# Real Estate Outlook

Japan – Edition 2020

# Cut through the noise

UBS Asset Management

# Opportunities despite traditional vulnerabilities.

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In early 2019, it became clear that Japan was in the midst of its longest post-war economic recovery. This view is now changing with near-term threats weighing on its outlook, while longstanding issues such as an ageing population still need to be overcome. Cutting through the noise is paramount for the astute real estate investor.

# Japan

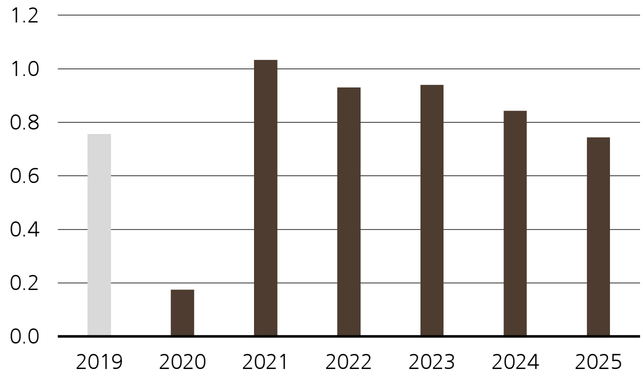
(Updated 25 March 2020 to reflect postponement of 2020 Tokyo Olympic Games.)

**Signposts**
- 2020 Tokyo Olympic Games
- Integrated resorts outcome (around 2020/21)
- Government polices on demography

**Threats**
- Abenomics after September 2021
- Vulnerabilities in the financial system showing
- Greying population is a perpetual risk

**Opportunities**
- Multi-family sector backed by fundamentals
- Value-add strategy in commercial real estate
- Japan hotel sector not just an Olympics play

**Figure 1: GDP forecast**
(Real, annual, %)




Source: Oxford Economics (as at 24 February 2020), UBS Asset Management, Real Estate & Private Markets (REPM), February 2020
Note: Data for the period 2020-2025 are forecasts

**Hitting a speed bump**
In early 2019, it became clear that Japan was in the midst of its longest post-war economic recovery as 2018 rounded up seven consecutive years of GDP expansion. Businesses have received a boost from the expansionary fiscal and monetary policies under Prime Minister Shinzo Abe, as seen in the rise of the Bank of Japan (BoJ) Tankan survey indices to multi-year highs and the growth of corporate profits, which then had flow-through effects to the labour market where improved prospects lifted the jobs-to-applicants ratio and drove the unemployment rate down to the lowest in close to 30 years.

Some positive momentum still continued into early 2019, but even the world's third largest economy cannot escape the punitive effects of the US-China trade war. Exports have been on a declining streak and business investment weakened, and where household consumption held up before, that too saw a sharp contraction in 4Q19 due to the consumption tax hike in October as well as the disruption from Typhoon Hagibis.

**Signposts we are watching out for**
How the near-term outlook pans out depends very much on how the government responds to the COVID-19 outbreak, both in terms of any potential stimulus measures as well as efforts to contain the spread of the virus. This is particularly apt given that the greatly anticipated Tokyo 2020 Olympic Games – originally due to be held from July to August – have, following much deliberation, been postponed to 2021.

There will be much added uncertainty in the near term and Japan will undoubtedly bear a large logistical cost; nevertheless, there have been and will continue to be positive economic benefits when the Olympic Games do eventually take place. Early positive effects to date had been the increase in construction investments, not just for the building of facilities for the Games, but also the construction of hotels and the improvement of transport infrastructure.

The other positive economic benefit would have been increased tourist inflows. Since the advent of Abenomics brought about the depreciation of the Japanese yen, the relaxation of certain visa requirements and an increase in the number of inbound flights have led to a record high number of visitor arrivals – reaching 31.9 million in 2019. The Tokyo Olympics would have been the key event to enable the government to reach its target of 40 million visitors in 2020, but with COVID-19's global reach and China being Japan's biggest source of tourists, that figure is likely to be unattainable in the short term.

