MARKET IN MINUTES

Savills Research

Residential Leasing

savills

Tokyo rents facing another marginal correction

Rents have posted a slight decline for a second consecutive quarter, though occupancy remains at a high level.

- Rents in the Tokyo 23 wards (23W) saw a slight pullback during Q3/2020, now standing at JPY4,076 per sq m – a decrease of 1.5% quarter-on-quarter (QoQ), but still 0.8% higher year-on-year (YoY).
- Average mid-market rents in the central five wards (C5W) also fell – albeit at a slower pace. Rents for Tokyo's top submarket are now at JPY4,835 per sq m after a decline of 0.5% QoQ, though rents are still up 1.8% YoY.
- The C5W saw its premium over the 23W average expand back to around 18.5%, with only the South and Outer East submarkets outperforming.
- At the ward level, Edogawa marked the strongest growth this quarter, posting an 8.7% QoQ gain. Shibuya took the top spot on an annual basis, displaying robust growth of 8.0% YoY.
- In the C5W, average rents for units in the 15-30 sq m size band remained flat, while units in the 45-60 sq m size band or with 2-to-3 bedroom layouts saw growth.
- After suffering a mild blow during the April and May lockdown, the average occupancy rate for the 23W recovered slightly, rising 0.2 percentage points (ppts) QoQ to 96.6% as of Q3/2020. That said, occupancy in the C5W has contracted once again, falling 1.4ppts QoQ to 94.7% - its lowest level since 2014.
- With work-from-home arrangements remaining the norm, there are indications that preferences for unit type are undergoing a shift, as more residents are prioritising spaciousness over location.

"Average multi-family rents continued to soften in Q3/2020, though occupancy has held steady. Amidst the ongoing COVID-19 outbreak in Tokyo, companies are expected to maintain remote and flexible working arrangements for the time being. Preferences for residential unit type, size, and location appear to be shifting as a result."

SAVILLS RESEARCH & CONSULTANCY

Savills team

Please contact us for further information

JAPAN

Christian Mancini
CEO, Asia Pacific
(Ex Greater China)
+81 3 6777 5150
cmancini@savills.co.jp

RESEARCH

Tetsuya Kaneko
Director, Head of Research & Consultancy, Japan
+81 3 6777 5192
tkaneko@savills.co.jp

Matthew D'Elia
Manager, Research & Consultancy, Japan
+81 3 6777 5179
mdelia@savills.co.jp

Simon Smith
Senior Director
Asia Pacific
+852 2842 4573
ssmith@savills.com.hk

MAP 1: Tokyo's 23 Wards By Survey Area

Source Savills Research & Consultancy

SURVEY GEOGRAPHY

In order to illustrate trends in the central Tokyo residential market, Savills has segmented Tokyo's 23 wards into seven distinct geographical areas: Central (or "central five wards"), South, West, North (Inner and Outer) and East (Inner and Outer).

RENTAL INDEX DATA CHARACTERISTICS

Savills collates thousands of leasing comparables each quarter in order to analyse trends affecting "mid-market" rental apartment units in Tokyo. Our benchmark rental data is based on average advertised monthly rents for units which fit the following criteria:

1) studio and one- or two-bedroom rental apartments of up to 100 sq m in size,

2) reinforced concrete structures built within the last ten years, and

3) properties located in Tokyo's 23 wards and situated within a ten-minute walk of the nearest station.

In contrast to the luxury residential market, advertised or "asking" rents for mid-market units fitting the above criteria are typically non-negotiable and are not subject to incentives such as rent-free periods. Savills mid-market rental indices are therefore considered to closely reflect movements in contract rents for the Tokyo market.

OVERALL RESULTS

After reaching a record high, average rents for the 23W and C5W have contracted for two consecutive quarters for the first time since 2016 and have fallen below their four-period moving averages, possibly indicating that the market has entered a downturn (Graph 1). Indeed, it appears that latent demand has yet to manifest following Tokyo's soft lockdown in April and May. With an ongoing COVID-19 outbreak in the capital, many companies are continuing remote working arrangements whilst major universities intend to do the same in the form of an online semester. The population of Tokyo Prefecture has thus remained flat since reaching a high watermark of 14 million in May. This, combined with restrictions on prospective foreign residents entering the country, has disrupted demand for residential units in the 23W.

