Japan - October 2020

SPOTLIGHT
Savills Research

Japan Retail

Rental growth remains positive for now

Summary

- Average 1F rental growth in Tokyo was sound in 1H/2020, with Shinjuku impressing over the year. Even so, rents have been inflated by the listing of previously in-demand prime assets, and as such, market conditions are very different in reality.
- Regional rental performance, whilst also impressive at face value, was very similar to the capital when looking at each region in isolation.
- As in the office sector, asset location and quality will be key in coping with the ongoing uncertainty.
- Equity investors appear to have some faith in the retail sector for the time being, with retail J-REITs performing relatively well. Investment flows, however, remain suppressed.
- Land prices, meanwhile, paint a less optimistic future, as areas previously reliant on inbound tourism have understandably been downgraded.
- Consumers are likely to direct some pent-up demand into experiences, rather than products, in a post-COVID-19 world. As such, retailers will have to adapt in order to accommodate these preferences by utilising facilities such as showrooms and pop-up stores.
- Without the end of the pandemic in sight, new consumer behaviours are likely to emerge. For that reason, the outlook for the sector remains downbeat.

TOKYO SUBMARKET RENTS

Despite being amid a global pandemic, retail rents counter-intuitively continued their ascent in 1H/2020. Specifically, according to the semi-annual survey by the Japan Real Estate Institute (JREI) and BAC Urban Projects, average 1F rents increased by 3.1% half-year-on-half-year (HoH) and 8.2% year-on-year (YoY). Non-1F rents, meanwhile, expanded by 8.8% YoY, though they remained flat over the half-year.

On the surface, therefore, it would seem that market fundamentals have been somewhat resilient throughout these testing times. Yet, all is not what it seems. Indeed, much of this uplift in rents appears to be paradoxical, with the listing of previously unavailable prime assets boosting average rents. Whether or not these listings will be filled remains to be seen, and as such, the sector's health should become more apparent in 2H/2020 and beyond. What is already clear, however, is the existence of a marked divergence in rents based on location and quality, and this trend is expected to become more pronounced going forward. Broadly speaking, whilst some sections of the retail sector may see better days soon, the recovery for others, such as F&B, is expected to be painfully protracted.

Ginza

Among the key submarkets, whilst rental growth was not the highest in Ginza, rents certainly are, and by quite the margin. To wit, following an uptick of 2.5% HoH and 7.2% YoY, 1F rents now stand at JPY80,600 per tsubo[1] – the first time rents have broken through the JPY80,000 barrier in well over a decade, and around 40% higher than the broader average. In contrast, non-1F rents continue to trail Omotesando, and this has been exacerbated by a 1.7% HoH decline in rents.

As home to many household names in the luxury sector, Ginza has been a clear benefactor of the boom in inbound tourism. As such, its absence this year has unquestionably hurt Tokyo's premier shopping district. Leasing activity has ground to a halt, as a result, and this is likely to be the case until at least mid-1H/2021. That said, despite the changes to store strategy brought on by COVID-19, the prestigious reputation of Ginza means that prime locations in particular have demonstrated some resilience. Indeed, luxury names are loathed to disappear from the main high street and will likely opt to vacate other locations beforehand in order to focus on brand awareness and sales efficiency. Non-prime locations, therefore, will not be as fortunate, and the outlook for these assets is certainly less encouraging.

Whilst rumours surrounding contract cancellations are limited, without the previous competition between would-be tenants, 1F rents look likely to trend lower from here. As for non-1F rents, given tenants are commonly in the F&B sector, a further worsening of fundamentals would not be a surprise.

Omotesando

The half-yearly and yearly performance of 1F rents and non-1F rents in Omotesando was mixed in 1H/2020. On the one hand, it was the only submarket to experience a decline in 1F rents over both periods. Specifically, they fell by 9.1% HoH and 8.6% YoY to JPY47,900 per tsubo – the lowest level in three years. For non-1F rents, meanwhile, Omotesando remains the most expensive submarket for the sixth consecutive half-year thanks to solid rental growth of 4.6% HoH and 16.4% YoY.

