Japan - October 2021

SPOTLIGHT
Savills Research

Japan Retail

On course for a bumpy recovery

Summary

- Average 1F rents in Tokyo have inched up in 1H/2021, though performance is mixed depending on location. The reality of the situation remains grim, however, with all submarkets posting high vacancy rates.
- The change in rents across regional markets was mixed, but like Tokyo, high levels of vacancy remain. Amongst the regional markets, Sapporo is suffering badly, while Fukuoka is faring comparatively well.
- Transaction volumes in 2021 are likely to surpass 2020 levels, with multiple large deals observed over the past two quarters.
- The F&B industry has been badly hit and the damage is likely to linger in the medium term, possibly lowering the NOI of properties, and consequently property valuations.
- Some investors have chosen to exit the tough environment, while other investors are using it as a chance to break into the market.
- High vaccination rates, plunging COVID-19 cases, strong pent-up demand, and excess savings are tailwinds for the retail sector.

TOKYO SUBMARKET RENTS

The pandemic has persisted into the second half of 2021, and Tokyo's retail market has continued to lag. As reported by the semi-annual survey by the Japan Real Estate Institute (JREI) and BAC Urban Projects, average asking 1F rents in Tokyo have slipped 4.0% year-on-year (YoY), although they have also ascended 1.5% half-year-on-half-year (HoH). At the same time, non-1F rents have seen a similar trend, seeing an annual decline of 6.2% YoY while also increasing this half-year by 2.1% HoH. While the increments in rents from the previous half-year might raise hopes of a recovery, the reality of the situation is that the listings of previously unavailable prime locations are boosting average rents. As such, market fundamentals have not improved, and uncertainty remains in the retail sector.

Some industries within retail have clearly suffered disproportionately throughout the pandemic, and F&B is one such industry. With its wafer-thin profit margins and very high break-even points, the sharp decline in sales has unsurprisingly left many restaurants in the red, and some have been forced to close. F&B outlets are ubiquitous and hold strategic importance for occupying mid-to-high floors in many retail establishments. As such, F&B's downturn continues to negatively affect a large number of retail properties. Nonetheless, the increased vaccination rates and the end of the nationwide state of emergency should bring foot traffic back to retail areas and put the sector on the road to recovery.

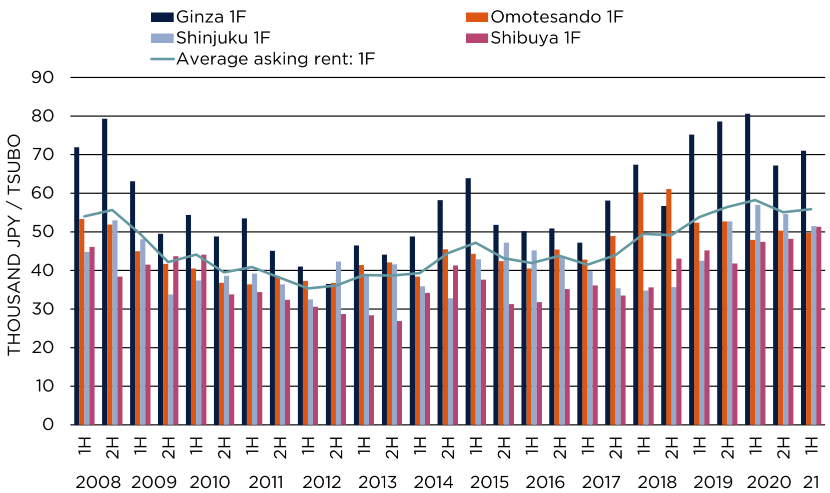
Ginza

Average 1F rents in Ginza have risen by 5.7% HoH to JPY71,000 per tsubo. However, this translates into an 11.9% YoY decline as record high rent levels were seen in 1H/2020. Nonetheless, when it comes to 1F rents, Ginza continues reign supreme, with a 27% premium over the Tokyo market average. In contrast, when looking at non-1F rents, Ginza was the only submarket to see a decline over the half-year – decreasing 5.3% HoH and 12.9% YoY to JPY30,300 per tsubo. In fact, for the first time since the initial coverage in 2008, Ginza posted the lowest non-1F rents in the Tokyo market, demonstrating its stark disparity with 1F rents.

