Japan - April 2023

SPOTLIGHT
Savills Research

Japan Retail

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Market recovering rapidly but with road bumps ahead

Summary

- In 2H/2022, average 1F rents in Tokyo have seen slight dips. However, this was partly due to a decline in the number of prime units listed, as they appear to have been taken up, and the overall market has seen a gradual decline in vacancies.
- In regional markets, average 1F rents have also seen a decline, which reflected a similar situation to that of Tokyo, and demonstrates increasing demand.
- Transaction volumes in 2022 have surpassed those of 2021 by almost 10%, and more deals in the retail sector are expected. The sector will likely attract more investors in this environment of elevated inflation and interest rates.
- While the luxury, discount, and daily essentials sectors are performing well and are expected to continue doing so, mid-market retail is expected to take longer to recover.
- Although Japan has transitioned to a post-pandemic state, office attendance and the consequent footfall in central business districts still lag pre-pandemic levels, which will impact the wider retail market.
- The effects of lifestyle changes and paradigm shifts that occurred during the pandemic, such as an expansion in online shopping, will likely linger, and retailers will need to continue adapting to these changes.
- Inbound tourism has made a robust comeback, which will provide a significant boost to related sectors.

TOKYO SUBMARKET RENTS

According to the semi-annual survey by the Japan Real Estate Institute (JREI) and BAC Urban Projects, average asking rents for 1F units in Tokyo have declined slightly by 1.3% half-year-on-half-year (HoH), translating to a moderate increment of 2.4% year-on-year (YoY). Meanwhile, non-1F rents declined marginally by 0.8% HoH but grew 4.5% YoY. While there were some differences in terms of rental performance between submarkets, vacancies have gradually been declining overall, although there is still some notable divergence between prime and non-prime areas.

Japan has transitioned into a post-pandemic state, characterised by the lifting of restrictions on going out and the resumption of inbound tourism. At the ground level, luxury brands have continued to do well, and prime locations have reportedly seen rental growth. On the other hand, non-prime areas that cater to mid-tier brands are still in a weaker position and will likely take more time to recover.

The retail sector has certainly been a beneficiary of the progress to a post-pandemic era, and more investors have started to show growing interest in retail assets. At the same time, it still faces some challenges across the board. For instance, heightened material and energy prices, as well as increasing labour costs are expected to linger, which will apply greater pressure on tenants, and might affect rental growth. Nonetheless, the market sentiment has improved overall, and should continue to do so going forward as more tourists come to Japan.

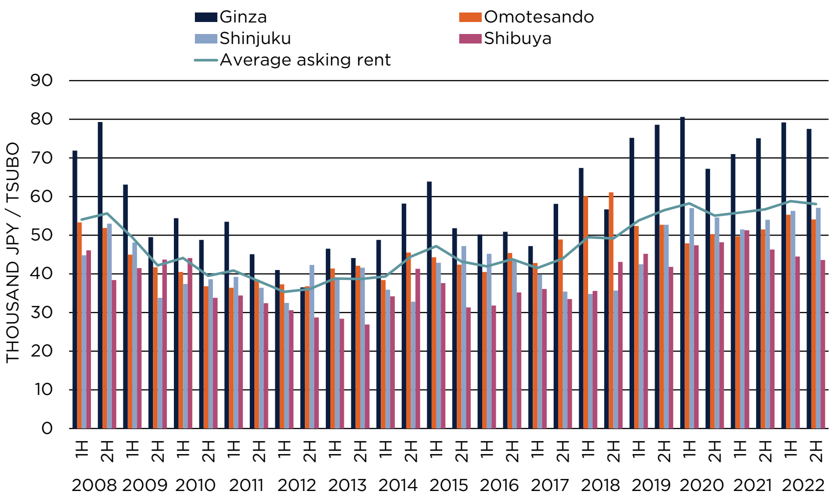
Ginza

Average 1F asking rents in Ginza dipped slightly by 2.1% HoH, but rose 3.2% YoY to JPY77,500 per tsubo in 2H/2022, maintaining a clear premium over other submarkets in Tokyo. Meanwhile, non-1F rents have increased by 2.1% HoH and 6.9% YoY to JPY34,100 per tsubo, and are on par with other submarkets.

