Alpha Investment Partners Limited

Alpha Watch
January 2014

Japan Abenomics
Higher odds of success

Contents

Author

Chua Chor Hoon
Director, Research

Executive summary

A year after Mr Shinzo Abe took office as Prime Minister of Japan, his efforts are yielding results. The economy is on a moderate recovery trend with four consecutive quarters of economic growth, rising business confidence and inflation returning. However, some uncertainties on the sustainability of economic growth remain. Corporate investments and wages have not risen significantly while progress has been slow in implementing the growth proposals. The consumption tax hike in April 2014 is expected to slow economic growth. The economic impact of hosting Olympic Games in 2020 is not significant enough to offset the negative impact given that spending and spillover effects will be spread over the next seven years. Nevertheless, the present landscape is providing better odds of success for reforms and sustained economic recovery. A stimulus package and possibility of more monetary easing will cushion the tax consumption hike. Many Japanese are backing Mr Abe's reforms after years of stagnation. There are reports of willingness among some companies to increase capital spending and wages. There is less political, bureaucracy and lobby group opposition. China's rising is pushing Japan to be more amenable to free trade.

Tokyo's property market is staging a recovery in line with economic growth, with the hospitality, residential and industrial sectors leading the upturn. The hotel sector has seen rising room rates and occupancies as international arrivals surged on the yen depreciation. Arrivals are expected to continue to rise due to interest generated by the Olympic Games and the government's tourism focus. The residential market has seen increased activity and prices since the beginning of 2013 on inflation expectations. The industrial and logistics sector is enjoying strong demand, driven by the growth in online retail sales and economic recovery. Tokyo's office market is bottoming, with falling vacancy rate and a slower pace of rental decline. Well-located good quality buildings are leading the recovery while non-prime space is still lagging in demand and rental increase. The rental upturn in Tokyo's retail market has so far been limited to the premier high streets. A wage rise will boost other retail sub-segments eventually. Investment interest soared in 2013, boosted by the recovering property market, easy lending conditions and attractive yield spreads. There has been an increase in new REITs and new funds targeting the Japanese market. Cap rates are on the downward trend. Realism still rules, as investors are mindful of yield compression ahead of rental increase and a potential reduction in yield spreads after monetary easing is terminated in the US.

Japan's moderate economic recovery looks on track to continue in 2014. The tapering of US' quantitative easing against Japan's monetary easing will keep the yen depreciated and continue to boost its competitiveness. We will be watching for more positive indicators in 2014 for assurance of self-sustained recovery amid external uncertainties on the recovery in the US and Eurozone economies, and risk to trade arising from Japan's territorial dispute with China and its increasing nationalistic actions.

Abenomics

Inflationary pressure is broadening beyond energy price increase fuelled by the cheaper yen.

The Japan economy is on a moderate recovery trend, a year after Mr Shinzo Abe took office as Prime Minister of Japan with his policy package of three arrows (see text box below). The economy posted positive growth for four consecutive quarters to 3Q2013 (Fig 1) and inflation has returned (Fig 2). The core CPI which excludes fresh food and energy rose for two consecutive months in October and November, indicating that inflationary pressure is broadening beyond energy price increase fuelled by the cheaper yen. Exports have risen year-on-year (yoy) for nine consecutive months in November 2013. Business confidence has been on the rise since the beginning of 2013, including those of small enterprises which turned positive in 4Q2013 (Fig 3). The Nikkei stock index surged 57% while the yen fell 18% against the USD in 2013 (Fig 4). Corporate profits are on the rise and the unemployment rate is declining (Fig 5 & 6).

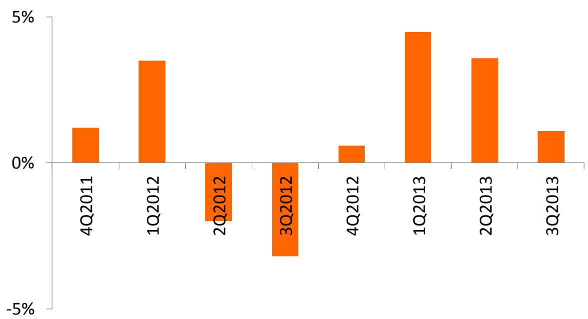
However, some uncertainties on the sustainability of economic growth remain. Companies making profits are still hoarding cash or investing overseas to be nearer their consumer markets: corporate profits rose 21.1% yoy in 3Q2013 but business investment increased by only 3.0% yoy (Fig 5). Workers' monthly earnings edged up by only 0.6% yoy in October (Fig 6). A cut-back in consumer spending is expected after the sales tax is increased in April. Uncertainties remain regarding the strength of recovery of the US and Eurozone economies which will affect export demand. The recently intensified territorial tensions with China could potentially affect Japanese businesses with China.

Abenomics

Abenomics is Japanese Prime Minister Abe's policy package consisting of three arrows aimed at lifting Japan's economy from stagnation and 15 years of deflation to a normal economy with strong growth and 2% inflation.

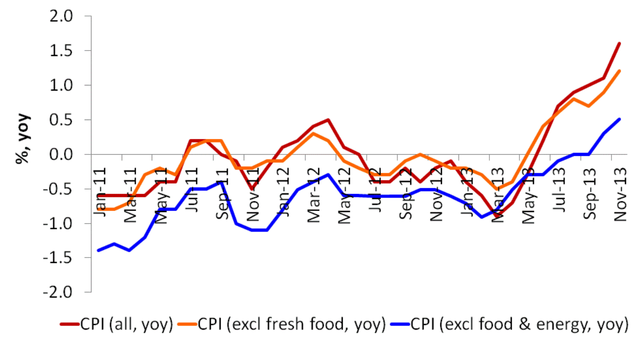
The first arrow was shot when the Bank of Japan (BOJ) announced bold quantitative and qualitative easing measures on 4 April, doubling both the volume of long-term bond purchases per month and the average maturity of government bonds. The second arrow, released as the supplementary budget for this fiscal year, increased government spending (mostly on infrastructure).The third arrow comprises growth proposals aimed at restructuring the economy to achieve long-term self-sustainable growth.

Figure 1: Real GDP growth (qoq, saar)



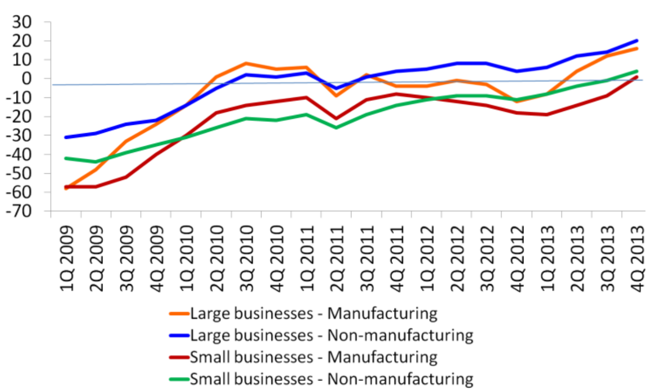
Source: Bloomberg, AIP Research

Figure 2: Consumer price index



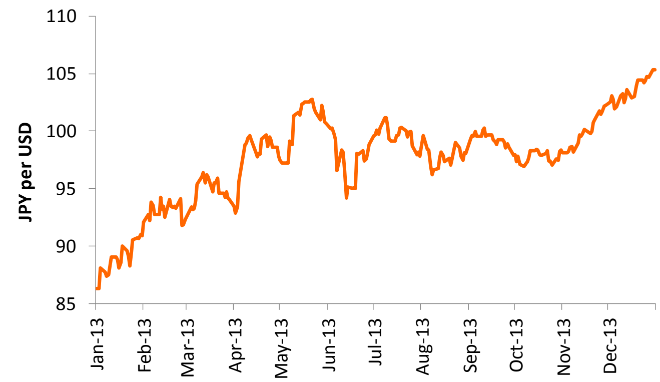
Source: Thomson Reuters Datastream, AIP Research

