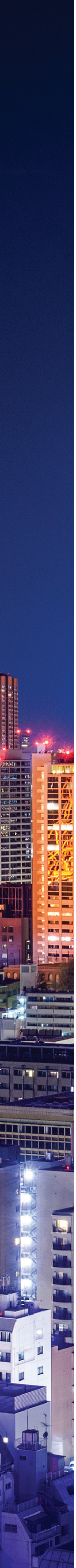
# Tokyo 2020

by Mard Naman



# *Property market performance in the build-up to — and beyond — the next Summer Olympic games*

Tokyo is preparing to host the 2020 Summer Olympics and become the focus of global attention as the world's best athletes perform. But how will Tokyo's property markets perform in the lead-up to the Olympics and after the teams have gone home? What are the city's strengths and weaknesses amid record-high bank lending in Japan's real estate sector? What opportunities does Tokyo real estate hold, both for investors interested in short-term sprints into and out of the market and marathon investors in it for the long run?

## Is residential hitting a performance wall?

In the years following the 2013 announcement Tokyo would host the 2020 Olympics, prices in the city's residential market surged. Now that surge has hit a wall, and the boom may be ending, as the number of unsold apartments reached its highest level in seven years. Chinese investor interest, which has been a major part of the boom, has cooled significantly because of China's slowing economy and new governmental restrictions that make it difficult to move money offshore. Deutsche Bank recently predicted Tokyo apartment prices would fall more than 20 percent over the next two years.

Despite the cooling demand and increased supply, Morgan Laughlin, head of Japan for PGIM Real Estate, believes demand for mid-market residential units in Tokyo remains strong and is supported by the city's increasing population and a long-term societal trend toward the fragmenting of families into more households, such as grandparents living independently and children moving out before marriage.

The high-end market may indeed drop 20 percent or more, unless there is strong inbound demand in the future, says Takuya Yamada, CEO of IDERA Capital Management in Tokyo. He notes, however, demand will be steady for low- to middle-class residential assets in Tokyo, as the trend for the younger generation to move to greater Tokyo will remain strong.

In addition, mid-market residential properties for lease in Tokyo's CBD are historically stable and are a defensive asset class in Japan, according to Shu Watanabe, director of capital transactions, Asia for TH Real Estate. This is in sharp contrast to high-end condominiums that target high-net-worth individuals, both domestic and international, and tend to be more cyclical in nature.

"From a price volatility standpoint, we are more concerned by Tokyo condos and not so much by the multifamily sector," adds Marc-André Flageole, portfolio manager for Presima. Fundamentals for multifamily appear to remain very stable, with occupancy levels increasing. Household formation is positive in Tokyo, supporting the demand for apartments, and Flageole says landlords are now able to selectively increase rents slightly.

If private apartment prices are, indeed, near or at peak levels, it may deter buyers from entering the market now, according to Jonathan Hsu, head of research, Asia for M&G Real Estate. As such, potential self-use buyers are likely to turn to the rental market until prices have adjusted and/or the risk of capital repricing due to oversupply has subsided.

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## Tourist boom and weaker yen: performance enhancers for hotel, retail and industrial assets

The yen has already depreciated more than 10 percent since the US presidential election, and if President Trump's inflationary policies are enacted, the yen will likely weaken even more. A weaker yen helps the export-oriented industrial sector, as well as the already-booming tourism market.

The United Nations World Tourism Organisation reported a 24 percent increase in international tourist arrivals in Japan in the first nine months of 2016. More than 20 million foreign tourists visited Japan last year (a record), and the government's goal is to have 40 million annually by 2020 and 60 million by 2030, according to *The Japan Times*.

Because the weaker yen makes it more expensive for Japanese to travel abroad, the "staycation effect", combined with booming international tourism, means hoteliers have enjoyed record room occupancies, according to Colliers International's first quarter 2017 *Colliers Hotels Insight*. In the run-up to the Olympics, retail and hospitality should continue to see a steady uplift as government investments to promote tourism increase, suggests M&G Real Estate's Hsu. And it is not only Tokyo that benefits. "Relatively-popular destination cities that have laid out plans to improve key transport infrastructure and to increase foreigner-friendliness are likely to benefit more from the inflow of tourism dollars. As a result, prime retail districts and hotels conveniently located near transport hubs in these cities should reap higher sales and higher occupancy rates," says Hsu.