Ginza's position as the premier retail district in Tokyo has not wavered throughout the pandemic, when luxury brands thrived with multiple new shop openings driven by demand from the wealthy unable to travel overseas. In the present post-pandemic era, the momentum of luxury brands has not slowed, and vacant spots are virtually non-existent in prime locations. Indeed, the strength of the luxury industry can be seen when observing the sales of Ginza Six, a department store known for its concentration of luxury brands, which hit a new record high in 2022, and were 10% higher than 2019, the previous record year. Notable openings in 2H/2022 include Versace's new flagship store along Harumi-dori, and CHANEL Fine Jewelry along Namiki-dori.

Ginza has performed well and looks to continue doing so in the current market environment. Other than luxury brands, clinics and beauty-related services have also continued to fill vacancies on mid and high floors, and the general recovery has also slowly improved the outlook of restaurants in Ginza, although night-time footfall still has some room for improvement. Overall, given the improving circumstances of the area, there is little worry about rents seeing further corrections.

GRAPH 1: Tokyo 1F Rents, 2008 to 2022



Source JREI, BAC Urban Projects, Savills Research & Consultancy

Japan has progressed to a post-pandemic state, with domestic demand and inbound tourism making a strong comeback. While this will certainly mean improvement for the overall retail sector, there are road bumps including the inflationary environment and a shortage of labour that will have an adverse impact, especially on mid-market retail which may take longer to recover. Nonetheless, retail assets will benefit from increasing popularity due to their rental prospects.

Omotesando

Average 1F rents in Omotesando followed a similar trend to that of Ginza, decreasing 2.2% HoH to JPY54,100 per tsubo, to an annual increment of 3.2%. Non-1F rents saw a dip of 3.6% HoH and 4.2% YoY to JPY34,600 per tsubo, losing its place as the submarket with the most expensive non-1F rents by a small margin.

Omotesando is widely known for its diverse range of fashion goods. However, a notable divergence persists in the submarket; while the high-end luxury brands along the main street between Jingumae and Aoyama have performed well, the more offbeat young fashion areas such as Meiji-dori and Cat Street appear to still be suffering. Indeed, lifestyle changes that manifested during the pandemic and the absence of tourists have negatively impacted these areas, resulting in greater bifurcation, although gradual recovery is expected in the current post-pandemic society. At the same time, Omotesando has also seen recovery in its pop-up stores that were widely used for marketing toward younger customers.

Omotesando has seen vacancies slowly decrease as the overall market sentiment improves. Going forward, the submarket is expected to broadly recover in the mid-term, further aided by upcoming developments in the pipeline like the Jingumae 6-Chome redevelopment project in mid-2023, and Harajuku Quest in 2025. In the meantime, smaller units should continue to see improvement with more vacant units filling up, although it might take some time for larger units to recover.

Shinjuku

Average 1F rents in Shinjuku have seen another consecutive increment, growing 1.4% HoH to JPY57,100 per tsubo, rising 5.7% YoY. Non-1F rents have likewise increased 4.2% HoH and 15.7% YoY to JPY34,700 per tsubo, leapfrogging Ginza and Omotesando to become the most expensive submarket in this category.

Vacancies in Shinjuku have been slowly declining, although they still remain markedly higher than pre-pandemic times. The luxury sector has again taken centre stage with its strong performance. For instance, Isetan Shinjuku, known for housing high-end luxury brands, has reported record-high sales in FY2022, surpassing the previous high in FY2019 by more than 20%. On the other hand, sales of the department store Lumine, which specialises in fashion, were 10% lower in 2022 than in 2019, demonstrating the disparity in recovery.

