MARKET IN MINUTES

Savills Research

Residential Leasing

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Downtrend in rents continues

Although rents have weakened, occupancy rates see a slow recovery.

- Rents in the Tokyo 23 wards (23W) fell by 0.9% quarter-on-quarter (QoQ) and 3.6% year-on-year (YoY) to JPY3,929 per sq m this quarter.
- Average mid-market rents in the central five wards (C5W) saw a small decline this quarter and are now at JPY4,661 per sq m – a fall of 0.2% QoQ and 3.6% YoY.
- The C5W premium has inched up to 17.9% – up 0.3 percentage points (ppts) from Q2/2021.
- At the ward level, some areas have posted growth this quarter. In particular, the Outer East submarket has displayed its strengths, with Edogawa growing 3.9% QoQ. On an annual basis, Arakawa took the lead, with rents rising by 6.2%.
- In the C5W, average rents for units in the 15-30 sq m size band have again decreased this quarter. However, the 30-45 sq m size band saw a small increase in rents.
- The average occupancy rate in the 23W rose by 0.2ppts to 95.6%. The C5W saw a similar increment, increasing 0.2ppts to 94.5%.
- The C5W has seen a population decline, driven by younger families who appear to prefer larger units.

"Occupancy rates have slightly improved this quarter, suggesting that future declines may be less marked. While the C5W continues to be the most negatively affected by the pandemic, the mid-term prospects of the submarket are brighter thanks to the multiple ongoing redevelopment projects. At the same time, public discourse regarding post-pandemic life has started to gain some traction."

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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 (23W) 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 apartments 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

Having corrected last quarter, rents in both the 23W and the C5W have again declined, and now find themselves at their lowest levels since 2018. In fact, average rents in the former are marginally lower than what was observed in 2008 – a clear sign of the negative market sentiment at present. Ultimately, the continued population outflow from the capital since June 2020 has taken its toll on Tokyo rents.

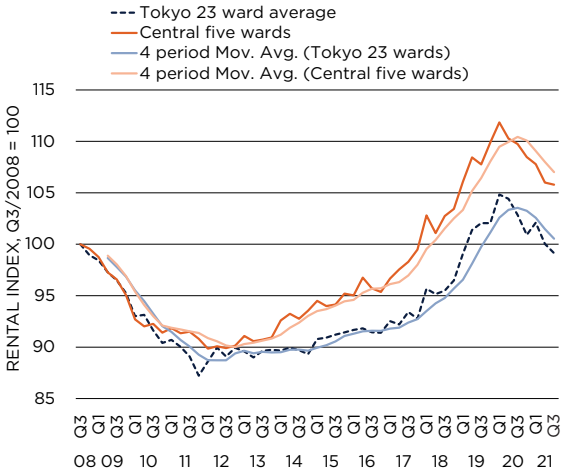
The overall population of Tokyo prefecture has decreased since its peak. Yet, looking a little closer, the changes vary significantly depending on location. For instance, while the 23W has seen an outflux of people, the populations of cities outside the 23W have remained flat. Indeed, this trend is to be expected given the high levels of remote work that have persisted throughout the pandemic. More specifically, many large companies have continued to implement some form of remote work, and this has provided an impetus for younger office workers in particular, who live in the 23W, to move to areas with cheaper rents or move back in with their parents. Even so, this trend could see a reversal of sorts once the risks of the pandemic recede, with many companies likely to reduce the extent of remote work and welcome employees back to the office. On a positive note, the Japanese economy is exhibiting signs of recovery. According to a survey conducted by the Cabinet Office, consumer confidence has notably increased over the past quarter, and unemployment has also decreased from 3.0% in May to 2.8% in August. Furthermore, the vaccination rate in Japan has been steadily rising, and it is now higher than in the United States. In truth, it will likely have one of the highest rates in due course, given Japan's strong peer pressure culture.

Much like the previous quarter, the correction in rents this time around was less marked in the C5W, and its premium over the 23W has inched up by 0.3ppts QoQ to 17.9% (Graph 2). Despite this slight expansion, the gap remains the tightest since 2017. In general, the spread between less expensive regions and the 23W at large has also narrowed considerably when compared with previous years. In the mid-term, however, the C5W is likely to see its premium expand once more compared to other regions, underpinned by the multiple redevelopment projects in the pipeline that will make living in the area more attractive.