Ginza is well renowned as the premier shopping district that hosts the flagship stores of many luxury brands. This characterisation has elevated the market's position during the pandemic, with the luxury goods industry performing well due to the boosted spending of wealthy domestic spenders unable to travel overseas. The strength of the industry can be further observed by the multiple new openings of flagship stores of high-end brands in the area this year, including Hugo Boss and Gucci. Furthermore, vacancies of 1F space are few and far between, especially in prime areas. Overall, prime areas in Ginza are forecast to maintain strong rents, underpinned by the sound demand for such highly sought-after locations.

In contrast, F&B businesses in Ginza have continued to see many closures, and these have led to notable levels of vacant space in many buildings, particularly on higher floors. While landlords have tried to find replacements in the form of beauty salons and shared office spaces, a majority of the gaps have yet to be filled. Such long-term vacancies have been particularly noticeable along 7-to-8-Chome. The prospects for similar subprime and minor roadways are poor, and rents are likely to see further corrections going forward.

GRAPH 1: Tokyo 1F Rents, 2008 to 1H/2021



Source JREI, BAC Urban Projects, Savills Research & Consultancy

Omotesando

Once again, average 1F and non-1F rents in Omotesando have trended in different directions. Specifically, 1F rents saw a slight dip of 1.2% HoH to JPY49,700 per tsubo, but remain higher than levels seen in the previous year. Conversely, non-1F rents have inched up 3.3% HoH to JPY34,900 per tsubo, but are 9.1% lower than what was recorded a year ago. When compared with other submarkets, Omotesando 1F rents were the lowest this half-year, while its non-1F rents were the highest in the market – the opposite of what was observed in Ginza. Historically, Omotesando has had more demand from the service industry than the F&B industry for retail space, and this tenant profile in the submarket appears to have helped contribute to the stability of its non-1F rents.

The landscape of the main shopping street between Omotesando and Jingumae bears resemblance to prime areas in Ginza, with its long rows of luxury brands and streets usually bustling with people. While the pandemic has undoubtedly reduced footfall, this street continues to thrive with minimal vacancies. However, the situation of areas like Takeshita Street and Cat Street, with many small shops, has not improved. More long-term vacancies have become apparent in these areas, especially in some large establishments and along streets that have lower levels of foot traffic. Indeed, the disparity between prime areas and subprime areas has grown. Even as the retail sector approaches recovery, the process is likely to be slow and challenging for currently underperforming locations.

The pandemic has predictably taken its toll on the retail sector and vacancy rates are still elevated across all markets as a result. The F&B industry has borne the brunt, and its struggles are likely to linger, possibly lowering the NOI of retail properties in the medium term. Against this backdrop, however, the high rate of vaccinations, plunging COVID-19 cases, strong pent-up demand, and excess savings spark hope for a recovery.

