Japan Insights

For global professional / qualified / Institutional clients and investors.

Demographics   Supply challenges   Rental outlook

Is Japan multifamily still attractive?

Navigating a new macro phase

Is multifamily still an attractive investment in this evolving macro landscape? We think so.

Japan's transition from deflation to inflation is expected to have positive implications on long-term yield spread and rental growth. Nonetheless, the demographic trend is a pivotal factor and should guide our investment focus.

Read our latest view in this paper.

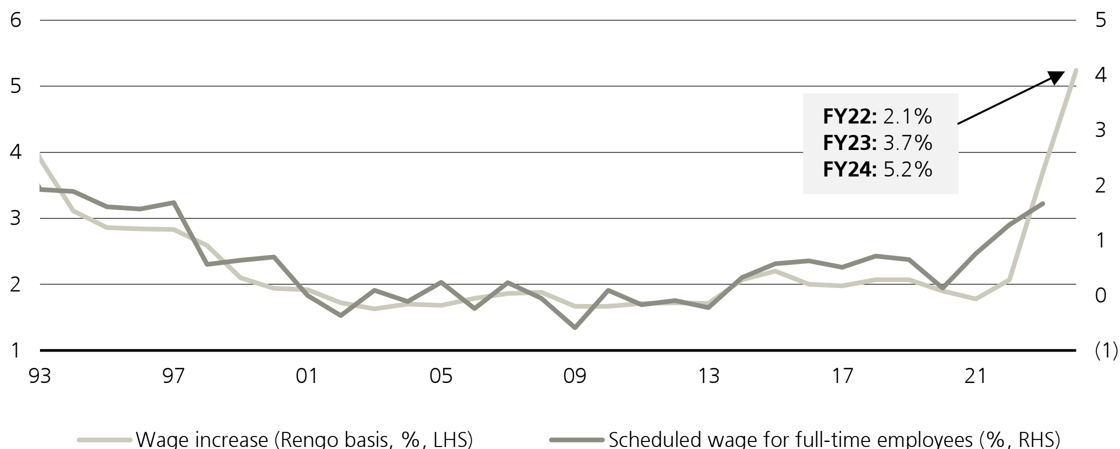
Macro: inching closer

Japan's economy is on the cusp of a major change, emerging from its three decades of stagnation. This narrative has further solidified since our *last paper*. Wage growth has shot up to the highest in more than three decades with the 2024 Shunto wage negotiation (annual wage negotiations between enterprise unions and employers in Japan) result at 5.2% (2023: 3.7%), see Figure 1. Adjusted for inflation, real wage growth also turned positive in June 2024 after falling consecutively for more than two years.

Encouragingly, this robust wage growth is finally translating into greater household spending. Indeed, 2Q24 household consumption registered the strongest growth in almost a decade if we were to exclude the period which benefited from post-pandemic normalization. It was also the first improvement after four quarters of decline. If sustained, it could help Japan rediscover its dynamism.

Nevertheless, it is perhaps still too early for celebration. Firstly, the price-wage virtuous cycle is still in its early stage and inconclusive. Secondly, it remains unknown whether positive real wage growth would lead to sustained household consumption as the aging society may opt to save more instead. Thirdly, policy error is a potential risk. Japan is highly accustomed to low interest rates after decades of easy monetary policy. The BoJ will likely need to be watchful of any withdrawal symptoms.

Figure 1: Spring wage negotiation results



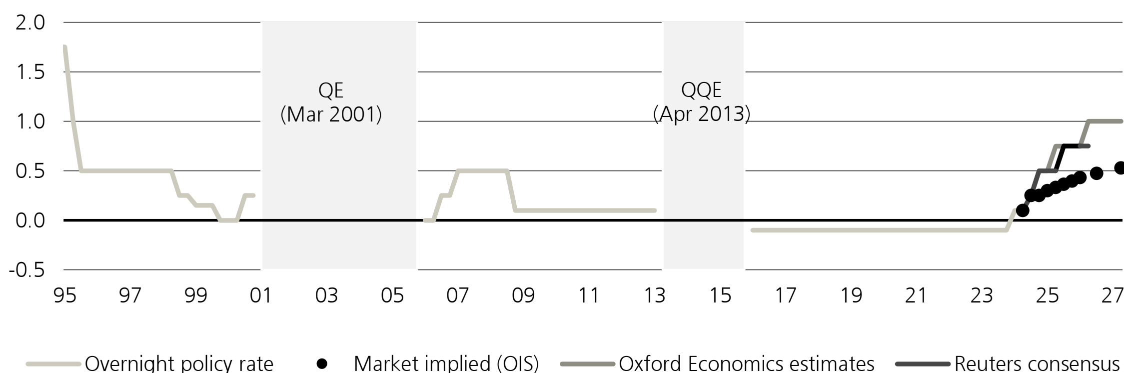
Source: CEIC; UBS Investment Bank; UBS Asset Management, Real Estate & Private Markets (REPM), September 2024.
Past performance is not a guarantee for future results.

Given the rising confidence, the BoJ has commenced its policy normalization and delivered two rate hikes in April and July. While the July rate hike was not entirely a surprise, the timing of its hawkish tone was less than ideal as it coincided with weak macro data and recession fear in the US. This resulted in sharp market volatility in the week following the policy tweak. The BoJ has since attempted to calm the market with a more neutral tone.

We continue to expect any policy normalization to be carried out in a slow and steady manner. The pace is especially crucial to minimize JPY volatility amidst policy divergence against the US as it soon enters a rate-cut cycle. In addition, an accommodative stance is likely still required to further bolster the formation of the price-wage virtuous cycle.