MID-MARKET RENTAL TRENDS BY SURVEY AREA

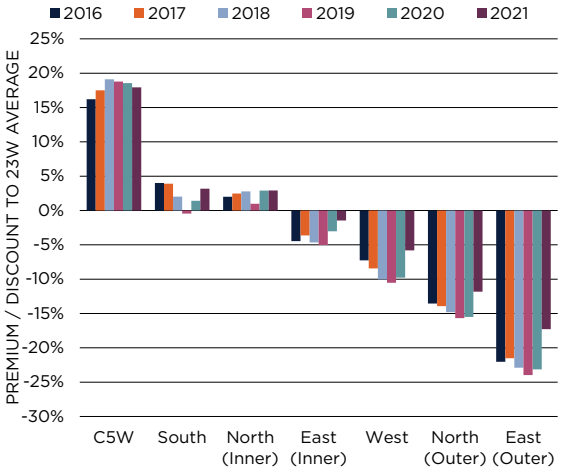
Average multifamily asking rents in the 23W decreased by 0.9% QoQ in Q3/2021 and now sit at JPY3,929 per sq m. In fact, rents have seen such contractions for many quarters, resulting in a 3.6% drop over the year. Broadly speaking, while all submarkets have slumped slightly, the decline this quarter was less prominent than what was seen in the previous quarter, suggesting that these corrections may be slowing somewhat. It should be said, however, that the population movement from the 23W to other regions in Greater Tokyo is likely to continue for the time being. Overall, on an annual basis, the trend of larger declines in more expensive submarkets like the C5W and the South, as well as less expensive regions like the Outer East experiencing increases in rents, has persisted. Indeed, the value of living closer to the city centre has been diminishing.

GRAPH 1: Mid-market Apartment Rental Index, Q3/2008 to Q3/2021



Source Savills Research & Consultancy

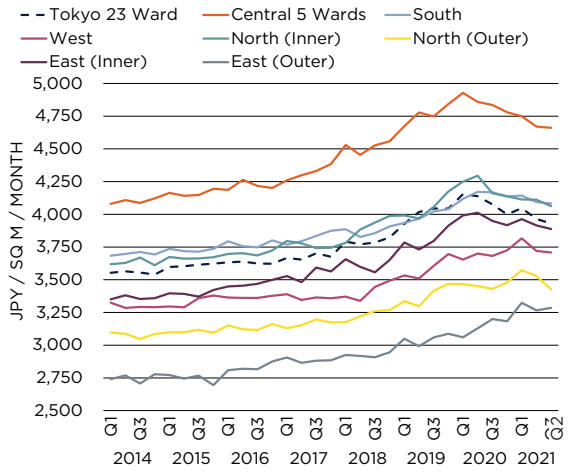
GRAPH 2: Rental Premiums/Discounts* vs 23W Average, 2016 to Q3/2021



Source Savills Research & Consultancy

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

GRAPH 3: Mid-market Apartment Rents, Q1/2014 to Q3/2021



Source Savills Research & Consultancy

The C5W was the only submarket to see its average rents decline consistently since the start of the pandemic in Q1/2020. As such, it has experienced the largest annual contraction in the 23W, with rents decreasing 3.6% YoY. Rents in Shibuya have seen the steepest drop in the 23W of 6.5% YoY, although it is still the second most expensive ward. In Q3/2021, most of the central wards demonstrated a mild quarterly decrease in average rents, pushing the submarket's rents 0.2% lower QoQ to JPY4,661 per sq m. Minato, the most expensive ward, was the only exception that saw an increase in rents over the quarter, primarily due to a large number of new-unit listings. Overall, when compared to recent quarters, it would appear that the decline in rents in the C5W has lessened. In the longer-term, the C5W looks forward to a spate of new developments over the next decade that will likely further increase the popularity of the submarket as a place to live.

Rents in the South submarket now sit at JPY4,083 per sq m after seeing a small correction of 0.3% QoQ. Rents in most of the submarket's constituents have not seen notable changes from the last quarter, with the exception of Ota that saw a slight dip. On an annual basis, the submarket as a whole has declined by 2.1%, although the performance of each individual ward varied significantly. For instance, this quarter, Meguro, the fourth most expensive ward in Tokyo, saw the largest annual decline of 5.2%. Meguro's popularity as a residential area stems from its abundance of greenery and the convenient access it provides to offices in the city centre, especially those in Shibuya and Minato. However, as seen in the population decline that Meguro has experienced since the start of the year, extended levels of remote work may have prompted some residents to find housing elsewhere, thus weakening rents.