Figure 3: Tankan business confidence indices



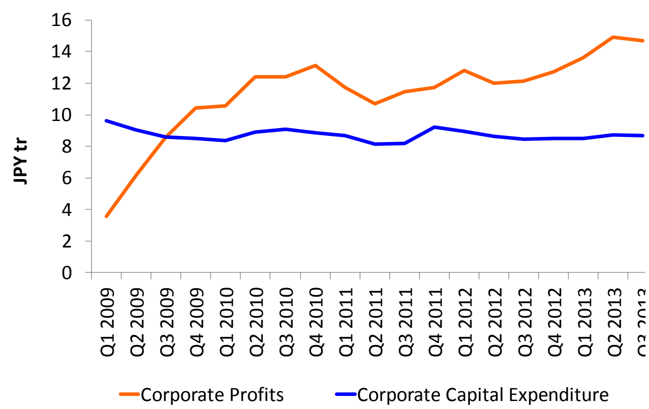
Source: Thomson Reuters Datastream, AIP Research

Figure 4: JPY exchange rate



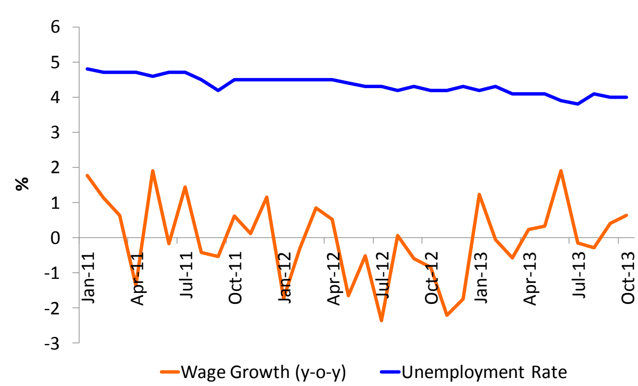
Source: Thomson Reuters Datastream , AIP Research

Figure 5: Corporate profits and capital expenditure



Source: Bloomberg, Thomson Reuters Datastream and AIP Research

Figure 6: Wage growth and unemployment rate



Source: Thomson Reuters Datastream and AIP Research

Consumption tax hike

The consumption tax hike in April 2014 is expected to slow economic growth. Although a consumption tax hike is expected to pose additional challenges to the economy, Mr Abe took the difficult decision in early October to raise the consumption tax by 3 percentage points to 5% from April 2014, to reduce Japan's high public debt (see text box). The Bank of Japan (BOJ) at end October has forecast GDP growth for FY2014 to be 1.5%, lower than its forecast of 2.7% for FY2013 due to front-loaded consumption. In the second half of FY2013 (Oct 2013 – Mar 2014), domestic demand is likely to be boosted by last-minute rush of buying prior to the consumption tax hike, and dip in the first half of FY2014.

Consumer confidence dipped in October following announcement of tax hike but this could be knee-jerk reaction

But fears over consumption tax hike may be exaggerated. Consumer confidence dipped in October after picking up in the preceding month, despite elation over the win to host Olympic 2020. This could however be a knee-jerk reaction to the announcement, as the index moved up slightly in November although it is still below the levels in January-September 2013. A temporary cut-back in spending is expected after the tax hike, but spending is likely to resume after 1-2 quarters if the economic growth remains on track and wages increase.

The situation is now different from previous rounds of hike. What sets this round of hike apart from previous ones is the stimulus package that will be introduced along with it and the economic conditions in 1990 and 1997. The tax hike has drawn much controversy given the economic decline when the consumption tax was first introduced at 3% in 1990 and increased to 5% in 1997. Japan's stock market and property market collapsed in 1990 but this was due to the bubbles that had built up fuelled by over-confidence and loose monetary policy, and pricked in 1998 with tighter monetary policy. In 1997, Japan's exports and economy was dragged down due to much cheaper regional currencies as a result of the Asian financial crisis. This was aggravated by a fiscal consolidation in 1997. As a result, Japan's economic growth fell from 5% in 1996 to 1.6% 1997, and sank into recession in 1998. In contrast now, the economy and property market are just recovering and a stimulus package has been approved to mitigate the negative effects of this year's tax hike. The regional Asian countries have come out much stronger since the 1997 financial crisis and most are not expected to face a similar crisis when the US tapers its quantitative easing which is likely to commence in 2014.

Sales Tax

Japan has the highest public debt among OECD countries, at 238% of GDP in 2012. Annual fiscal deficits of about 8% were recorded over the last three years. This has led to mounting concerns about Japan's fiscal stability and solvency in recent years. The short-term stimulus under the second arrow thus has to be followed by a medium-term fiscal consolidation.

Legislation was passed in 2012 to raise the consumption tax rate from 5% to 8% in April 2014 and then to 10% in October 2015. The Abe administration decided in October 2013 to raise the tax rate to 8% from April 2014. Finance Minister Taro Aso said on 25 Oct that next year's July-September GDP growth rate will be key in deciding whether to raise the sales tax to 10% in 2015.

The stimulus package would mitigate negative impact of tax hike. The total package of measures approved in December 2013 amounted to JPY18.6 trillion (USD182 billion), which includes loans from government-backed lenders and spending by local government that was already scheduled. The core of the package is JPY5.5 trillion (USD 54 billion) in spending measures which include funding for infrastructure and construction projects for the Olympic Games, corporate investment and tax benefits, assistance to the low-income group and rebuilding of coastal communities affected by the 2011 quake-tsunami. According to the Cabinet, the total package will add 1 percentage point to GDP and create around 250,000 jobs. Some economists who were less optimistic have cited a lower contribution of 0.4% as the payouts to the elderly and families could go into savings instead of being spent. Nevertheless, the stimulus measures are expected to have some knock-on effect on the economy.

Trade unions plan to demand pay increase of over 1%.

Some wage increases appear to be in the horizon. The Japanese Trade Union Confederation has announced plans to demand pay increase of more than 1% in the spring labour negotiations, according to a statement in October. Mr Abe has called four meetings since September with union and business leaders to persuade them to raise wages. Toyota and Hitachi, two major manufacturers, have agreed to consider raising wages. Some major non-manufacturers have also indicated similar plans. Nomura Holdings Inc., Japan's biggest brokerage, was reported in late November that it will increase base pay by about 2% on average for around 4,000 staff this April. Lawson Inc., Japan's second largest convenience store chain also said it hoped to increase wages by 2-3% this April.

Corporate investment to increase with more assurance of growth. In a survey by Reuters of 400 companies in late September and early October, only about one-fourth said they would boost capital spending. While one-quarter of companies is not sufficient to ensure a sustainable recovery, this is to be expected in the initial stage of recovery when most companies would want to be more assured of a sustainable growth before dipping into their cash reserves. It will take time for widespread increase in corporate investment due to the risk-averse corporate culture after years of stagnation. In a more recent survey by Japan's leading Nikkei Business Daily, nearly 1,400 firms polled said investments in plants, equipment and other capital spending would increase by about 13% yoy for the current fiscal year ending March 2014. This would be the biggest annual gain after a 13.7% jump in FY2005. While both surveys probably cover different companies and the results vary, they are indicative that some companies are intending to spend on capital investment. More will follow suit if the economy and profits continue to grow.

There could be more monetary easing to boost consumption and inflation if the economy flags more than expected. BOJ governor Haruhiko Kuroda had commented in October 2013 that he was ready to pull the trigger on fresh policy moves if the economy headed south. The Ministry of Economy, Trade and Industry (METI) has also said that it will mobilise an entire spectrum of policies and measures, including the tax system, the budget, financial assistance, and regulatory and institutional reforms.

Growth strategy

The speed and content of growth strategy have fallen short of expectations. As the growth strategy is critical to ensure a self-sustaining growth, many have criticized the Abe administration for its slow progress in releasing details of the growth proposals and implementing them, since the first announcement of the proposals in June 2013 (see side box). There are doubts on whether the growth proposals can be successfully implemented, as many of them are similar to previous ideas that never took off due to the challenges of structural changes and overcoming tradition and mindsets. Some have also criticised the proposals as being not bold enough in solving the long-term structural problems such as shrinking labour force and ageing population.

Some progress has been made and more is expected this year. Japan is involved in the on-going Trans-Pacific Partnership (TPP)[1] negotiations, and has passed a bill in November to set up National Strategic Special Zones. Three to five special zones, including Tokyo, are expected to be designated early this year, aimed at attracting people and investments from both at home and abroad through deregulation and tax incentives. Regulations in the special zones will be loosened to promote urban redevelopment, allow private firms to operate public schools, enable hospitals to increase beds more easily and expand the scope of treatment by non-Japanese doctors and nurses.

