Japan - May 2021

SPOTLIGHT

Savills Research

Japan Retail

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Greater polarisation emerging

Summary

- Average 1F rental growth in Tokyo has decreased in 2H/2020, with Omotesando seeing a notable decline. The market may see further correction as rents remain somewhat inflated by the increase in the number of prime-location listings that have come onto the market during the pandemic.
- Regional rental performance was similar to that of Tokyo, with rents seeing a drop from the previous half year.
- Transaction volumes in 2020 were around half of 2019 levels. However, we expect to see more transactions this year stemming from increased corporate real estate disposals.
- The polarisation between the winners and losers is increasing. Prime assets remain popular in both transaction and leasing, whereas retail assets selling consumer discretionary goods have been greatly damaged.
- Pandemic-induced changes in demographic and consumer lifestyles make suburban retail with solid revenues more attractive.
- The number of mixed-use buildings is likely to increase as these assets are able to meet the evolving and diversified demand of end-users.
- The slow pace of vaccinations suggests that these paradigm shifts observed in the retail sector are likely to linger.
- The increasing success within the logistics space may encourage speculative investors to target well-located general merchandise stores (GMS) in the hope of repurposing under zoning changes. These assets are located in advantageous areas for logistic facility development due to their high accessibility to customers and workers.

TOKYO SUBMARKET RENTS

As expected, the effects of the global pandemic have finally taken their toll on the Tokyo retail market. According to the semi-annual survey by the Japan Real Estate Institute (JREI) and BAC Urban Projects, average asking 1F rents in Tokyo have slumped 5.4% half-year-on-half-year (HoH) and 2.4% year-on-year (YoY). Meanwhile, non-1F rents have seen a steeper decline of 8.1% both HoH and YoY, receding to 1H/2019 levels after remaining flat over the last half-year.

The pandemic has accelerated the speed of digital transformation in Japan, which has in turn weakened the demand of some brick-and-mortar retail. However, there are rays of hope for the sector: vaccines are being distributed, albeit slowly. Furthermore, some countries have started to exhibit post-COVID activities, allowing us to envision what a post-COVID economy would bring. In Tokyo, footfall in retail and recreational areas has already improved to about 80-90% of pre-COVID levels. As the vaccinations progress, the sector could look to further reassert its position going forward.

Ginza

While still the principal retail district in Tokyo, average 1F rents in Ginza have slipped significantly by 16.6% HoH to JPY67,200 per tsubo following a small uptick seen in the previous half-year. This translates to a decrease of 14.5% YoY, the lowest rental levels since 2018. After commanding an impressive 40% premium over the 1F market average for a year and a half, Ginza's position has weakened to a premium of 22.0%. On the other hand, non-1F rents have declined by a smaller degree of 8.0% HoH and 9.6% YoY. In fact, Ginza still remains the second-most expensive in this category next to Omotesando.

Although the damage COVID-19 dealt to the retail sector was substantial, some areas have been disproportionately affected. Prime areas such as Ginza, have begun to exhibit some level of recovery, particularly among the luxury brands located in the vicinity, boosted by wealthy domestic spenders. In contrast, duty-free shops, largely dependent on inbound tourists for revenue, continue to suffer and will require some form of substantial business reformation to continue. Furthermore, high vacancies persist, especially in the non-1F space, as a result of many F&B outlets having gone out of business, despite efforts to fill vacancies with tenants from the beauty services industry.