Market consensus expects another 25bps rate hike before end-2024 and further 25bps each year in 2025 and 2026 to reach a terminal rate of 1.0% (see Figure 2). UBS Investment Bank similarly expects a 1.0% terminal rate though with a slightly more aggressive timeline of two hikes in 2025. In a scenario where a 2% inflation target is achieved, UBS Investment Bank expects Japan will be able to deliver, on a sustained basis, 1% real GDP and 3% wage growth annually.

Figure 2: Japan policy rates (%)



Source: CEIC; Reuters; Oxford Economics; BoJ; UBS Asset Management, Real Estate & Private Markets (REPM), September 2024.
Past performance is not a guarantee for future result

A shifting landscape

We think a modest inflationary environment is positive for real estate rents and values in general, albeit at a varying degree for different sub-sectors. We think the residential sector (multifamily) would be a top beneficiary as wage growth for individuals / households directly improves rental affordability. This is followed by the retail sector as stronger spending power supports tenant sales and lowers occupancy costs. At the other end of the spectrum, any positive read-through for offices would be via the macro health and less direct. Our key focus in this paper is Japan multifamily as we seek to refresh our investment thesis amidst the evolving macro landscape.

To begin, let's explore the capital market perspective. Despite global market volatility, Japan's real estate market has generally held up well in the last two years, with multifamily being one of the most preferred sectors alongside logistics. Both investment volumes and valuations were relatively stable mainly due to Japan's stable monetary policy. Will this hold as the BoJ starts to normalize its policy? We think it will be a function of the normalization pace. If managed well, Japan should reignite nominal growth and enhance its long-term investment appeal. We think multifamily plays well into this theme.

As the outlook of rising interest rates becomes increasingly clear, potential cap rate expansion has emerged as one of the hottest topics. In our *last paper*, we struggled to pinpoint a clear causal relationship between interest rates and cap rates using historical data. We think a more informative approach is to compare against other established multifamily markets. Based on data as of 2Q24, Japan has a yield spread of 240bps, which is 120-240bps higher than the US, Europe and UK (see Figure 3). Historically, Japan traded at a much higher yield spread of 400bps vs. other countries' 200-270bps due to its weaker rental growth profile amidst the deflationary environment. Looking ahead, however, Japan will likely be able to justify a tighter yield spread comparable to other countries if it is able to achieve a broadly similar inflation outlook of 2%. Under this approach, we expect minimal cap rate expansion (thanks to the big spread buffer) to be largely offset by higher rental growth, thereby minimizing valuation decline.

Tokyo is the second largest multifamily market globally in terms of transaction volume, according to MSCI data. However, residential made up only 19% of overall transaction volume in Japan, significantly lower than 39% in the US over 2020–2023. As a percentage of portfolios, residential allocations are still low at 18% in Japan, compared to 29% in the US and 26% in Europe. This represents potential allocation upside for Japan multifamily amidst a global preference for the living sector.

To top it all off, the investment appeal of Japanese assets is also enhanced by its cheap currency, which has depreciated 30% since 2019. The outlook of narrowing yield differential against other countries is likely to drive JPY strength in the next 1–2 years. Its 10% rally in July offered a glimpse of the potential gains. UBS Investment Bank forecasts JPY to appreciate to 130 / USD by 2025. On a more conservative approach, hedging FX exposure is also expected to yield significant hedging gains.

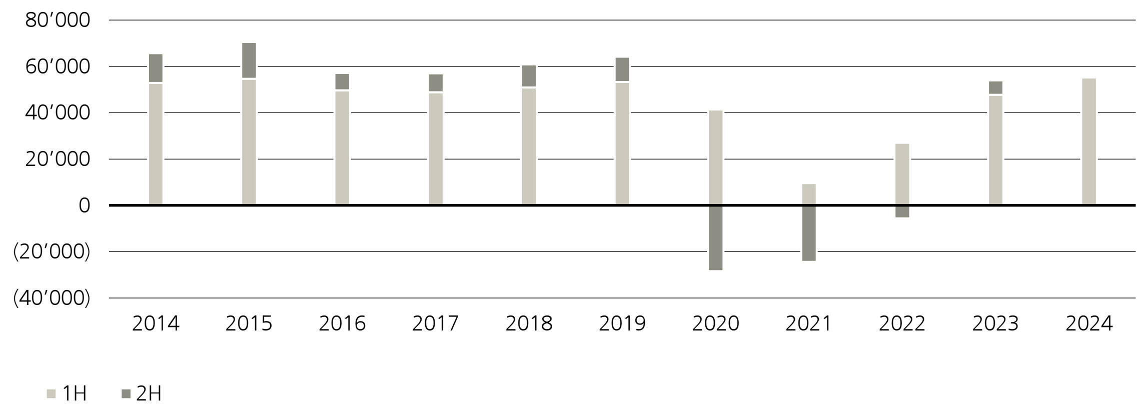
Figure 3: Multifamily yield spread to 10-year bonds (ppt)

Source: MSCI; Green Street; CBRE; Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), September 2024. **Past performance is not a guarantee for future results.**

Riding the population wave

Population headwinds in Japan are well documented with the number of residents having peaked in 2011. Since then, the country has lost 3.5 million people or 290,000 people p.a. to reach 124 million in 2023. According to a recent projection, its population is expected to fall another 3% by 2030 and 9% by 2040. However, this affects mainly the rural areas. The outlook is not at all gloomy for key economic centers such as Tokyo and Osaka as people migrate in from other parts of Japan. The allure of these key cities is further evidenced by the full recovery of net inflow after years of disruption from COVID-19 lockdown (see Figure 4).