While landlords may find less demand for vacant units over the coming months, most can rest assured that their tenanted properties will maintain stable performance for the time being. Japan's unemployment rate stands at 3.0% as of August 2020, only 0.8ppts higher than its record low of 2.2% in December of last year. As such, tenants should generally have the capacity to pay their current rents. That said, labour demand has clearly fallen, with the job-to-applicant ratio dropping from 2.08x in December 2019 to 1.22x as of August. This will inevitably weigh on incomes and put downward pressure on rental growth going forward.

As rents generally fell faster in the outer submarkets in Q3, the C5W's premium has expanded by 1.1ppts to 18.5% (Graph 2). Only the Outer East submarket posted growth for the quarter, perhaps because of its affordability. This contraction is not occurring across the board, however, as larger units and layouts with multiple rooms have seen rents grow so far this year.

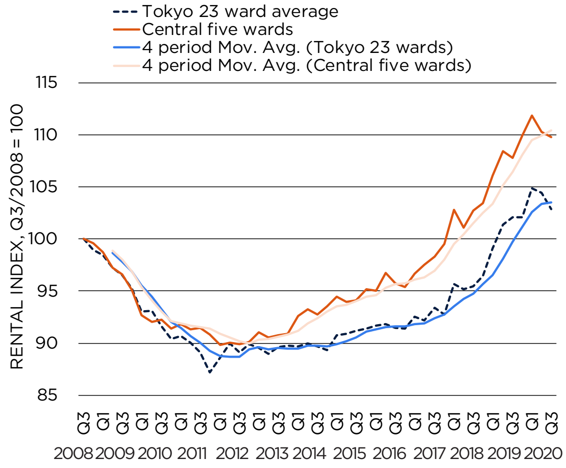
Average occupancy in the 23W remains comfortably high, rising 0.2ppts QoQ to 96.6%. The number of residential listings continues to increase, however, suggesting that a disruption to leasing demand may lie ahead. Though leasing activity resumed following the April and May lockdown, it remains somewhat slower than in previous years. C5W occupancy falling below 95% is a case in point. Indeed, pent-up demand was not as robust as landlords had originally hoped and this is likely to be true until at least the end of the year.

MID-MARKET RENTAL TRENDS BY SURVEY AREA

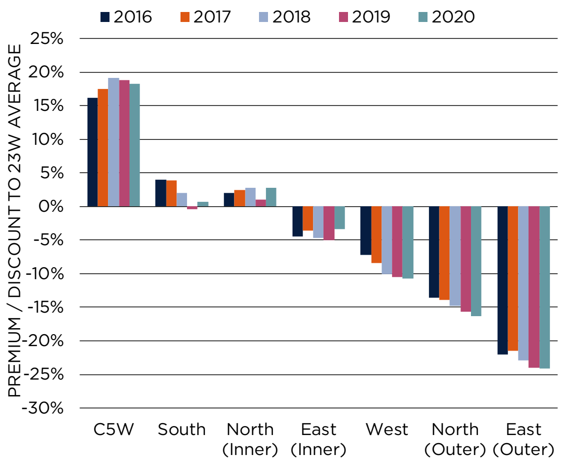
Average multifamily asking rents for the 23W have fallen by 1.5% QoQ, landing at JPY4,076 per sq m as of Q3/2020. Rents are still 0.8% higher YoY, remaining comfortably above levels seen just prior to the Global Financial Crisis. In a reversal from the previous quarter, rents in the C5W saw a less pronounced drop of 0.5% QoQ and remain 1.8% higher YoY. Some of the more expensive submarkets in the 18 outer wards (18W) pared back the rental gains made last quarter, though all submarkets have maintained higher rents on an annual basis (Graph 3).