Although Watanabe believes the part of the tourist boom related to currency fluctuation is mostly "short-term noise", he sees increasing numbers of inbound tourists as a long-term trend, as wealth in other parts of Asia continues to grow.

Similarly, the Olympics could be considered short-term noise for tourism. As Laughlin puts it, "While the impact of the 2020 Olympics on Tokyo tourism is significant, one cannot build a hospitality strategy on the back of three weeks of peak demand." Like other experts, Laughlin believes the growth of Tokyo's inbound, as well as domestic, tourism will continue long term, creating interesting hospitality opportunities, particularly in the "affordable luxury" segment.

Hotel construction starts in Japan hit their highest level in 18 years in 2016, partly in response to a projected 4,000-room shortage in Tokyo by 2020. Because of this building surge, Tokyo no longer is expected to have shortages by the time of the Olympics. Flageole says in the wake of this increased supply, some institutional investors are now more cautious on the hotel sector. Prices have increased in recent years and, while fundamentals remain solid, incremental growth might be lower than in previous years.

Flageole leans toward hotels either located in tourist hubs or hotels that cater to leisure demand, as opposed to business travellers. "I would be more prudent on business hotels, as Japanese corporations seem to be managing expenses tightly in an environment still characterised by low economic growth," explains Flageole.

In the lead up to 2020, Hsu believes Japan will invest in making cities more "foreign-friendly" by improving visitors' ability to navigate them, especially those hosting Olympic events. In addition to Tokyo's CBD, there are venues around Tokyo Bay, Yokohama, Saitama, Sendai and Sapporo. "Similar to recent hosts, such as the United Kingdom and China, inbound tourism is likely to improve pre- and post-Olympics, directly benefitting both the retail and hospitality sectors over the long run," suggests Hsu.

For retail in Tokyo, Presima's Flageole would favour assets located in tourist shopping districts, such as Ginza. These specific core locations benefit from tourist spending, particularly by mainland China tourists. Watanabe says "fortress malls" — A+ rated malls with at least one fashion department store, at least four anchors and surrounded by a "moat" with vast parking and strong connectivity to public transportation — are rarely available but would be a good long-term investment based on his firm's historical investment track record.

For industrial assets, aside from monitoring the yen, Hsu says it is crucial for investors to focus on the financial health of key exporters, and the logistics needs of these exporters, when making investment decisions. While select consumer electronics produced in Japan may continue to gain traction with a wider global consumer base, the same may not hold true for the automotive industry, which largely has shifted key operations overseas. "With increased competition from China and South Korea, Japan's stronghold in domestically-manufactured products will continue to be tested despite a weakened currency," predicts

## Growth and workforce hurdles

Japan is the world's third-largest economy, but it has been mired in a cycle of low growth and deflation for decades. Its leaders have been struggling with strategies to jump-start the economy, even trying negative interest rates — rather than receiving a small amount of interest, banks are charged to keep their reserves at the Bank of Japan. In theory, this would encourage banks to sit on less cash and lend out more, thereby stimulating more economic activity and demand. But deflation has not vanished, and it has not effectively kick-started growth, according to *The New York Times*.

Despite the BOJ's monetary stimulus plan to keep borrowing rates at record lows, property sales in Tokyo are now slowing, and some major developers are delaying projects due to labour shortages. In addition to a rapidly ageing and shrinking workforce, Japan is suffering from shrinking domestic demand and weak wage growth. At the same time, the country's GDP growth for 2017 is projected to be somewhere between 0.6 percent (Oxford Economics) and 1.5 percent (Japanese government forecast), both well below Asia Pacific's projected 4.2 percent overall growth.

Although such macroeconomic indicators are important, investors base their decisions on fundamentals in select cities, rather than Japan as a whole, notes Jonathan Hsu, head of research, Asia for M&G Real Estate. And key cities such as Tokyo, Osaka and Nagoya may actually see population growth through increasing urbanisation and the hollowing out of rural areas. Elsewhere, population decline will be a big problem for Japan. But Hsu argues that even with the projected decline in population from 127 million today to 83 million in 2100, this is still a larger population than the current combined populations of Australia (24 million), South Korea (51 million) and Singapore (6 million).