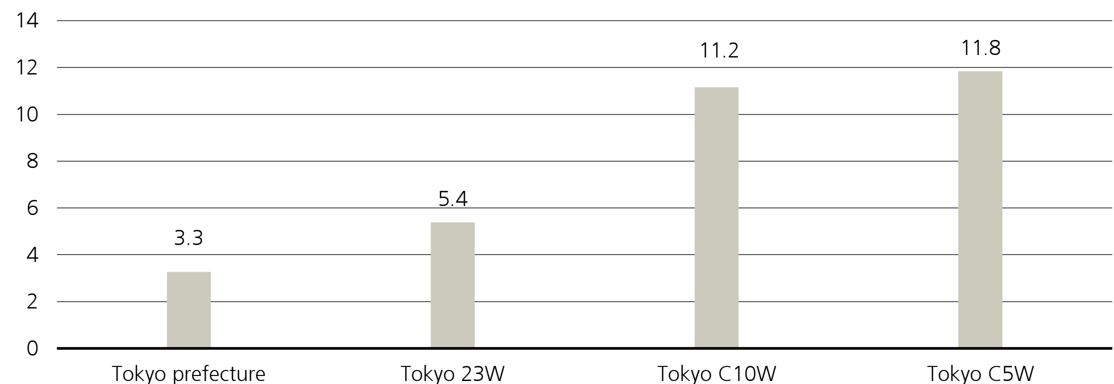
Figure 4: Net migration to Tokyo 23W (people)



Source: Japan Statistics Bureau; UBS Asset Management, Real Estate & Private Markets (REPM), September 2024

At a more granular level, not all wards are experiencing the same level of population inflow. The outperformers in recent decades have been the central wards, a trend which is expected to continue (see Figure 5). In Tokyo's 23 wards (23W), for example, top locations in terms of population growth are those situated in the central 10 wards (loosely defined as the central 5 wards plus five other surrounding wards). Hence, we believe long-term housing demand should also be better supported in these areas.

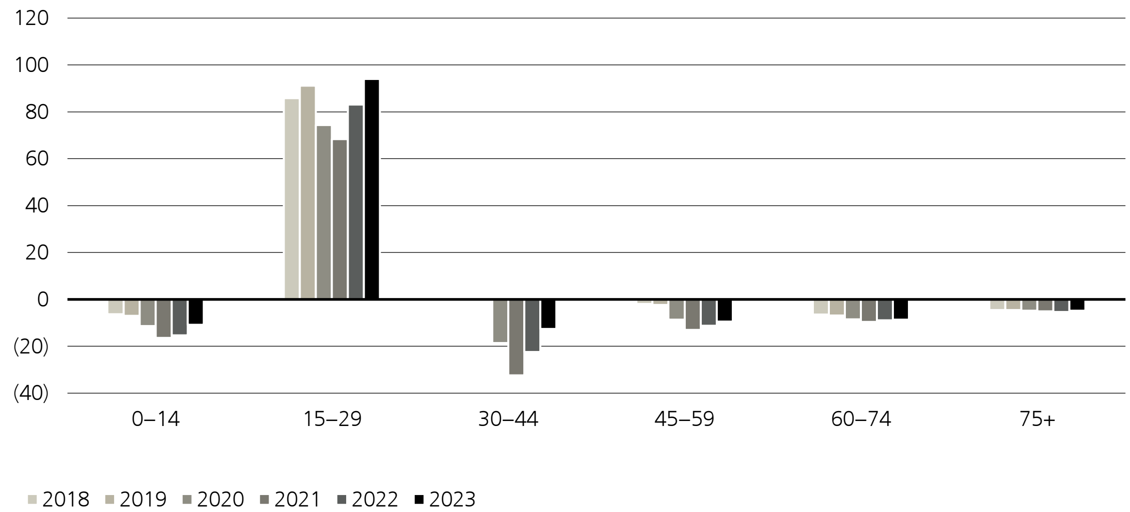
Figure 5: Population growth projection (2020-40F, %)



Source: National Institute of Population and Social Security Research; UBS Asset Management, Real Estate & Private Markets (REPM), September 2024

By age group, this population inflow is mainly driven by those aged between 15–29 years old (see Figure 6). In fact, this age group accounts for more than 100%, mathematically speaking, as other age groups registered consistent net outflow. They comprise mainly students and young professionals, many of which left their hometowns in pursuit of educational and professional opportunities.

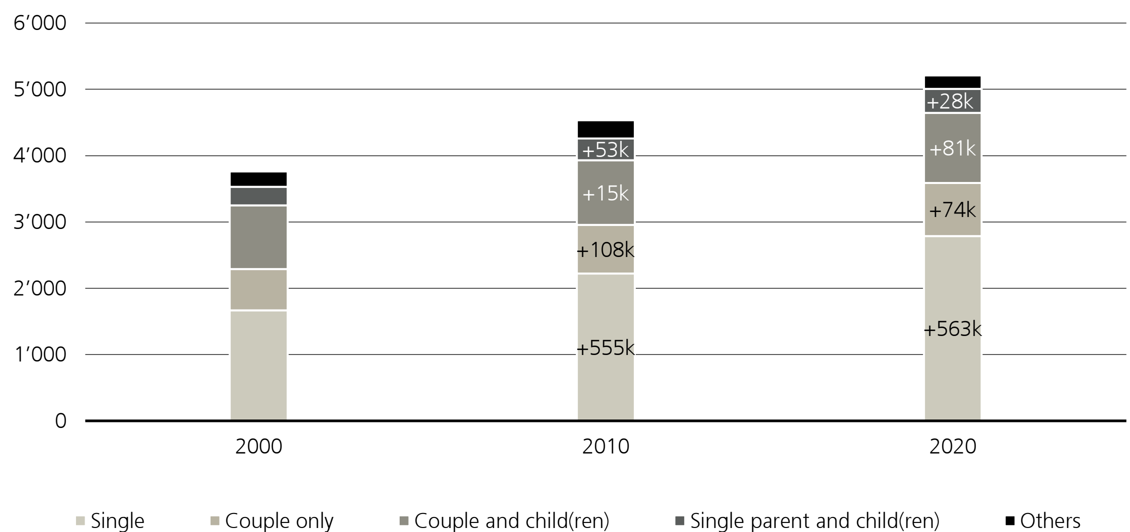
Figure 6: Tokyo 23W net migration by age group (in thousands)