Each ward in the C5W – save for Shibuya – experienced a quarterly decline in average rents. With Minato's rents declining 2.0% QoQ and those of Shibuya rising 2.0% QoQ, the latter has once again taken the top spot for average rents in Tokyo. In fact, following steady growth over the past year, the submarket has seen an 8.0% YoY increase in

GRAPH 1: Mid-market Apartment Rental Index, Q3/2008 to Q3/2020



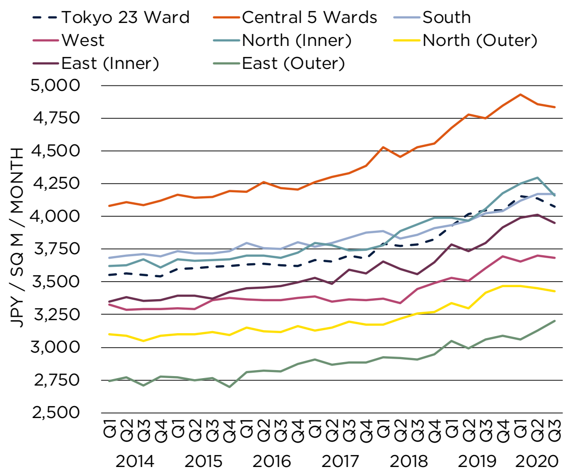
GRAPH 2: Rental Premiums/Discounts* vs 23W Average, 2016 to 2020



Source Savills Research & Consultancy

* The above represents the average premium/discount over the respective year.

GRAPH 3: Mid-market Apartment Rents, Q1/2014 to Q3/2020



Source Savills Research & Consultancy

rents, second only to the highly-discounted Edogawa in the Outer East submarket.

Following nine consecutive quarters of growth, the South submarket saw rents remain more or less flat in Q3/2020, falling just 0.1% QoQ to JPY4,168 per sq m. As in the previous quarter, Meguro marked the strongest growth – coming in at 1.4% QoQ and 7.6% YoY. Rents in the ward are now higher than those of both Chuo and Shinjuku in the C5W. The number of new-unit listings in Meguro has nearly doubled over the past year, potentially contributing to this gain. The ward's proximity to Shibuya and Minato, combined with the availability of green spaces and a charming riverfront, could be making the area more attractive in the wake of COVID-19. However, the high number of new-unit listings could imply less demand and rents could fall once these units are leased out. Nearby Shinagawa gave back some of its recent gains with a 2.2% drop in rents over the quarter. All wards in the South still have higher rents on an annual basis.

After demonstrating impressive annual growth of 8.2% as of last quarter, the Inner North submarket saw a pullback in rents during Q3. Specifically, rents fell 3.1% QoQ – the most significant decline of any submarket this quarter. This pullback was led by Bunkyo, which, after posting robust growth of 4.4% last quarter, saw those gains disappear with a 4.8% QoQ contraction this time around. Despite this significant drop, rents across the ward remain 5.1% higher on annual basis. Nearby Toshima posted a milder contraction of 1.2% QoQ, though the ward's performance on an annual basis is far less impressive. On the other hand, given the ward's significant discount to both adjacent Bunkyo and the C5W, and strong commercial development pipeline, there may be more upside potential in Toshima in the years to come.

(Please refer to our Spotlight Report "Ikebukuro" for further analysis on the Inner North submarket)

The Inner East submarket has similarly seen a contraction after a period of robust growth, with rents falling 1.6% QoQ, but still up 4.0% YoY. With the largest rental growth last quarter, Sumida saw the most significant decline in rents this quarter, falling 4.2% QoQ. Average rents in the ward are still up 4.8% YoY, however. Taito and Koto marked YoY growth of 4.4% and 3.0%, respectively, though rents in the former fell 0.5% while those of the latter remained flat on a quarterly basis.

The West submarket felt a mild contraction of 0.5% in Q3/2020, and average rents now stand at JPY3,682 per sq m. Nakano, which led the submarket's growth last quarter, saw rents fall by 0.3%, while those of nearby Suginami remained flat. Rents in Nerima, the most discounted ward in the submarket, declined by 1.2% QoQ. Each ward in the submarket is maintaining higher rents on an annual basis, with Nakano taking the lead at 4.9%. The ward appears to have many times more listings than in the same quarter last year, which is likely a key contributor to its robust annual performance. As in Meguro, however, the spike in new listings could indicate a drop in demand, while also setting the ward up for a larger contraction in rents next quarter.

The Outer North submarket saw rents soften once again after a 0.6% QoQ drop. Itabashi continues to see its rents recover somewhat after falling from a historic high in Q3/2019, posting growth of 0.9% QoQ but still down 5.7% YoY. Kita experienced a softening of 2.0% QoQ, but still maintains a 6.8% premium over the same period last year.