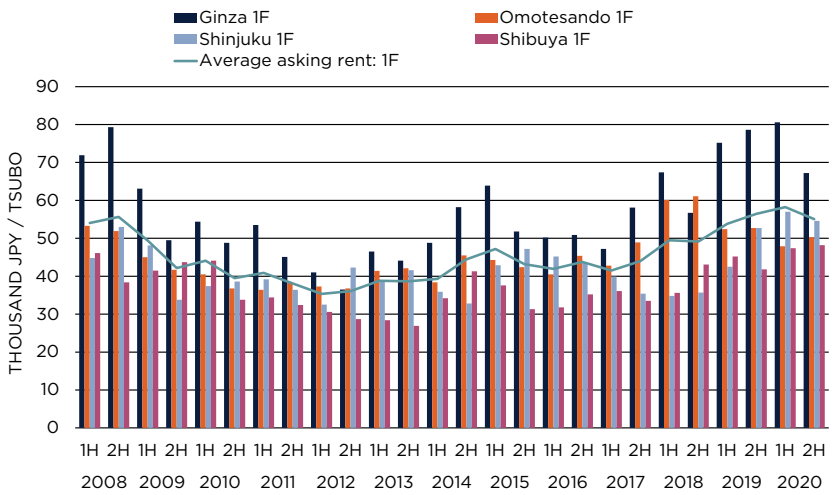
Overall, prime areas, particularly those along 2-to-6-Chome, are expected to see solid rents continue as we observe ongoing rumours of multiple applications from potential tenants. Conversely, the prospects for non-prime retail are in a more precarious position, particularly large stores in occupation of multiple floors, having to reconsider the amount of space rented.

Omotesando

As in the previous half-year, average 1F and non-1F rents have once again exhibited diverging trends in Omotesando. On one hand, 1F rents bounced back 5.0% HoH to JPY 50,300 per tsubo from the dip seen in the last half-year, although they are still lower than levels seen one year ago. On the other hand, non-1F rents have dropped 12.0% HoH and 7.9% YoY to JPY33,800. Nevertheless, non-1F rents in Omotesando are still the highest in the market, supported by the persisting demand for service shops and office use in the area.

Omotesando is home to a wide range of shopping districts and tenants, some of which have been worse affected by the global pandemic

GRAPH 1: Tokyo 1F Rents, 2008 to 2H/2020



Source JREI, BAC Urban Projects, Savills Research & Consultancy

than others. The street between Jingumae and Omotesando, known for its line-up of luxury brands, has seen new stores open with few vacancies in sight. Elsewhere, places known for their offbeat and hipster culture such as Cat Street are noticing increasing vacancies. Indeed, although Omotesando once accommodated many short-term showrooms and pop-up stores, the marketing it provided to e-commerce has ironically reduced the need for such stores. However, when compared to areas like Shinjuku and Shibuya, one notable trait that Omotesando has is a relative scarcity of F&B and entertainment establishments, two industries particularly hurt by the pandemic. Omotesando has thus been less impacted in this aspect, although COVID-19 has arguably halted its eat-and-walk culture.

In the near future, there is understandable concern that rents may weaken as a result of large tenants taking steps to cut costs through space reduction. However, going forward, projects such as the Jingumae-6-Chome district redevelopment, expected to be completed in 2022, alongside upcoming development projects in Cat Street, the area appears to be well positioned to uphold a strong appeal for both customers and tenants.

The pandemic has caused rents to correct and led to a further polarisation between winners and losers. Prime assets remain sought after, however, and demographic and lifestyle changes appear to have strengthened the investment appeal of suburban outlets with strong revenue streams. Looking ahead, we are likely to see more mixed-use developments to meet the more diversified demand of end users. Given the slow pace of vaccinations, these changes to traditional shopping patterns are likely to linger.