Source: Japan Statistics Bureau, UBS Asset Management, Real Estate & Private Markets (REPM), September 2024

Such an age profile suggests that the bulk of them are likely to be singles. This makes them a big driving force for the formation of singe households. Indeed, single households made up 83% of total household formation over 2010–2020 and 77% over 2000–2020 (see Figure 7). Japan's National Institute of Population and Social Security Research forecasts single households will remain the key driver in the next decade. Consequently, housing products catering to single households are likely to remain popular in the foreseeable future. According to MLIT's Housing Survey 2018 (a quasi-census), younger individuals (30 years old and younger) and single households (<65 years old) are more likely to rent versus their other compatriots (at 97% and 86% respectively). This makes them the typical main target market for residential landlords.

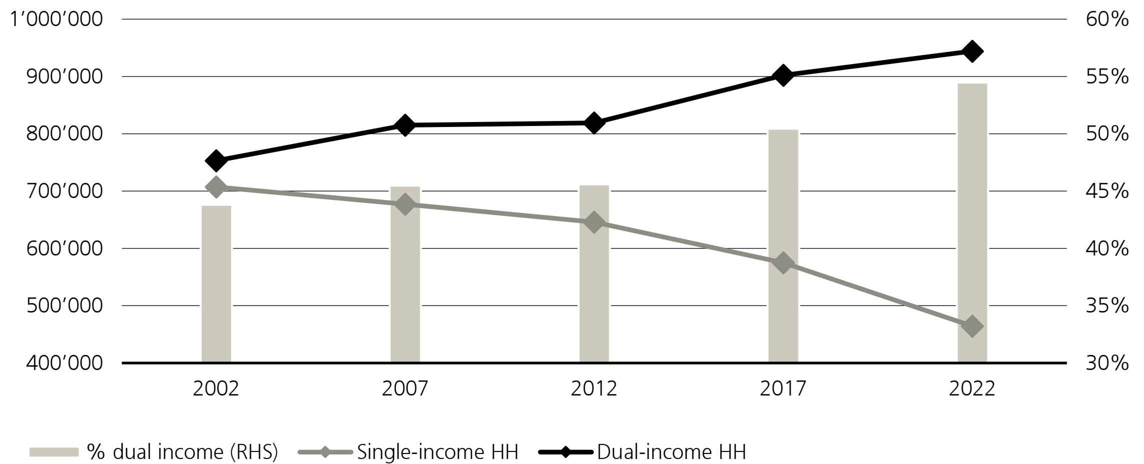
Figure 7: Number of households in Tokyo 23W (in thousands)



Source: Population Census (Statistics Bureau of Japan); UBS Asset Management, Real Estate & Private Markets (REPM), September 2024

Besides the single households, there are also positive tailwinds in other household types, particularly couple households that are still in their working age (see Figure 8). The rising female participation rate in the labor force has been a counter to the declining population in the last decade. As a result, dual-income households are growing fast among the couple households with its share rising from 44% in 2002 to 54% in 2023. Consequently, income for households of two persons or more also rose faster than single households in the last decade. Therefore, couple households are likely to have stronger affordability metrics.

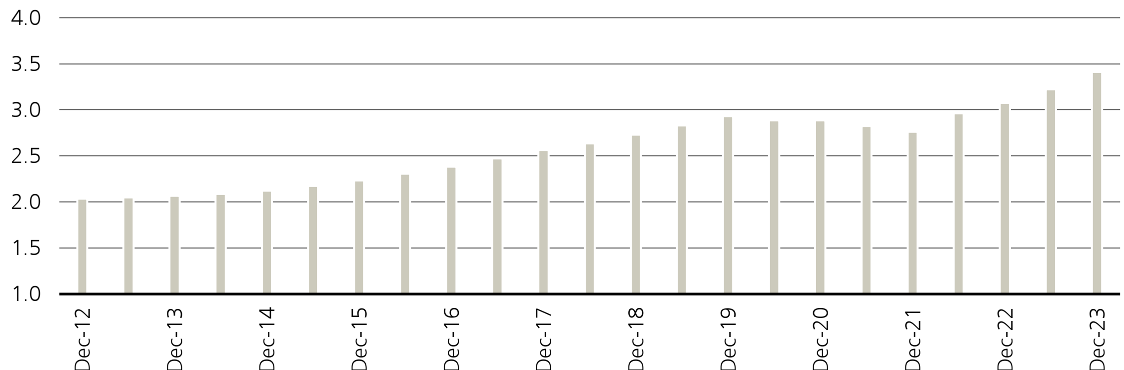
Figure 8: Dual- vs single-income households (Tokyo 23W)



Source: Ministry of Internal Affairs and Communications, UBS Asset Management, Real Estate & Private Markets (REPM), September 2024

