Japan Elections: Positive for Real Estate

- Loose monetary policy and low interest rates to continue
- Some room, albeit limited, for further cap rate compression
- Positive on offices; more circumspect on retail and hospitality

What happened?

At the Lower House elections on 22 October, the Liberal Democratic Party (LDP), led by Prime Minister (PM) Shinzo Abe, together with its coalition partner, Komeito, retained their 2/3 super majority.

Another four years of Abenomics

The election victory boosted PM Abe's chances of winning another term as the head of LDP in the party elections in 2018. He is likely to remain as PM until 2021.

Monetary easing to continue

Bank of Japan (BoJ) Governor Haruhiko Kuroda is expected to be re-appointed when his current term ends in April 2018; if not, someone of similar mindset is expected to succeed him. Loose monetary policy will therefore be likely to continue, which means that there will be less appreciation pressure on the JPY.

Mr Abe has not pushed through any significant structural reforms since taking office in 2013 and most analysts do not expect him to do so after the October 2017 elections. In light of the tensions with North Korea, he might instead focus efforts on revising the Constitution's Article 9 to legitimise the existence of the Japan Self Defence Forces. Hence economic expansion will come mostly from the ultra low interest rate environment.

Boost to economic growth

The economy has already seen six consecutive quarters of expansion. Corporate profits and capex spending have increased since 4Q2016. The unemployment rate has fallen to a low of 2.8% with higher hourly rates for part-time workers and more conversion of part-time jobs to full-time basis. Tourist arrivals have been growing by double-digits yearly. Retail sales and household consumption are now mildly positive. Four more years of Abenomics will thus continue the growth momentum.

Consumption tax hike in October 2019

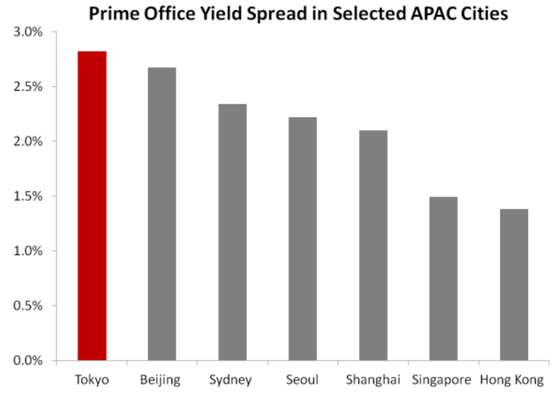
Mr Abe has indicated that the planned consumption tax hike from 8% to 10% in October 2019 will go ahead unless there is another crisis similar to the Global Financial Crisis (GFC) in 2008/2009. This will have some negative impact on consumption and economic growth but the impact is expected to be less than in 2014 when the first tax hike from 5% to 8% was implemented. If the economy continues to expand over the next two years, barring any unforeseen shocks, it will provide more fat to buffer the tax hike. In the two years before the 2014 tax hike, the economy only had four consecutive quarters of expansion; business sentiment was weaker while the unemployment rate averaged around 4.0%.

Implications on real estate

Room for slight compression in cap rates

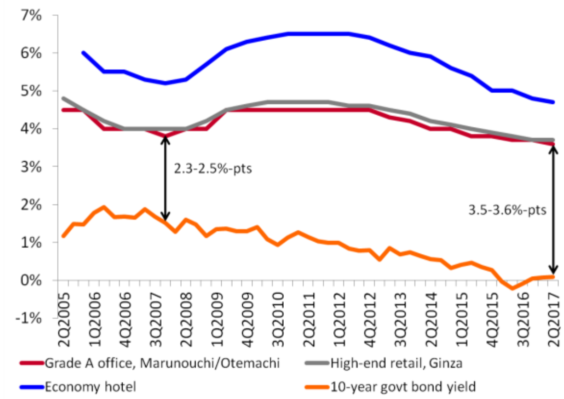
The continuation of loose monetary policy is a positive for the Japanese real estate market. With interest rates expected to remain low, yield spreads are comparatively higher than other Asian cities (Figure 1) and also higher than the pre-GFC levels (Figure 2). This implies that there is still some room, albeit limited, for further compression in cap rates. We expect capital flows into Japanese properties to continue.