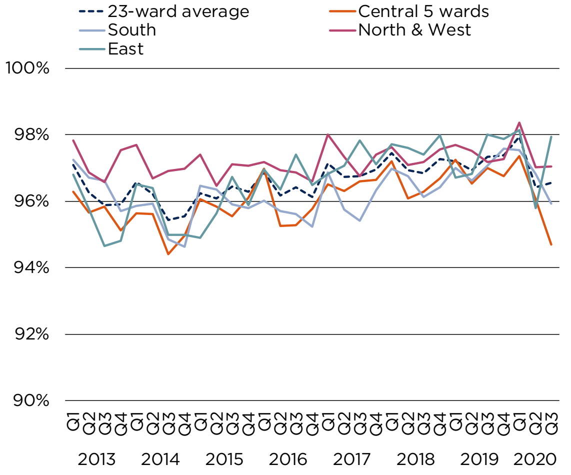
The Outer East, the 23W's cheapest submarket, was once again home to the strongest growth of all surveyed submarkets this quarter, with rents increasing 2.3% QoQ and 4.6% YoY to JPY3,129 per sq m in Q3/2020. Each ward in the submarket save for Katsushika saw growth this quarter. In a divergence from last quarter, Edogawa, the least expensive ward in the 23W, saw rents grow 8.7% QoQ, the strongest growth of any ward in Tokyo this quarter. This appears to have largely been an upward correction given that Edogawa saw rents decline in the first two quarters of the year. As such, despite its quarterly contraction, Katsushika still produced annual growth of 7.8%. The Outer East is the most suburban submarket in the 23W and recent rental growth here may reflect a growing preference for a less urban environment and more affordable areas. Recent occupancy trends add some validity to this argument.

OCCUPANCY RATES

With the resumption of leasing activity following the April and May lockdown, the average occupancy rate in the 23W rose 0.2ppts QoQ to 96.6%. While this is a positive development, the recovery in occupancy rates is milder than initially expected. Moreover, in the C5W, Tokyo's top submarket, occupancy has contracted 1.4ppts QoQ to 94.7%, falling below the 95% mark for the first time since 2016. The East submarket, on the other hand, has seen occupancy swing in the other direction, rising 2.1ppts to 97.9%, which is probably supporting rental growth in the submarket.

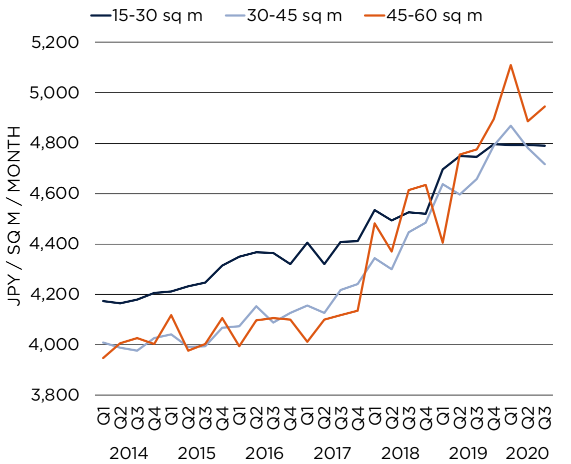
Whilst beyond the scope of coverage in this report, it is also worth noting that, based on J-REIT disclosures, properties located in

GRAPH 4: Average Occupancy For J-REIT Residential Assets, Q1/2013 to Q3/2020*



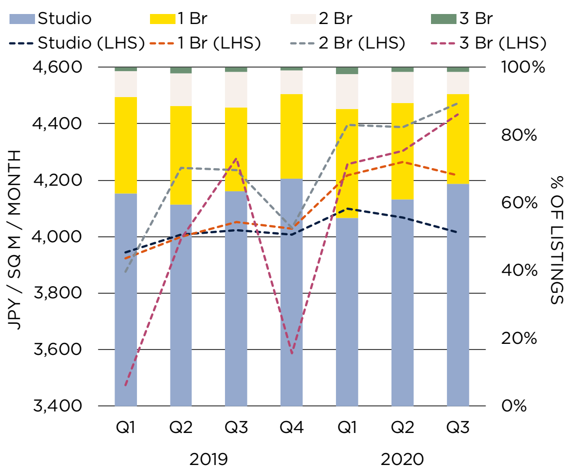
Source Savills Research & Consultancy based on publicly disclosed J-REIT property data (Advance Residence and Nippon Accommodation Fund)
* Q3/2020 is as of August 2020