Unlike Ginza, Omotesando caters to a more diverse group of shoppers as well as tenants, ranging from international brands in Aoyama to the quirkier Harajuku. The latter, for instance, is well-known for its confectionary stands, drug stores and fast fashion and, perhaps consequently, is more reliant on inbound tourism. With that in mind, therefore, it is not surprising to see some vacancy arising, especially in less prominent locations such as nearby Cat Street. Moreover, pop-up stores were a common feature of the area in the past, but this demand has all but disappeared. Listings have kept increasing since the start of 2018 as a result, and, like Ginza, the gap between prime and non-prime looks set to widen.

On a brighter note, there is real potential for the submarket going forward, particularly with the opening of new developments such as With Harajuku and Miyashita Park. What's more, Harajuku Station, which had previously gained notoriety for being highly congested, has been redeveloped, greatly improving accessibility in the surrounding area. As such, once the current situation is under control, the submarket is expected to be abuzz with activity again, with pop-ups and showrooms also returning.

SHINJUKU

For the first time in four years, 1F rents in Shinjuku have exceeded their counterpart in Omotesando, making the area the second most expensive submarket in Tokyo. A combination of the contraction in the latter and a jump of 8.2% HoH and 34.1% YoY in the former has seen rents land at JPY57,000 per tsubo. Highs set prior to the financial crisis have finally been surpassed as a result. That said, it is important to remember the inherent volatility

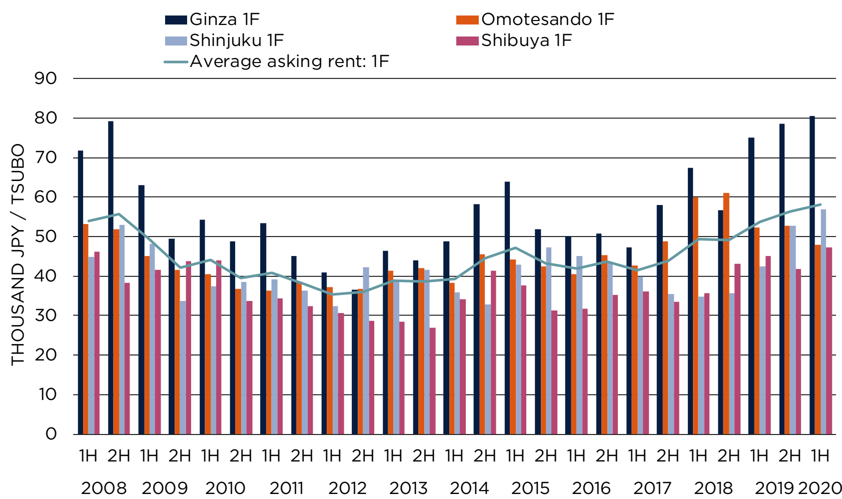
1 Throughout the report, "per tsubo" is shorthand for "per tsubo per month".

found in 1F rents due to the scarcity of assets. Additionally, as mentioned throughout this report, much of this rental boost is due to previously unattainable prime assets coming online, and therefore current rents are unlikely a full reflection of market conditions. Turning to non-1F rents, they remained somewhat flat over the half-year, but grew 3.7% YoY to JPY31,000 per tsubo.

As the busiest station in the world, the significant level of footfall was a notable boon to the retail sector in the pre-COVID era. Yet, despite some recovery in the number of commuters since the lifting of the nationwide soft lockdown in May, the changes in working practices, combined with the disappearance of inbound tourism, has left a gaping hole for retailers. Within this group, F&B, drug stores

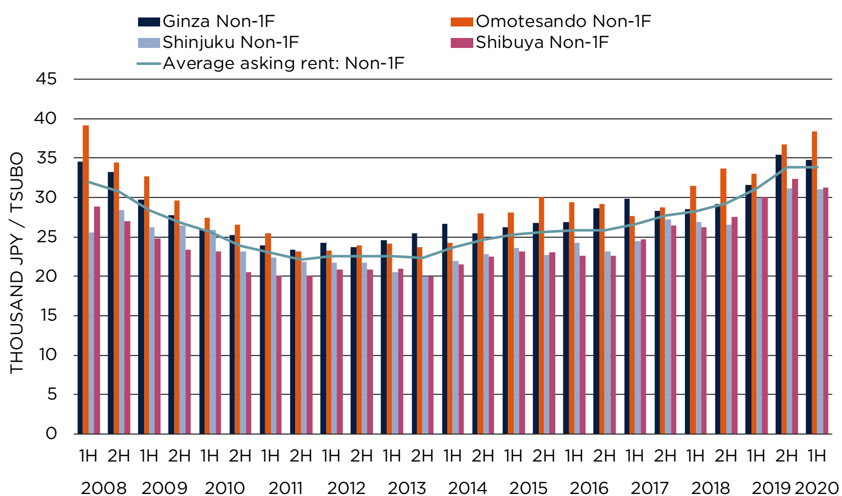
Amid the economic hardship, retail rents counter-intuitively experienced solid growth. Much of this, however, was driven by the availability of previously unattainable prime assets – paradoxically boosting listed rents. Going forward, asset location will be critical, whilst early adaptors to the new landscape are likely to become successful retailers.

