SAVILLS INVESTMENT MANAGEMENT

Still zen in the yen?

The safe haven appeal of Japan and the multifamily sector

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EXECUTIVE SUMMARY:

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Recent modifications to the monetary policy regime have cast doubts on the endurability of Japan's safe haven status for real estate investors. We lay out our arguments as to why the medium to long term investment appeal of Japan continues to be burnished by unique drivers.

The fundamental drivers of the Tokyo multifamily sector are solid and have been proven over cycles. Investors continue to be attracted to its strong income security and the relatively high cash-on-cash yields.

INTRODUCTION

The Japan real estate market needs little introduction. As an established core market in the Asia Pacific (APAC) region, investment activity has bucked the global trend. A global retreat in risk appetite led to the wider pursuit of a reliable safe haven. That, in part, contributed to relatively favourable investor sentiments towards Japan. Case in point - As of H1 2023, Tokyo was the most active property market in APAC, running way ahead of peer markets. (Figure 1)

Solid fundamentals have underscored Japan's allure as a key investment market over the years. That said, Japan is certainly not immune to global economic forces. End-user demand for commercial real estate wavered during the pandemic, which was a familiar story playing out globally. Yet, we continue to see pockets of resilience in some segments and remain convinced about the medium to long term prospects of the Japan real estate market. Short of appearing to preach to the choir, this update on our views is timely as investors navigate a choppy global environment.

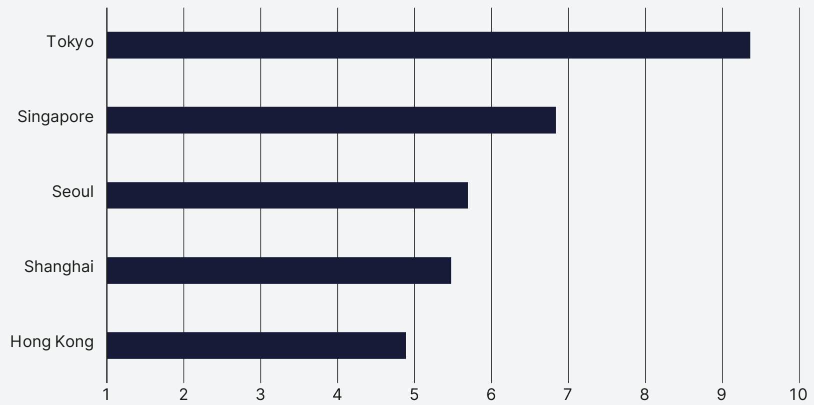
STILL A DESIRABLE SAFE HAVEN

From the top-down perspective, the investment appeal of Japan is burnished by a few unique drivers.

Monetary policy to remain accommodative.
In recent conversations with investors, one recurring topic has been the perceived policy direction of the Bank of Japan (BoJ). With inflation running high, there are growing calls for the BoJ to tighten its policy stance. At the conclusion of the policy meeting on 28 July 2023, the central bank introduced greater flexibility to its yield curve control (YCC) policy. The BOJ kept unchanged its short-term interest rate target at -0.1% and that for the 10-year government bond yield around 0%. However, it now

FIGURE 1:

Most active Asia Pacific metros by real estate transaction volumes (H1 2023, USD billion



Source: MSCI RCA (Q2 2023)

Note: Apartment, hotel, industrial, office, retail and seniors housing transactions included. Entity level deals included. Development sites excluded.

allowed the 10-year yield to move within a 0.5% band anchored around the 0% target, up from the current band of 0.25%. Importantly, it said those new parameters would be "references" rather than "rigid limits". The BOJ also added that it would now offer to buy 10-year Japanese government bonds (JGB) at 1.0% in fixed-rate operations, instead of the previous rate of 0.5%. This suggests a newfound tolerance for the 10-year bond yield to rise to a maximum of 1.0%, despite the 0% target.