Performance in the Inner North was similar to the average of the 23W this quarter, with rents contracting 1.2% QoQ to JPY4,062 per sq m. One observation was that, although the Inner North submarket has held its position as the second most expensive submarket since 2018, its average rents fell slightly below the South submarket this quarter. Bunkyo, the more expensive member, again saw the larger annual decline of 2.9%. Toshima also saw rents decrease by 1.8% YoY. Indeed, similar to Meguro, a significant factor for the popularity of the two wards was the convenient access that they provide to the city centre, and the reduced necessity of commuting to the office has lessened that premium. Nonetheless, especially for Toshima, rents may increase going forward with the large-scale Minami-Ikebukuro 2-chome redevelopment project revitalising the area.

The Inner East submarket overall saw a contraction of 0.7% QoQ and 1.6% YoY to JPY3,888 per sq m. However, the performance of each constituent varied greatly. In detail, Koto and Taito saw quarterly declines of 1.5% and 1.8% respectively and have declined on an annual basis overall. On the other hand, Sumida, traditionally the least expensive member, saw an increase of 1.3% QoQ, and was the only one to see an annual increment in rents.

Rents in the West submarket saw a slight dip of 0.3% QoQ to JPY3,708 per sq m, but was one of the few submarkets to have seen annual growth. However, this was not distributed evenly within the submarket. For instance, the more expensive wards, Nakano and Suginami, both saw annual growth – likely due to their excellent access to JR Chuo Line. Meanwhile, Nerima, the least expensive ward due to unfavourable access from the city centre, saw a small annual decline of 1.3% YoY.

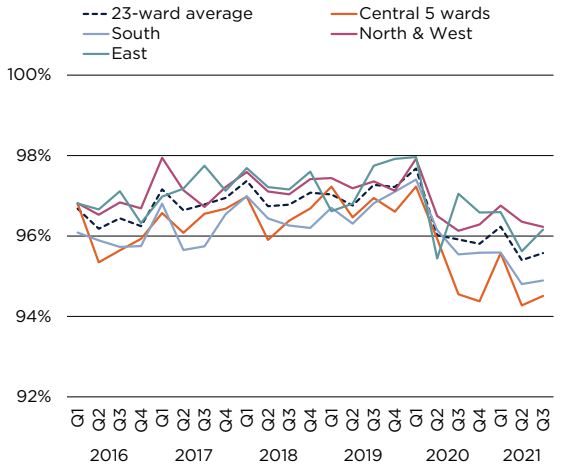
The Outer North submarket saw a notable correction this quarter of 2.9% QoQ – the largest quarterly decline exhibited in any submarket. Both Kita and Itabashi saw many new developments this quarter priced below the market average, which led to part of this decline. Rents are now at JPY3,426 per sq m. Despite this large quarterly drop, rents in the Outer North have remained flat on an annual basis. For instance, Kita, the more expensive of the two constituents, has seen rents increase by more than 8% over the last two years. Rents in the submarket have, on the whole, held more steadfast when compared to others.

The Outer East submarket has been best performer over the past few quarters, and it was the only submarket that had growth this quarter – growing 0.6% QoQ to JPY3,285 per sq m. Moreover, it has exhibited the largest annual increment of 2.7% YoY. Within the submarket, Arakawa and Katsushika saw the most impressive yearly performances, increasing 6.2% and 5.6% YoY, respectively. The overall market trend since the pandemic has seen the spread between the more expensive wards and less expensive wards gradually narrow.

OCCUPANCY RATES

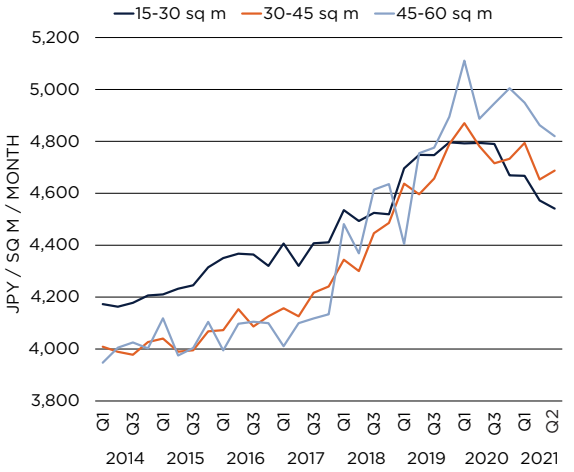
Despite the population of the 23W shrinking by around 12,000 since this June, occupancy rates do not appear to have been adversely impacted. On the contrary, they have actually risen in the 23W by 0.2ppts from the previous quarter, and now stand at 95.6%. Elsewhere, occupancy rates in the C5W have also risen 0.2ppts QoQ to 94.5%, moving in tandem