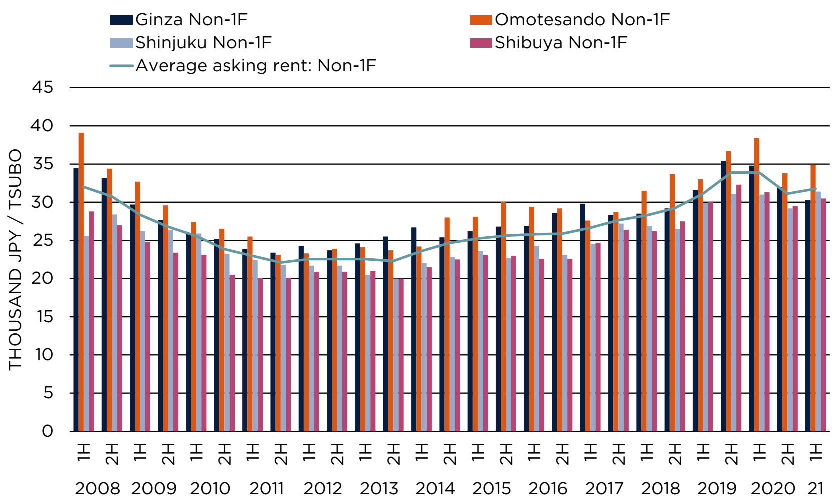
Shinjuku

Average 1F rents in Shinjuku have continued the downward trend seen in the previous half-year, declining 5.7% HoH and 9.6% YoY to JPY51,500 per tsubo. Despite the decline, its average 1F rents are still the second highest in the Tokyo market – for two years consecutively. Elsewhere, average non-1F rents have moved in the opposite direction, increasing 7.5% HoH and 1.3% YoY to JPY31,400 per tsubo.

Shinjuku is one of the areas that has been hit the hardest by the pandemic, owing to its high concentration of F&B outlets and entertainment centres. Although Shinjuku station is Japan's busiest station, and an important transit terminal, the decline in footfall due to the increase in remote work and the slump in tourism is apparent. As mentioned throughout this report, the relatively high rental levels are indicative of the increase in vacancies of prime units, especially in areas like Kabukicho where units are compact and the rent per unit of space is high. Furthermore, the large sites that Barneys New York and Yamada Denki departed from remain empty. With the current situation unlikely to see significant immediate improvements, further rent corrections are in the crosshairs.

Nonetheless, as with other submarkets, some areas are bucking the market trend and have seen amicable performance given the circumstances. For instance, Shinjuku 3-Chome, an area that has a higher proportion of brand names, has remained steady with few vacancies. Moreover, throughout the pandemic, Shinjuku Street has reportedly seen fewer vacancies than its rivals like Shibuya and Ikebukuro – a testament to its overall market strength and long-term potential. While the submarket still needs to brace itself for tough times ahead, its troubles should slowly disappear as the mood of the pandemic starts to dissipate.

GRAPH 2: Tokyo Non-1F Rents, 2008 to 1H/2021



Source JREI, BAC Urban Projects, Savills Research & Consultancy

Shibuya

Average 1F asking rents in Shibuya have increased to new highs of JPY51,300 per tsubo, with growth of 6.4% HoH and 8.2% YoY. Meanwhile, non-1F rents have increased 3.4% to JPY30,500 per tsubo, bouncing back from the drop in the previous half-year, although rental levels are 2.6% lower than the previous year. Overall, the situation of the submarket has not changed significantly from what was seen six months ago – multiple prime locations still remain vacant, and this occurrence is inflating average rents.

Shibuya's strengths, before the pandemic, lay in its diverse and numerous retail streets that fanned out from the main station, including Centre-Gai and Inokashira Street. The convenient access to a variety of eateries, live houses, and amusement centres added to the area's vibrancy and culture. Now, however, these strengths have led to the submarket's downfall, as F&B outlets and entertainment establishments are suffering from the pandemic. Indeed, vacancies can be found even along main streets, and become even more apparent further away from the station and in large buildings. Unfortunately for the submarket, the pandemic has diluted the positive impact that the multiple new developments like Tokyu Plaza and Miyashita Park should have had.

Times are hard for Shibuya, and the submarket may see rent corrections going forward. Unlike its peers, it has a relatively lower proportion of luxury brands to support the submarket in the current situation. While the easing of restrictions on the F&B industry is a consolation, it could take some time before spending returns to pre-pandemic levels, especially considering the significant contribution from inbound tourism recently. As such, the road to recovery for Shibuya's retail market is likely to be a long one.

REGIONAL CITIES

Average regional 1F rents have continued to climb, increasing 4.5% HoH and 9.0% YoY to JPY26,350 per tsubo. All markets have seen rental growth, with Sapporo leading the way. Meanwhile, non-1F rents have experienced a slight dip of 0.8% HoH, reducing the annual growth to 0.7%. Here, performances varied significantly from city to city, with some areas like Osaka's Shinsaibashi posting notable gains, but others like Fukuoka seeing corrections over the year. However, like Tokyo, rents are generally inflated by the increase in listings located in prime locations that were previously unavailable, and observations of rental growth should not be taken at face value.