The odds of some success are better than before. Despite doubts, possibly conditioned from years of unsuccessful attempts, a confluence of various factors is now aligned that can pave the way to implement some if not all the reforms:

- The ruling party LDP has won the upper house parliamentary elections in July giving it control of both houses of Parliament. Mr Abe is now able to focus on policy making without having to worry about elections for another three years, and push through his policies with less opposition.
- After years of stagnation, there is strong expectation for Abenomics to turn around the economy, and hence greater support for the reforms.
- China's economic rise and assertive territorial claims have influenced Japan to be more amenable to opening up its economy with the US and other countries, thus joining the TPP for trade negotiations.
- Opposition to the proposed reforms is dwindling. As the number of ageing farmers shrinks, the powerful agriculture lobby group's vocal protest against freer trade in the sector is softening. Opposition from the bureaucracy is also reduced with Ministers directly involved in the restructuring being excluded from a recently formed National Strategic Economic Growth Area Committee headed personally by Mr Abe to drive the implementation of the reforms.

Growth proposals

Promote free trade
- *Joining Tran-Pacific Partnership*
- *Starting EPA negotiation with EU*
- *Promoting exports of infrastructure related products*

Corporate tax cut
- *New tax measures to promote capital expenditure*
- *Additional tax incentives to enhance wage increases*
- *Cut in income tax rate*

Industrial restructuring/ consolidation
- *Tax measures or public money scheme to reduce overcapacity or ease over-competition*
- *Strengthen corporate governance*

Enhance labour mobility
- *Encourage women's labour participation*
- *Promote mobility of labour, reduce long-term unemployment*

Deregulation
- *Targeting medical, agricultural and energy industries*
- *Special economic zones*
- *PFI/PPP to promote domestic infrastructure investment*

[1] The TPP is being negotiated by 12 nations—Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States and Vietnam—that together make up 40% of the global economy. The agreement will cover both new and traditional trade and investment issues, and seeks to create jobs and promote economic development, in a bold step towards establishing a free trade agreement for the Asia Pacific.

- While the US slows and eventually stops quantitative easing (QE), Japan will continue and could increase its QE. This will provide tailwind to the yen and boost Japan's competitiveness.

Implementation will take time. Although the proposed reforms have been criticized as being not bold and ineffective, it should be noted that it is not easy to tackle long-term structural problems of the nation. Past attempts at reforms have failed due to resistance from various interest groups and lack of political determination. Hence some small start now can be considered a great step forward. According to the Ministry of Economy, Trade and Industry (METI), the next five years will be a "period of accelerating structural reform". The determination and perseverance of the Abe administration are crucial to overcoming resistance and critics, as they roll out more details of other proposals from this year. Widespread positive impact on the economy and property market will thus take some time to be felt.

Olympic Games 2020

Construction investment is about JPY400 billion, and spread over seven years

Direct economic impact is insignificant. Although there had been expectations that winning the bid in September to host Olympics 2020 in Tokyo will boost Japan's economic recovery as a fourth arrow to Abenomics, the impact is not significant given the amount and spread over a seven-year period. Construction investment is estimated to be close to JPY400 billion (USD4 billion) for the Olympics facilities, which includes a mixture of new buildings and refurbishment to existing sports facilities. Two of the planned permanent venues would have been built irrespective of the outcome of the 2020 Games bid, as they are planned in the four sports clusters in the Tokyo Vision 2020 which is elaborated in the next section. The spillover effects are estimated to be close to JPY3 trillion[2] from 2013 to 2020. The government's estimate of the games contribution to GDP is an additional 0.3% but some economists have estimated it to be in the range of 0.5% to 0.8% over the next seven years.

But winning the bid to host the Games boosts sentiment and could spur spending. Confidence surged in 3Q2013 on the win as reflected in the Tankan confidence index (Fig 3). The Olympic hosting win could also spur spending and growth-enhancing innovations.

[2] Tokyo Metropolitan Government

Tokyo property market

Tokyo, being the host city for the Olympic Games, stands to benefit the most, and if implementation of the Tokyo Vision 2020 is forthcoming. Tokyo Vision 2020 was formulated by the Tokyo Metropolitan Government (TMG) at end 2011 to spur the revitalisation of Tokyo and Japan. A new version 2023 is currently under review. 12 key projects were identified in the 2020 vision, including attracting Asian headquarters to Tokyo (see text box), bolstering the transport network and building four big sports clusters which led to Tokyo putting in its bid to host the 2020 Olympic Games. The Asian headquarters project aims to attract 500 or more foreign companies to establish operations in designated areas by 2016 with a range of incentives so as to boost Tokyo's international competitiveness. The designated areas are near major stations in the central five wards and some waterfront areas (Map 1). It would probably be difficult to make all of these measures a reality; but conditions are now more optimistic with possible dovetailing with some of Abe's growth proposals and Tokyo Olympic Games developments. Since promotion of the zone in 2012, two foreign companies have established their R&D centres in the Special Zone (Ikaros Rising Corporation and Vestec Inc.).

It will take time for a robust broad-based recovery across all property sectors and areas

Within Tokyo, the Tokyo Bay area stands to benefit from the concentration of key Olympic Games venues within a compact zone (see Map 2). Development at the bay had stalled for many years due to the cancellation of the 1996 World City Expo and the earthquake in 2011. The permanent competition facilities and improvement to the transport network and environment are expected to support land and property values in several adjoining residential and commercial submarkets.

Tokyo's property markets are mostly near the bottom cycle with some already on the growth path. The hotel and prime high-street retail segment have benefitted from the yen depreciation and high tourist arrivals. The residential sector has seen increased sales and prices particularly around the Tokyo Bay area. It will however take time for a robust broad-based recovery in rents across all property sectors and areas, when the economy shows more self-sustained growth with wage increase and more corporate investments.

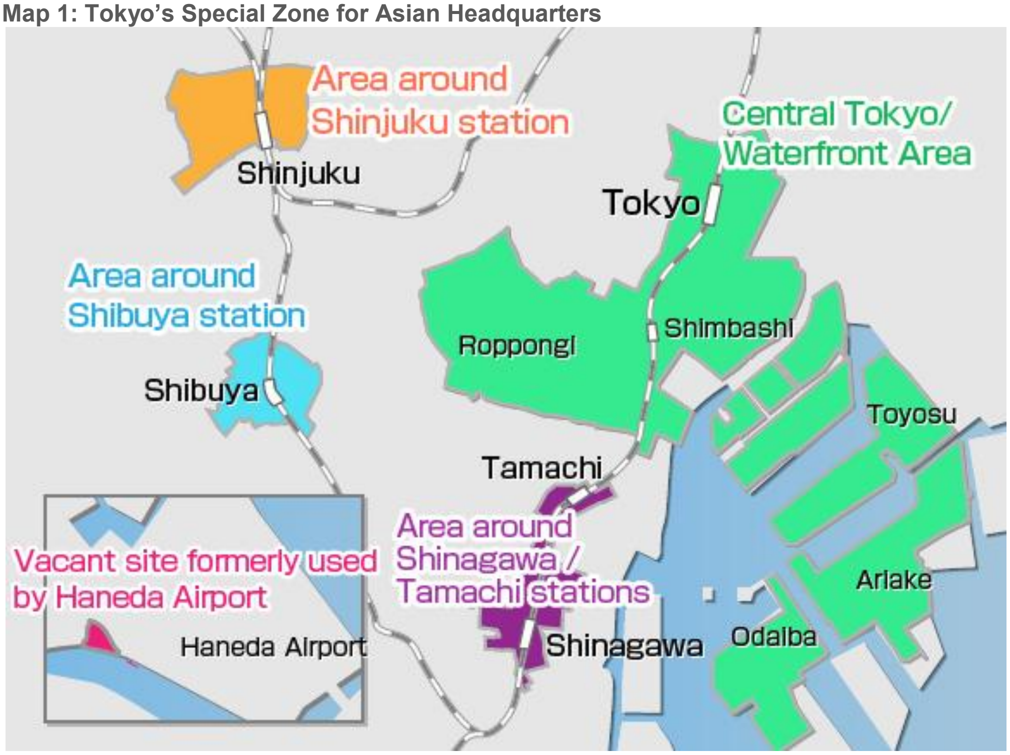
Asian Headquarters Project

The strategies cover a combination of tax benefits, deregulation and urban development. Tax incentives proposed include reduction in the corporate tax rate of 38% to 28.9%.

