Property -
Japan Goes Shopping

Joachim Klement, CFA 1 May 2018

Back in the 1980s, investors used to talk in hushed tones about how the value of land in the square mile around the royal palace in Tokyo exceeded that of the whole of California. This was, of course, the time when Japan represented a 'new paradigm', when its executives were said to be finely honing 100-year plans informed by medieval samurai strategy manuals.

We're firm believers that if anyone tries to sell you an investment thesis premised on how to defeat multiple sword-wielding assailants in a rice paddy – for those interested, Miyamoto Musashi's *Book of Five Rings* has the details – you show them the door. If they mention the phrase 'new paradigm', you should double-lock it once they have exited.

Japan, economically and based on its reputation, has never fully recovered from the ensuing downturn. Nevertheless, it remains the world's third largest market, with a wealth of investment opportunities. Japanese stocks have served investors well over the past few years; in line with the S&P 500 and well ahead of the main UK and European indices. Japanese corporate profits have expanded by more than half, with margins at multi-decade highs, since it became clear Shinzo Abe would become prime minister near the end of 2012. "Yet," points out the Financial Times, "Japanese companies, relative to earnings, are no more expensive than they were during the doldrums of the early 2000s."[1]

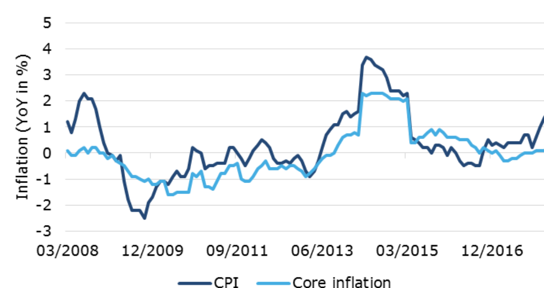
Japan's real estate sector, despite being the region's largest, has been rather under the radar. We believe the market offers institutional investors such an opportunity, particularly in the direct retail space.

Japan's economy: better than it's painted

Pessimism on the Japanese economy abounds. The World Bank estimates Japan's growth in 2018 will be 1.3%, down from the 1.7% estimate for 2017.[2] Compared to other major economies this is low "and likely to remain so," say analysts at Nomura, estimating future growth at about 0.5%.[3] According to the Financial Times, the economy is still "suffering from weak consumption. That suggests robust growth was unlikely to turn quickly into higher inflation, despite a tight labour market, with unemployment down to 2.8 per cent."[4] Inflation, too, is well below the Bank of Japan's 2% target, despite half a decade of stimulative Abenomics.

At first pass, none of this seems to lay the basis for a particularly enticing investment thesis. However, this misses the underlying trends. While Abenomics hasn't delivered the promised revolution, it is generating evolution.

Fig 1: Inflation is low but trending upwards



Source: Bloomberg, Fidante Partners.

Ending deflation is Bank of Japan Governor Haruhiko Kuroda's prime objective. As can be seen from the charts above, while inflation is low, the trend is upwards. This is supported by rising wages, in both real and nominal terms. This year's *shunto* – the spring wage negotiations between employers and unions

[1] 12 May 2017, https://ftalphaville.ft.com/2017/05/12/2188550/us-stocks-too-expensive-consider-japan/

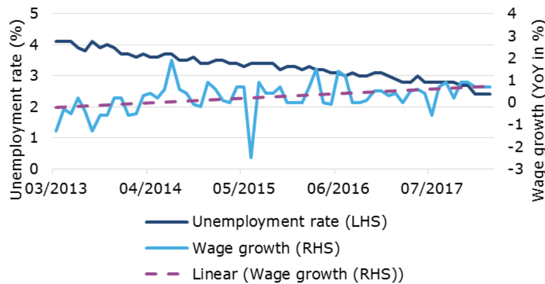
[2] Japan Times, https://www.japantimes.co.jp/news/2018/01/10/business/economy-business/world-bank-estimates-japans-growth-2018-1-3-1-7-estimate-2017/#.WstIY4jwY2w

[3] The Japanese Real Estate Investment Market, Nomura Research Institute, October 2017.

[4] FT, 8 December 2017 https://www.ft.com/content/32f019ac-dbbb-11e7-a039-c64b1c09b482

– will be the fifth one where wages increase, although it is likely to fall short of Abe's 3% target.