Beyond local demographics, another emerging trend that deserves more attention is the rising foreign population in Japan (see Figure 9). In 2023, there were 3.4 million foreign nationals residing in Japan, making up about 2.7% of the total population. The pace of foreigner immigration has accelerated since 2014. It halted at the height of the COVID-19 lockdowns but the inflow has since rebounded to 240k people per year in 2023. As the Japanese population continues to decline owing to the low birthrate, the government would likely find it crucial to replenish its workforce through further relaxation on its immigration policies. Indeed, a Japanese government body is forecasting the percentage of foreign nationals to almost double to 5.2% by 2040 and to almost double again to 10.8% by 2070. That implies an addition of ~165k foreigners per year on average over the projection period. This demographic trend should prompt housing developers / landlords to start rethinking their future product offering in order to cater to the changing social fabric.

Figure 9: Foreign population in Japan (in millions, people)



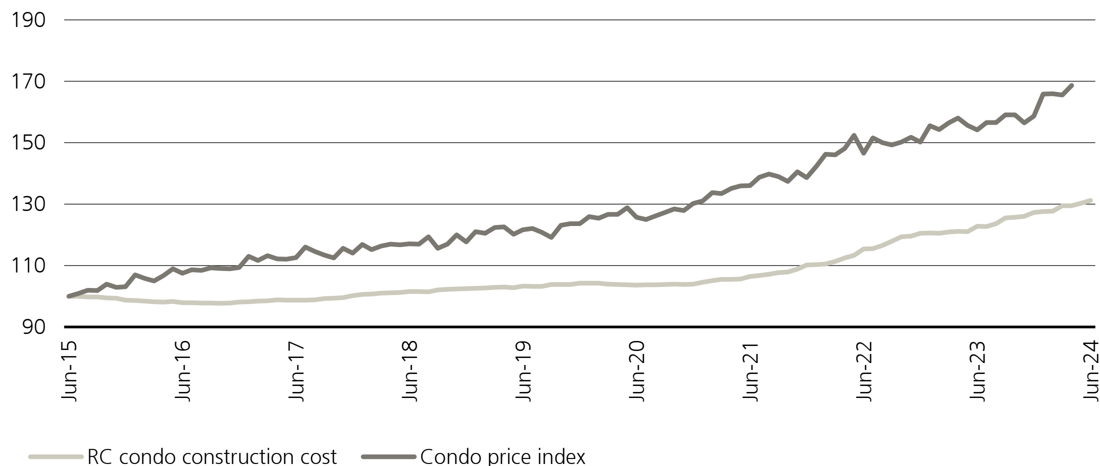
Source: Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), September 2024

Dampened supply outlook

Rising construction costs have been a global issue in recent years and Japan is no exception (see Figure 10). The JPY weakness did not help as Japan imports a bulk of the commodities input (such as iron ore, coal and other fuels) for the production of raw materials for construction (such as steel and cement). Construction costs have risen by 26% since end-2019 until June 2024 – driven by raw material prices on the back of the supply chain disruption in 2021–2022 and labor shortages in 2023–2024.

Looking ahead, labor shortages could remain an issue in the near term. However, that should ease as the industry adapts to a longer project schedule under the newly implemented work-style reform. Mitigating this cost component would be the 'improving' outlook for raw materials. Raw material prices have mostly fallen across the world but not yet in Japan mainly due to its currency weakness. This should change as JPY starts to gain strength. The potentially rising finance costs is a negative variable but we expect a relatively slow rise. All in all, we expect a stabilization in construction costs from 2025. Nonetheless, we think the current labor shortage situation could lead to completion delays and potentially weigh on housing supply in the short term.

Figure 10: Construction costs vs. home prices (Tokyo)

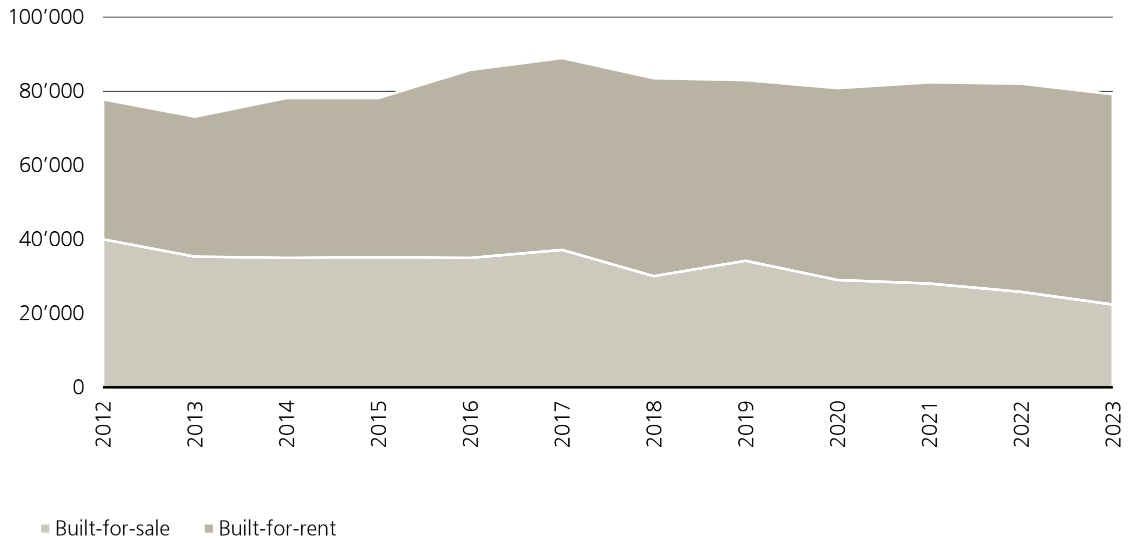


Source: Construction Research Institute, CEIC, UBS Asset Management, Real Estate & Private Markets (REPM), September 2024