In the longer term, the government has been seeking to grow tourism as a pillar of Japan's economy with plans to eventually hit 60 million visitors by 2030, and having realized the untapped potential of the many destinations outside of the Tokyo Metropolitan Area, the focus has turned to the promotion of regional tourism. Aside from capitalizing on its rich history and culture and diverse natural environments, and organizing events such as the Osaka 2025 World Expo, another purported revenue-generating strategy that seems be to materializing is Japan's plan to legalize casino and gambling.

In mid-2018, lawmakers passed a law to allow the construction of three Integrated Resorts (IRs) in a bid to revitalize the economy, and at least eight areas – namely Yokohama, Osaka, Wakayama, Nagasaki, Hokkaido, Chiba city, Tokyo and Nagoya – have indicated their interest to play host. Given the economic gains that have been witnessed in other countries which have legalized casinos, including Macau and Singapore, the desire by regional cities to host the IRs is understandable as they battle the longstanding challenges of a shrinking population and slowing economy, but the strategy is not without its fair share of controversy. With the IRs slated to open in 2025, the next few years will see how the casino plan will play out, and which cities will end up hosting them. The boost to the national economy is significant, and the IRs will also be a shot in the arm for the commercial real estate sector.

With Japan being the country with the world's largest proportion of its population over 65, demographic policies will undoubtedly be in the spotlight over the medium term. The past few years have seen the government tap the often-overlooked labour pool of women and the elderly, and the plan to get more of such workers to join the labour force has borne fruit – those aged 65 and over, and women aged 25 to 54 were the two largest contributors to employment growth since 2012. With the labor force participation rate already on an uptrend where it recently hit an 18-year high of 62.6% in October 2019, the government has turned to another target demographic to engage – foreigners. To be sure, efforts to recruit foreigners have already been underway with the Abe administration relaxing certain rules since 2015.

On 1 April 2019, a notable immigration reform took effect with a new "Specific Skilled Worker" (tokuteigino) visa status created for skilled foreign workers in Japan. The scheme aims to bring in more than 345,000 skilled migrants to Japan over the next five years. As a departure from existing schemes, foreign workers can now be considered regular employees and there is a path to permanent residence status. With foreign workers making up only about 2% of the labor force, there is room to raise this in the medium term, although much depends on the government's ability to create policies that can successfully maneuver local sensibilities.

**Imminent threats**

With much of the recent optimism in the markets and the economy owing to the policies put in place under Prime Minister Abe, the end of Abe's term as the leader of the Liberal Democratic Party and as Prime Minister of Japan come 30 September 2021 will be a key event to watch. What will become of Abenomics after September 2021?

Indeed, what will the future of Japan's political leadership look like once the nation's longest-serving leader steps down, given that Abe has emerged as a stabilizing force after a string of revolving door prime ministers?

While there have been some clear wins from his now-seven years in office, other pledged agenda items, such as Abe's goal to deliver structural reforms, will be left to his last two years in office, a Sisyphean task given that some of these reforms are regarding complex issues such as pension, healthcare and and corporate reforms. Will the new administration continue with a similar focus, or will we see a reversal of the progress that Abe has put in place?

While speculation has begun, it is impossible to predict the answers to these questions at this stage where there is still so much uncertainty and near-term challenges on hand. But investors will be remiss to lose sight of the changes that will soon take place in Japan's political landscape.

