic conditions are stable and jobs are available, the number of migrants generally increases.

Graph 7 clearly exhibits this relationship. The chart shows that demographic inflows from Others to Tokyo 23W each year has generally moved in tandem with the expected number of jobs available for new graduates for the next year. Unsurprisingly, companies lowered the expected number of jobs available in 2020 and 2021 due to the pandemic, which appears to have resulted in lower demographic inflows from Others.

Given the discussions thus far, whether and when the net-migration volume to Tokyo 23W will recover largely depends on future economic conditions and telework arrangements. Regarding the former, although profound uncertainty remains in the global market, Japan's economy is gradually recovering, and in Q2/2022 its GDP appears to have attained levels seen in pre-pandemic times. As for the latter, more workers are returning to offices as the pandemic transitions to an endemic state, although hybrid work styles that are currently prevalent are expected to remain in place. This paradigm shift should somewhat reduce the need to live in central areas compared to the pre-pandemic levels.

However, a reversal of this trend could happen as society moves towards normalcy. As such, we expect that the net-migration to Tokyo 23W will increase going forward, although the growth will be slower overall. Indeed, recent monthly statistics show signs of improvement over the past year. Reviewing the net-migration data for the 20-to-29-age band, which is a primary source of net-migration to Tokyo, the weakish trend has started to bottom out around Q1/2021 and is continuing to improve through more recent quarters (Graph 8).

We expect that this recovery trend will continue going forward because living in the capital comes with benefits not limited to a shorter commute. For instance, with the redevelopments happening across Tokyo, the capital should become increasingly attractive to live.

In addition to improving domestic net-migration trends, the revived inflow of foreign nationals should help Tokyo's population recover. With border restrictions partially lifted, the number of foreign nationals moving to Tokyo 23W from overseas has increased in recent months. During the pandemic, areas that had relatively large foreign populations suffered a larger demographic loss. However, with border controls relaxed, these wards are expected to see stronger growth[2].

ECONOMIC STRUCTURE OF RESIDENTIAL MARKET

As mentioned in the introduction, Tokyo's residential market remains popular due to its defensive nature. This strength has been emphasised especially during current uncertain times, and the sector is gaining more investor interest. However, the risks and limitations inherent in this sector are seldom discussed. In this section, we will shed some light on several challenges in the residential sector that investors should pay attention to.

Firstly, it should be noted that the competitiveness of residential properties tends to depreciate with age. For instance, average rental levels of Savills samples that are less than ten years of age are approximately 10% higher than samples of Tokyo Kantei that are approximately 20 years old on average (Graph 10). Newer residential properties have also generally enjoyed higher occupancy over the past few years (please see Appendix). The difference in performances indicates that the economic value of residential properties generally depreciates during their holding periods and would require a substantial amount of capital expenditure to remain competitive.

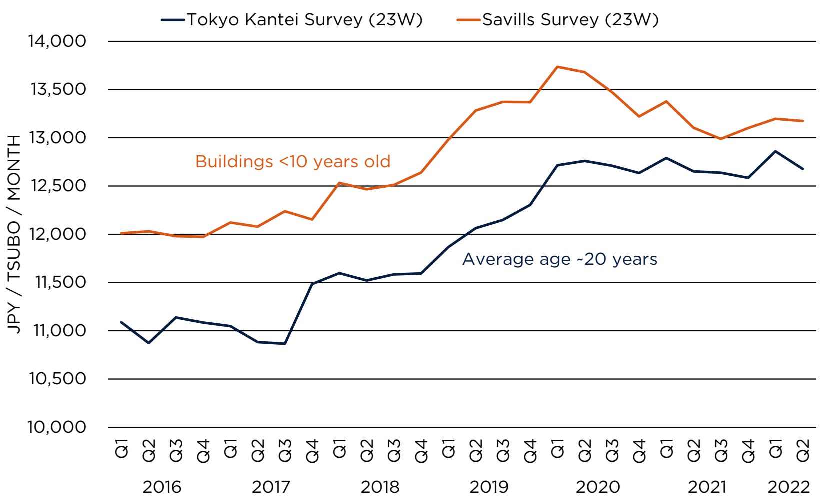
One likely reason for this performance gap is the high substitutability of mid-market residential properties. Unlike high-end residences, mid-market residential properties, which are the acquisition targets of most investors, typically offer products that are largely interchangeable, with location and building age being two of the largest differentiating factors. Additionally, the rental market's high transparency that allows people to compare hundreds of listings with a few clicks makes the competition tougher for older properties. In this environment, older properties are less desirable than new supply unless effective capital expenditure plans are in place, and many would need to lower rents to attract tenants. Moreover, older and poorly located properties would require labour intensive services such as advertising and proactive leasing management, which further shaves off yields.