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



Source JREI, BAC Urban Projects, Savills Research & Consultancy

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



Source JREI, BAC Urban Projects, Savills Research & Consultancy

and entertainment establishments – a common sight in Shinjuku – appear to have suffered most. Even so, rumours of cancellations amongst newer facilities in prime locations are limited, emphasising the disparity based on location and quality once again.

As with the other submarkets, Shinjuku has long-term potential, driven by redevelopments and improvements in accessibility, such as the opening of the East-West Passageway at JR Shinjuku Station. Indeed, while the resilience of the submarket will continue to be tested, there are surely better days ahead.

Shibuya

Much like Omotesando, rental performance in Shibuya was a mixed bag in 1H/2020. 1F-rents saw significant growth of 13.4% HoH to JPY47,400 per tsubo – the highest rate among all submarkets. Non-1F rents, in contrast, fell to JPY31,300 per tsubo after a 3.1% contraction over the same period. Annual growth was more consistent, however, with rents in both market segments increasing between 4%-5%.

Prior to the onset of COVID-19, retail rents in Shibuya had dovetailed nicely with the ostensibly unstoppable rise in office rents – themselves driven by demand from rapidly growing technology companies. As such, in order to capitalise on this growing affluence, as well as its international appeal, retail developments have been numerous, particularly near the main station. From Parco to Scramble Square, in addition to the recently opened Miyashita Park, there is now a diverse range of retailers on show which should help drive demand from those wanting to shop around. Now, however, with these two fundamental drivers nixed, the submarket faces an uphill battle. Specifically, the slowdown in office market rents – which was particularly pronounced in Shibuya – should lead to softening non-1F rents to boot.

REGIONAL CITIES

Average regional 1F rents lost some momentum in 1H/2020. Despite a substantial increase in rents in Shinsaibashi, a sharp fall in rents in the Sendai market dragged down the overall average. Consequently, regional rents now lie at JPY22,433 per tsubo – a slight contraction of 1.2% HoH. Rents were, however, able to maintain growth of 3.0% YoY. As for non-1F rents, growth over both the half-year and year was impressive. Standing at JPY14,600 per tsubo, rents in this segment have now exceeded the previous high set in 2008 thanks to a sharp uptick of 11.0% HoH and 14.2% YoY. Here, Tenjin was by far the standout submarket. Much like Tokyo, however, at the submarket level, rents have, in the main, been inflated. That said, there does appear to be some divergence among the submarkets in terms of prospects.

Starting in Osaka, 1F rents in Shinsaibashi swiftly reversed the decline experienced last period, growing 20.7% HoH and 6.2% YoY to JPY29,200 per tsubo. Non-1F rents, in contrast, were not able to follow suit. Rents remain on a downtrend, falling by 2.2% HoH and 3.6% YoY, and now lie at JPY13,500 per tsubo.

On the surface, market fundamentals appear sound, all things considered. In fact, average rents for the whole submarket have even reached a new post-financial crisis high. Yet, this positive direction of rents appears to be papering over the cracks. For instance, a key pillar supporting rental growth, particularly in Shinsaibashi, had been the boom in inbound tourism. Yet with international travel all but prohibited, there is a sense that the tide has turned. The excess supply amongst drug stores – a previous staple for overseas visitors – has started to be corrected, for instance, with closures increasing in number. As such, without new tenants willing to lease the now vacated spaces, rents are likely to soften. The short-term prospects for Shinsaibashi are therefore undeniably downbeat. That said, there is hope that new developments and the implementation of the "Go To" campaign will spur activity among domestic travellers, partly making up for lost revenue.