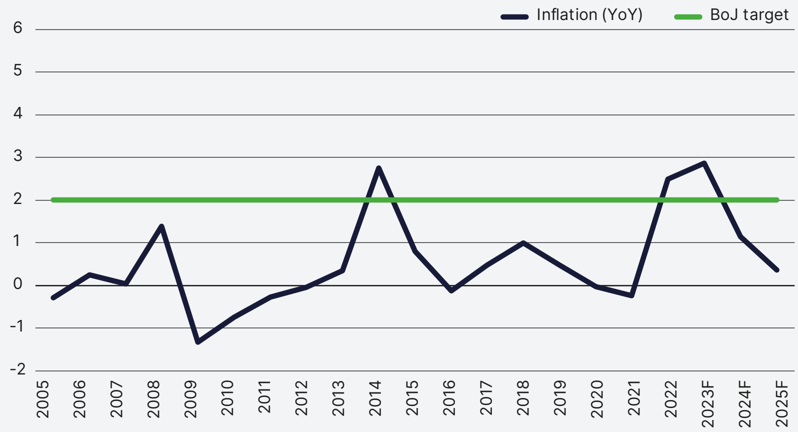
While this is seen by many as a precursor to the curtain finale of the current interest rate regime, there is a practical aspect to it. By artificially suppressing the 10-year yield, the BOJ had been indirectly distorting the bond pricing mechanism. This intense bond buying has undermined, somewhat, the market's ability to engage in price discovery. That in turn affects corporate bond issuances, which are critical for a normal functioning capital market. With greater flexibility around the YCC now, the BoJ will hope to restore some market efficiency into the fixed income market.

Inflation has been persistently stubborn since late 2022 and peaked at 4.3% in January 2023. That has since come off. At the point of writing, the latest reading for Japan's core inflation clocked in at 2.8% as at September 2023. This was hardly surprising as imported price pressures are easing. While inflation continues to hover above the BoJ's inflation target, it is expected to trend down by mid-2024 to below 2%. (Figure 2) The BoJ has emphasized that the existing monetary framework will stay in place until cost-side tensions translate into meaningful demand driven inflation.

As at December 2022, Japanese companies (excluding insurance and financial firms) held a record JPY 251.8 trillion in cash and deposits. This was 6.0% higher than December 2021, and 24.2% higher than December 2019 (Pre-COVID). While this might indicate a lack of investment momentum, it also provides much comfort around the financial stability of Japan Inc. even as global uncertainties remain high.

FIGURE 2:

Japan inflation and target rate (%)

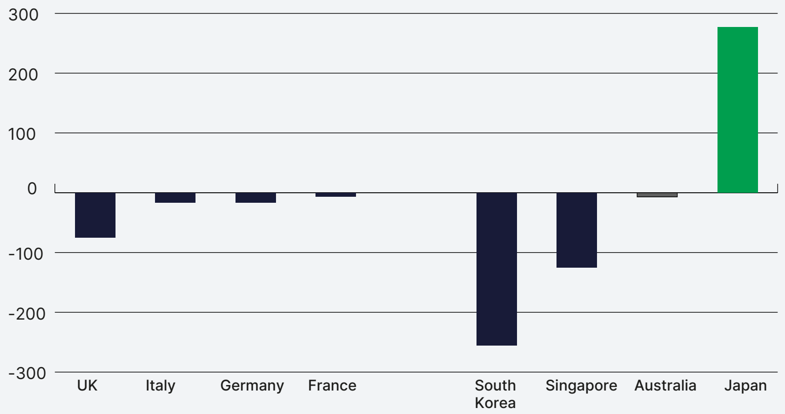


Source: Oxford Economics (17 October 2023)

From the public finance point of view, the Finance Ministry estimates that each percentage-point increase in interest rates for the 2025/2026 fiscal year will boost debt servicing expenses by 3.7 trillion yen ($29 billion) to 32.5 trillion yen ($251 billion). That is around 25% of Japan's annual budget.

Our view is that any shift in monetary policy will therefore have to be gradual, steering the economy to a gentle landing as inflation eases. By extension, the property market will have sufficient time to adjust, and this will be on the back of recovering occupier performance. The relative disparity in interest rates between Japan and the rest of the world will not change overnight. (Figure 3) Using the office sector as a basis for comparison, the cap rate spread in Japan is amongst the highest globally (Figure 4). That continues to be supportive of pricing and accretive financing in the Japan property market.

FIGURE 4:
Estimated cap rate spread (office sector, bps)



Source: MSCI RCA (Q2 2023), Savills Investment Management estimates (as at 30 September 2023)

Note: For illustration purposes only. Cap rate spread is defined here as the difference between (i) aggregate market transacted cap rate for the office sector, and (ii) the estimated 3-month floating all-in financing cost, in each respective market.