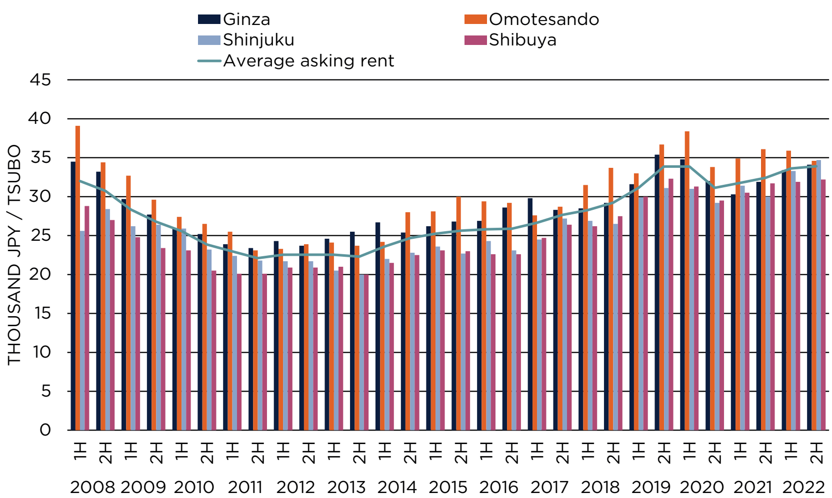
Indeed, bifurcation still exists in the submarket. Retail on the east side of Shinjuku station has reportedly seen greater attention due to the ongoing construction and redevelopment on the west side. In addition, while the area south of Shinjuku-dori is performing well, the Kabukicho area still exhibits noticeable amounts of vacancy. Nonetheless, overall market conditions appear to be more optimistic, with the large site next to the station that used to house Uniqlo appearing to have secured a new tenant. Overall, the gradual upgrades that Shinjuku has been adding, such as the Meiji-dori bypass in late 2022 to help smoothen traffic flow, look to improve the image and the popularity of the area.

Shibuya

Average 1F asking rents in Shibuya declined 2.0% HoH and 5.8% YoY to JPY43,600 per tsubo, and are the least expensive amongst the four Tokyo submarkets. Non-1F rents have seen a slight increment of 0.9% HoH and 1.6% YoY to JPY32,200 per tsubo, and like 1F rents, remain the least expensive.

Shibuya had a weaker presence of luxury brands compared to the other Tokyo submarkets, and its retail sector overall saw the poorest performance due to the high concentration of restaurants and live entertainment establishments. In the current post-pandemic era, recovery is underway

GRAPH 2: Tokyo Non-1F Rents, 2008 to 2022



Source JREI, BAC Urban Projects, Savills Research & Consultancy with the reported reopening of some live entertainment establishments such as LINE CUBE SHIBUYA. Nonetheless, leasing looks to take more time, especially in subprime areas like Inokashira-dori, and places further away from the station that appear to be suffering. Indeed, there have been reports of tentative tenants cancelling openings in such areas.

On a positive note, vacancies have been slowly decreasing over the past year, although they are still double 2019 levels. Furthermore, shopping centres such as PARCO have performed decently well, managing to hit 2022 revenue targets of JPY20 billion. Going forward, Shibuya Sakura Stage is expected to be completed in late 2023 and should bring more attention to the southern side of Shibuya station.