Secondly, the stickiness of residential rents, which is an attractive characteristic during a downturn, could also limit upside potential during an upturn. In the residential market in Japan, ordinary-lease contracts, which give tenants strong legal protection, account for about 95%[3] of residential leases. With these contracts, it is difficult for owners to raise the rents of existing tenants, meaning that the rental growth of current contracts tends to be slower than that of market rents (see Appendix). Considering this limitation together with the tight cap rates in the current market environment, expected returns might not be very attractive for investors with higher return targets. This may be especially so given concerns over interest increases.

Moreover, the rental market's tenant profile also limits rental upside. Given that people in their twenties have the highest mobility, they make up a large portion of demand in the rental market. However, their ability to pay high rents is limited by their relatively low salaries. While some companies provide subsidies to cover a portion of rents, this subsidy has been declining over the past few decades - it was about JPY11,700 per month in FY2019, about 20% down from the level seen in FY2002 according to Keidanren's annual survey.

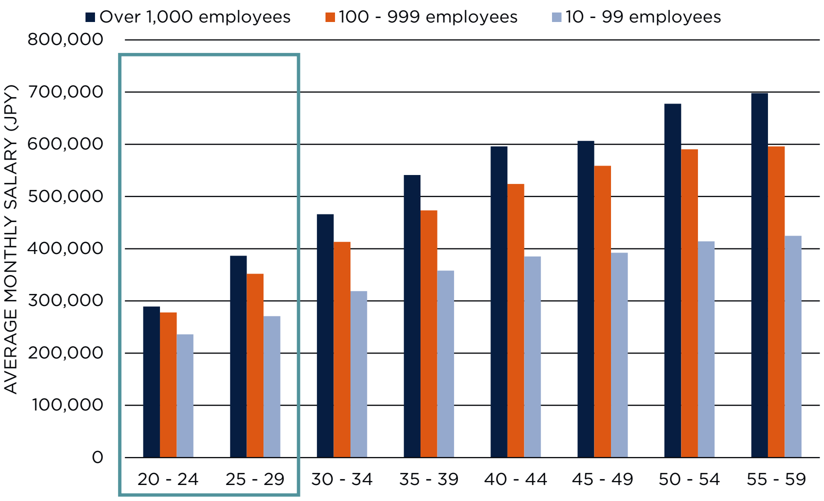
That said, companies seem to have become more willing to pay higher salaries to people with highly desired skills regardless of age. In fact, entry-level salaries for new graduates have kept increasing noticeably due to the competition for talent and the increasing profitability of listed Japanese companies, and

GRAPH 10: Tokyo Kantei vs. Savills Rental Data (23W), Q1/2016 to Q2/2022



Source Tokyo Kantei, Savills Research & Consultancy

GRAPH 11: Average Monthly Salary in Tokyo by Age Group, 2021



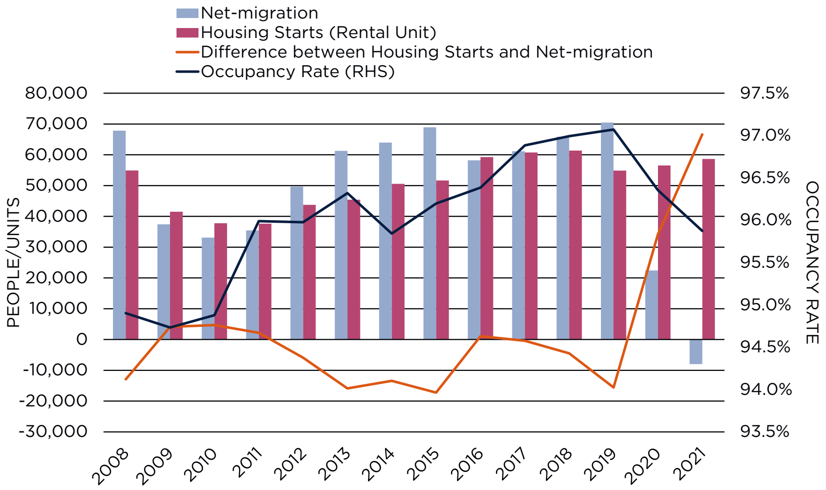
Source Tokyo Metropolitan Government, Ministry of Internal Affairs and Communications, Savills Research & Consultancy

Note: The figures in the chart are including fixed monthly salaries and one-twelfth of annual bonus amounts. They do not include overtime pay.