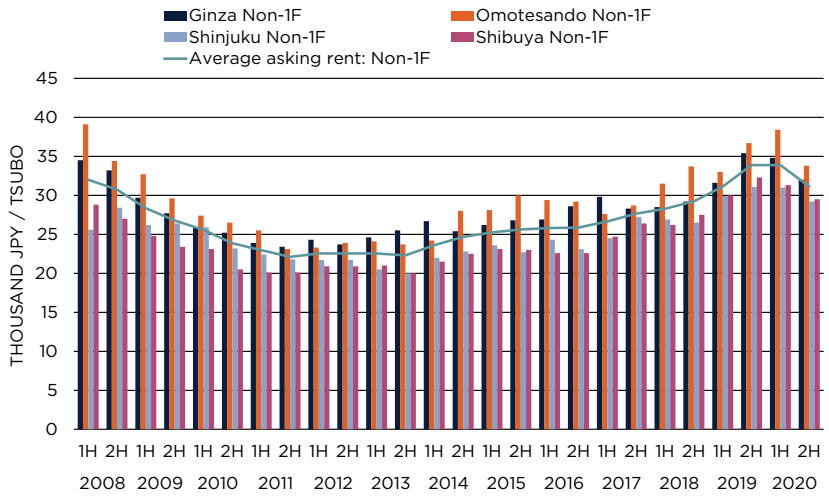
Shinjuku

Shinjuku has seen asking rents contract slightly from the last half-year for both 1F and non-1F rents. Average 1F rents have dipped 4.2% HoH to JPY54,600 per tsubo, although rents in the area still exhibited an annual increment and managed to surpass Omotesando. Average non-1F rents have, in a similar fashion, decreased 5.8% HoH to JPY29,200 per tsubo. Overall, the rental levels seen in 2020 are still significantly higher than previous levels since 2H/2019. However, as in the previous half-year, these high levels are partially a result of the listings of previously unavailable prime locations that have consequentially boosted average rents.

A significant increase in the number of vacancies of both 1F and non-1F units has been observed over the past year. Indeed, Shinjuku's status as the busiest station in Japan has acted as a double-edged sword with a decrease in footfall inadvertently leading to spates of store closures along Shinjuku-dori and Kabukicho, the well-known adult-oriented district of Japan. Furthermore, large-name retail stores, Barneys New York, and Yamada Denki, have closed their Shinjuku stores. Therefore, the current high rental levels are unlikely to paint an accurate picture of the on-the-ground situation in Shinjuku, and if high vacancies persist, rents may see some corrections going forward.

Despite its grim situation at present, there is promise for the submarket, with stimulating projects in the pipeline. For instance, Odakyu and Keio have redevelopment plans for Shinjuku with potentially multiple mixed-use buildings, which should increase footfall around the station when realised. In the same vein, IKEA's decision to set up a store along Meiji-dori will help this trend. Footfall at train stations is currently at about 75% of pre-pandemic levels, suggesting that some stores have the potential to recover. Overall, while Shinjuku has certainly been undermined by the global pandemic, the submarket has undeniable potential, and should hope to shine again once the storm blows over.

GRAPH 2: Tokyo Non-1F Rents, 2008 to 2H/2020



Source JREI, BAC Urban Projects, Savills Research & Consultancy

Shibuya

Although Shibuya's 1F asking rental levels are presently the lowest in the market, it still saw an uptick this half-year with an increase of 1.7% HoH and 15.3% YoY to JPY48,200. However, as shown in other submarkets, the increase in rent is more a reflection of the increase in the number of prime listings now available rather than the strength of the market; actual rents of individual units have not actually increased.

Meanwhile, non-1F rents have seen a drop of 5.8% HoH and 8.7% YoY to JPY29,500 per tsubo. Non-1F rents are therefore a better indication of the decline that the market has seen. Part of the growth that Shibuya had previously displayed was due to the large number of IT companies that established offices there. However, these IT companies were also the first to implement remote work measures and reduce office space. As a result, stores in Shibuya have suffered and

many have had to close, particularly those in the F&B industry. Furthermore, unlike Ginza, it is more difficult for Shibuya to replace these stores with beauty salons because Shibuya does not exude the same high-end ambiance that the former has, therefore limiting future tenant candidates.

Indeed, as a culture centre known for its live music and other entertainment establishments, Shibuya has unsurprisingly taken a large amount of damage from the global pandemic. Long-term vacancies have been reported especially in areas further away from the station, and iconic retail stores like Asbee and ITS'DEMO have permanently closed. With most retailers hesitant to open large new stores, Shibuya may see further tough times ahead if the overall pandemic situation does not see significant improvement.

REGIONAL CITIES

Average regional 1F rents have seen an upward trend over the last half-year with an increase of 4.3% HoH and an increase of 0.7% YoY to JPY25,225 per tsubo. All markets, with the exception of Fukuoka's Tenjin district, have seen an upturn in rents, with notably large increases in Osaka's Shinsaibashi and Sapporo. Likewise, non-1F rents have seen an uptick this half-year of 1.5% HoH to JPY14,817 per tsubo. This translates to an increase of 12.7% YoY, primarily attributed to the large annual increment seen in Tenjin. The narrative in regional retail locations bears resemblance to some submarkets in Tokyo: while the average asking rents in many regions have increased over the past year, this is again due to previously unavailable prime locations that are now listed on the market. As such, in this case, the increase in rent should not be taken as an improvement in market conditions, but rather as a grim reminder of the market situation.