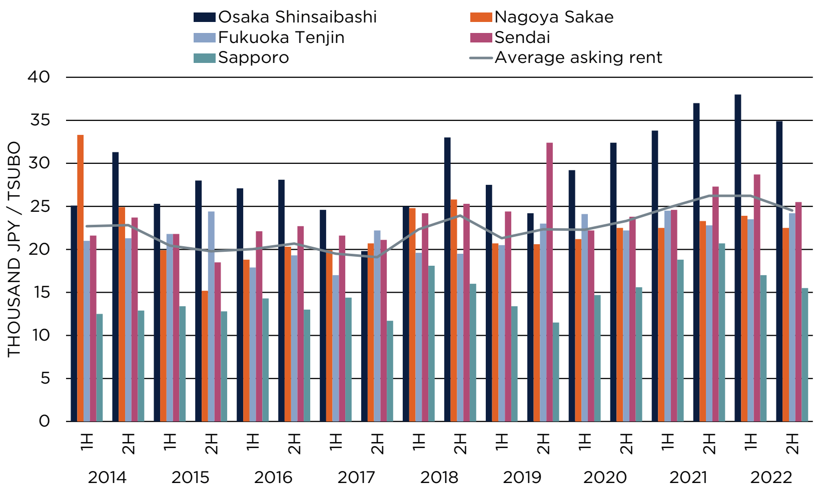
REGIONAL CITIES

Average 1F asking rents in regional cities saw a decline of 6.5% both HoH and YoY to JPY24,520 per tsubo. Non-1F asking rents moved in the opposite direction, increasing 3.3% HoH and 5.1% YoY to JPY16,100 per tsubo. Market conditions have improved overall on the back of the transition to a post-pandemic state and the return of inbound tourism, and vacancies have been on the decline overall. Like Tokyo, many regions appear to be experiencing some bifurcation, with prime locations doing well and less prime locations performing more poorly, although the general retail environment has been steadily improving in the post-pandemic era. Nonetheless, global economic headwinds stemming from increasing material and energy prices, on top of the labour shortage in Japan, have added additional pressure on the overall retail sector, further thinning the margins of tenants. As such, rental increments are likely subject to the area and tenant in question.

In Osaka's Shinsaibashi, rents moved in line with the overall regional market trend, with average asking 1F rents dipping 8.2% HoH and 5.7% YoY to JPY39,400 per tsubo, and non-1F rents increasing a slight 1.2% HoH and 3.1% YoY. The Midosuji area, known for its line-up of luxury brands in the same vein as Ginza, led the submarket in performance, with new developments in the area reported to have already secured tenants. On the other hand, the Shinsaibashi Shopping Arcade area appears to still be lagging behind and has some notable vacancies. Overall, while vacancies have stopped climbing, it is expected that more time will be needed for them to come down closer to pre-pandemic levels. Nonetheless, the overall market sentiment is more positive, especially in areas more dependent on inbound tourism such as Ebisubashi and Dotonbori which have reportedly seen some new store openings entering 2023.

In general, the return of inbound tourism has impacted Nagoya's Sakae lightly. The submarket has seen 1F rents decrease 5.9% HoH and 3.4% YoY to JPY22,500 per tsubo. Overall, vacancy levels have declined slightly, and market recovery appears to be abound, with an increasing number of shop rental inquiries due to higher levels of footfall. At the same time, like other submarkets, retail involving general fashion appears to have performed more poorly. For instance, Otsu-dori, which was known for its lineup of fashion retail, has seen more drug stores take up tenancy, and hence diluting the fashion image of the street. Looking ahead, there are many redevelopment projects in the pipeline in the main Sakae crossing vicinity, which should bring more spotlight to the area. At the same time, this could comparatively weaken the south side of Sakae, where Loft is expected to exit in mid-2023.

GRAPH 3: 1F Rents in Retail Districts of Regional Cities, 2014 to 2022



Source JREI, BAC Urban Projects, Savills Research & Consultancy

Average 1F asking rents in Fukuoka have increased 3.0% HoH and 6.1% YoY to JPY24,200 per tsubo, although non-1F asking rents saw another consecutive slight decline. Fukuoka performed strongly even during the pandemic, and its prime districts such as Nishi-dori and the Tenjin 2-Chome area have seen rental growth with few vacant lots in sight. Indeed, some owners in the market have reportedly been bullish and more reluctant to lower rents since mid-2022, although this has led to some weakening in locations such as the high floors of large shopping complexes. Going forward, Fukuoka Daimyo Garden City, part of the Tenjin Big Bang project, and the greater return of inbound tourists should help to further increase footfall.