Fig 2: Wages tick up as unemployment drops



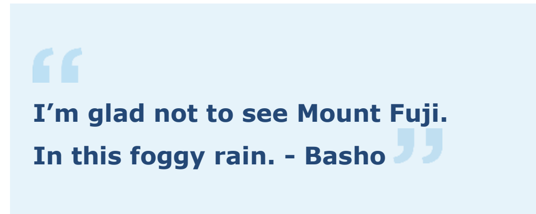
Source: Bloomberg, Fidante Partners.

All this has encouraged the steady increase in consumption since the sharp decline in April 2014, when a hike in consumption tax saw a fall in spending. While retail sales are more volatile, they have been rising since the autumn of 2016, though the larger and more generalist department stores have seen sales slide since the start of the year. This indicates that where one is invested in subsectors will make a difference. The Japanese department store is a veritable Aladdin's cave of household consumables. All human life is here, including *faux* markets, with the stalls occupying entire floors. The last one I set foot in even had an old guy in traditional dress seated on the floor with a range of grinding stones to sharpen your kitchen knives, as feudal Japan rubbed shoulders with hyper-Japan. It is possible that Japanese consumers are being more specific in their choices, shunning the *depāto* giants, and investors must follow suit.

Fig 3: Consumption is growing

Source: Bloomberg, Fidante Partners.

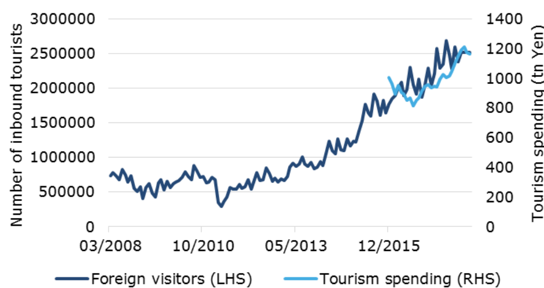
The boost from tourism



Japan's surging tourism also helps retail. The country is ranked fourth in both the direct and total contribution of travel and tourism to national economies.

The direct contribution was JPY12,043.2bn (£75.6bn), or 2.2% of GDP. This is forecast to rise by 2.3% in 2018, and by 1.6% a year between 2018 and 2028 and is estimated to be worth £90.3bn – 2.5% of total GDP by 2028. The effect is much greater when total contribution is considered: 6.8% of GDP in 2017, and 7.4% of GDP in 2028.

Fig 4:Thirty-six (and counting) views of Mount Fuji: Tourism takes off



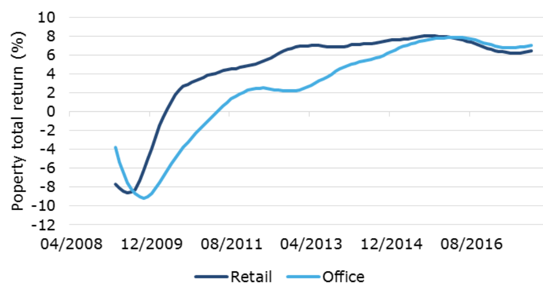
Source: Bloomberg, Fidante Partners.

This tourism boom, initially focused on the metropolis, is fanning out into the regions, with a target of 40m tourists by 2020, up from less than 10m in 2014. Importantly, this substantial boost to consumption will help offset Japan's population decline.

Allocating within real estate: retail over office

All of these trends favour retail real estate: tourists buy stuff, as do domestic workers with more money in their pockets. Indeed, despite broadly similar total investment returns for retail and office real estate (see Fig 5), we prefer retail to office and, indeed, to real estate as a whole. For example, while Tokyo office rents are on the rise, office worker numbers are declining, implying lower future demand for space. New supply is expected to grow, however, so there will likely be downward pressure on rents. Office rental rates are expected to be flat elsewhere.

Fig 5: Total return, retail and office

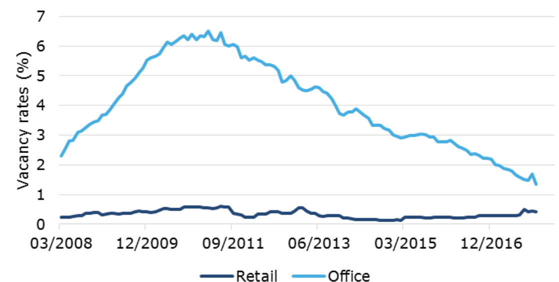


Source: Bloomberg, Fidante Partners.