GRAPH 5: Rents By Unit Size, C5W, Q1/2014 to Q3/2020



Source Savills Research & Consultancy

GRAPH 6: Rents By Unit Layout And Proportion of Listings, Q1/2019 to Q3/2020



Source Savills Research & Consultancy

major hubs in the periphery of Greater Tokyo, such as Yokohama and Funabashi (Chiba), are exhibiting almost full occupancy. This, along with trends observed in the East submarket of the 23W, might suggest that a common perception is in fact true – namely that in the face of COVID-19, residents are leaving central Tokyo in favour of more affordable suburban environments. That said, these data represent a small number of high-quality assets outside of the Tokyo 23W. Still, this may imply an emerging trend.

RENTS BY UNIT SIZE

Tokyo's rental market is principally made up of compact single-occupier units, typically less than 45 sq m (13.6 tsubo) in size. Such units can often make up as much as 75% or more of the 23W area's rental listings. Unlike other major global cities such as London and New York, house or apartment sharing does not form a major segment of the rental market. As a result, there is a large, stable market for small- to mid-sized units.

Average rents for units in the 15-30 sq m size band, which account for the lion's share of unit supply, have essentially remained flat over the quarter, extending the plateau seen since Q4/2019. Units in the larger size bands appear to have diverging trends, however. Specifically, average rents for units ranging from 30 to 45 sq m have seen a quarterly decline, whilst those for units ranging from 45 to 60 sq m have seen an increase over the same period. The latter segment of the market accounts for only a small portion of total supply and therefore fluctuations are common. Even so, units in this size band have been holding at a high level year to date.

While it may be too early to extrapolate broad shifts in demand from these recent rental movements, changing preferences for layouts could partially explain the divergence in rents among units over 30 sq m. Within the 30-45 sq m size band, for instance, there tends to be a concentration of units around 40 sq m with one-bedroom layouts. Such units are typically targeted towards couples, or individuals with more spending power. The rise of dual-income households in particular had been driving growth in this segment of the market, with couples valuing convenience over unit size.

The sudden implementation of work-from-home arrangements has likely altered this dynamic, prompting these demographics to require more space and layouts with an additional room. Individuals with extra cash, for instance, are more mobile and likely to change their lifestyle in response to the COVID-19 environment. Units in the 45-60 sq m size band presumably have the two bedroom layouts that would accommodate this need. This, combined with the fact that supply of units with such layouts is far more limited, could be a factor supporting this segment's recent performance.

A SHIFT IN UNIT PREFERENCES?

Japan continues to adjust to a 'new normal' in the midst of the ongoing pandemic. Employees and companies of all types are quickly being prompted to adapt to teleworking and flexible commutes to reduce contagion risks. A Reuters Corporate Survey undertaken in early August 2020[1] found that office space utilisation, compared with a year ago, has seen a sharp drop. Specifically, over a sixth of firms said office utilisation had fallen 10-20%, while 25% said it had decreased 30-50% and 9% said that it had more than halved over the period. Whilst only a short-term shift for now, the long-term effects are still uncertain given the proportion of remote working employees in a post-pandemic world is still unknown. Regardless, increased flexible working is seemingly becoming more likely.

The prevalence of compact studio and single-bed units in Tokyo has allowed many to live in convenient locations at an affordable price – optimal for a pre-pandemic lifestyle where a home was little more than a place to sleep. With living spaces now playing host to much more, preferences for unit layout and location have, unsurprisingly, changed. In an attempt to measure this shift, SUUMO conducted a survey analysing people's preferences for unit size vs. proximity to the nearest station. The findings showed that over a six-month period to July 2020, preference for size had increased from 42% to 52%, whilst station proximity had fallen from 40% to 30%. In both surveys, 18% of respondents decided either was acceptable. Whilst this data does not necessarily imply an impending exodus from central Tokyo, the perception of the practicality of 'micro-living' has certainly shifted.