In Osaka, the increase in 1F rents in Shinsaibashi has been huge. Increasing 11.0% HoH and 33.9% YoY to JPY32,400 per tsubo, it comes as no surprise that Shinsaibashi was a key contributor to the increase in average 1F asking rents across the whole regional market. Non-1F rents have also seen an increase this half-year, increasing 3.7% HoH and 1.4% YoY, landing at JPY14,000 per tsubo.

The ongoing depletion of inbound tourists has continued to devastate the shopping areas in Shinsaibashi, resulting in record-high vacancy levels of prime locations on the first floor, especially along the main shopping district. Only a select few areas like Mido-suji, that hosts many luxury brand stores, are faring relatively well. Shinsaibashi's hopes lie in a speedy revival of tourism that may come with greater proliferation of the vaccine.

Rents have grown for 1F and non-1F units in Sakae, Nagoya, with the average asking rents increasing 4.2% HoH to JPY17,300 per tsubo, an 8.1% jump from the year before. However, these moderate bumps in rent merely mask the reality of the situation; vacancies are somewhat higher and actual rents have already seen downward corrections for both 1F and non 1F units. Nonetheless, Sakae's low dependence on inbound tourism has turned out to be a blessing in the current state-of-affairs, and consequently, the district is faring notably better than its Tokyo and Osaka counterparts. In addition, new developments like the Nagoya Mitsui Building North Building that opened recently in March 2021, hosting the GUCCI flagship store, could hope to propel consumer demand further going forward.

In Sendai, Miyagi, rents appear to have inched up in the past half-year by an increase in HoH of 7.2% to JPY23,800 per tsubo, despite a 26.5% contraction YoY following spiked rental levels in 2H/2019. In contrast, non-1F rents have seen more gentle growth of 5.6% HoH and 9.4% YoY to JPY15,200 per tsubo. Although average asking rents have increased, the more pronounced loosening in vacancy levels in the second half of 2020 also contributed to the increment, and actual rental levels are expected to have deteriorated slightly.

Looking more closely at the market, Sendai, like Sakae, is less reliant than other submarkets on inbound tourism. That said, like other submarkets, Sendai has felt the impact on its F&B industry, taking a big hit and resulting in increased vacancies. While stores within the vicinity of Sendai station have been relatively better shielded from the effects of the pandemic, there have been disproportionate increases in vacancy within further located shopping streets. Indeed, recent developments around the station, like the JR Sendai East Gate Building, will continue to divert footfall away from secondary areas, towards the station area, inducing further worry for the prospects of the other shopping districts in Sendai.

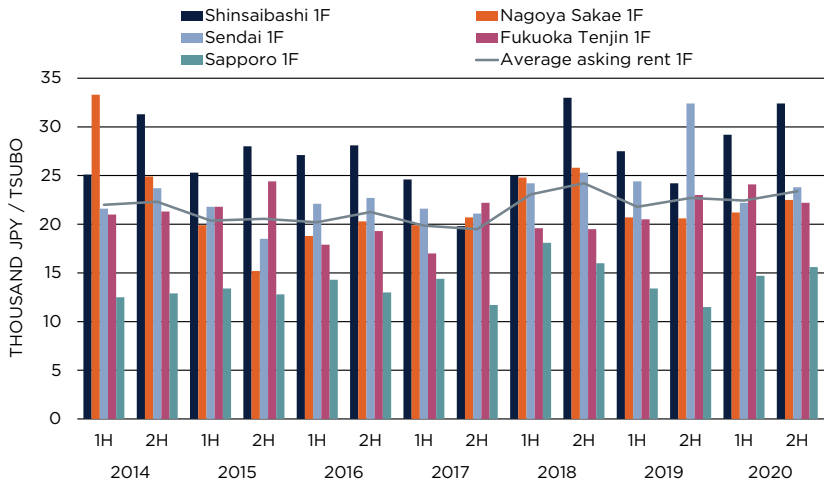
Average asking 1F rents in Sapporo, Hokkaido have increased 6.1% HoH to JPY15,600 per tsubo, establishing an impressive 35.7% increase YoY. Although, due to a limited sample pool of available listings, actual rents are believed to have likely remained flat since the onset of COVID-19. As a region, largely dependent on both domestic and international tourism, Sapporo has taken a considerable amount of damage from the pandemic. The Susukino district, known for its nightlife, has been hit disproportionately harder, leading to the closure of iconic discount chain store Don Quijote in the area.