Deregulations proposed include easing entry and re-entry processes, eased regulations for international schools and healthcare/ pharmaceuticals and promotion of MICE events and integrated resort facilities including a casino.

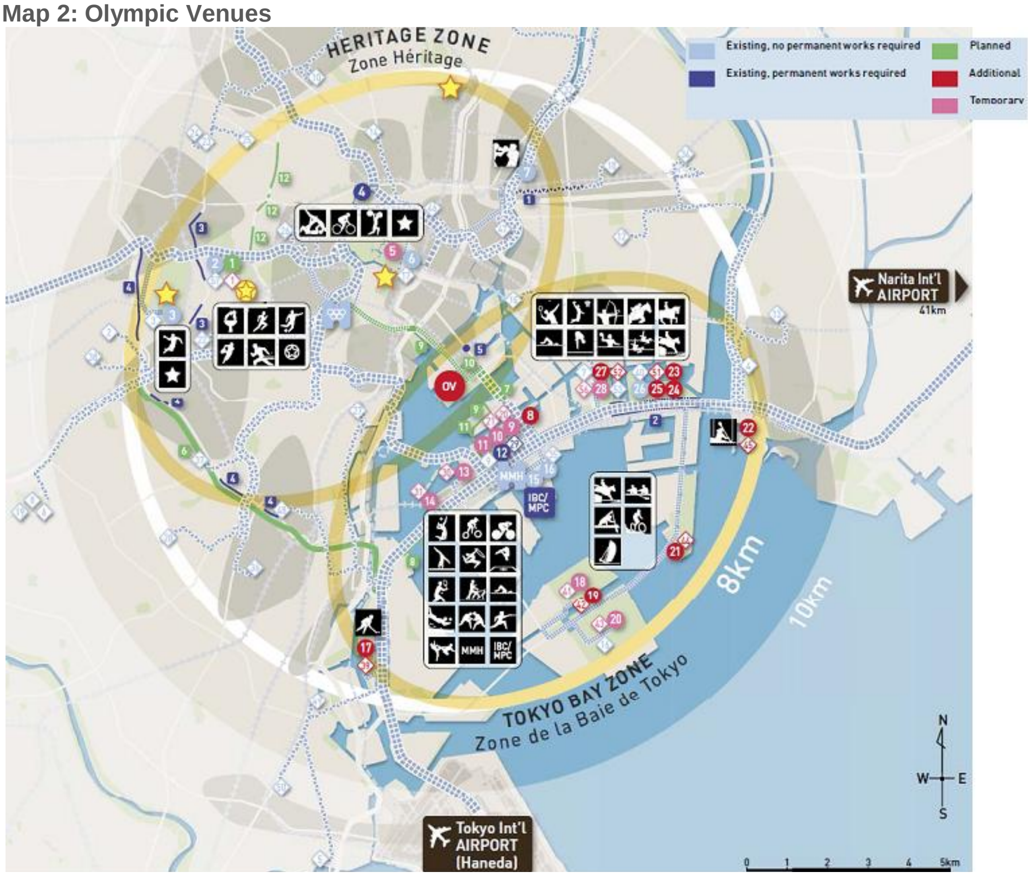
To encourage investment, measures are proposed to relax plot areas and building height restrictions, acceleration of approval processes and tax support.

Map 1: Tokyo's Special Zone for Asian Headquarters



Source: TMG

Map 2: Olympic Venues



Source: TMG, Savills

Offices

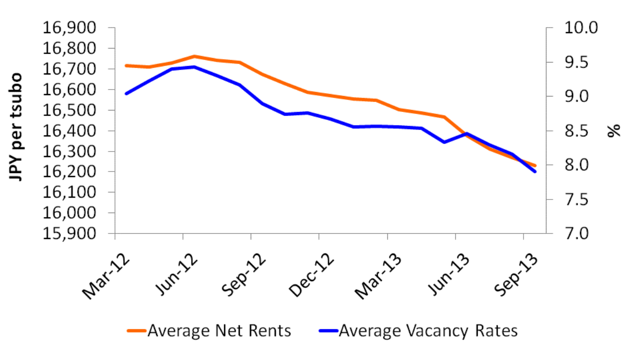
Tokyo's office market is bottoming. Vacancy rate is falling and rents are declining at a slower pace, after a bout of new supply in 2012 and limited new supply in 2013. The average vacancy rate for offices in the CBD has been trending down since peaking at 9.4% in June 2012 to 7.9% in September 2013[3]. Rental decline has been below 1% each quarter for the past one year[3] (Fig 7).

Better quality space is leading recovery. The low rental rates, preference for earthquake-proof buildings and availability of new quality space have led to an ongoing demand shift to modern well-specified space, at the expense of older and small-scale buildings. According to Miki Shoji, asking rents for new properties rose 9.1% yoy in 3Q2013 but fell 2.8% yoy for existing buildings in the CBD. Rents of Grade B offices have not shown upward potential. As rent increases for top-end Grade A properties, market demand will eventually filter to cheaper office premises.

As Grade A rents increase, demand is likely to refocus on Grade A- and Grade B+ offices

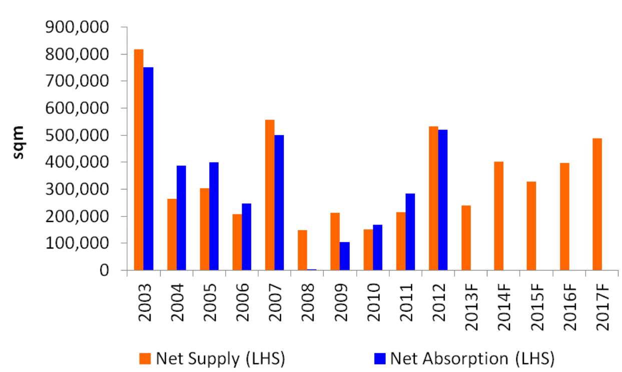
Overall demand and rents are expected to gradually increase this year, although expansion is still limited and cautious at the moment. Rising business confidence, falling vacancy rate and gradual recovery in the west will aid the recovery of the office sector. Companies are likely to increase capital investment, including expanding office space, after reviewing the current fiscal year's business performance and the stimulus measures. The strength of recovery in rents will be dependent on the effectiveness of Mr Abe's growth strategy and the US recovery, given that there is a concentration of pipeline supply to be absorbed in the next four years (Fig 8). The average annual supply pipeline of Grade A CBD space from 2013 to 2017 is around 370,000 sq m (112,000 tsubo), more than the average annual demand of 337,000 sq m (102,000 tusbo) seen in the past ten years[4], if there is no delay to the projects. Sustained healthy economic growth would lead to higher than historical absorption in the medium term and continue to boost rents. The success of the Asian Headquarters project will boost demand as well.

Figure 7: Tokyo CBD office rents and vacancy rates



Note: Net rents exclude CAM and tax
Source: Miki Shoji , AIP Research

Figure 8: Tokyo CBD Grade A office demand & supply



Source: Jones Lang LaSalle and AIP Research, 3Q2013

[3] Miki Shoji
[4] JLL REIS

Retail

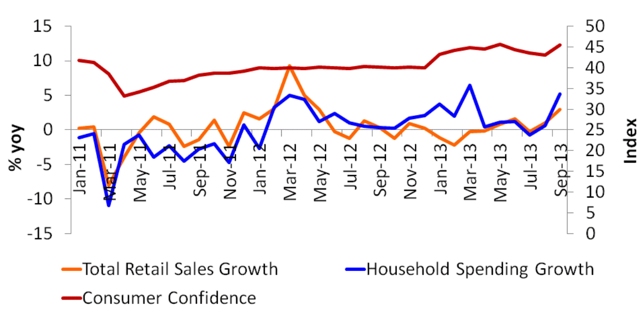
Spending mainly on luxury and big items ahead of sales tax hike

Retail spending has increased in recent months but could be due to advance spending. As there has been little wage increase, retail sales growth and household spending have not shown a significant rising trend in the past year until September (Fig 9). Although there was a strong improvement in retail sales growth and household spending in the past few months, the spending was mainly on luxury goods, automobiles and food, the former two of which could be due to advance spending ahead of April's sales tax hike. More than 60% of Japanese workers are employed in small- to medium-sized companies where their wages and salaries are lower than those in major companies like Toyota and Mitsubishi which make up only 0.3% of all Japanese corporations. Consumer spending thus depends largely on small- to medium-sized corporate workers.