2 Specifically, Shinjuku saw the largest decline of about 8,700, followed by Toshima (5,500) and Nakano (4,300) when comparing foreign populations in 2019 and 2021 . Minato, which has a high concentration of embassies and foreign companies, also saw a decline of 3,400.

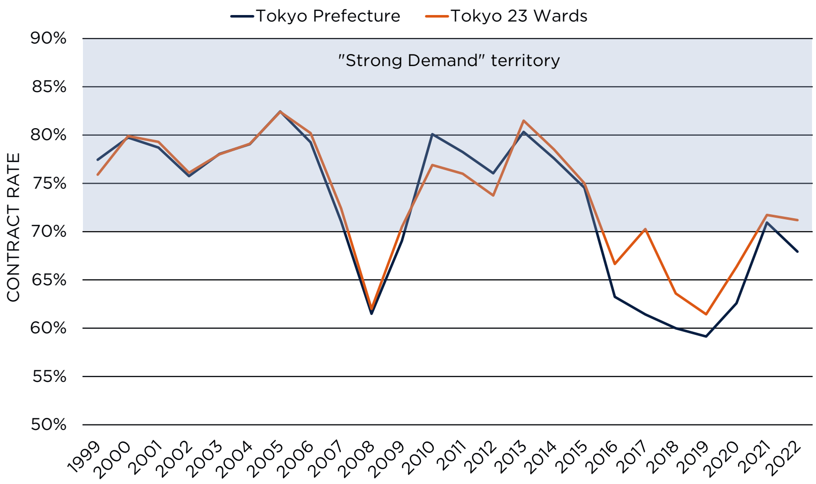
3 According to an annual survey conducted by the Ministry of Land, Infrastructure, Transport and Tourism, 95.5% of people who moved to rental units had ordinary-lease contracts in 2020.

GRAPH 12: Net-migration vs Housing Starts of Rental Units vs Occupancy Rates in Tokyo 23W, 2008 to 2021



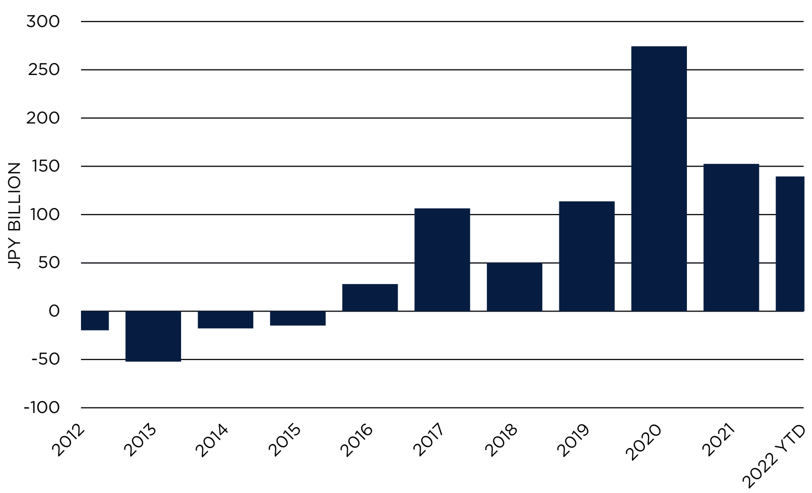
Source Ministry of Internal Affairs and Communications, J-REITs, Savills Research & Consultancy

GRAPH 13: New Condominium Contract Rate, 2005 to Q1/2022



Source Real Estate Economic Institute, Savills Research & Consultancy
Note: "Contract rate" refers to the % of units in a new building sold within the first month of sales effort.

GRAPH 14: Net Acquisition by Overseas Investors in Japan, 2012 to June 2022



Source RCA, Savills Research & Consultancy

this trend should continue going forward. Therefore, residential properties that have favourable characteristics to these highly skilled workers (i.e. location and amenities) are likely to enjoy stronger growth, suggesting a reason as to why rental recovery in the C5W has been stronger in recent quarters.

Lastly, supply could also disturb the market, especially during a downturn. The number of housing starts is typically in sync with the net-migration trend into Tokyo, and occupancy rates tend to be stable under this environment. However, the decline in net-migration due to economic slowdown has led to a glut of newly constructed rental units, leading to declines in occupancy. While demographic trends are relatively stable and are easy to project during normal times, the current downturn with possible paradigm shifts makes projections more difficult and could consequentially result in a mismatch between supply and demand.