In Osaka, Shinsaibashi has once again seen notable increases in both 1F and non-1F asking rents. Specifically, 1F rents increased 4.3% HoH and 15.8% YoY to JPY33,800 per tsubo, maintaining its upward trend. Meanwhile, non-1F rents have increased 7.9% HoH and 11.9% YoY to JPY15,100 per tsubo. At the same time, the submarket still faces high levels of vacancy, which has contributed to these increases in average asking rents.

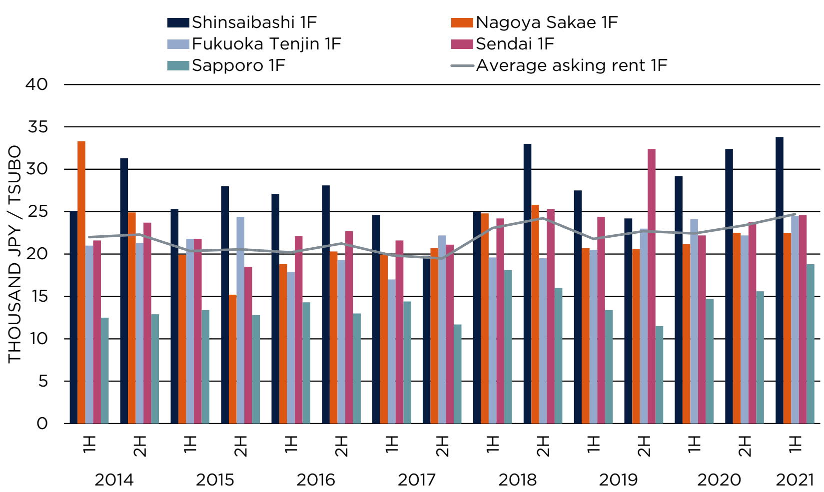
Within regional cities, Shinsaibashi bears the most resemblance to the prime retail districts in Tokyo. The submarket is characterised by high levels of footfall and foreign tourists, and contains a mix of high-end goods, drug stores, apparel, and F&B outlets. However, with the exception of the Mido-suji area that has been supported by the performance of its luxury stores, other areas are suffering from the plummet in tourists, and even new developments like Parco have lured only a limited number of customers to the area. In August, Uniqlo decided to close its iconic Shinsaibashi outlet, further damaging the image of the district. Even with the speedy vaccine rollout, recovery appears distant for the submarket considering it was a major beneficiary of inbound tourism.

Rents have seen a slight correction in Sakae, Nagoya, with average all-floor rents declining 2.9% HoH to JPY16,800 per tsubo, although still remaining 1.2% higher over the year. The slight weakening in rents was primarily present in non-1F units, whereas 1F units remained firm. Nagoya's position as a strong economic hub that was originally not as dependent on inbound tourism as Tokyo or Osaka is a key reason that Sakae has been relatively insulated from the pandemic. However, its F&B industry along main streets have still been disproportionately affected, and such businesses will take longer to recover. Meanwhile, ongoing developments in the area like the new Chunichi Building have been going smoothly. Another project on the Sakae Hiroba plans to house Daimaru Matsuzakaya Department Store on its lower floors and looks set to help boost consumer demand in the area upon completion. Moreover, with Aeon Mall Nagoya Noritake Garden opening close to Nagoya station, and Iias Kasugai opening in Kasugai City at the end of October, large shopping malls appear to have maintained their popularity in both urban and suburban areas.

Average all-floor rents in Fukuoka's Tenjin saw a correction of 2.1% HoH and 4.2% YoY to JPY19,000 per tsubo. Tenjin's retail market was supported by the demand brought in by inbound tourists, and restrictions that came with the pandemic have unquestionably damped its prospects. This rings especially true for its F&B and apparel industries that are still facing challenging times. For instance, the site where Abercrombie & Fitch's flagship store once stood remains vacant. However, unlike many of its counterparts, vacancies in Tenjin have somewhat decreased over the year – a sign of some recovery in the market. Indeed, new store openings are slow, but gently making progress in the submarket. Redevelopment tailwinds like the Tenjin Big Bang Project are also underway, and will be one of the cornerstones of the market's vitality in the future.