Growth rates found in 1F and non-1F rents in Sakae, Nagoya were not particularly eye-catching. Indeed, the fact that the submarket ranks towards the bottom for annualised growth over both the past three and five years further emphasises this point. Nonetheless, all-floor rents grew 3.8% HoH and 6.4% YoY, suggesting some potential stability may be present. Whilst this is partly true – as a result of the lower reliance to inbound tourism – concerns over the much talked about F&B and fast fashion sectors continue to linger. Even so, despite the immediate future being clouded by uncertainty, redevelopment projects, especially in Sakae, such as the tentatively named Nihonseimei Sakae-cho Building project, accommodating BINO Sakae by Parco, give a glimmer of hope going forward.

Observing the flatness of average rents in Sendai over the periods in question, one would assume that market conditions have been calm amid the pandemic. Yet, in truth, it was anything but in 1H/2020. For instance, 1F rents, having reached a historic high in 2H/2019, have come crashing down, once again highlighting the volatility of this prime market segment given the limited sample size. Rents are now JPY22,200 per tsubo – an astonishing 31.5% HoH reduction, as well as a 9.0% YoY drop – as rents corrected this period. Non-1F rents, meanwhile, were comparatively less volatile, with rents growing 3.6% HoH and 11.6% YoY to JPY14,400 per tsubo – a new record high.

Even before COVID-19, an idiosyncratic transition in the retail landscape was afoot in Sendai. Namely, the retail hub has been shifting away from the traditional shopping district in the west, to the area surrounding the namesake station, where newer buildings are gathered. In addition to the latter's convenience, the smoother accessibility due to a pedestrianised overpass appears to have swayed consumers. Consequently, the divergence between the two is widening, and this has become more pronounced of late.

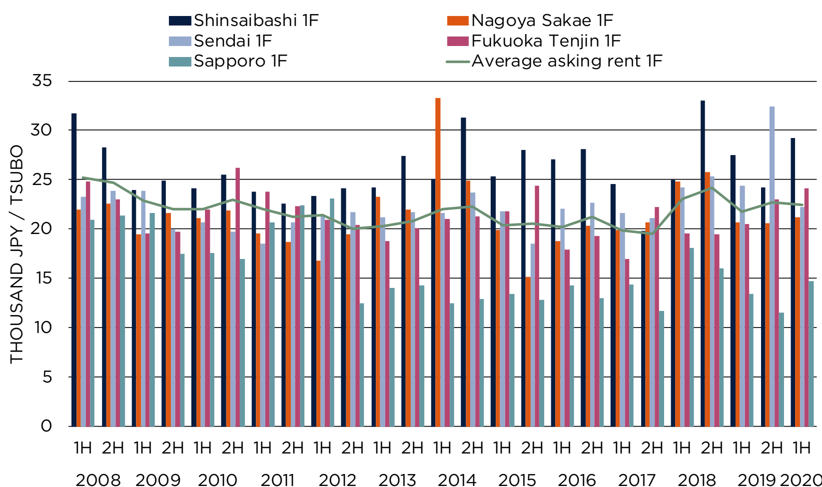
Unsurprisingly, the limited sample size of 1F listings in Sapporo would have contributed greatly to the 27.8% HoH and 9.7% YoY increase in rents to JPY14,700 per tsubo this period. Despite the magnitude, another factor, somewhat unique to the submarket, may have also played its part. Specifically, Sapporo faces significant levels of snowfall every winter and, as such, the direct connection from underground streets warrants its prime designation, leading to a premium versus above ground retailers.

Regardless, COVID-19 has been particularly harsh on Sapporo on two key fronts. First, being one of the first epicentres of COVID-19 outbreak in Japan, the region has technically faced two lockdowns – one in each quarter of 1H/2020. Secondly, the region is also highly reliant on inbound tourism. Retailers, therefore, face significant headwinds going forward. Within the city, Susukino has naturally struggled given the region's above-average exposure of F&B and entertainment establishments.