CURRENCY AND HEDGING: ICING ON THE CAKE

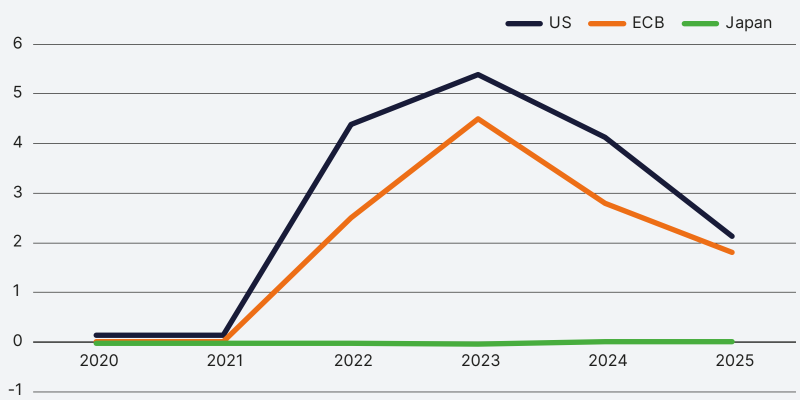
Real estate investors typically do not engage in currency speculation but the influence of currency fluctuations on return outcomes is undeniable. As major economies embarked on their rate hike cycles in and around 2021, the Japanese yen has come under significant pressure, much of that owing to the clear divergence in interest rates.

For cross-border investors, hedging provides protection against currency movements.

From that perspective, the vintage and entry point of cross-border investing is technically less important when underwriting investments. Still, many investors have taken a shine to the Japan commercial real estate, motivated by the opportunity to ride on a cheap(er) currency.

In October 2022, the yen plummeted to a 32-year low against the US dollar, but that reversed when the government introduced interventions. An adjustment to the YCC by the BoJ in December 2022 sent some ripples through the market, as did the most recent YCC modification. However, at the point of this writing, the Japanese yen is trading at close to a one-year low against the dollar. As we alluded to earlier, the market is clearly expecting the interest rate differential between Japan and other economies to stay wide, at least for now.

FIGURE 3:
Central bank policy rate (%, end of period)

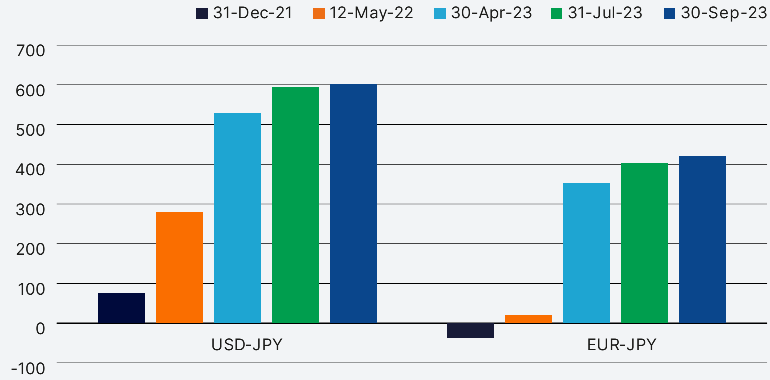


Source: Oxford Economics (30 September 2023)

Looking ahead, however, Oxford Economics sees the Japanese yen gaining ground against the US dollar and the Euro from 2024 onwards. (Figure 5) To reiterate, this is not an outcome driven solely by the BoJ moving away from its monetary stance. Rather, interest rate differentials are likely to narrow, with the US and the ECB expected to start cutting rates in 2024 and 2025. This implies a window of opportunity between now and 2025 to capture some upside from the yen appreciation by participating in the Japan real estate market.

A hedging premium exists between the Japanese yen, and that of the US dollar and the Euro. As at end-September 2023, US dollar investors enjoy a hedging premium of more than 600 bps when investing into Japan. The same can be said of Euro-dollar investors, at around 420 bps. (Figure 6) Again, this hedging premium is a function of the divergence in interest rates between Japan and other countries. Although we expect to see the spread narrow over the next few years, the fact that there is still a differential implies an additional return component via the hedging premium, on top of the robust underlying real estate performance.