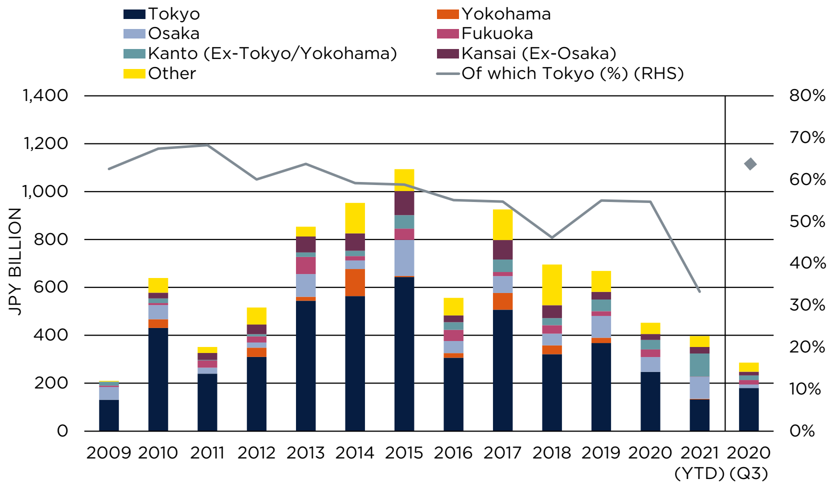
Looking at Sendai, Miyagi, average 1F rents have increased by 3.4% HoH to JPY24,600 per tsubo. Non-1F rents have, on the contrary, trended downward, shrinking 3.3% HoH to JPY14,700 per tsubo. While Sendai's low dependence on inbound tourism has shielded it from a significant negative effect of the pandemic, its F&B industry has not been spared. Compared to the previous half-year, Sendai has seen a notable increase in the number of vacancies, especially in the Kokubuncho area, which has a high concentration of F&B businesses. Indeed, the decreased footfall in these areas has taken its toll on the industry, and prospects for the submarket are looking grim, especially for the shopping streets. Nonetheless, there are some positives, especially around Sendai station, where the Yodobashi Sendai Dai-ichi Building project is underway. Ongoing redevelopment should contribute to the submarket's long-term potential.

GRAPH 3: 1F Rents in Retail Districts of Regional Cities, 2014 to 1H/2021



Source JREI, BAC Urban Projects, Savills Research & Consultancy

GRAPH 4: Retail Property Investment By Region, 2009 to Q3/2021*



Source RCA, Savills Research & Consultancy
*Q3/2021 volume is provisional and is likely to be revised upwards. In principle, RCA investment volumes do not include related-party transactions, such as those between a J-REIT and its sponsor.

TABLE 1: Selected Retail Transactions, Announced Q2/2021 to Q3/2021

ANNOUNCED	PROPERTY	LOCATION	GFA (SQ M)	PRICE (JPY BIL)	DIRECT CAP RATE	BUYER
Apr 2021	Sumitomo Corporation Shinsaibashi Building	Chuo Ward, Osaka	2,500	24.9	3.3%*	Deka Immobilien
Aug 2021	Aeon Mall Takasaki	Takasaki, Gunma	126,000	17.2	5.3%	Aeon REIT
Aug 2021	Aeon Mall Shinkomatsu	Komatsu, Ishikawa	80,000	15.1	6.4%	Aeon REIT
Aug 2021	Aeon Mall Narita	Narita, Chiba	123,000	14.0	4.7%	Aeon REIT
Jun 2021	Mitsui Shopping Park LaLaport Shin Misato Main Building (34%)	Misato, Saitama	46,000	10.3	4.7%	Frontier REIT

Source Press releases, RCA, Savills Research & Consultancy
*The cap rate for the Sumitomo Corporation Shinsaibashi Building transaction is a quoted rate reported by RCA.