Buttressed by a surge of 31.3% HoH and 44.5% YoY in 1H/2020, broader retail rents in Tenjin have skyrocketed to JPY19,800 per tsubo – the highest level on record. Annualised growth over the previous five years has been significantly inflated to over 6% per annum, as a result. Surprisingly, however, this marked rise was driven by a sharp uptick in non-1F rents, rather than 1F rents – which was commonplace in 1H/2020.

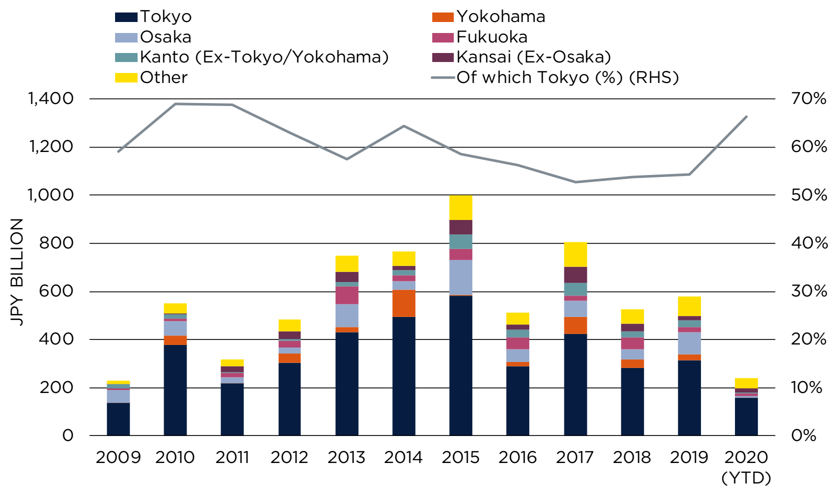
To be sure, the larger sample size found in this segment of the market means it is a better indicator of the true state of the retail landscape, and in that regard, market fundamentals may appear sound. That said, this jump occurred in Q1/2020, rather than Q2/2020, and as such, it may in fact be a hangover from the Japan-South Korea disputes that stole the headlines towards the end of 2019. Indeed, Tenjin had already been suffering from declining inbound tourism even before the onset of the pandemic. It would, therefore, not be inconceivable to say that what is occurring in many other submarkets now, namely an increase in

GRAPH 3: 1F Rents In Retail Districts Of Regional Cities, 2008 to 1H/2020



Source JREI, BAC Urban Projects, Savills Research & Consultancy

GRAPH 4: Retail Property Investment By Region, 2009 to Q3/2020*



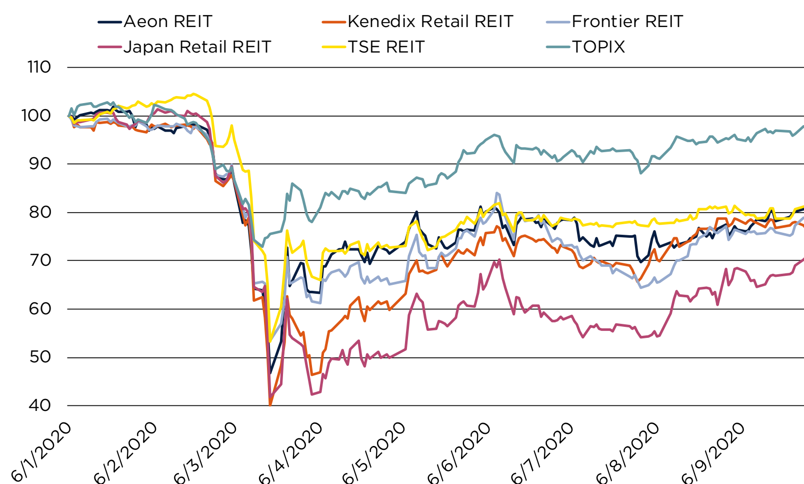
Source RCA, Savills Research & Consultancy
*Q3/2020 volume is preliminary and is likely to be revised upwards. In principle, RCA investment volumes do not include related-party transactions, such as those among a J-REIT and its sponsor.