Figure 1: Tokyo has the highest yield spread



Source: JLL Global Market Perspective Aug 2017

Figure 2: Yield spreads higher than pre-GFC levels

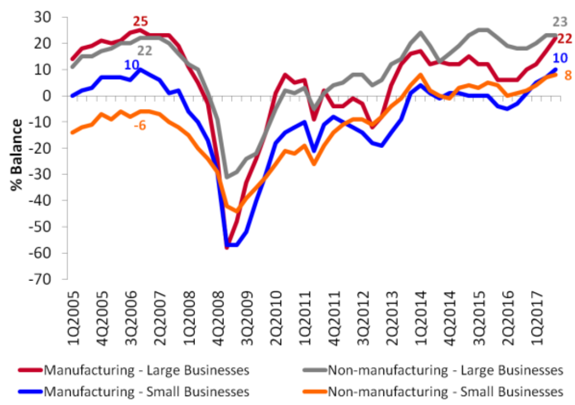


Source: Japan Real Estate Institute, Bloomberg, KepCap Research

Improving business sentiment positive for office market

Office demand is expected to remain healthy with rising corporate profits and business sentiment amongst both small and large businesses (Figure 3).

Figure 3: Improving business sentiment



Source: Bank of Japan, KepCap Research

Besides traditional occupiers, there is an increase in demand from co-working operators catering to start-ups, flexible working arrangements, workers on the move and even large corporations needing temporary extra space. For instance, WeWork is looking to open 10-20 locations in Tokyo while Regus is planning to increase its traditional serviced office locations in Japan from the current 150 to 500 by 2020[1]. This increase in flexible workspaces is in line with the government's work-style reforms, where promoting flexible work styles such as telecommuting, is one of the initiatives.

Notwithstanding rising business confidence and new occupiers, Grade A offices in Tokyo could see rental growth moderating and vacancy rate rising against a looming supply influx and demand challenges from technological disruptions. For instance, Japan's three major banks are planning to trim jobs through automation. As occupiers seek better quality space to retain or attract talent and more efficient floor plates to improve productivity, Grade A offices with modern specifications will be in greater demand over older buildings.

The limited availability of investible stock has seen investment flows moving out of Tokyo CBD to other parts of Greater Tokyo and other cities. This has led to the narrowing of the yield premium for regional cities which may not justify investing out of Tokyo which has a larger demand base and a more liquid market. The yield premium of Osaka Grade A offices versus Tokyo Grade A offices has fallen since 2009.

Grade B offices in Tokyo are attractive alternatives as their average yield is noted to be similar to that of Osaka Grade A offices. Rents are also more resilient due to the more limited pipeline supply and large potential tenant pool of small and medium-sized enterprises (SMEs). About 90% of companies in Tokyo are companies with less than 30 employees. Business sentiment amongst SMEs has also improved and is better than the pre-GFC period[2] (Figure 3). Well-located Grade B office properties with good specifications can also benefit from the increase in demand from co-working operators.

[1] Savills, Tokyo Coworking: Separating Fact from Fad, Aug 2017
[2] BoJ Tankan Survey, Sept 2017

The ageing stock of mid-scale offices provides opportunities to renovate for rental uplift. According to Xymax, 81% of small and mid-scale offices were built over 20 years ago, compared to 50% for large-scale offices.

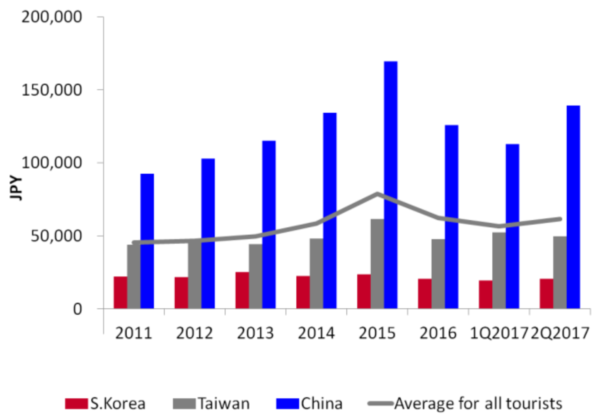
Retail riding on the rise in tourism

While the tight labour market and rise in part-timers' pay have supported a slight increase in consumption, a greater increase in regular full-time wages is needed to boost consumption significantly. Average real wage growth for full-time workers has been relatively flat for the past few years. Little wage growth will exacerbate the negative impact on consumption, retail sales and economic growth when the consumption tax is hiked in October 2019.