Sendai has seen 1F rents decline 11.1% HoH and 6.6% YoY to JPY25,500 per tsubo. The submarket can be divided into the Sendai west exit area, which houses large shopping centres, and the shopping arcade area, consisting of the streets from Hapina Nakakecho to Ichiban-cho. The bifurcation between these two areas has persisted, with the shopping arcade area seeing considerably weaker performance than its counterpart. Vacancy levels are still high overall, although there are signs of gradual improvement like new restaurants and fashion stores, bolstered by the increased footfall. Overall, the situation nonetheless remains subdued for the shopping arcade area, which might further lose its standing to upcoming developments around Sendai station.

Sapporo's 1F rents have seen a considerable decline of 8.8% HoH and 25.1% YoY to JPY15,500 per tsubo, although this decrease in asking rents is likely due to greater uptake of prime units that were previously available on the market. Indeed, aided by the return of inbound tourism and vacancies have been on the decline over the past year, although they still remain significantly higher than pre-pandemic levels. Nonetheless, further recovery is expected going forward, especially with the peak summer tourism season coming up. The simultaneous large redevelopments ongoing around the station are expected to temporarily shift attention away from the area, but will likewise gravitate large amounts of traffic once they are complete.

INVESTMENT TRENDS

The results of the October 2022 semi-annual survey conducted by JREI saw cap rates compress slightly in a few areas over the last half-year. In prime retail properties, cap rates in Nagoya tightened 10 basis points (bps) to 4.7%, while other markets, including Ginza, remained flat. Meanwhile, for suburban retail properties, Tokyo, Sapporo and Fukuoka all tightened 10bps. In general, many areas have seen a gentle compression of cap rates over the past year, demonstrating greater confidence in the retail sector, especially now that restrictions on going out have been lifted completely. It should be noted that actual market cap rates could be as much as 100bps lower than these surveyed cap rates.

One notable transaction that took place between Q4/2022 and Q1/2023 was the acquisition of three retail properties in Shibuya, Minato, and Fukuoka by FPG for JPY40 billion. Acquisitions of properties located in prime districts by domestic investors suggest that some have become more bullish on the retail market. Meanwhile, some J-REITs have been shuffling assets, including Tokyu Land's Tokyu Plaza Ginza for JPY39 billion.

Japan transitioned into a post-pandemic state, which should further boost footfall around retail facilities. At the same time, the country has also started to move away from an era of zero-interest rates and the new governor of the Bank of Japan is expected to gradually normalise monetary policies. According to preliminary data from Real Capital Analytics, retail transactions in 2022 have surpassed those of 2021 by almost 10%, with transactional volumes of around JPY700 billion. The retail sector will likely receive greater attention amidst the inflationary environment and elevated interest rates as investors seek out retail assets with prospects of rental increments on the back of stronger inbound demand, or regional properties with stable but high yields of 5% or more as a yield play.

POST-PANDEMIC RETAIL ENVIRONMENT

The pandemic broadly transformed some of the landscape of commercial real estate, and even as society has progressed to a post-pandemic state, many trends that materialised over the past few years will linger and have an impact on the market.

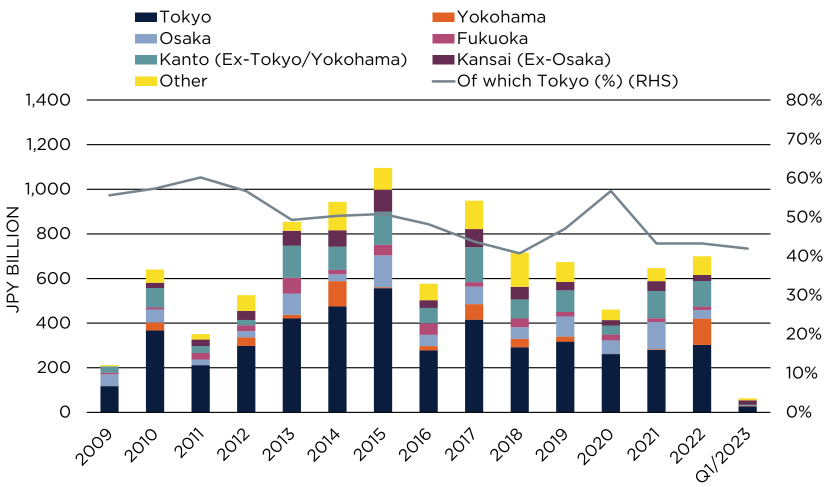
For instance, even though companies are generally pushing for greater office attendance, commuter traffic is estimated to be as much as 20-30% lower than pre-pandemic times in some of Tokyo's central business districts, which has negatively affected the retail sector. While levels of remote work are not as high when compared to other western countries, hybrid work systems are still prevalent, especially in Tokyo, and will likely persist. They have resulted in some lifestyle shifts, such as a greater amount of shopping done online, and retail establishments will need to understand and adapt to these habitual changes of the new era.