TABLE 1: Selected Retail Transactions, Announced Q2/2020 to Q3/2020

ANNOUNCED	PROPERTY	LOCATION	GFA (SQ M)	PRICE (JPY BIL)	DIRECT CAP RATE	BUYER
Jul 2020	Ginza Timeless 8 (Sanyo Ginza Tower)	Chuo, Tokyo	4,000	12.0	n/a	Domestic Company
Aug 2020	G-Bldg. Tenjin Nishi-dori 02	Fukuoka City, Fukuoka	1,400	5.0	3.4%	Japan Retail Fund
Apr 2020	Mon Cheri Daikanyama	Shibuya, Tokyo	2,500	3.6	3.2%	Japan Retail Fund
Apr 2020	Lions Square	Kawaguchi, Saitama	7,300	2.9	4.5%	Domestic Company
Aug 2020	Sports Plaza Ibaraki	Ibaraki, Osaka	8,000	2.7	4.7%	Daiwa House REIT

Source Press releases, RCA, Savills Research & Consultancy

GRAPH 5: Retail J-REIT Performance Compared To TSE REIT And TOPIX indices, 2020*



Source J-REIT Disclosures, Japanese Exchange Group, Savills Research & Consultancy
*Data is as of 30 September

listed rents, had already been portended in this submarket, albeit on a much smaller scale. It is, therefore, worth keeping an eye on Tenjin for any further early harbingers of gloom. Nonetheless, what is in line with other regions is the fact that convenient access to the main station, as well as redevelopment tailwinds, such as the Tenjin Big Bang Project, will likely play a large part in the future recovery of the market.

INVESTMENT TRENDS

According to the April 2020 results of a semi-annual survey by JREI, expected cap rates have held firm for prime retail property in the capital compared to the previous six months. Specifically, cap rates in Ginza and Omotesando are still 3.4% and 3.5%, respectively. Meanwhile, expected cap rates for suburban shopping centres in the Tokyo area and in regional areas were 5.4% and 5.4%-6.5%, respectively. It is worth noting, however, that actual market cap rates could be 50-100 basis points lower than these surveyed cap rates.

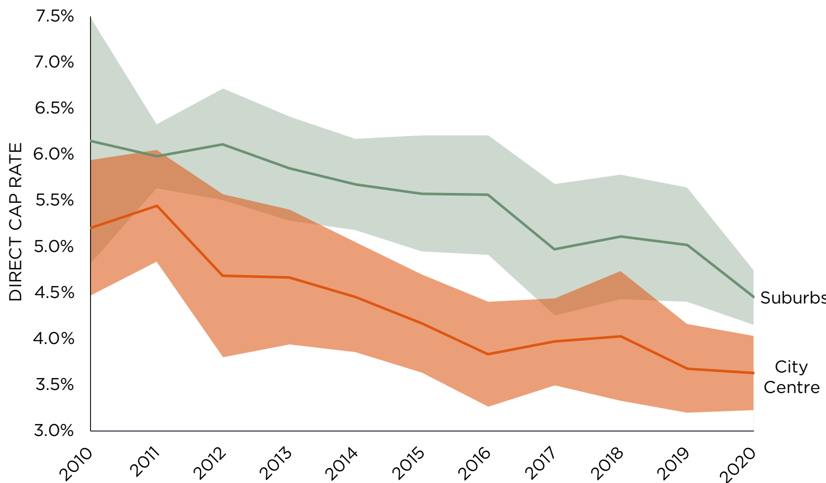
As one of the hardest hit sectors, retail transaction volumes have predictably declined following the outbreak of COVID-19. To wit, preliminary data from Real Capital Analytics (RCA) shows total flows amounted to an estimated JPY240 billion as of Q3/2020 – a near 50% YoY decline. Looking ahead, however, deal flow should pick up somewhat as high street properties, for example, remain popular given their high land value. Elsewhere, sellers of conveniently located suburban properties in metropolitan areas may be more willing to negotiate, as a result of their ongoing struggles through the pandemic, presenting some upside upon the recovery of sales figures.

AN UNCERTAIN TIMELINE FOR RECOVERY, BUT GLIMMERS OF HOPE REMAIN

The complexities facing the retail sector are unique. They have arisen not from an economic downturn – which has often been the case with previous recessions – but rather from the fight against the pandemic. Thus, with the sector ostensibly in unchartered territory, the pace of recovery will vary significantly amongst market participants. Even so, broadly speaking, there are some potentially positive signs on the horizon, despite the clouds of uncertainty.