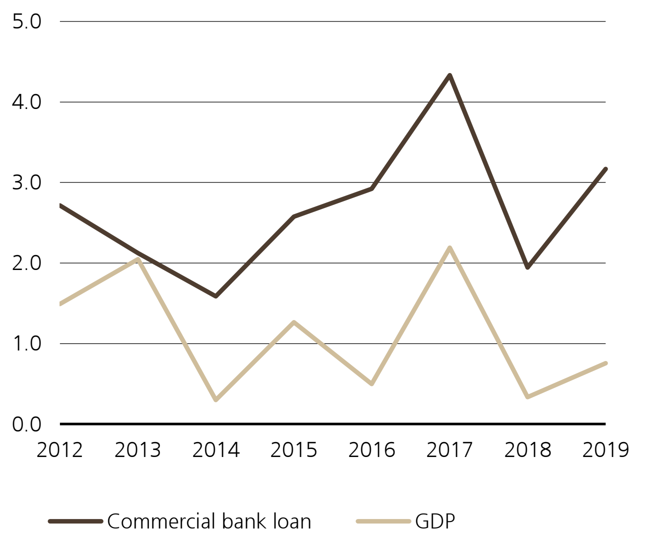
A risk which has arisen out of the BoJ's unprecedented ultra-easy monetary policy is that of increasing vulnerabilities in the financial system. It is not just that the accommodative monetary conditions have led to credit growth rising at a faster rate than GDP (Figure 2), but the broader issue is that the prolonged period of ultra-low interest rates as well as the structural challenge of an aging and shrinking population are starting to hurt the profitability of banks, leading to narrower margins and prompting financial institutions to take greater risks in lending and securities investments. Loans to the real estate sector have risen, and taken as a percentage of GDP, the BoJ estimates that total levels have exceeded that of the previous bubble period and thus warrants some attention.

The third risk we want to highlight is one that is well-documented and an issue we have already alluded to in earlier paragraphs – that of Japan's greying and shrinking population. Not to belabor the point, but this is a real risk to Japan's economy because it necessarily reduces the potential output of the country by virtue of definition. Other challenges that will arise are the implications for fiscal expenditure, given that spending on healthcare and social security will inevitably increase while the tax base will shrink, which would place further pressure on Japan's already high public debt levels and potentially lead to stress in the bond market.

Reductions in productivity levels are typically also compensated by advances in technology, and Japan is already pushing ahead in this area with its world-leading position in its production and use of industrial robotics. In the logistics sector, much of the outperformance of some facilities can be attributed to site locations which are in strategic proximity to residential catchments or transport nodes, which allows for the easier hiring of workers in a shrinking labor market.

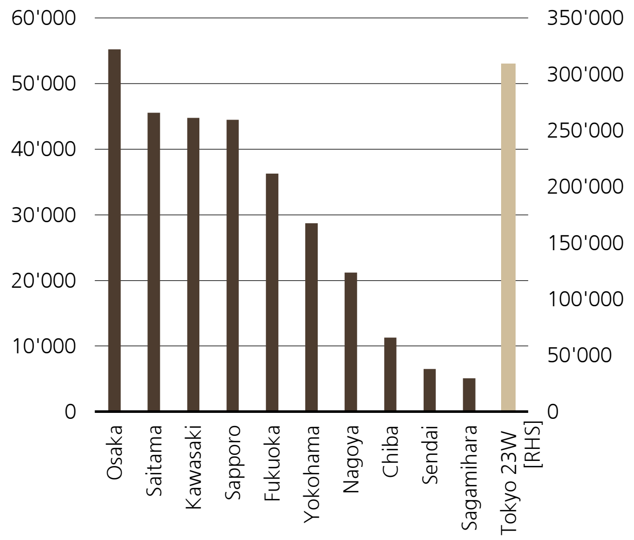
overall Japan at 62% (which is already lower than other major markets including China and Australia) and points to a deep tenant pool of multi-family tenants that exists in the major cities. Other factors such as the rise of single-person households due to changing demographics (aging, growing number of divorcees etc) and the policy thrust to bring in more skilled foreign workers into Japan, will likely add to this demand pool.

**Figure 2: Credit vs GDP growth**
(%, YoY)




Note: Latest commercial bank loan data from IMF as at 2018. 2019 figure estimated by Oxford Economics. Source: Oxford Economics, UBS Asset Management, Real Estate & Private Markets (REPM), March 2020

**Figure 3: Japan cities with positive net-migration**
(Number of people, 2015-19)




Source: Statistics Bureau of Japan, UBS Asset Management, Real Estate & Private Markets (REPM), March 2020

**Opportunities in the next five years**

We think that Japan remains one of the most viable multi-family rental markets in APAC, supported by fundamental demand drivers. While the nationwide population is indeed decreasing, the employment and education opportunities that tend to be higher in economic centres continue to draw migrants to the major cities in Japan, resulting in positive net migration and population growth at the city level (Figure 3).