Furthermore, the extension of the Hokkaido bullet train from Hakodate to Sapporo to be completed in 2030 is expected to further centralise footfall around Sapporo station. In response, some tenants have gravitated toward the station in anticipation, exacerbating the damage being dealt to the big-box retail located further away from the station. Overall, Sapporo's recovery should go hand-in-hand with the recovery of tourism. As summer, the peak tourism season approaches, the city may look forward to some recovery.

Looking southwards, Tenjin, Fukuoka was the only submarket to have seen a contraction in rents from the previous half-year. Tenjin's 1F rents came down 7.9% HoH to JPY 22,200 per tsubo. Average asking non-1F rents lie at JPY18,700 per tsubo after seeing a 0.5% dip and translates to an increase of 47.2% YoY due to the spike seen the last half-year. Furthermore, the larger sample pool and relatively stabilised occupancy should provide a stronger indicator of the market situation.

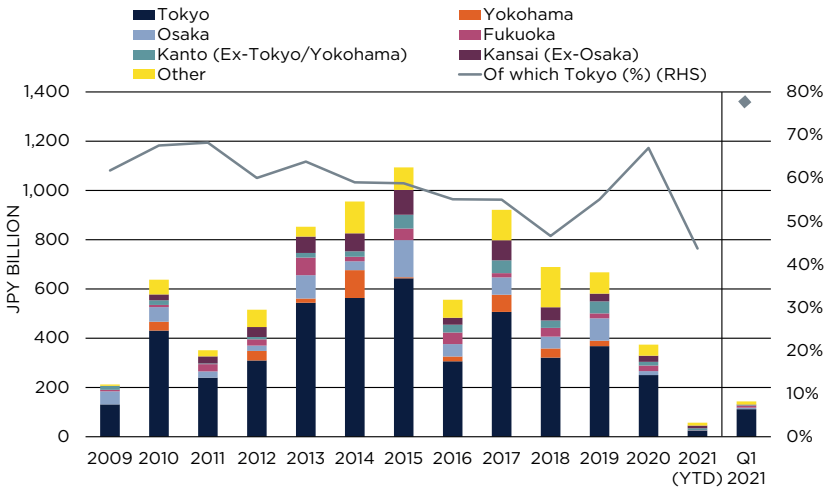
While the Tenjin's department stores and drug stores have been hurting from the drop in inbound tourism, it is worth noting that, unlike areas such as Shinsaibashi, the original number of such stores was not excessive. As