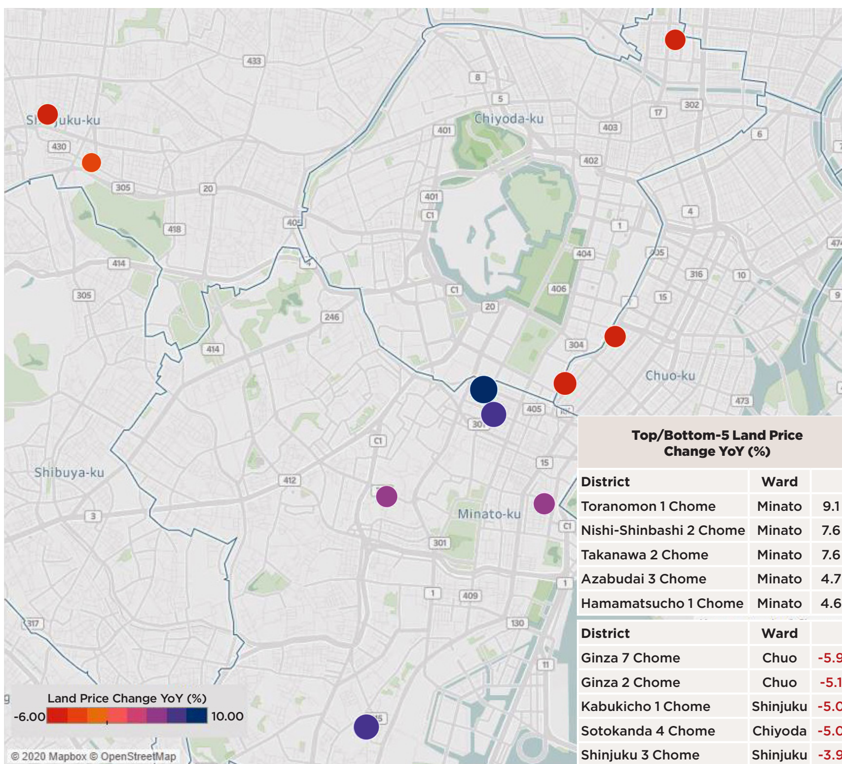
For starters, the performance of most retail focused J-REITs has been satisfactory when compared to the TSE REIT index (Graph 5). Aeon REIT in particular stands out in this regard. Here, the presence of master-lease arrangements with fairly creditworthy tenants (including Aeon itself) provides an element of stability, meaning the J-REIT has somewhat similar characteristics to a mezzanine. In truth, however, these large regional malls are not the most popular among hard assets due to slightly declining revenues and growing capex requirements.

GRAPH 6: Average Retail Direct Cap Rates Of J-REIT Transactions In Select Prefectures* By Location, 2010 to Q3/2020



Source J-REIT disclosures, Savills Research & Consultancy
*The prefectures are Sapporo, Miyagi, Tokyo, Aichi, Osaka and Fukuoka. The bands represent the standard deviation (1δ) of the transactions.

Map 1: Top/bottom Five Changes (%) In Retail Land Prices (Kijun Chika) In The C5W, July 2020



Top/Bottom-5 Land Price Change YoY (%)

District	Ward	
Toranomon 1 Chome	Minato	9.1
Nishi-Shinbashi 2 Chome	Minato	7.6
Takanawa 2 Chome	Minato	7.6
Azabudai 3 Chome	Minato	4.7
Hamamatsucho 1 Chome	Minato	4.6
District	**Ward**	
Ginza 7 Chome	Chuo	-5.9
Ginza 2 Chome	Chuo	-5.1
Kabukicho 1 Chome	Shinjuku	-5.0
Sotokanda 4 Chome	Chiyoda	-5.0
Shinjuku 3 Chome	Shinjuku	-3.9

Source MLIT, Savills Research & Consultancy

That said, considering that the weighting of the TSE REIT index heavily favours sectors that have been less impacted by the pandemic (office), as well as those that have performed strongly (logistics and residential), the performance of Aeon REIT looks more impressive.