Housing supply has been largely stable in the last decade. Despite COVID-19 disruption, annual housing starts (4-year average post- versus pre-pandemic) have only fallen about 10% in Japan and 5% in Tokyo 23W (see Figure 11). This has kept the housing supply-demand equation largely in check. However, this stability belies a changing contour in the home ownership structure. Home affordability has deteriorated over the years due to the ever-rising home prices amidst stagnant wages since early-2010s. It worsened in the last few years as construction costs surged and the outlook is not encouraging with rising interest rates.

The inability to own a home has pushed more housing demand towards the rental market. This trend is reflected in the changing mix of new housing supply where developers have been building more rental units at the expense of built-for-sale units in the last decade. According to MLIT, rental housing starts in Tokyo 23W have increased from 49,000 units in 2019 to 57,000 units in 2023. In contrast, built-for-sale housing starts have fallen from 34,000 units to 22,000 units over the same period.

Figure 11: Tokyo 23W housing starts (units)

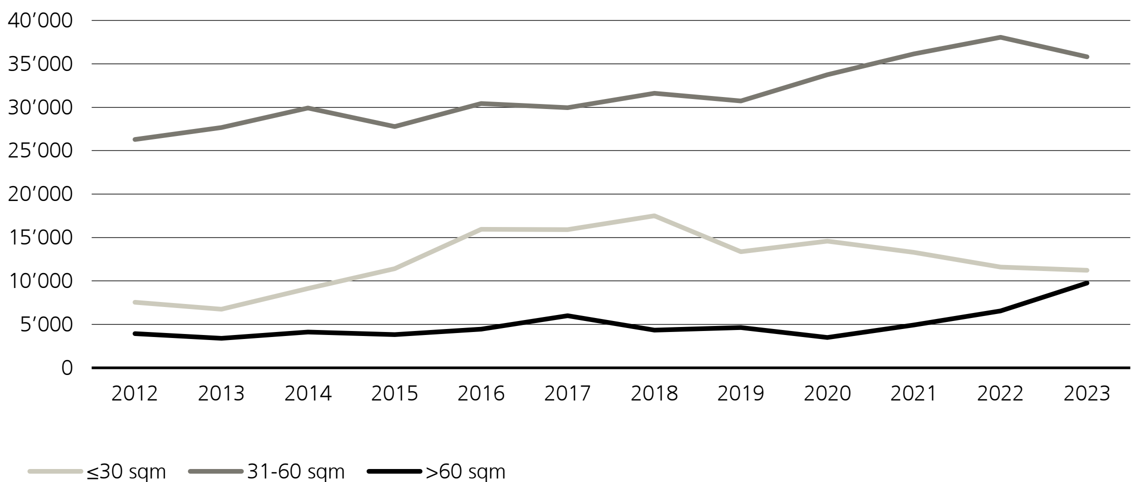


Source: Ministry of Land, Infrastructure, Transport and Tourism; UBS Asset Management, Real Estate & Private Markets (REPM), September 2024

Soaring costs and falling home affordability were not the only challenges brought about by the chain reaction of the COVID-19 outbreak. The pandemic has also transformed the way people work and live. Flexible working is now a new norm. For various reasons, people have also come to appreciate a bigger living space after struggling through the lockdown period. These factors have led to greater demand for bigger unit sizes in recent years. As a result, homebuilders have been churning out significantly more larger units since 2019. For example, housing starts for compact units (30–60 sqm) and family units (>60 sqm) have jumped from 35,000 units in 2019 to 46,000 units in 2023 (see Figure 12). In contrast, supply for smaller units dwindled in reaction to weaker internal migration flow.

It remains to be seen whether this trend will continue as life gets back to normal. Some form of normalization seems probable, but we think it's unlikely to fully return to pre-pandemic norms. Already, we are starting to see smaller units being snapped up by tenants at a faster pace. If this continues, the supply of single units could tighten after years of pullback in new construction.

Figure 12: Rental residential construction starts by unit size – Tokyo 23W (in units)



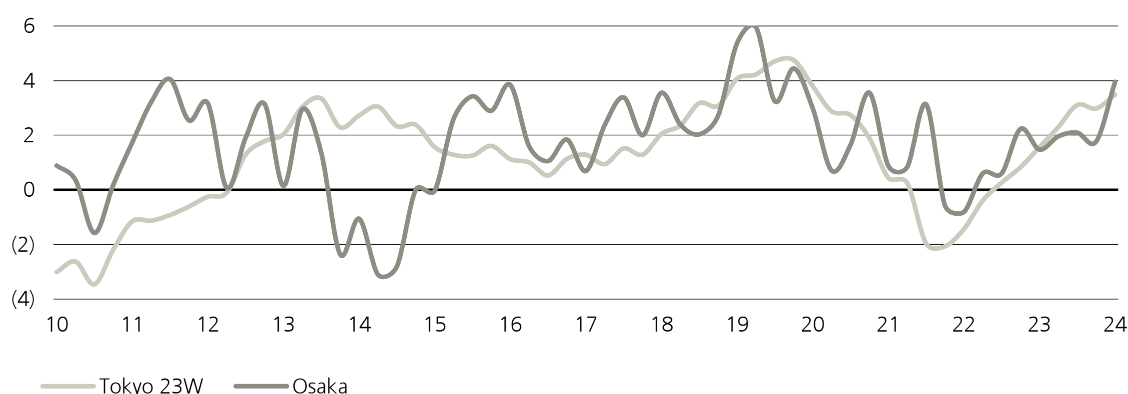
Source: Ministry of Land, Infrastructure, Transport and Tourism; UBS Asset Management, Real Estate & Private Markets (REPM), September 2024