FIGURE 6:
Hedging premium/discount (basis points)



Source: Bloomberg (31 July 2023), Savills Investment Management calculations (31 July 2023)

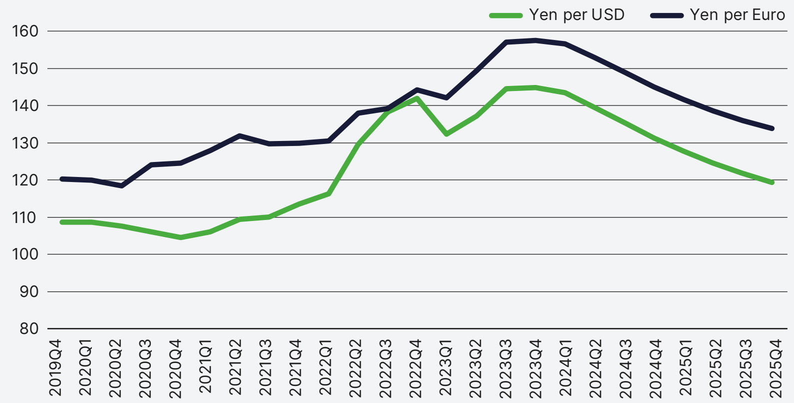
AN UPDATE ON THE MULTIFAMILY MARKET

Recap: COVID-19 put paid to the internal movement of people into Tokyo. Companies re-assessed their inter-prefecture assignment of manpower, while jobseekers became more cautious. The corollary of that was a sharp decline in the net internal migration numbers in the pandemic years of 2020, 2021 and 2022. In fact, Tokyo saw an overall decline in resident population in the year 2021, which is almost unheard of in recent history.

As the vestiges of the pandemic began to fade away in 2022, there is an encouraging reversal in population trends. Notably, overall year-on-year population growth in Greater Tokyo became positive in 2022, which is in stark contrast to the situation on the national level. (Figure 7) As at September 2023, there are approximately 37 million residents in the Greater Tokyo region. This makes it the most populated metropolitan area in the world.

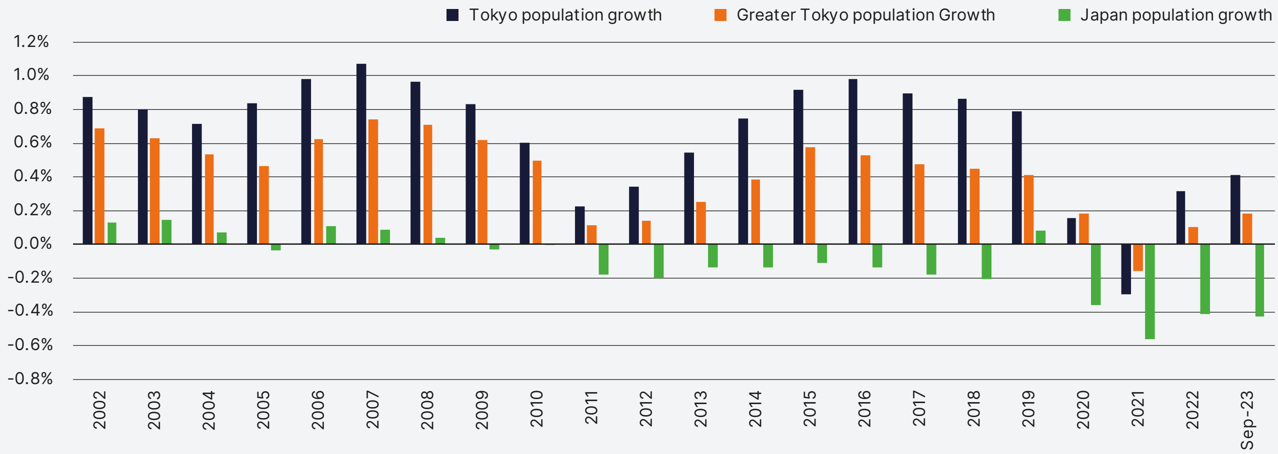
On a city-level, Tokyo also saw a rebound in population since 2022, and the momentum is strong. Net internal migration in 2022, whilst only half of pre-pandemic levels, increased by more than six times from 2021 levels. (Figure 8) As of 26 September 2023, cumulative net internal migration is already at close to 75% of 2019 (pre-pandemic) figures.