In addition to the changes in the demographic trends discussed in the previous section, a potential preference shift from renting to buying could also disturb the balance between supply and demand. Specifically, contract rates of newly constructed condominiums, which are a proxy of condominium demand, reached 70% in 2021 after they remained below the benchmark rate between 2016 and 2020 (Graph 13). While prices for condominiums in Tokyo remain elevated, factors such as low interest rates, the increasing number of dual-income households, as well as changes in living preferences due to the pandemic (please see our Tokyo Residential Sales 1H/2022) appear to have prompted more people to switch from renting to buying condominiums. Additionally, according to REINS, the number of transacted second-hand condominium units has hit a historical high in FY2021 after four consecutive years of growth.

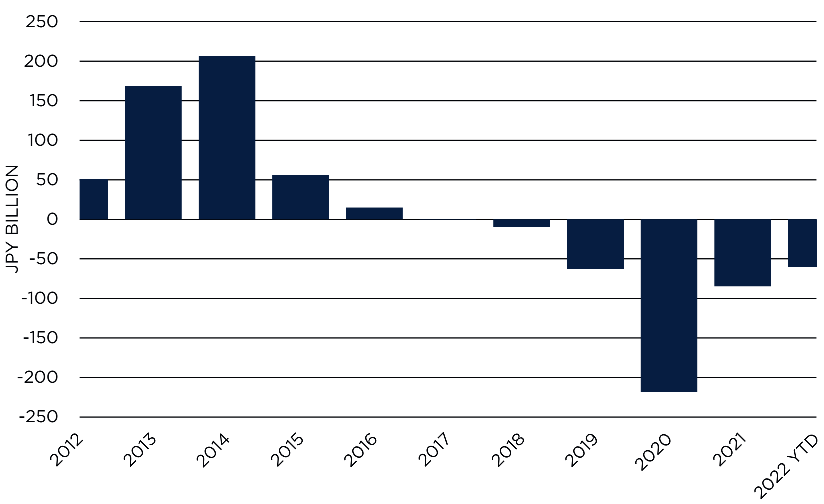
TRANSACTIONS

As indicated in the introduction, overseas buyers have grown particularly active in Japan's residential market in recent years. After Blackstone acquired a portfolio of residential properties from General Electric Japan for approximately JPY200 billion in late 2014, various international players also began making acquisitions in this sector. Most recently, M&G Real Estate's acquisition of 30 assets from Blackstone was for JPY49 billion. One challenge in the residential sector is the small sizes of individual residential properties, and amassing them into large portfolios can provide the scale that institutional investors with large capital for deployment require. At the same time, a handful of overseas investors appear more aggressive than others, and an increasing number of secondary transactions among institutional investors could limit room for new owners to add value.

Based on RCA data, Graph 14 illustrates that net-acquisition volumes by overseas investors have increased in recent years. In fact, a few overseas investors stand out when comparing acquisition volumes over the past five years (Table 2). On the other hand, interestingly, the REITs/Listed category has shown an opposing trend and recorded negative net-acquisition volumes during the same period. In fact, J-REITs appear to have been taking more cautious stance on the residential sector with acquisition cap rates seldom being lower than 4%, although they use "stabilised" appraisal cap rates. While this gap in investor sentiments is not of concern at this moment, it might raise a question about the current situation when the market starts to show softness.

Indeed, some investors, especially those already with sizeable AUM, have started to show concerns over interest increases, and are taking a wait-and-see attitude. Although the Bank of Japan (BOJ) repeatedly reaffirmed its stance to keep its monetary policy in place, the stark difference between the stance of the BOJ and global counterparts has further weakened the yen, making some investors worried about possible interest increases in Japan. With yield spreads already slim due to low cap rates in the residential sector, it is possible that some start to freeze new investments if the uncertainty increases. Please refer to "2022 Investment Strategy" report for further analysis and insight.

GRAPH 15: Net Acquisition by REITs/Listed Vehicles in Japan, 2012 to June 2022



Source RCA, Savills Research & Consultancy

TABLE 2: Top 5 Buyers of Residential Properties Over the Past 5 Years

REGION	BUYER	JPY BILLION
1	Blackstone	428.5
2	Allianz	165.9
3	AXA Group	129.4
4	Samty	76.1
5	Nuveen Real Estate	76.1

Source RCA, Savills Research & Consultancy

OUTLOOK

Although it was not fully insulated from the pandemic, Tokyo's residential market has already started to exhibit recovery after experiencing relatively mild corrections. The resilience that this sector has demonstrated speaks to its defensive nature and has attracted growing interest from overseas investors.