Brightening growth prospect

Following a period of sluggish performance during COVID-19, multifamily rent has been steadily rising since end-2022. In 1Q24, annual rental growth accelerated to 3.5% in Tokyo 23W and 4.0% in Osaka as vacancy rates gradually tightened (see Figure 13). Notably, this rate of increase is not nearly as impressive as the double-digit increases in most other key cities globally such as Manhattan, London, Singapore, Seoul and Sydney in 2022-23. Understandably, this was because of the minimal supply disruption in Japan during the pandemic period while its macro performance has also been more modest compared to the overheated demand in most other countries.

Nevertheless, this should not be viewed negatively. Japan should continue to deliver predictable returns precisely for this reason. While other countries are starting to see peaking rents and moderating growth, Japan remains on a steadily upward trajectory with further room to grow. Rents are still affordable relative to historical values, in the range of 20–25% of monthly income.

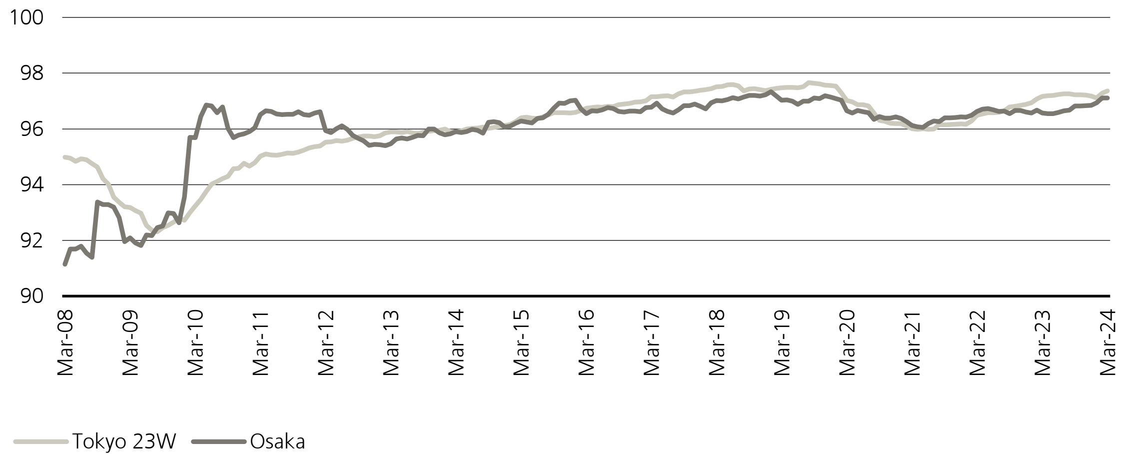
Figure 13: Residential rental growth YoY (%)



Source: At Home Co. Ltd; UBS Asset Management, Real Estate & Private Markets (REPM), September 2024

Multifamily occupancy in Tokyo 23W has recovered to just above 97%, close to the pre-pandemic high (see Figure 14). This is also near the record high in more than two decades since the data became available in 2004. When vacancy rates were at sub-3% in 2019, rental growth accelerated to 4–5% per annum. If history repeats itself, the current supply-demand dynamics, worsened by potential project delays from labor shortages, seem to indicate that we are only at the start of a rental upcycle. Barring an economic recession (or a global downturn), we think the near-term fundamentals look favorable.

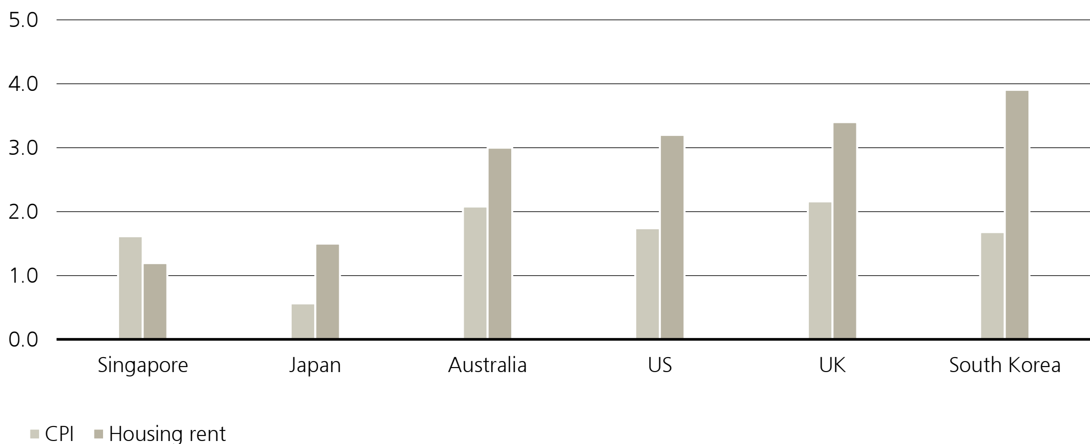
Figure 14: Multifamily occupancy rates (Tokyo 23W and Osaka, %)



Source: ARES; UBS Asset Management, Real Estate & Private Markets (REPM), September 2024

Looking beyond the short-term strength, we think the long-term rental growth potential looks equally promising should Japan be successful in escaping deflation. A higher inflation scenario should have positive implications for wage growth, which would ultimately support renters' ability to pay up. Over 2009–2019, rents in key global cities grew at an average of 100bps above their respective national inflation rate (see Figure 15). In the case of Japan, Tokyo rents grew 1.5% p.a. over this period compared to the inflation rate of 0.6%. If this relationship holds, a 2% inflation rate in Japan could lead to an acceleration of rental growth to 3% p.a. over the medium- to long-term.