Average rental prices by layout lend some credence to a growing preference for larger units. Within our 23W sample set, larger units (two-and-three bedroom) posted 2.5% QoQ growth between Q2 and Q3/2020, even as smaller units (studio and one bedroom) recorded a fall in prices of 1.2%. It is worth noting, however, that larger units represent less than 10% of the overall sample set as of Q3/2020 and are therefore more susceptible to price fluctuations (Graph 6). Despite this, the divergence in growth over the longer term since the start of 2019 highlights that the larger units have performed better, at an average growth of 3.7%. This represents a 2.2% margin over the smaller units. Interestingly, units with larger layouts in the C5W followed a similar trend, indicating that the coming shift in preferences may not necessarily be geographic.

The distinction of work, office and home

1 The corporate survey, conducted for Reuters by Nikkei Research between 3-13 August, polled 495 big and midsize non-financial firms. Of that total, 220 firms responded to the survey.

has become unclear, as many Japanese corporates announce an indefinite extension of remote working policies, led by tech savvy companies and increasingly supported by the government. One deduction from these findings would suggest that workers have been given the opportunity to prioritise good health and a less stressful lifestyle. Employees may now be looking to the suburbs - drawn by cheaper rents, more spacious housing and nature closer to hand. That said, the aforementioned SUUMO survey reported that 30% of respondents still prioritise station proximity over size, suggesting that many people are still willing to compromise and live minimally. Nevertheless, signs of a shift in the market have started to appear. Whilst only modest at this stage, they offer an indicator for the future of Tokyo's residential market.

OUTLOOK

As with essentially all asset types, the multi-family residential sector is facing headwinds brought about by the global pandemic and resulting economic slowdown. With Japan's economy laying firmly in recession territory, the potential for short-term rental growth will likely be outweighed by the financial constraints of residents. Still, the sector continues to display resiliency. Tokyo rents have seen particularly robust growth since 2018 and much of the downward pressure in this quarter occurred in the wards and submarkets that saw the most robust growth last quarter, suggesting that rents are still facing a correction rather than an outright downturn.

With this perceived resiliency, particularly when compared to other core asset types such as office and retail, overseas institutional investors, such as Allianz Real Estate and AXA Investment Managers, have made significant investments into the sector during the first half of the year. Cap rates have remained stable as result. As significant capital continues to chase the few available assets, yields are likely to remain flat for the time being.

Indeed, considering the extent of the current global upheaval, prospects for the residential sector are positive. That said, there are some indications that the market is undergoing a transition that could affect certain subsets of the sector. The C5W, for instance, has seen occupancy in investment-grade assets fall below 95% for the first time since 2016 and rents for smaller units and layouts are facing downward pressure. Further, latent demand following the soft lockdown in April and May has yet to manifest, as prospective residents from regional Japan continue to hold off on making a move to the capital.

While it is too early to assume that residential demand is undergoing a paradigm shift, the sudden large-scale implementation of remote work and e-learning is certainly having some impact on preferences for the type of living space and location. Despite the outbreak, many residents still seem to prefer the urban lifestyle that only Tokyo can offer. It is also worth noting that the median age of a resident in the 23W is 44 years old, four years younger than the national average, but higher than in other global cities. As such, we can expect a more conservative approach to relocations amongst the overall population. There is also some hope for a relaxation of visa restrictions towards the end of the year, allowing for some recovery in demand from foreign residents, which should be a boon for the C5W in particular.

In the end, Japan paints a far more stable picture than other developed countries and the residential sector is a key benefactor of this stability. Following Prime Minister Abe's resignation, the new cabinet appears likely to maintain key economic policies, while leveraging the well-established political clout of the Abe Administration. The country and its capital markets should thus remain stable – a stark deviation from the West. Also, the unemployment rate sits at 3.0% – compared to 3.9% in the United Kingdom and 8.4% in the United States – as of August. While unemployment is likely to tick up further as economic pressures drag on, mass unemployment is unlikely to manifest soon and therefore residents should still be able to cover their rents for the duration of the pandemic. To be sure, overall rental growth is likely to be curbed in the short-to-medium term and occupancy is likely to soften. Even with this in mind, Japan's multi-family sector offers a comfortable degree of certainty for those deploying capital in an increasingly uncertain world.