Although Mr Abe has asked companies to raise total wages (inclusive of base pay and annual seniority-related increments) by 3% during next year's spring wage negotiations, it remains to be seen if companies will heed his call, given that this is higher than the average annual increase in total wages of about 2% in the last two years. Due to the life-time employment system in Japan, companies will raise wages only if they are confident of their long-term economic prospects or if structural labour reforms are implemented.

With no significant boost to domestic consumption expected, we are more positive on tourist-oriented retail than suburban retail centres. After falling in 2016 in tandem with the JPY appreciation, average spending on shopping per tourist has increased again in 1H2017 (Figure 4).

Figure 4: Average expenditure on shopping per tourist



Source: Japan Tourism Agency, Japan Department Store Association, KepCap Research

Oversupply challenges in hospitality despite strong arrivals growth

Despite the continued double-digit growth in international arrivals (+18.0% yoy in 9M2017), we are concerned about a potential oversupply of hotel rooms and the challenge from alternative accommodation.

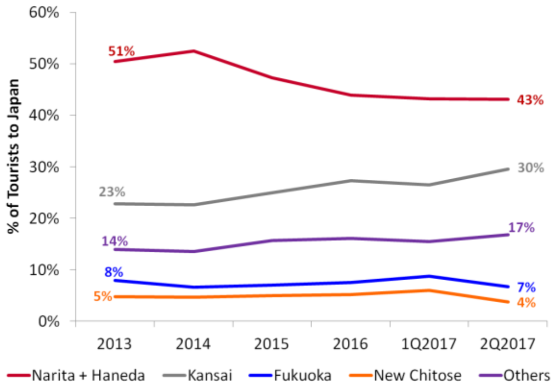
The strong growth in tourist arrivals in the past few years has prompted an increase in hotel developments. Compared to three years ago, the number of construction starts of hotels in FY2016 increased by ~4x in Tokyo, 6x in Kyoto and as much as 15x in Osaka[3]. According to the Nikkei Real Estate Market Report, an estimated 26,000 rooms in Tokyo could be completed by 2020, about 26% of the current stock. This is also significantly more than an earlier estimate of 16,700 rooms that would have been able to meet demand in 2020.

Alternative accommodation is adding to the oversupply challenge. Japan passed a new law in June 2017 that allowed short-term private housing rentals ("minpaku") in Japan up to 180 days per year, along with other conditions. Besides Airbnb which has about 55,000 listings in Japan, other large operators are entering the market. China's largest vacation rental site, Tujia, in partnership with Japanese e-commerce firm Rakuten, aims to increase the number of properties available for holiday rental in Japan by 10 times from 10,000 now to about 100,000 by 2019[4].

Although the government targets to hit 40 million tourists by 2020, an increasing share of tourists could visit Japan by cruise, and to other parts outside Tokyo (Figure 5). The number of foreign tourists visiting Japan by cruise has increased rapidly from 174,000 (1.7% of total inbound tourists) in 2013 to 1,992,000 (8.3% of total inbound tourists) in 2016[5]. About 60% of visitors to Japan are repeat visitors[6], so their subsequent visits may to be to explore other regional cities, given the government's promotion of regional tourism.

[3] Nikkei Real Estate Market Report Aug 2017
[4] Bloomberg, China's Answer to Airbnb Sets Sights on Japan, 6 Oct 2017
[5] Japan Ministry of Land, Infrastructure, Transport and Tourism
[6] Savills, Capitalising on Japan's New Tourist Trends, Jun 2017

Figure 5: Inbound tourists to Japan by port of entry



Source: Japan Tourism Agency, KepCap Research

These could explain why RevPAR and average room rates in Tokyo have stagnated despite the strong growth in national inbound tourists. Hospitality investments will have to be more targeted such as limited-service hotels for business travellers or medium and high-end hotels, as alternative accommodation attracts mostly families or groups on leisure holidays looking for cheaper accommodation.

Conclusion

In the near and medium term, the continuation of Abenomics is a positive for the Japanese property market. Capital flows into Japanese real estate will continue as yield spreads remain comparatively higher than other APAC cities. We are positive on the Tokyo office sector but more circumspect on the retail and hospitality sectors.

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