Rental growth is limited to the premier high streets of Ginza and Omotesando. Top retail rents on these two streets are on the rise with increased retailer demand and limited new supply. Asking retail rents have increased by 13.4% yoy in Ginza and 11.0% yoy in Omotesando in 3Q2013 (Fig 10). However, in other submarkets in Tokyo, and the sub-streets of Ginza and Omotesando, average rents continue to soften as landlords struggle to raise occupancies.

Wage rise will boost retail sector. With the improvement in the economy, amplified by the elated mood from winning the bid for the Tokyo 2020 Olympic Games, and expectations of higher consumer spending from more tourists and from the locals as wages rise, we expect to see strong retailer demand. This will in turn drive occupancy costs up, despite the threat of a temporary cut-back in spending following the sales tax hike this year.

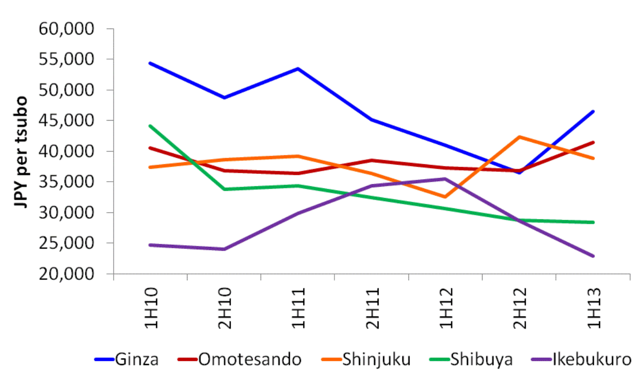
Figure 9: Japan consumer confidence index, retail sales and household spending



Note:
For consumer confidence index, a score above 50 indicates optimism, below 50 shows lack of confidence and 50 indicates neutrality

Source: Thomson Reuters Datastream, AIP Research

Figure 10: Tokyo Downtown 1F retail asking rents



Source: Japan Real Estate Institute, BACUP and AIP Research, 1H2013

Hospitality

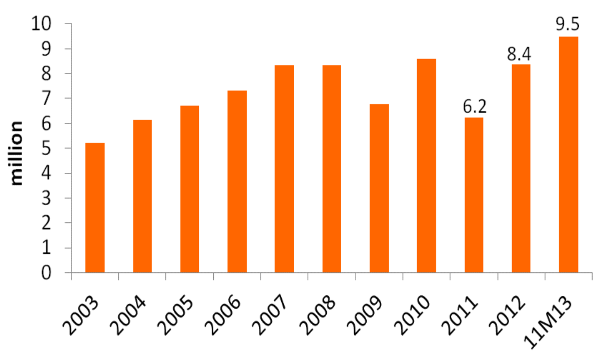
11M2013 foreign arrivals rose by 23.9% yoy, higher than the annual arrivals in the past 10 years

Abenomics has boosted tourism. For 11M13, foreign arrivals rose by 23.9% yoy to 9.50 million, higher than the annual arrivals seen in the past 10 years (Fig 11). The depreciation of the yen coupled with flight additions from regular and low-cost carriers, and simplified VISA issuing process for Southeast Asia visitors have boosted foreign tourist arrivals. This is in spite of an 11.3% yoy fall in Chinese tourists, due to territorial disputes, which made up the third largest group of tourists after the Koreans and Taiwanese. Domestic arrivals rose more moderately, with 1H2013 arrivals accounting for 52% of 2012's 611 million.

Likewise, the hotel sector has seen improved performance. In Tokyo, average daily rates increased by 9.8% yoy in 8M2013[5]. Occupancy rates of business and city hotels have increased to above 82% in 2Q2013 (Fig 12). Although domestic guests made up the bulk of accommodation guests (82.2% in 2012)[6], international guests is the growth segment given the surge in their arrival numbers and Tokyo being a global tourism destination. In 2012, the number of international guests increased by 38.1% compared to 4.8% for domestic guests[6].

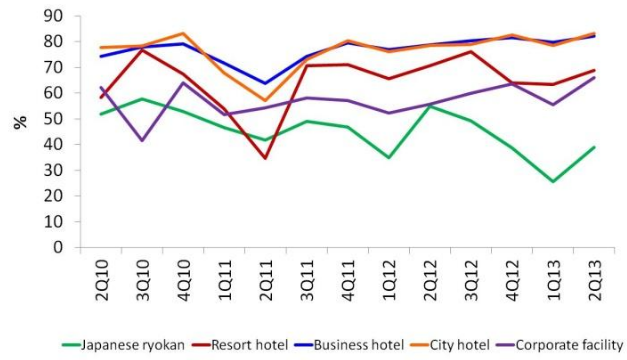
Tourism plan will drive demand. The medium term outlook for the sector is positive, with the government promoting tourism as a growth pillar. In 2012, the Cabinet approved a new "Tourism Nation Promotion Basic Plan" with the objectives of achieving 18 million foreign visitors by 2016 and 25 million by 2020. For the domestic tourism segment, the target is to increase tourism consumption to JPY30 trillion (2009 was JPY25.5 trillion) and achieve an average length of stay of 2.5 nights (2010 was 2.12 nights) by 2016[7]. The 5-year plan covering fiscal years 2012 to 2016 is to create attractive tourist areas, conduct promotion campaigns, and increase international competitiveness in the Meetings, Incentives, Convention and Exhibition (MICE) field including international conferences.

Figure 11: Japan international arrivals



Source: Japan National Tourism Organisation and AIP Research

Figure 12: Tokyo's hotel occupancy rate



Source: Japan Tourism Agency, AIP Research

[5] CBRE Asia Hotels MarketView 1H2013
[6] Japan Tourism Agency, JLL Japan Hotel Intelligence 2013
[7] Japan Tourism Agency

Olympic Games will provide tailwind to tourism plan. The win to host the 2020 Olympic Games and continued depreciation of the yen will provide a boost to the tourism plan. 8.5 million tourists are expected to visit Japan for the games[8], providing tailwind for the government to achieve its 2020 target. Domestic arrivals could increase as the economic recovery gains strength and becomes more broad-based.

Room supply and RevPAR are likely to grow in pre-Olympic and Olympic years. A recent JLL study[9] found that previous host cities shared some similar traits in their hotel sectors and these are likely to be experienced in Tokyo:

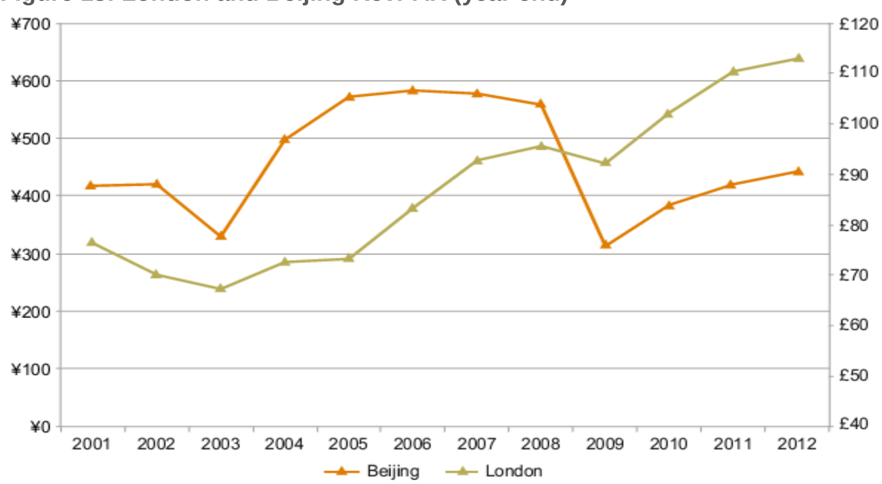
RevPAR typically grew at a faster rate in the seven years between announcement to Olympic year

- Room supply grew over the two years leading up to the Olympic year. London's supply grew at a 3.4% compounded annual growth rate (CAGR) (2010 – 2012) while Beijing's supply grew 10.1% CAGR (2006 – 2008).