Up in the north, average all-floor rents in Sapporo have inched up 2.4% HoH to JPY13,000, translating to a yearly increment of 10.2%. However, the narrative of Sapporo is similar to that of other regional cities – actual rents have stayed flat, and any rental growth is more likely due to the increase in listings. In fact, vacancies in Sapporo have seen a large jump from the previous half-year, and many closures have been observed for non-1F units. Indeed, the multiple state of emergencies and restrictions have hurt the sales of consumer goods and services all around, and even the peak tourism season in summer should not be enough to compensate.

It should be noted that the damage done to Sapporo was not evenly spread. Specifically, shops closer to Sapporo station and around the Odori area are faring much better than Susukino, which has a high concentration of restaurants and entertainment establishments. In fact, Susukino is the root cause of the spike in vacant units, which has overall more than tripled from the previous half-year, and immediate prospects for the area are dim even with the end of the state of emergency. Nonetheless, there is hope going forward with the recent announcement of the Sapporo Susukino Ekimae Complex Development Project to be built on the former Susukino Lafiler site, introducing an 18F mixed-use facility comprising retail and hotel in 2023. The potential that this development has to rejuvenate the area should be a big win for Susukino and its surroundings.

INVESTMENT TRENDS

The latest results of the April 2021 semi-annual survey conducted by JREI indicated that the expected cap rates for prime retail property have remained unchanged over the past six months. For instance, cap rates in Tokyo's premier district, Ginza, stand at 3.5%. Over the same period, expected cap rates for suburban shopping centres in the Tokyo area and regional cities have also stayed mostly flat between 5.4% and 6.5%. Osaka was the only member to have seen cap rates tighten by 10 basis points (bps) from 5.8% to 5.7%. However, it should be noted that actual market cap rates could be as much as 100bps lower than these surveyed cap rates and remain stable.

The retail sector faces challenges as a majority of industries under its umbrella have been directly affected by the pandemic. Despite these testing times, interest in the sector appears higher than in 2020, with many big-ticket transactions led by J-REITs aiming at stable returns and investors optimistic about economic recovery observed over the past half-year. For instance, AEON REIT acquired four AEON malls located in various regional hubs in a transaction totalling JPY50.2 billion. Frontier REIT has also acquired a portfolio of retail properties, including a stake in a LaLaport mall, for JPY22.1 billion. Foreign investors have also been active, with Deka Immobilien acquiring the Sumitomo Corporation Shinsaibashi Building, a landmark retail property in the heart of Osaka City, for an estimated JPY24.9 billion. Indeed, prime retail and suburban retail properties with solid revenues remain attractive.

Retail transactions in 2021 look set to surpass levels seen in 2020. According to the preliminary data from Real Capital Analytics (RCA), transaction volumes amounted to almost JPY400 billion as of Q3/2021, a 39% increase from the same period last year. Indeed, the multiple transactions of the range of assets, both large shopping complexes in regional cities as well as smaller retail facilities located in city centres, may demonstrate increasingly positive market sentiment. As such, more transactions are expected as the pandemic chapter begins to close and confidence levels in the sector inch higher.

THE PANDEMIC AFTERMATH

The pandemic has persisted for almost two years, and it has understandably resulted in brick-and-mortar retail being greatly damaged. In addition, the rapidly growing e-commerce sector may have made matters even worse. Compared to other sectors, the F&B industry continues to suffer, and the distress is likely to linger considering the post-pandemic landscape with highly infectious new variants.

The F&B industry is diverse, ranging from small operations to multi-billion-dollar chains. They typically operate on paper-thin profit margins, and traditionally have one of the highest break-even points – over 90%. Given the high costs associated with rent, labour and equipment, the F&B industry heavily depends on high sales volumes. The industry is cut-throat even during good economic times, and the low footfall and restrictions on operations during the pandemic have clearly forced many F&B outlets deep in the red, with many being forced to shut down.