GRAPH 4: Average Occupancy for J-REIT Residential Assets, Q1/2016 to Q3/2021*



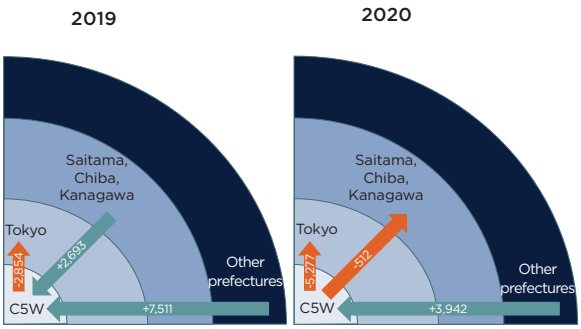
Source Savills Research & Consultancy based on publicly disclosed J-REIT property data
*Q3/2021 is as of August 2021

GRAPH 5: Rents by Unit Size, C5W, Q1/2014 to Q3/2021



Source Savills Research & Consultancy

GRAPH 6: Net Migration Flows into the C5W*, 2019 and 2020



Source : Ministry of Internal Affairs and Communications, Savills Research & Consultancy
*Does not include those moving in and out of Japan

with the 23W. However, it should be noted that the occupancy levels of both markets are lower than what they were in the same period last year, with the 23W falling 0.3ppts and the C5W falling 0.1ppts. Overall, occupancy rates leading up to the pandemic were very high, and it is unlikely that similar levels will be attained in the near future. It would appear that the markets have settled into a cycle where average occupancy rates are a few ppts lower than 2019 levels, bearing resemblance to the average occupancy seen in 2015. Nonetheless, investors can find solace in the fact that occupancy rates are still high in general. They are unlikely to see further significant dips and should thus not be taken as a major setback.

Occupancy levels in all other submarkets have seen annual declines. However, most have also encouragingly seen a small increase in occupancy this quarter and appear to have returned somewhat to their seasonal cycle. A gentle recovery could also be expected in the next quarter, especially if the prospects surrounding COVID-19 improve. One trend that has become more apparent is that occupancy levels in the C5W have become the lowest in the 23W. This observation is coherent with the trends seen in rental levels – the C5W has weakened the most. Not all is doom and gloom for the C5W, however, as future developments in the pipeline should gradually help bring it back into the spotlight, and with it more hopeful residents.

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.

While units measuring 15-30 sq m have always dominated the number of available units in the C5W, the proportion of units in this category has only risen with the pandemic. This increment is likely a product of the relatively fewer number of younger people moving to the C5W for work and education because of the pandemic. Moreover, the prevalence of remote work may have prompted single residents living there to move to somewhere less expensive or even to their parents' house. This trend seems to have persisted somewhat into this quarter with rental levels in this band again experiencing a slight dip of -0.7% QoQ.

The largest 45-60 sq m band experienced a similar decrease of 0.9% QoQ, seeing multiple consecutive declines in average rents, although it should be noted that this band has the smallest sample size, thus making it more susceptible to market fluctuations. Meanwhile, the 30-45 sq m band has bucked the trend having seen an uptick of 0.7% QoQ in rents. Overall, the two larger bands still hold a premium over the smallest band, likely due to the prevalence of remote work that has made larger apartments more sought-after. However, it should also be noted that the number of units available in the 30-45 sq m and 45-60 sq m band has risen since the pandemic as the population of the C5W has decreased.

A CLOSER LOOK AT THE CENTRAL FIVE WARDS

Until 2019, the C5W was growing at a comfortable pace, with a steady flow of people moving into the central region every year, and rents steadily increased as a result. However, COVID-19 has thrown a spanner in the works. Indeed, this growth has been significantly disrupted by the introduction of higher levels of remote work, leading to a noticeable demographic shift in the C5W.

According to data from the Ministry of Internal Affairs and Communications, in 2019, more than 10,000 people from other prefectures moved to the C5W, which represents about 0.9% of its population. In the same year, around 3,000 residents of the C5W moved to other parts of Tokyo, mostly the other members of the 23W, resulting in a net increase of around 7,000 people in the C5W submarket. A majority of those moving into the C5W are young professionals between 20 and 29 years old, who historically relocated to the capital for employment purposes.