Migrants into the cities also tend to be younger than the overall population being of job-seeking age, and would have a greater likelihood of turning to the rental market for their accommodation needs – as evidenced in the homeownership rate in Tokyo, which at 46% is much lower than that for

The supply side of the multi-family equation also suggests that upcoming stock remains at balanced levels. Changes in inheritance tax laws indirectly led to a temporary spike in housing starts in Japan since 2015, as high net worth individuals and families began to build rental housing on the land that they hold in a bid to reduce the eventual tax burden. Since 2017, however, housing construction starts for multi-family have been falling consistently, suggesting that the initial euphoria surrounding the inheritance tax laws has now subsided.

Data from the Association for Real Estate Securitization shows that occupancy rates for the major cities of Tokyo and Osaka have been consistently above 90% over the past 10 years, and since early 2013 the range has been even tighter at above 95%. Rental volatility is also lower than that of other asset classes, and going forward, we think that the stable, defensive nature of the Japan multi-family sector coupled with a favourable demand-supply dynamic would present investment opportunities there.

Japan's office markets have displayed strong performance in recent years, where vacancy rates have compressed to extremely tight levels. Tokyo's office market has proven to be particularly resilient in spite of the high levels of supply, with demand supported by the optimism among businesses (which has understandably faded in light of recent developments) as well as legislation to shorten working hours that has led to increased occupier demand.

Vacancy rates there have fallen to a record low of 0.7% – the lowest among major APAC cities, according to CBRE data – with similar trends taking place in Osaka, Nagoya and Fukuoka. While these trends have prompted investors to seek out prime office assets in core markets, we think a case can be made for opportunities in value-add offices instead.

It is estimated that approximately 80% of small and mid-sized office buildings in Tokyo were built more than two decades ago. With more than 90% of office tenants in Tokyo being small and medium companies employing less than 30 employees, the demand-supply dynamics favors the value-add of existing class B office assets. According to Savills data, Grade A vacancy rates in the central five wards of Tokyo was 0.2% as at 4Q19 while Grade B was 0.1%. To that end, the demand profile underpins a structural opportunity to capitalize on the aging profile of office assets in the form of asset enhancements and value creation.

Furthermore, new supply in recent years have been predominantly in the Grade A space while that for Grade B space has received limited new stock. Concerns of an economic downturn are likely to affect the Grade A sector to a larger extent, with Grade B offices likely to remain more resilient.

The affirmative theme underlying the Japan hotel sector has not gone unnoticed by investors, especially in the last few years. While many investors will consider this a play on the Olympic Games, akin to what happened in Beijing and London previously, our view on the hotel sector is structural. With the COVID-19 virus making it presence felt globally in the hospitality sector, it might be easy to dismiss the hotel sector in Japan entirely. Yes, the hotel sector has always been a cyclical one, and that volatility and risk has always been reflected in the higher return requirements. And not many investors are able to embrace a hotel strategy, especially core investors.

The one important difference between Japan and many other Asia markets is that the bulk of accommodation demand in Japan is in fact driven by the domestic traveler. To put things into perspective, the demand for accommodation by domestic travelers is almost six times that of international tourists, and has been stable in the last few years. Because of the competition in terms of pricing and asset sourcing in the Japan hotel market, we believe the astute entry strategy for investors looking at the hotel sector is in fact in value-add and development of limited service hotels, with a predetermined forward exit by locking in an operator, thus mitigating against the leasing risks often encountered with development projects. The Japanese hotel sector is on the cusp of an unprecedented structural transformation. With the possible emergence of more hotel focused REITs and the entry of institutional investors, hotels are fast becoming a mainstream and liquid asset class in Japan.

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