Going forward, even with the sharp decline in the number of COVID-19 cases and many restrictions being lifted, some challenges remain for the F&B industry. The highly infectious new variants have obligated the industry to keep high levels of space per customer, capping sales at levels that allow them to break even. In addition, the industry is labour-intensive and securing enough workers will be another obstacle upon re-opening. Moreover, firms may have difficulties in securing sufficient funding. The industry is traditionally thinly capitalised, with both large and small firms holding an average of less than 1.5 months of revenue in cash reserves in pre-pandemic times. Many food service companies acquired additional short-term loans during the pandemic to get by, and banks may thus be hesitant to provide additional loans to the already debt-ridden industry.

The ubiquity of F&B makes it an essential component of retail. Restaurants and pubs also hold a unique strategic niche when it comes to occupying the mid-high floors and underground space of retail establishments, especially for small-scale buildings. With the pandemic resulting in multiple closures of F&B outlets, a notable amount of such space remains vacant. While landlords have tried to fill some of these units with tenants such as beauty-related services, there are limits to these efforts. Overall, the vacancies created from the F&B industry's struggles may have a marked impact on NOI, and eventually property prices in the medium term. Considering this tough environment, some investors have exited retail, but this also may present an entry opportunity for others.

Fortunately, a number of listed F&B companies have demonstrated sound recovery through the streamlining of their business processes. In addition, some industries such as luxury goods and daily essentials have been thriving amidst the pandemic. Such industries will serve as pillars to support the retail sector as it recovers, although its journey to pre-pandemic times appears to be a long one.

OUTLOOK

The extended effects of the pandemic have continued to hamper the retail sector. While average rents have seen incremental changes on the surface, they are not a reflection of improving market conditions, but rather a product of the increased availability of prime retail locations and the vacancy levels of major retail areas in both Tokyo and regional cities remain high. Indeed, with the decreased footfall in shopping areas, many shops have been forced to close, especially those highly dependent on inbound tourists.

Amidst this downturn, some industries have suffered disproportionately. For instance, the luxury goods industry has thrived on the back of increased domestic spending from the wealthy who have been unable to travel overseas. In contrast, the F&B industry has been one of the hardest hit. Not only did it have to cope with the lower number of customers and increased hygiene-related spending, but also with the multiple restrictions imposed by the government. Furthermore, the prevalence of the F&B industry and its importance in occupying mid-high floors in retail space is likely to adversely affect many landlords who may struggle to find suitable tenants as replacements, and might lead to lower expected NOI, and consequentially property prices.

Despite the depressing state of the retail market in the first half of 2021, there are beams of hope. First and foremost, the vaccination rate in Japan has increased rapidly over the past few months, and the proportion of fully vaccinated people is now approximately 70%. Moreover, this rate is likely to become one of the highest in the world in due course, due to Japan's strong peer pressure culture. Secondly, the number of new COVID cases have plummeted since early September and the state of emergency has been lifted across Japan. Importantly, the eased restrictions on restaurants are a breath of fresh air for the F&B industry. With new political leadership, the government would like to put Japan firmly on the path to recovery and normalcy. Indeed, discourse on the post-pandemic economy has already begun worldwide.

In addition, while inbound tourism has been a major boon to the Japanese economy, serving as an important growth catalyst since 2013, it remains a small part of total economic activity in Japan. In fact, a majority of retailers rely primarily on a stable base of domestic demand to support their businesses. Specifically, inbound retail accounted for a mere 1% of total retail revenue even before the pandemic, as mentioned in our first COVID-19 report, "COVID-19 and Japan Property". Hence, while a rebound in international travel looks distant, rapid recovery should still be possible on the back of domestic demand. There is strong pent-up demand as well as high levels of excess savings across the nation, and wealthy people unable to travel overseas have already demonstrated their desire for luxury products. Now that government restrictions have been lifted or loosened, a greater surge in demand is likely to be observed before long. While the road to recovery for the retail sector may be a long and bumpy one, its prospects should improve with time as the pandemic comes to an end.

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