GRAPH 3: 1F Rents in Retail Districts of Regional Cities, 2008 to 2H/2020



Source JREI, BAC Urban Projects, Savills Research & Consultancy

GRAPH 4: Retail Property Investment By Region, 2009 to Q1/2021*



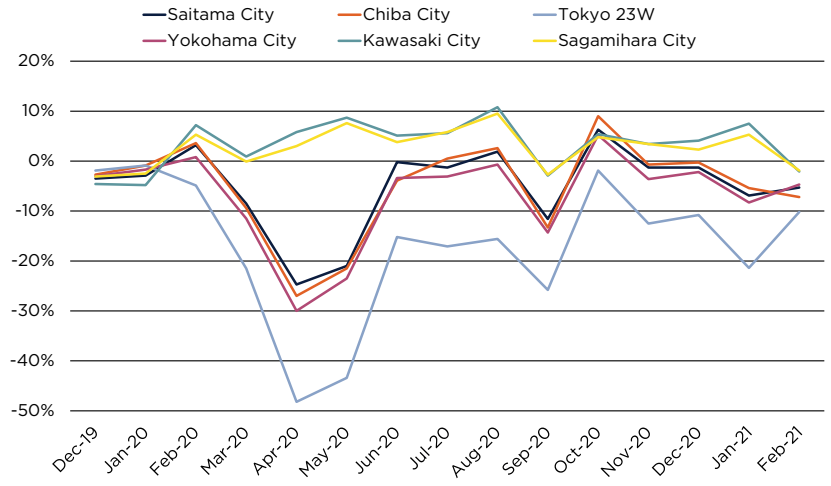
Source RCA, Savills Research & Consultancy
*Q1/2021 volume is preliminary and is likely to be revised upwards. In principle, RCA investment volumes do not include related-party transactions, such as those among a J-REIT and its sponsor.

TABLE 1: Selected Retail Transactions, Announced Q4/2020 to Q1/2021

ANNOUNCED	PROPERTY	LOCATION	GFA (SQ M)	PRICE (JPY BIL)	DIRECT CAP RATE	BUYER
Dec 2020	Aeon Mall Yamato	Yamato City, Kanagawa	85,000	17.2	5.2%	Domestic Company
Mar 2021	Aeon Takatsuki	Takatsuki City, Osaka	40,500	11.0	6.1%	Domestic Company
Apr 2021	Kitera Town Chofu	Chofu City, Tokyo	23,600	10.5	4.8%	Kenedix Retail REIT
Dec 2020	Uniden Ginza Building	Chuo Ward, Tokyo	1,900	8.0	-	International Company
Feb 2021	Almost Blue	Minato City, Tokyo	2,100	7.2	3.2%	Domestic Company

Source Press releases, RCA, Savills Research & Consultancy

GRAPH 5: Changes in Sales at Department Stores and Supermarkets in Greater Tokyo by City, YoY, December 2019 to February 2021



Source Ministry of Economy, Trade and Industry, Savills Research & Consultancy

such, despite the pain from the pandemic, there have been relatively few closures in the area for such stores. Additionally, Tenjin appears to have had better luck replacing closed entertainment establishments with clinics and other services. Nonetheless, the areas in Tenjin known for their culture or live music and clubs will take time before activity in the area can return to normal.

INVESTMENT TRENDS

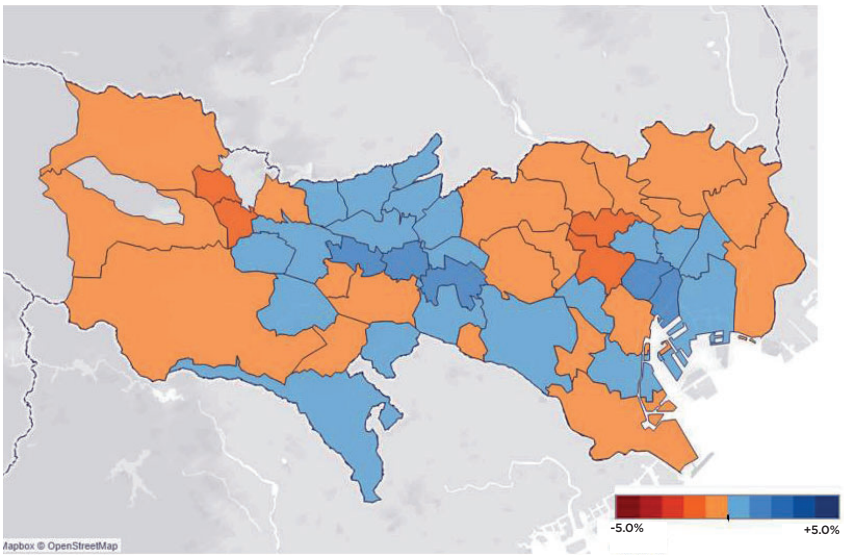
According to the October 2020 results of a semi-annual survey by JREI, expected cap rates for prime retail property in the capital have eased marginally compared to the previous six months. Specifically, cap rates in Ginza have increased 10bps from 3.4% to 3.5%. Meanwhile, expected cap rates for suburban shopping centres in the Tokyo area have remained firm at 5.4%, while in regional areas they range between 5.4% - 6.5%. However, it is worth noting, that actual market cap rates could be 100 basis points lower than these surveyed cap rates. There is still sound demand for prime retail and suburban retail facilities with stable revenue. For instance, Ginza retail property and two large AEON malls in regional hubs were transacted in the past half-year, demonstrating the appetite present in the market for such assets. Many are cautious about big stores, resulting in more attention paid to smaller supermarkets in residential areas, while some are interested in stable assets with high yield. Market rumours suggest more large transactions to come in these sound segments.