- RevPAR grew at a faster rate during the seven years between the announcement to the Olympic year (Fig 13). According to STR Global's data from 2001 to 2012, London's seven-year (2005 - 2012) CAGR was 6.4%, more than the 12-year CAGR of 3.3%; Beijing's seven-year (2001 – 2008) CAGR was 4.2% while the 12-year CAGR was 0.45%. It should be noted that RevPAR growth is also determined by other factors such as economic growth, and new developments.

- During the Olympic year, average occupancies were found to decline. It was a common occurrence for hotel demand to fall in the two months prior to the Games, as non-urgent business or leisure trips were postponed to avoid the Olympic crowd. There was however a substantial increase in the average daily rate during the Olympic year, which offset the lower occupancy rate to give positive RevPAR growth (Fig 14).

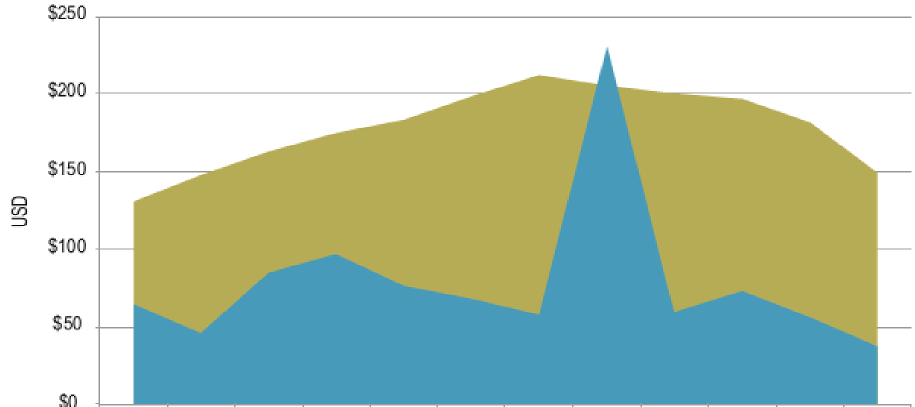
Figure 13: London and Beijing RevPAR (year end)



Source: STR Global

[8] Tokyo Metropolitan Government
[9] Tokyo 2020 – The Olympic Games Effect

Figure 14: London (2012) and Beijing (2008) Olympic year RevPAR



	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC
London	131.1	148.1	164.0	175.1	183.8	198.9	213.1	205.3	200.2	197.3	181.2	150.1
Beijing	64.6	45.9	85.3	97.4	77.2	69.1	58.1	231.9	60.1	74.3	56.8	38.6

Source: STR Global

Like London, Tokyo's mature hotel market is unlikely to result in substantial post-Games decline

Post-Olympic performance is dependent on new supply and tourism plan. The performance of hotels varied among host cities after the games. In Beijing, the average occupancy rate and RevPAR fell after the Games due to oversupply and the start of the Great Financial Crisis (GFC) in 2008 (Fig 13). However, London's average occupancy rate rebounded quickly during the final quarter of 2012 because there was less new supply and it had recovered from the GFC in 2010. The precise impact thus depends on a number of factors including the maturity of the tourism market, the degree of Olympic induced hotel supply, how well the country leveraged the Games for its tourism industry and the state of the economy.

Given Tokyo's mature tourism and hotel market, like London's, a substantial post-Games decline in RevPAR is unlikely. Although an increase in the number of hotel rooms leading up to the Games can be anticipated to tap on the increase in tourists before and during the Games, this is not likely to result in oversupply thereafter as the government's focus on infrastructure development and tourism plan would help to maintain high visitorship after the Games. Plans are afoot to submit an initial bill to Parliament by the end of 2013 to consider legalising casino gambling. If this is allowed in Tokyo, it will provide another draw factor, and additional rooms to cater to the new demand. How the Japan economy recovers from the growth strategy or suffers from unforeseen external events or natural calamities will also affect the outcome for the sector.

Residential

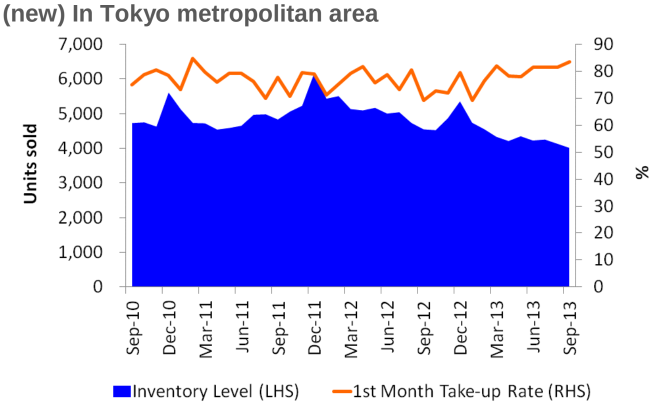
The residential market has seen increased activity since the beginning of last year, driven by the buoyant economic sentiment, anticipation of inflation ahead, and expectation that the consumption tax will be increased in April. Excitement has further increased since Tokyo's successful bid in September 2013 to host the 2020 Olympic Games.

30% more new launches and over 80% take-up rate in 1st month of sale

More new condominiums were launched and sold in 2013. In the Tokyo metropolitan area, the total number of existing condominiums sold rose by 15.2% yoy to 27,445 during 9M2013[10] (Fig 15). Almost 30% more new condominiums were put on the market in the first nine months of the year (39,718 units) compared to the same period last year. The average contract rate of new units within the first month of being put on the market was 80.2% in 9M2013, the first time it went beyond the 80% mark since 2005. As new apartments purchased by the end of September 2013 that are due to be handed over after this April will still be priced under the current 5% consumption tax rate, September saw an unusually large number of apartments released for sale and higher contract rate of 83.5%[11].

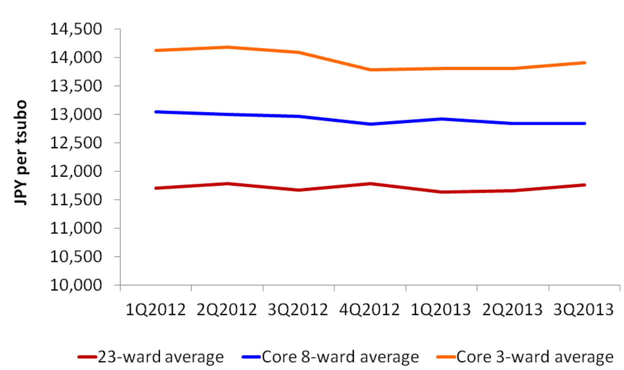
Prices have risen while rents are just entering the recovery phase. The average price of existing condominium units in the Tokyo metropolitan area rose by 8.7% yoy to JPY409,500 per sq m[11]. Rental levels were still below 2012 levels although asking rents have stabilised in 3Q2013 with some areas showing a mild increase of less than 1%. In Tokyo's core-three residential wards, the average asking rent for mid-market units increased by 0.7% qoq to JPY4,206 per sq m (JPY13,906 per tsubo) in 3Q2013 but were 1.3% below asking rents one year ago[11] (Fig 16). Occupancy in the rental market remains healthy, using the average occupancy rate for J-REIT-owned rental apartments in the 23-ward area as the benchmark. The occupancy rate has stayed above the 95% threshold for the 12th consecutive quarter in 3Q2013.