In fact, Tokyo's population is expected to resume growth as the pandemic transitions to an endemic state. Gradual economic recovery should increase net-migration from other prefectures as job opportunities increase in Tokyo. Furthermore, the foreign population has already started to return to Japan with border controls being relaxed.

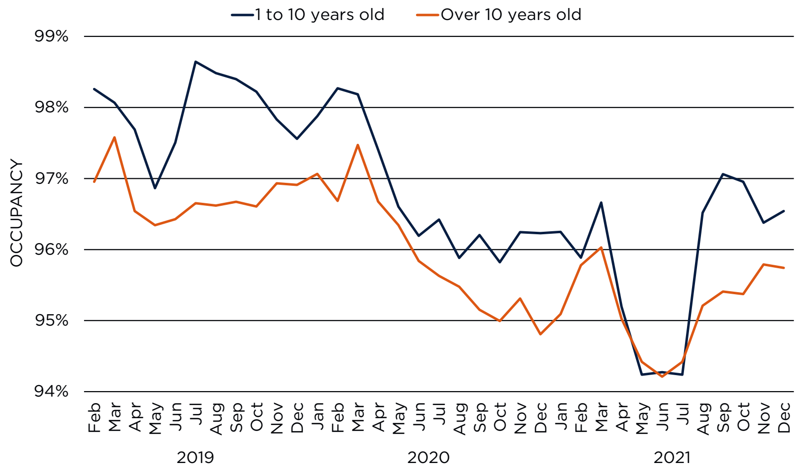
However, with cap rates for residential properties getting even tighter in conjunction with concerns over interest rate increases, the pool of investors that can compete in this sector might become limited. Indeed, while a handful of overseas investors have made large transactions, domestic investors such as J-REITs have been relatively quiet in comparison. Due to the sector's limitations, the upside potential may not seem very appealing to some investors compared to other sectors with more value-add opportunities.

That being said, there are opportunities as new trends are emerging. For instance, an emergence of highly paid, skilled workers creates opportunities for properties with features that appeal to them. Moreover, undergoing redevelopment projects across Tokyo will add new landmarks and make neighbouring areas attractive.

Overall, the market fundamentals of the residential market are expected to remain stable going forward, and the areas that suffered during the pandemic should continue their recovery. However, with signs of some overheating present, investors should tread carefully and keep their optimism in check.

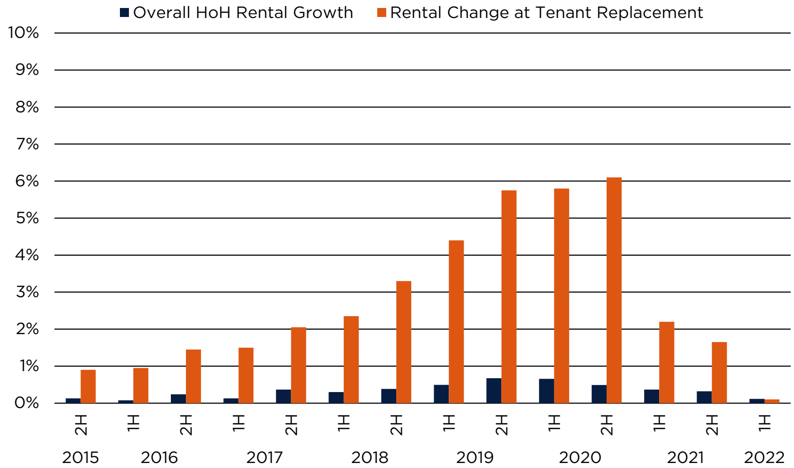
Appendix

GRAPH 16: Occupancy Rate by Building Age in Tokyo, February 2019 to December 2021



Source Advance Residence Investment Corporation, Savills Research & Consultancy

GRAPH 17: Overall Rental Growth vs Rental Change at Tenant Replacement, 2H/2015 vs 1H/2022



Source J-REITs, Savills Research & Consultancy

Some of the characteristics of residential properties we have mentioned in the report can be observed by reviewing data published by J-REITs. For instance, Graph 16 illustrates that newer properties tend to have higher occupancy rates. Although the pandemic temporarily shrank the difference at the beginning, the gap has widened since.

Additionally, Graph 17 shows how residential rents have been sticky, leading to differences between market rents and contract rents for existing tenants. Over the past years, the J-REITs managed to raise rents at 2.8% on average when introducing new tenants, in comparison to the average rents of its overall portfolio that has increased marginally at 0.3%.

Certainly, private players could take more aggressive approaches and increase rental levels more noticeably, but these aspects of residential properties are important to keep in mind during the underwriting process.

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