However, these population dynamics have been completely re-shaped by the pandemic. Looking at Graph 6, 2020 saw fewer people from other prefectures move to the C5W, and there was even a population outflux to the nearby prefectures of Saitama, Chiba, and Kanagawa. At the same time, more people from the C5W moved out to other parts of Tokyo.

Upon inspecting the population changes more closely, a deeper insight can be gained about who is moving, and where they are moving to. For instance, the largest population declines in the C5W in 2020 were from the 30-to-39-year-old, 40-to-49-year-old, and 0-to-9-year-old age groups, suggesting that many younger families contributed to this change. In terms of where they are moving to, other cities in Tokyo and neighbouring prefectures (Chiba, Saitama, and Kanagawa) are unsurprisingly major destinations. Larger housing in these

prefectures are more affordable, and are still commutable from Tokyo, and these factors in combination with increased remote work may have prompted some to move.

On the other hand, the 20-to-29-year-old category has been the least affected, with both 2019 and 2020 seeing a net increase of approximately 9,000 people in this age group, which largely offsets negative trends in other age groups. Considering that the major source of net-migration in this age group comes from other prefectures outside of Greater Tokyo, they appear to have less propensity to stay or return to their hometowns. Nonetheless, there were fewer people in this age category moving in from other prefectures. This decline was perhaps counterbalanced with an increment in the number of people moving into the C5W from the rest of the 23W, likely by those who saw the opportunity to move into the C5W at more affordable prices.

When looking at trends by gender, women have a higher propensity to come to and stay in the C5W than men, although this tendency is admittedly also present in the whole of Tokyo prefecture as well. However, there were fewer women in the 20-to-29-year-old category that moved into the C5W in 2020. As of August 2021, Tokyo prefecture has around 260,000 more women than men, showing that this has been an ongoing trend in the prefecture.

More recently, population declines have continued in the C5W since August 2021, though the rate of decline is slowing, particularly among the Japanese contingent. While the C5W has lost some of its lustre over the past year, the numerous redevelopment projects planned in the submarket should reignite its appeal. For instance, the upcoming Toranomon-Azabudai project in 2023 looks to add new office, retail, residential and recreational space to Minato ward that should spark increased interest in the area. Other plans in the pipeline include the Takanawa Gateway project and the redevelopment of Shinagawa station area. Overall, the future of the C5W remains promising with these projects looking to revitalise the submarket as a residential area, especially Toranomon-Azabudai area in the near future.

OUTLOOK

The downturn observed in the previous quarter has extended into Q3/2021, and average rents have again seen a slump. As a result, the corrections seen since 2020 have effectively wiped out the growth seen in 2019. Before the pandemic, rents in the 23W were steadily growing on the back of the steady population influx into Tokyo and a stable economy, and demand for offices in the city centre was naturally high. Specifically, the 23W saw rents increase by almost 15% between Q1/2016 and Q1/2020, and rents in the C5W rose by more than 17% in the same period. However, when the pandemic struck, the population of the 23W began to shrink, and consequently reduced the demand for housing. While these corrections have been relatively large, they were partly in response to the market that had seen marked increases in rents in some areas pre-COVID. The decline was particularly notable for single units in central locations – especially in wards that saw a reduction in their foreign population.

Rents in the 23W are still comfortably above 2018 levels but may face potential risks. To be sure, residential leases in Japan usually span two years while the length of an average occupancy can span about four years. However, a large residential J-REIT has recently noted that there has been an increase in the number of tenants who have decided to move out after only two years, before the renewal fee is due. This was especially the case for those who entered their contracts when rents were close to their peak in 2019. This implies that the market may need more time to digest the rental adjustments derived from the pandemic. Amidst the gloom, occupancy levels have seen a small uptick from the previous quarter, showing that there is still sound demand for quality accommodation. That said, less popular units may see further corrections in order to attract tenants.

One silver lining for the market is the steady rise of fully vaccinated individuals in Japan despite its early hurdles. In fact, the rate is actually higher than that of the United States. Given Japan's strong peer pressure culture, the nation's uptake is likely to be one of the highest in the world in due course. There is greater confidence that the pandemic era is nearing a close and the public discussion on post-pandemic life has started. One of the greatest factors that will impact the residential market is the continuity of remote work. Many companies have indicated that they expect most workers to be back in the office post-COVID, but many also plan to retain the option of partly working from home. Residents may have to look for apartments that strike a balance between the convenience of commuting and the space to comfortably work from home. The level of demand returning to the C5W, therefore, needs to be closely monitored moving forward.