Retail transaction volumes have dropped in 2020 with the challenges wrought by the pandemic throughout 2020 appearing to persist into 2021. To wit, data from Real Capital Analytics (RCA) shows total flows amounted to JPY374 billion in 2020 – a near 45% YoY decline. Preliminary data in Q1/2021 indicate that investment volumes have declined 64% compared to the same point last year (Graph 4) with total transaction value standing at JPY57 billion. Investor allocations towards retail have been shifting for a while but looking ahead, 2021 could bring new opportunities to the market. For example, there appear to be logical but speculative moves to acquire general merchandise stores (GMS) for conversion or redevelopment into plain vanilla or semi-logistics facilities. However, zoning laws continue to be the primary hurdle to this. As local governments continue to be desperate for additional employment and tax revenue during the pandemic, changes in zoning law seems to be the logical move forward for some local governments.

POLARISATION AND CHANGES

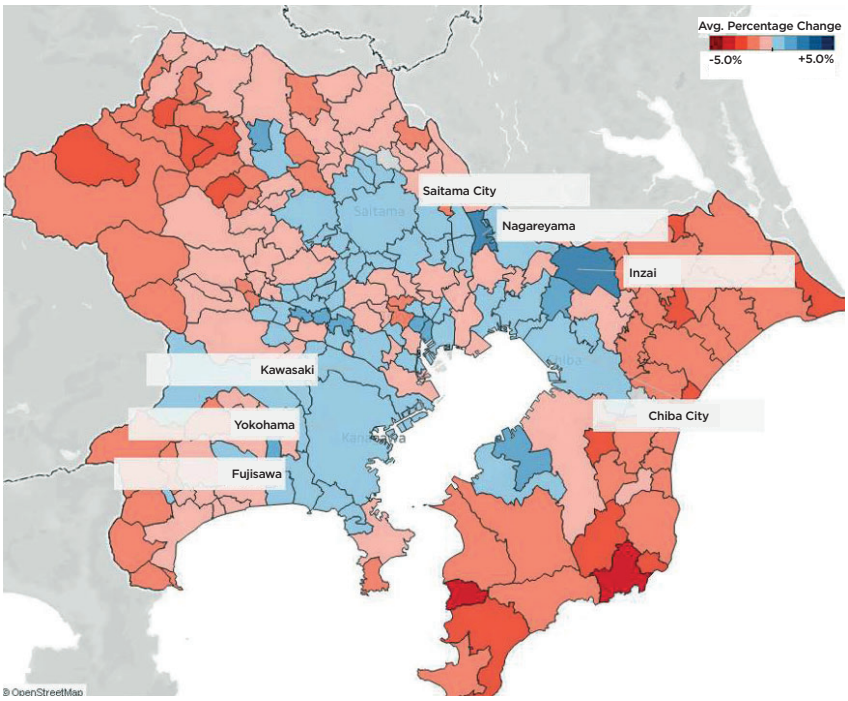
One full year has elapsed since the first nation-wide state of emergency implemented on 16 April 2020. Despite such measures, COVID-19 cases have persisted, and the Japanese government has declared a third state of emergency in Tokyo and Greater

MAP 1: Population Demographic Changes of Tokyo Prefecture, January 2020 to March 2021



Source Tokyo Metropolitan Government, Savills Research & Consultancy

Map 2: Population Demographic Changes of Greater Tokyo, January 2020 to March 2021*



Source Tokyo Metropolitan Government, Chiba Prefectural Government, Saitama Prefectural Government, Kanagawa Prefectural Government, Savills Research & Consultancy
*The population changes for Kanagawa prefecture are from January 2020 to September 2020 as the prefectural government has temporarily halted its population census until June 2021.