*— Mard Naman*

Hsu. Logistics warehousing remains important, however, as both ageing and younger Japanese increasingly will depend on e-commerce as the key retail portal for both discretionary and non-discretionary goods.

### Office supply bulks up

Colliers International has forecast a 24 percent drop in new Tokyo office supply in 2017, compared with 2016. But 2018 and 2019 will bring major new supply — nearly the most in a decade. And it will be largely in Tokyo's three central wards. This means "grade A office is likely to see increased pressure from upcoming supply over the medium term," notes Hsu.

Hsu says investors should focus on risk mitigation during the impending period of strong supply. This includes exploring relatively–more resilient submarkets in Tokyo, locking in longer-term leases as rental levels near their peak, taking a more measured approach with assets that have higher leasing risks, and looking at lower-grade office stock located in prime locations. IDERA's Yamada believes it may be difficult to increase rents in Tokyo's grade A office market after the new supply comes online in 2018 and 2019.

In addition, says Flageole, with the supply pipeline of grade A office, grade B offices appear generally better positioned at this point, having a more-manageable expected supply. Grade B offices cater primarily to small and medium enterprises (SME), while larger firms and multinationals generally seek out grade A. SMEs have been a large growth engine for Japan in recent years, particularly in technology-related sectors.

Regardless of the upcoming supply in the central three wards in the eastern half of Tokyo, grade A office in the western half, with its more populous and wealthier residential neighbours, would be a better and more stable long-term investment, adds TH Real Estate's Watanabe, especially to avoid competition with dominant local players.

In its March 2017 *Tokyo Office Market Update,* JLL notes office investment activity remains subdued, partly because of the scarcity of assets available for sale. With very favourable refinancing conditions and positive rental growth in the grade B office sector, landlords are reluctant to sell.

JLL also finds Tokyo's suburban offices are attracting a wider pool of investors. Although this may be a good play for institutions, Watanabe says it is important to know whether the suburban office is supported by a mixed-use trend or strong transportation link, as such properties are expected to perform well over time. He advises to exercise much more caution with suburban offices with a weaker transportation link, measured by ridership and proximity to the station.

As urbanisation continues and people seek shorter commutes, Watanabe likes mixed-use

## Record-high lending to real estate

Recently, Japan has seen record-high bank lending in real estate. Between April and September 2016, new lending rose 16 percent from a year earlier to 5.9 trillion yen (US$53.96 billion). Bank of Japan data showed this exceeded the previous peak in real estate lending, which occurred during the 1980s and early 1990s economic bubble. That bubble burst in the early 1990s, and Japan's economy still has not fully recovered. Is there too much credit now in the system, and does this represent a new bubble investors should be worried about?

Jonathan Hsu, head of research, Asia for M&G Real Estate, thinks not and says big differences are apparent between today's circumstances and the 1990s. The correction during the 1990s resulted from comparatively-looser credit checks, aggressive asset valuation by the banks and higher loan-to-value ratios. Today, lenders impose a more-stringent credit system, assume more-realistic market rental rates and have more-conservative asset valuation. In addition, the loan-to-value ratios are 50 percent to 60 percent today, versus 75 percent to 85 percent in the 1990s. With the BOJ's commitment to keeping interest rates low, Hsu believes investors should continue to utilise a higher-leverage strategy to maximise returns from real estate.

The high level of lending to real estate has played an important role in driving up prices, allowing buyers to add earnings with acquisitions, despite their high prices on an absolute basis, explains Marc-André Flageole, portfolio manager for Presima. For J-REITs in particular, investors have been willing to buy at lower cap rates because they seemed to be still positively contributing to the future distribution to shareholders, thanks to the use of leverage and low financing costs.

Japanese banks appear eager to continue growing their lending volumes, and real estate is one of the main sources of demand, so Flageole believes this situation could continue in the short term, potentially expanding asset values even more. Although Flageole expresses concern with the high level of lending, he also believes the involvement of the BOJ is a potentially-mitigating factor, as authorities clearly seem committed to maintaining low interest rates and avoiding shocks to the debt market.