Luxury goods have continued to perform strongly because of the heightened demand from high-net-worth individuals that have fared better throughout the pandemic. Indeed, major department stores that house many of these luxury brands across Japan have performed exceptionally well leading up to the country's transition to a post-pandemic state. For instance, in FY2021, Isetan Shinjuku reported that more than 50% of its sales were from the top 5% of its customers. Furthermore, the return of inbound tourism will further boost sales. On the other hand, mid-market retail goods face more dire straits. Indeed, after bracing depressed footfall during the pandemic, they now have to combat an inflationary environment which will likely be accompanied by somewhat decreased discretionary spending, even with some wage growth observed. Elsewhere, discount stores of reasonable quality, as well as essential goods like supermarkets and drug stores are faring well, and are expected to continue doing so in the current inflationary environment.

Another factor that will have a significant impact on the market is the current labour shortage. The pandemic led to extensive layoffs in the retail industry, in addition to an exodus of foreign workers and students. With market conditions rapidly recovering, although many shops have looked to expedite hiring, the shortage of available labour has made it difficult to do so. Indeed, the job-to-applicant ratios for sales, kitchen, and service staff have increased significantly over the past few months. Retail shops may have to resort to shortening business hours or raising wages in order to cope, which will have an adverse impact on their bottom lines, especially for businesses that have wafer-thin profit margins like lower-end restaurants.

For investors, elevated inflation and interest rates should bolster investment appetite for retail assets with prospects of rental increments, and assets that have high, stable yields of 5% or higher, like suburban shopping centres, will likely garner more attention going forward.

GRAPH 4: Retail Property Investment by Region, 2009 to Q1/2023*



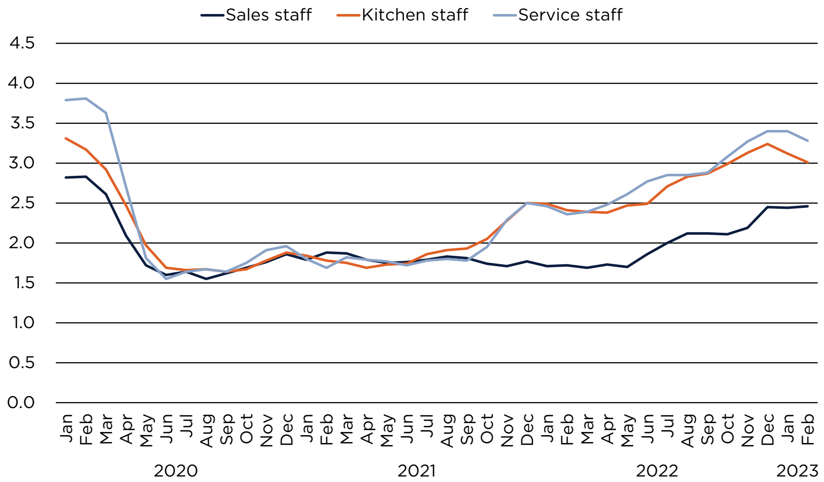
Source MSCI Real Capital Analytics, Savills Research & Consultancy
* Q1/2023 volumes are preliminary and is likely to be revised upwards. In principle, MSCI Real Capital Analytics investment volumes do not include related-party transactions, such as those between a J-REIT and its sponsor.