Osaka beginning 25 April 2021. As a result, many large establishments have been requested to close during this period. Through sporadic changes in policy by the government, the retail sector has suffered tremendously. With the slow speed of vaccination in Japan, the retail sector will undoubtedly have to further endure harsh times as some areas and industries will bear more of hit than others.

Traditional prime retail locations have been hit badly because of the steep decline of inbound tourists. However, select luxury brand stores in these prime locations appear to be faring better, spurred on by wealthy domestic consumers benefitting from strong stock prices having given the wealthy additional spending power. Furthermore, part of the three trillion yen that the Japanese spend annually on overseas travel may have been converted to high-end domestic consumption. In fact, there have been multiple new store openings and renewals by luxury brands in prime areas such as Ginza and Omotesando, further demonstrating the continued confidence that luxury brands have.

Elsewhere, as seen in Graph 5, retail establishments in Greater Tokyo's non-central hubs have fared better when compared with the Tokyo 23W. These regions appear to have seen relatively better performance due to demographic changes as well as consumer behavioural changes. Firstly, in Tokyo, there has been movement from central to non-central areas. For instance, regional hubs in Greater Tokyo like Saitama City, Nagareyama and Fujisawa have seen population increases whereas the 23W has seen an overall decrease in population. Secondly, the pandemic has led to many consumers being increasingly cautious about traveling long distances from their residences for leisure and shopping.

Predictably, since the pandemic onset, large retail establishments have suffered, and some have ceased business operations. However, it is worth noting that many of the establishments with plans to shut down are closer to pure retail establishments. In contrast, mixed-use buildings, with the diversification they have in residential and office assets, are managing better. As such, we expect to see an increase in the number of mixed-use buildings going forward. For instance, an urban redevelopment project on the former Don Quijote site in Dogenzaka, Shibuya will become mixed-use buildings comprising office, hotel and retail floors with a GFA of 84,000 sq m.

In summary, while the retail sector has taken significant damage from the pandemic, some areas like luxury retail and suburban retail with sound revenue streams

are generally doing better. Going forward, we also expect to see more mixed-use buildings as suitable developments in a post-COVID era, to capture evolving and diversified demand from retail customers. In this rapidly changing sector, investors may need to have several options on tenant-mix and business plans based on deep comprehensive analyses. Traditional one-pattern or one-fits-all strategies may not work well anymore.

OUTLOOK

The effects of the pandemic have greatly materialised in the present half-year. To wit, rents have overall decreased and vacancy rates have increased. However, amidst this overall decline, greater polarisation has emerged. For instance, prime assets remain popular in both investment and leasing markets, whilst retail revenues amongst outlets such as supermarkets selling daily essentials, have demonstrated solid results. In contrast, retail selling consumer discretionary goods has been negatively impacted, partly as a result of consumers prepared to turn to e-commerce for such items. Therefore, mixed responses within different classes of the retail sector itself will create further disparity going forward.

With vaccinations slowly but surely taking place in Japan, the post-pandemic world appears in sight. However, the prospects of the retail sector differ from player to player. While some investors look ahead at post-pandemic activity and consequently seek opportunities, other industries and companies are still suffering from the pandemic, likely to result in increasing corporate real estate disposals. This trend is expected to continue for a while, given the slow pace of vaccinations in Japan. We therefore expect to see an increase in the number of transactions of retail facilities.

Also, the lingering pandemic has changed not only consumer behaviour but also demographic distribution. Looking forward, suburban areas with good access to central parts of Tokyo should prosper. The number of mixed-use buildings is likely to increase as these assets meet diversified demand and use. In addition, the pandemic has damaged the financial health of local governments. In light of this, some buyers are looking to acquire well-located GMS, in hopes that zoning restrictions may be eased and allow them to convert or redevelop the properties into logistics facilities. This speculation may well suit the imminent needs of local governments desperate for tax sources and employment. Indeed, the retail sector faces multiple challenges but offers new opportunities.

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