FIGURE 5:
Japanese yen outlook (yen per USD, yen per Euro)



Source: Oxford Economics (30 September 2023)

FIGURE 7:
Population growth (%, y/y)



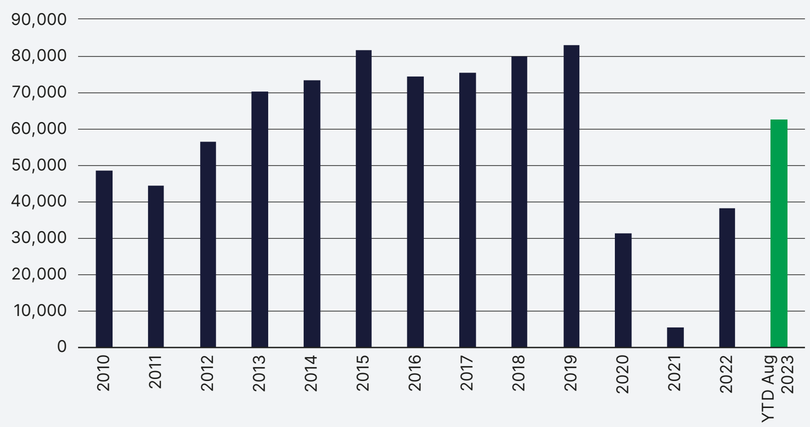
Source: Statistics Bureau of Japan, Tokyo Metropolitan Government, PMA (as at September 2023)

Latest official data released on 26 July 2023 shows that the number of foreigners in Japan rose 11% from 2021 earlier to comprise 2.4% of the total population as at end-2022. Despite a temporary blip due to the pandemic, the number of workers from overseas has more than doubled in the last decade alone, while the broader foreign community (including students and families) has risen by 50% in the last ten years.

According to the Ministry of Education, Culture, Sports, Science and Technology, the number of foreign students in Japan dropped by 20%, from around 312,000 in 2019 to 242,000 in 2021. It now aims to raise the number of foreign students to the 400,000 level by the year 2033. While not very significant in absolute numbers, this does signal a determined stance by the government to further open up and this also positions Japan to welcome more students, and potentially, workers in the years to come.

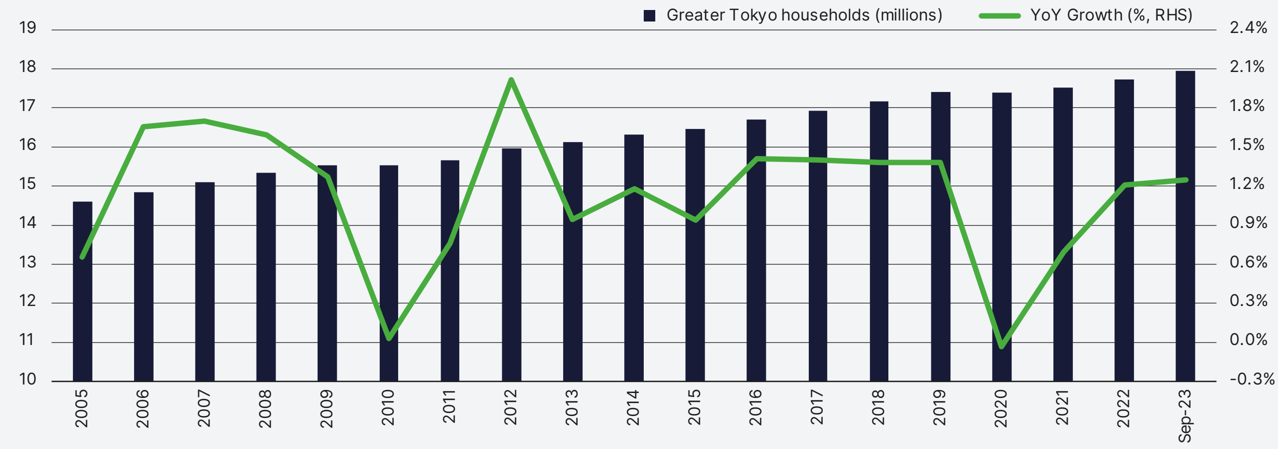
High quality housing assets are still very much in demand in Japan. Given that working from home is not a pervasive feature, small to mid-sized unit types will still drive the bulk of rental accommodation demand. Latest available data tells us that household numbers continue to increase steadily over the years. Household numbers in Greater Tokyo, for instance, are increasing by around 1.4% per annum, on aggregate. While the growth may not seem to be significant, that works out to approximately 180,000 to 230,000 new households every year. (Figure 9) Also, as we look towards the

FIGURE 8:
Net internal migration in Tokyo (number of persons)



Source: Statistics bureau of Japan, report on internal migration in Japan (26 September 2023)

FIGURE 9:
Greater Tokyo household numbers and growth (millions, y/y %)