Figure 15: Sales volume (existing) and take-up rate (new) In Tokyo metropolitan area



Source: Real Estate Economic Institute, The Land Institute of Japan and AIP Research

Figure 16: Asking rents for mid-market rental apartments



Source: Savills, AIP Research

[10] Real Estate Economic Institute Co, Land Institute of Japan
[11] Savills

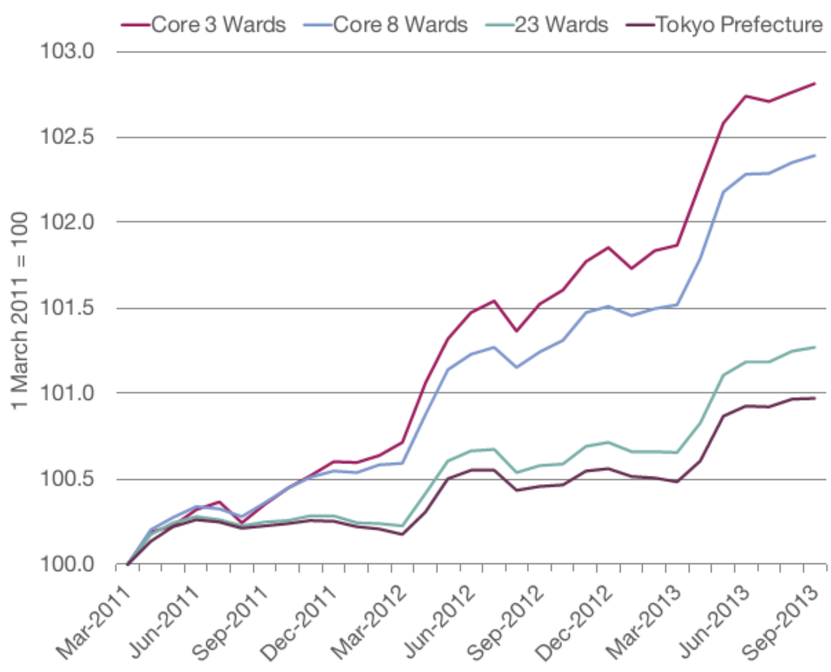
Tokyo's population increased 0.5% yoy and household numbers grew 1.0% yoy

Tokyo's large and steadily growing population is expected to support demand for housing in the medium term. Although Japan's population has been falling nation-wide, it is rising in Tokyo given its attraction as the capital city (Figure 17). Tokyo Prefecture's population increased 0.5% yoy to reach 13.28 million as of 1 September 2013, with higher growth rates recorded in the central areas of the capital. The number of households grew at a faster rate of 1.0% yoy due to the trend toward smaller household sizes[12].

Fundamentals are strong in the mid-market sector, particularly modern apartment buildings designed for single-occupier and DINK (dual income, no kids) households. Improved macro-economic conditions, along with the government objective to increase household incomes, would provide some degree of rental and price increase potential over the next few years. The volume of sales is not likely to be affected after the sales tax increase in April 2014 due to tax breaks that will be given to mitigate the effect.

The Tokyo Bay area in particular is enjoying the limelight now due to the venue of the Games. There was a rise in condominium purchases in the area after Tokyo was chosen as the host city. According to Mizuho Chief Real Estate Analyst Takashi Ishizawa, apartment prices in the bayside areas could increase by as much as 30% over the next five years. However, the supply of homes in the area is expected to rise rapidly which could have a dampening effect after the Games. In a recent report published by Tokyo Kantei, about 10,000 apartments are expected to be supplied in the bayside area in the next few years. There could be additional supply leading up to 2020 and more is expected thereafter as the Olympic Village will be converted into residential buildings after the Games.

Figure 17: Population change in Tokyo



Source: Savills Research & Consultancy based on TMG data

[12] Savills Tokyo Briefing Residential Leasing 3Q2013

Industrial and logistics

Japan was ranked 4th globally in 2012 in internet retail sale volume

Japan's industrial and logistics sector is enjoying strong demand, driven by the growth in online retail sales and demand for optimised network systems to provide faster and more efficient delivery of goods. Japan was ranked 4th globally in 2012 in terms of the volume of internet retail sale[13]. Increasing demand for same-day deliveries and the spreading usage of advanced logistics systems of third party logistics (3PL) companies beyond food and sundries to other sectors have generated more demand for high-specification logistics space.

Rents are rising on low vacancy. The vacancy rate remains tight in the Tokyo metropolitan area due to strong demand coupled with the limited supply of modern logistics space (Fig 18). The average vacancy rate of large logistics facilities for multi-tenants was 4.3% in 3Q2013. Although this is an increase from the 2.6% in 2Q2013 due to the completion of new facilities in the quarter, it is far below the peak vacancy of 18% in 2009[14]. Rents have been rising since 2011, with asking monthly rents for medium- to large-sized space in Tokyo averaging JPY6,020 per tsubo in 3Q2013, a 16% rise from 2H2011 (Fig 19). In Tokyo, demand continued to be robust for prime logistics locations fronting Tokyo Bay. However, given limited available space, the majority of leasing continued to take place in Greater Tokyo where there is ample new supply. With the increasingly widespread use of smartphones for online purchases, demand for well-located and modern logistics space is expected to remain robust.

Figure 18: Vacancy rate of large multi-tenant logistics space in Tokyo metropolitan area

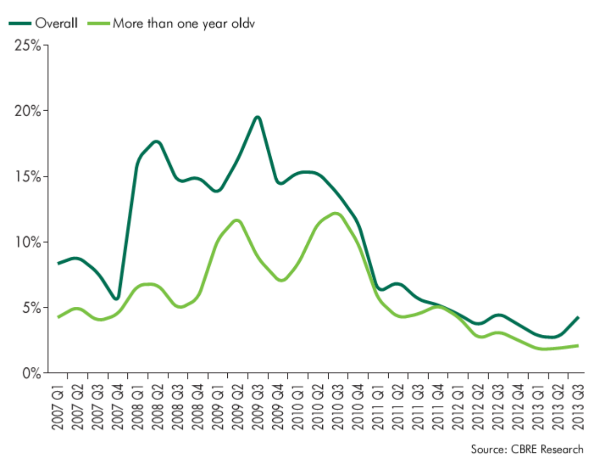
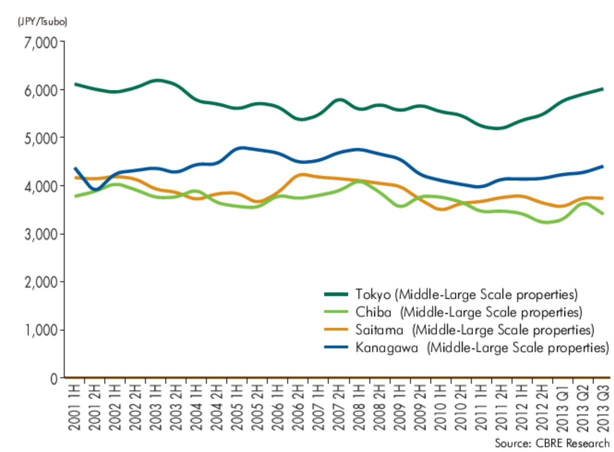


Figure 19: Average asking monthly rent for medium- to large-sized logistics space in Tokyo metropolitan area



13 Euromonitor International
14 Savills

Investment trends

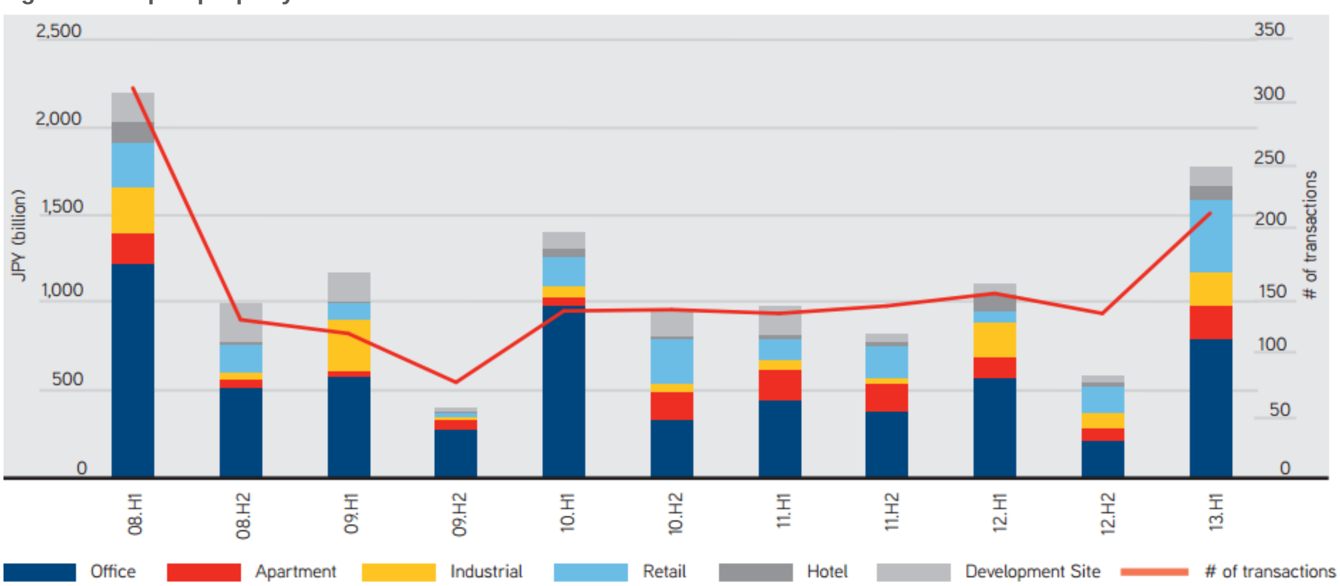
Transaction volume in 1H2013 is already on par with 2012 volume

Japan saw very strong investment sentiment and activity in 2013YTD. Transaction volume in the first half 2013 is already on par with the total volume transacted in 2012 (Fig 20). According to Real Capital Analytics (RCA), Tokyo is the second largest market after metro New York in property sales in the first half of 2013.