In contrast, investors appear to have some concerns regarding Japan Retail Fund given the above-average exposure to urban high street retail. Even so, these worries may have led to an overcorrection, especially considering how sought out these assets are given the high land value attached. In addition, the J-REIT has maintained its dividend payments thus far, suggesting some stability under the hood, likely in part due to the solid long-term relationships with tenants. Indeed, this deep understanding of individual circumstances gives the REIT resilience. Still, broadly speaking, given investors' expectations of a longer recovery for hard assets than corporations, J-REITs continue to lag the TOPIX.

J-REIT retail transaction cap rates, like much of the broader Japanese real estate market, have been on a downtrend over the past decade or so, with assets located in the suburbs and the city centre sinking below the 5% and 4% levels, respectively (Graph 6). Interestingly, this momentum has not notably altered in 2020, as calmness has prevailed thus far. Going forward, J-REIT acquisition speed may slow down, however, owing to unit prices trading at a discount to their NAV.

Elsewhere, recent changes in retail land prices somewhat temper the optimism going forward. Specifically, according to the Kijun Chika (a land price survey conducted by the Ministry of Land, Infrastructure, Transport and Tourism (MLIT) every July), average prices in the Tokyo 23 Wards increased by 1.8% YoY in 2020. In isolation, this appears fairly reasonable, all things considered. Unfortunately, the equivalent survey in 2019 saw land price growth of 8.4% YoY – a near 7.0 percentage-point difference.

Unsurprisingly, social distancing initiatives and the lack of inbound tourism has hurt areas such as Asakusa. In Tokyo's central five wards (C5W), meanwhile, Ginza suffered a similar fate, with the area taking the bottom two places for land price growth (Map 1). In contrast, driven in part by the enormous redevelopment of the area, things look brighter for Minato Ward. Specifically, in Toranomon and Azabudai, there is the sense that the neighbouring areas will be significantly revitalised, as previously observed in Roppongi following the completion of Roppongi Hills in 2003.

Considering the above, therefore, things appear to be in a better state than the headlines may suggest. Even so, the uncertainty surrounding the longevity of the virus itself will continue to plague the optimistic outlook for the retail sector, and therefore, further suffering cannot be ruled out.

OUTLOOK

On the surface, retail rents appear to have weathered the global pandemic commendably with multiple cases of growth witnessed across the nation. Yet, the reality could not be more different. Amid the continued caution amongst consumers, rents have paradoxically surged, mostly due to prime locations becoming available. Concurrently, vacancies have also risen, especially in areas reliant on inbound tourism. As such, rather than demonstrating solid underlying fundamentals, these material increases appear more akin to a canary in the coal mine.

Though prospects are somewhat ominous for the sector at large, certain segments of the market and locations will face more challenges than others. In fact, as seen during other times of distress, asset location will determine the winners and losers further down the line. Indeed, whilst the immediate future will undoubtedly be challenging, those who do emerge as winners in a post-COVID world, or are early adopters to the new environment, could be richly rewarded.

Somewhat supporting this view is the recovery in footfall around retail districts in Japan. According to mobility data provided by Google, whilst Tokyo did experience a drop-off in activity, it was nowhere near as pronounced as the sharp drops seen in the London and New York markets. More recently, footfall remains 20% off normal levels in the capital. What's more, this recovery is likely to accelerate following the inclusion of Tokyo in the "Go To" campaign in October, stimulating retail sales across the nation. At the same time this could also be perceived as a sign that the nation is finding ways in managing the pandemic to some extent, paving the way for an improvement in consumer confidence.

In this context, considering the increased levels of household saving of late, another factor to consider is pent-up consumer demand. Whilst an obvious fillip to the sector, its level of contribution will depend on the state of the broader economy. This is especially true given the slight drop in cash earnings, despite the relatively sound employment figures in Japan. As such, a sound recovery in consumer confidence will be vital to the sector indeed.

Looking ahead to this new era, consumers' appetites for experiences over goods are likely to accelerate. For some time now, people have been unable to freely enjoy experiences without a sense of trepidation. Demand for products, on the other hand, has been satisfied in part by e-commerce. In anticipation of this phenomenon, therefore, retailers of goods in particular will have to incorporate unique ways to enhance the retail experience such as showrooms and pop-ups. Simultaneously, given that e-commerce is here to stay, it is vital that retailers see it as an opportunity to adapt, rather than as a threat.

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