Figure 15: Pre-pandemic housing rent growth vs. inflation (2009–19 CAGR)



Source: At Home Co. Ltd; CBRE; CEIC; Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), September 2024

Strategic viewpoint

Japan macro is emerging from three decades of stagnation. A successful transition would improve the country's investment appeal and we think real estate is well positioned.

However, we think there ought to be winners and losers as the BoJ undertakes policy normalization in the new inflation era. We think sub-sectors that can deliver stronger rental growth will be able to hold their value better.

Multifamily is a good inflation hedge as higher wage increases improve affordability. This is positive for long-term growth. For the short term, the fundamentals are equally attractive. The supply outlook seems muted given potentially longer project schedules under the work-style reform implemented in April 2024. However, this impact should be temporary. On the demand side, rising interest rates make mortgages less affordable at the margin and could channel more housing demand towards the rental market.

Demographic trends are a crucial factor for multifamily investments. Geographically, central wards are projected to have stronger population growth and should outperform fringe areas. Single households are likely to remain the key driver for household formation and hence a big source of rental demand. That said, couple households should not be disregarded either given their positive income outlook. Other emerging trends to consider include the changing preferences of unit sizes and the rising foreigner population in the country.

Most investors would agree that the fundamentals of Japan multifamily are attractive, as suggested by various investor sentiment surveys. However, a key hurdle most of them are facing tends to be the low returns amidst a rising interest rate outlook. Core assets tend to trade at rich cap rates with a low-income growth profile due to traditional leases that favor tenants' rights over landlords'. Marking rents to market could take a long time with a typical turnover ratio of ~20% per year.

As returns for new investments shrank over the years on the back of falling cap rates, investors with lower risk profiles scrambling for alpha have increasingly turned to forward commitments – a contractual agreement to purchase a project under development in the future at a fixed price upon completion. This strategy allows investors to capture higher market rents more efficiently while limiting development risk exposure – a win-win. However, this approach may look increasingly challenging as general contractors gain stronger bargaining power amidst rising construction costs and labor shortages.

At the other end of the risk spectrum, investors with development strategies are in a unique position to capitalize on this market gap. They would be better positioned to influence project designs and attributes in order to cater to the latest changes in demographic trends, and be rewarded for the increased risk. However, that is not to say that development returns are more attractive than ever. More control measures are also now required given challenges in the construction industry. Ultimately, for investors, it would boil down to their acceptable risk premium given the additional risk taken.

In addition to the traditional investment approach above, there are also other alternative investment strategies that are starting to gain more traction. For example, notably, some real estate investors are teaming up with living operators in order to curate better customer experiences and offer flexible lease terms. The aim is to generate additional return by taking on more operational risks in a controlled manner.

Lastly, the currency factor is now a very meaningful component for overseas investors. We think the JPY is currently cheap and should offer a boost to overall investment returns. With a more conservative approach, hedging the FX risk should also yield attractive gains given the presently wide interest rate differential against other countries.

For more information, please contact:

UBS Asset Management
Real Estate & Private Markets (REPM)

Wai-Fai Kok
Real Estate Research & Strategy – Asia Pacific

sh-am-private-markets-research@ubs.com

Follow us on LinkedIn

To visit our research platform, scan me!

www.ubs.com/realestate

This publication is not to be construed as a solicitation of an offer to buy or sell any securities or other financial instruments relating to UBS Asset Management Switzerland AG or its affiliates in Switzerland, the United States or any other jurisdiction. UBS specifically prohibits the redistribution or reproduction of this material in whole or in part without the prior written permission of UBS and UBS accepts no liability whatsoever for the actions of third parties in this respect. The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith but no responsibility is accepted for any errors or omissions. All such information and opinions are subject to change without notice. Please note that past performance is not a guide to the future. With investments in real estate / infrastructure / food and agriculture / private equity / private credit (via direct investment, closed- or open-end funds) the underlying assets are illiquid, and valuation is a matter of judgment by a valuer. The value of investments and the income from them may go down as well as up and investors may not get back the original amount invested. Any market or investment views expressed are not intended to be investment research. **The document has not been prepared in line with the requirements of any jurisdiction designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.** The information contained in this document does not constitute a distribution, nor should it be considered a recommendation to purchase or sell any particular security or fund. A number of the comments in this document are considered forward-looking statements. Actual future results, however, may vary materially. The opinions expressed are a reflection of UBS Asset Management's best judgment at the time this document is compiled and any obligation to update or alter forward-looking statements as a result of new information, future events, or otherwise is disclaimed. Furthermore, these views are not intended to predict or guarantee the future performance of any individual security, asset class, markets generally, nor are they intended to predict the future performance of any UBS Asset Management account, portfolio or fund. Source for all data/charts, if not stated otherwise: UBS Asset Management, Real Estate & Private Markets. The views expressed are as of September 2024 and are a general guide to the views of UBS Asset Management, Real Estate & Private Markets. All information as at September 2024 unless stated otherwise. Published September 2024. **Approved for global use.**

© UBS 2024. The key symbol and UBS are among the registered and unregistered trademarks of UBS. Other marks may be trademarks of their respective owners. All rights reserved.