A confluence of drivers is giving the investment market a boost. Lending conditions are favourable with low interest rates and banks increasing lending to the real estate sector. Tokyo's real estate is coming off a cyclical bottom and pricing looks "good value" compared to historical levels. With market fundamentals across the property sectors close to all-time lows, downside risks are mitigated by potential upside gains. For foreign investors, the depreciation of the yen has made pricing more attractive historically and relative to other global cities. Tokyo also offers attractive yield spreads of above 3% compared to many other Asian markets due to its low bond rates (Fig 21).

While J-REITS dominate among buyers, there has also been an increase in domestic and foreign investors. The rise in stock prices and resultant decline in dividend yields has allowed existing J-REITS to make accretive property purchases at lower yields. The liquidity in the market has also led to a number of new REITS being listed. There has been an increase in foreign wealthy individuals and investment firms notably from Singapore, Hong Kong, Taiwan, Australia, US and Europe. New funds are raised targeting the Japanese market.

Figure 20: Japan property transaction volume



*Over JPY 1 billion/asset

Source: Prepared by Colliers International (Japan) Research from RCA data

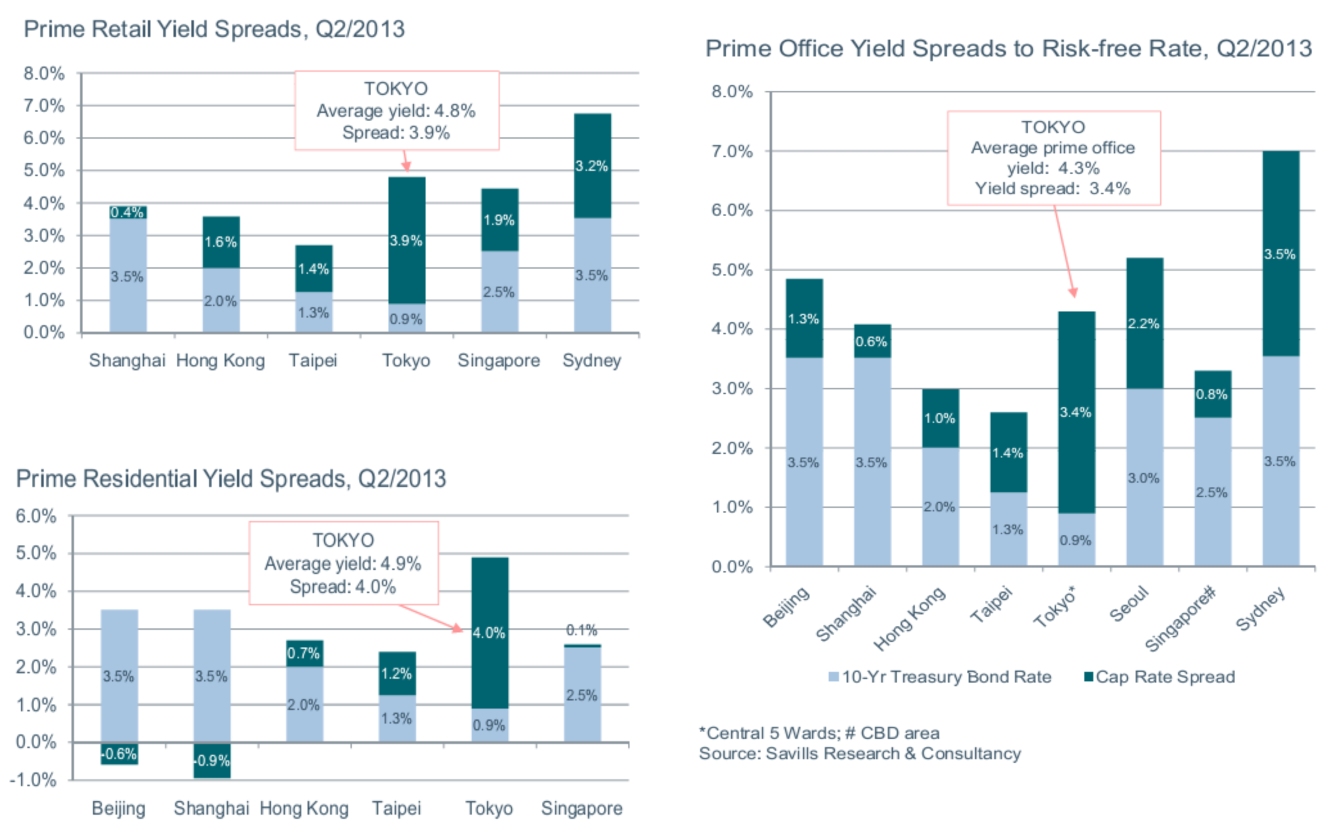
Investors are mindful of yield compression ahead of rental increase

Investment interest is keen in all sectors. Offices remain the favoured asset class but owners are under no pressure to sell given that rents are entering the growth phase. Interest in industrial and logistics assets is strong as the demand fundamentals in the sector remain robust despite some new supply in the pipeline. Prime high street retail assets in Tokyo are in strong demand in anticipation of increased consumer spending. Demand for residential properties is also strong given the higher yields while the hotel sector is becoming active. Competition for real estate particularly in Tokyo has increased, resulting in bid prices moving closer to sellers' expectations and compressing yields.

Realism still rules, as investors are mindful of yield compression ahead of rental increase and a potential reduction in yield spreads after monetary easing is terminated in the US. While some local investors are willing to buy core assets at lower yields for long-term holding, other investors are still making opportunistic bids and more are increasingly willing to look outside Tokyo for opportunities.

The investment market will become more competitive when there are signs of more sustained recovery in the economy and rents. According to a recent report by PwC and Urban Land Institute[15], Tokyo is ranked 1st among Asian cities as the city with the most investment prospects in 2014, from 13th position in 2013.

Figure 21: Comparison of Tokyo's property yield spreads



*Central 5 Wards; # CBD area
Source: Savills Research & Consultancy

[15] Emerging Trends in Real Estate Asia Pacific 2014

Conclusion

Japan's moderate economic recovery looks on track with the stars more aligned for higher odds of success to Mr Abe's attempts to revitalise the economy. Given the difficulties in overcoming deep-seated traditions and mindsets to reform long-term structural problems, some progress is a great step forward in the Japanese context. Mr Abe's reform programme will however take time and his determination will be crucial to rally the Japanese companies and people to support his attempts. We are therefore cautiously optimistic about Japan's recovery. Demand is mostly focused on good quality and well located properties and it will take time for less prime properties to see increased demand and rents.

We will be watching for more positive indicators in 2014 when the stimulus package to mitigate the consumption tax hike kicks in, some growth proposals are implemented, and companies review investments and wages in the next fiscal year's budget. Japan's growth will also depend on the strength of recovery in the US and eurozone economies, whether the territorial dispute with China escalates, and how the US tapers and terminates its quantitative easing programme. Key indicators to watch for assurance of a self-sustaining recovery are:

- increase in wages to stimulate sustainable consumption
- increase in labour opportunities or jobs
- increase in exports of Japanese goods
- rise in corporate capital investment
- yen remains at depreciated level
- no deterioration in the external economies.

Alpha Investment Partners

Alpha Investment Partners (AIP) is a real estate investment advisory firm managed by a team of established professionals with proven fiduciary experience.

We aim to achieve superior performance by capitalizing on our uniqueness and pertinent insights into the region's property markets, offering investors the competitive advantage akin to a local player.

www.alphaipartners.com