"I believe that the fact that the Bank of Japan purchases J-REIT shares directly in the market shows a strong support for the real estate sector and aims at boosting yield-seeking investors' confidence in the long-term viability of the asset class," explains Flageole.

*— Mard Naman*

projects. The Roppongi Hills development project set the trend of encompassing office, retail, hotel and multifamily space, and now others have followed. The Marunouchi district has evolved to provide more retail and hotel properties, while the Shibuya district is expected to grow its amount of office space. "We would select the best assets that suit these long-term trends and developments," says Watanabe.

M&G Real Estate's Hsu notes the increased construction activity in preparation for the Olympics has heightened construction costs, given the large allocation of labour to Olympics-related infrastructure and building development. In addition, the industry faces labour shortages. As a result, Hsu believes pursuing higher-return investments that require extensive asset enhancement will be less attractive because of increased labour costs.

### Property market scorecard

PGIM Real Estate's Laughlin says Tokyo's real estate sectors have been performing quite well in recent years in both capital and leasing markets. Rents are growing, while cap rates have fallen to historic lows in most sectors. Looking forward, prospective returns might not be as good as investors have experienced the past few years. "However, we believe that returns will remain attractive, particularly in the for-rent residential and retail sectors," says Laughlin. The extremely-low borrowing costs will be a positive addition to the levered returns.

***Athletes from around the world will go for the gold at the 2020 Olympic Games, and Japanese property fundamentals likewise should win a host of medals for investors in the coming years.***

The main factors in support of Tokyo's property markets are the abundant availability and low cost of financing, as well as investors' appetite for yield, according to Presima's Flageole. With long-term financing (10 years or more) available at notably-low interest rates, buying properties with leverage could make a lot of financial sense, at least in the short run. "I believe that this currently provides support and stability to commercial property prices as various bidders are purchasing assets," says Flageole. In an environment where fixed-income instruments are yielding returns close to zero percent, the relatively-predictable yield generated by real estate could be an attractive option for local investors. Flageole expects this dynamic will continue for years.

But the notably-low cost of financing, coupled with a typically-higher use of leverage, could also be viewed as a potential weakness. Asset prices have come up significantly since the end of the global financial crisis and the advent of Abenomics at the end of 2012. The use of leverage, particularly when short-term dated, makes investors vulnerable to fluctuations in property values. "This means that a potential property downturn could be more pronounced in Japan," warns Flageole.

Also, while rents are stable and predictable, they typically move very little in Japan. As such, high-income growth from property investments may not be widely available in Japan, and most funds and J-REITs tend to rely more on external acquisitions to grow their revenues.

Watanabe believes a key strength in Tokyo's property markets is the planned new infrastructure prior to the Olympics, especially public transportation, which will improve and rejuvenate Tokyo. Watanabe says the new infrastructure will reshape Tokyo's landscape, enhance its position as a key gateway city and provide new investment opportunities for long-term global investors.

Hsu does foresee a post-Olympic "recession", as both the large infrastructure investment and tourism spike leading up to 2020 will see sharp drop-offs after the Olympics. He believes long-range prospects are good, however, because of the benefits from the infrastructure improvements and the structural increase in tourism. The enhanced infrastructure should also benefit investments in logistics warehousing, as improved connectivity leads to more-efficient transport networks.

### Going for gold

Tokyo continues to draw global investor interest because of the size of the market, the resilience of lessee demand, the availability of very attractive limited-recourse leverage, freedom of capital flow into and out of Japan, and the clarity and reliability of the legal structure. "Within this overall framework, Tokyo has consistently delivered interesting asset investment opportunities across market cycles and at all places on the investment risk curve," notes PGIM Real Estate's Laughlin.

While the overall Japanese economy may continue to struggle, Tokyo's prospects look brighter, and hosting the Olympics is not the only reason. "We believe that a whole host of factors, including the continued urbanisation of Japan, the ongoing evolution of artificial intelligence, and the growth of intraregional trade and tourism, will ensure strong demand over the foreseeable future for central Tokyo real estate," concludes Laughlin.

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