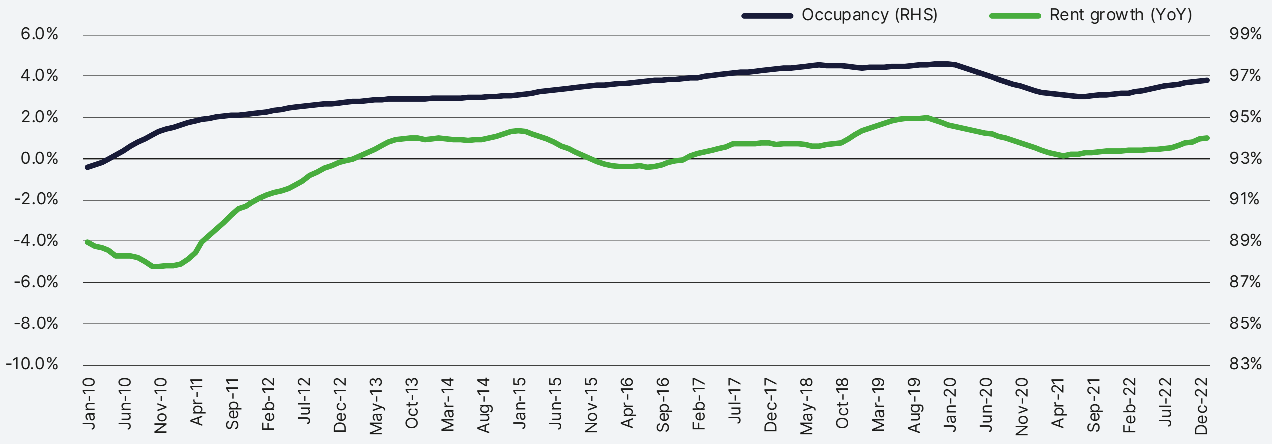
Source: Statistics Bureau of Japan, PMA (latest, as at September 2023)

longer-term demographic trends, it is clear that household sizes in Japan, and globally, are shrinking, which in turn lends itself to tangible demand for compact unit types.

According to the Ministry of Internal Affairs and Communications, Japan's unemployment rate in August 2023 was at a remarkable low of 2.7%, which is supportive of the leasing market in the multifamily sector. Employees in Japan saw a strong boost in their nominal wages in May 2023, with a 2.9% y/y increase, according to data from Japan's Labour Ministry. This was the 16th consecutive month of positive nominal earnings growth, and the highest since February 1995. That trended down slightly to 1.2% y/y in August but remains a strong showing. Of note, Japan's main labour unions won their biggest wage hike in three decades in the 2023 annual spring wage talks. Key unions and their employers reached a preliminary agreement to raise overall wages by 3.8%, which is the most since 1993. The uplift in average wages is a positive driver of leasing demand and rent growth in the multifamily sector.

Like many other sectors and markets, the Tokyo multifamily sector was affected by economic uncertainty during the pandemic. Across the 23 wards, aggregate occupancy rates trended down to 96% in the middle of 2021(compared with 92% during the GFC), from almost 97.5% before the pandemic. Overall rent growth also slowed down. Taking a glass half-full view, the small magnitude of declines indicates the resilience of the sector. Over the short- to mid-term, we should expect to see occupier performance improving. The inflationary environment is a current burden on real incomes, but we do not expect price pressures to be permanent. As at latest availability of market data, rent growth and occupancy rates are trending up and this looks poised to continue. (Figure 10)

FIGURE 10:
Tokyo multifamily YoY rent growth and occupancy (6-month moving average, percentage)



Source: The Association for Real Estate Securitization (ARES) Japan Property Index (latest available data published on 20 September 2023)

After a lacklustre year of acquisitions in the residential sector in 2021 and 2022, cross-border investors are jumping back into the fray. Foreign sentiments seem to be picking up alongside the better news on mobility and border restrictions. As at Q2 2023, cross-border capital made up more than 40% of recorded acquisition activity in Japan, albeit likely overstated due to limited transaction disclosures by domestic buyers other than J-REITs. As rental demand increases alongside stronger net-migration and inbound movement of people, we will likely see capital pivot back to the sector in the remainder of the year.

In summary, the fundamental drivers of the Tokyo multifamily sector have been solid and tested over cycles. Population growth and changing priorities have reinforced the already strong propensity to rent amongst urbanites. The strong labour market continues to support nominal wage growth. While the national population of Japan is declining, that is hardly the case in major cities such as Tokyo. Internal migrants, workers and foreigners are not exactly temporary residents, but they are largely transient over the medium

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