TABLE 1: Selected Retail Transactions, announced Q4/2022 to Q1/2023

ANNOUNCED	PROPERTY	LOCATION	GFA (SQ M)	PRICE (JPY BIL)	DIRECT CAP RATE	BUYER
Dec 2022	Retail portfolio (3 properties)	Shibuya, Minato and Fukuoka	6,300	40.0	-	FPG
Mar 2023	Tokyu Plaza Ginza (partial)	Chuo, Tokyo	48,000	39.0	2.5%	SPC of Tokyu Land
Mar 2023	Aeon Mall Wakayama	Wakayama City, Wakayama	95,000	16.8	5.1%	Aeon REIT
Oct 2022	Iias Kasugai	Kasugai, Aichi	70,000	14.5	4.5%	Kenedix Retail REIT
Nov 2022	Ameyoko Center Building	Taito, Tokyo	7,000	7.7	-	Domestic company

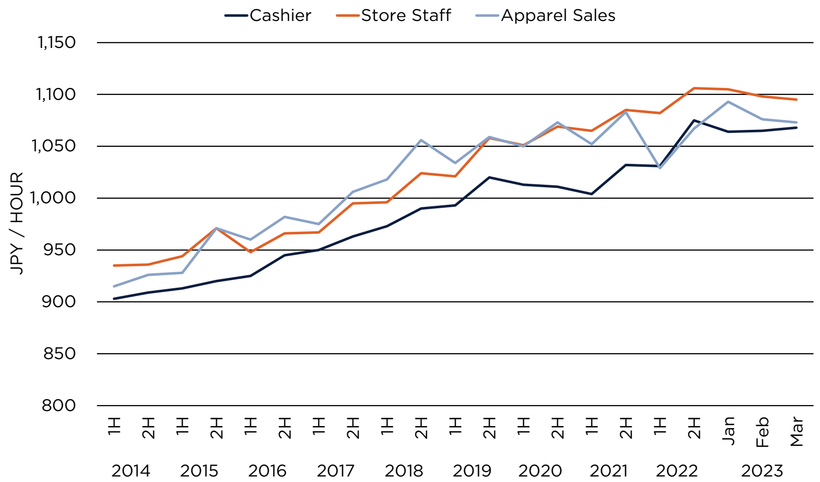
Source Press releases, MSCI Real Capital Analytics, Savills Research & Consultancy

GRAPH 5: Job-to-applicant Ratio, 2020 to February 2023



Source Ministry of Health, Labour and Welfare, Savills Research & Consultancy

GRAPH 6: Average Hourly Wages for Retail Staff, 2014 to March 2023



Source Jobs Research Center, Savills Research and Consultancy

OUTLOOK

The outlook for Japan retail in the post-pandemic era is certainly more optimistic than it was before, and further recovery has been observed. Luxury goods have continued to perform strongly on the back of a wealthy clientele, mostly domestic, while the return of foreign travellers has helped to boost retail sales, especially in areas dependent on inbound tourism, and should continue improving strongly.

At the same time, there are multiple hurdles for the retail sector as a whole, and more so for some categories than for others. Mid-market fashion retail and restaurants, which although they have improved over the past few months, are still performing relatively poorly, and prospects for recovery in the near future are somewhat dim. Indeed, the inflationary environment is likely to linger and depress some discretionary spending, which will hit mid-market retail harder. Furthermore, rising labour costs and the difficulty in acquiring new staff will have a negative impact on the wider market, and shops may have to resort to raising wages to attract talent, or shorten business hours, both of which will affect profits. Despite these circumstances, other retail categories, most notably the luxury sector, discount stores, and daily essentials, are expected to fare well, meaning that the bifurcation between strong performers and underperformers looks to linger.

Going forward, despite the ongoing challenges, the retail sector is nonetheless expected to steadily recover as footfall in retail areas has increased in the post-pandemic era. As footfall further improves, even weaker retail segments like the mid-market and F&B should follow suit. In addition, as the retail assets with prospects of rental increments strengthen amidst an environment of elevated inflation and interest rates, stable retail assets offering higher yields, like those in regional suburban areas, will also probably attract greater attention from investors.

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