In addition, while office vacancy rates are declining, they are still higher than those for retail. While now within a percentage point of each other, between 2008 and today office vacancy rates peaked at 6.5%, where retail has never gone above 0.6% (see Fig 6).

Cap rates are also set to rise for offices, according to the Japanese Real Estate Investor Survey[5]. Conversely, retail cap rates are falling, and at a record low in central Tokyo. We'll look at the fundamentals of the retail market in greater detail later.

Fig 6: Pretty vacant: Office vacancy rates vs. retail



Source: Bloomberg, Fidante Partners.

Institutional buyers increase real estate allocations

Certain policy actions work to the advantage of real estate. In particular, Japan's JPY145tn (£0.96tn) Government Pension Investment Fund (GPIF), the world's largest, is allocating 5% to alternative asset classes, up from virtually nothing, after amending its investment mandate in 2014. This means increased international allocation, but it will also benefit the domestic market.

In parallel, as part of its quantitative easing programme, the Bank of Japan has scrapped its long-held rule limiting ownership of individual Japanese real estate investment trusts (J-Reits) to 5%. As part of its Quantitative Easing programme, the Bank buys JPY90bn of J-Reits each year, and now owns more than 5% of 12 of them.

Real estate prices are further supported by bank lending to the real estate industry, with terms reported to be the loosest since 2000. This trend is likely to continue, with regional mid-tier banks entering the market, and so skewing the supply/demand dynamics for real estate loans further to the advantage of borrowers.[6]

[5] October 2017. The capitalisation (cap) ratio is the ratio of net operating income to property asset value. Low cap rates imply lower risk, higher cap rates imply higher risk.

[6] The Japanese Real Estate Investment Market, Nomura Research Institute, October 2017.

More than Tokyo

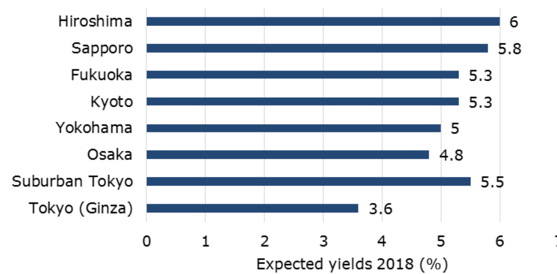
The Japanese real estate market offers investors both transparency and maturity. It is easy to become transfixed with Tokyo, by far Japan's largest city, in much the same way UK real estate investors are drawn to London. The prefecture of Greater Tokyo is the world's most populated metropolitan area, and also boasts the highest GDP. Its population increase has consistently outpaced estimates. This is largely due to the fact that 40% of the growth is accounted for by foreigners, a trend that is expected to increase. There are, however, good regional opportunities to be found, if one knows where to look.

For a long time, Japan has seen growth in major urban areas and regional economic centres alongside declines in rural and non-urban areas. Many villages look like thinly populated retirement homes. Nevertheless, population growth is increasingly focused in urban areas outside Tokyo: of the fastest-growing 20 wards[7] between 2010-2015, 13 are not in greater Tokyo. We believe neighbourhood shopping centres in these areas which are servicing this growth offer attractive risk-adjusted returns compared to other sectors. Such suburban retail property investment is fundamentally driven by the location and characteristics of local populations; individual catchment characteristics are the most important drivers of investment returns for each asset, and one therefore needs a granular approach.

Yield differentials resulting from this can be seen from Fig 7, below. This chart shows the yields at which property investors would be willing to invest in properties in different regions. Readers of this report need to take these yields with a grain of salt, because the depicted yields are somewhat aspirational. Realistically achievable property yields for different regions in Japan are lower. Tokyo's glitzy shopping district of Ginza has the lowest yields, at 3.6%, but in reality, most transactions are done at yields of 2.8% to 3.0%. In contrast, the city's vast but far less shiny suburbs offer a yield of almost two percentage points more. Sapporo, the main city on the northernmost of Japan's four main islands, Hokkaido, returns more still, as does Hiroshima. A century and more ago, Hokkaido was very much the Japanese equivalent of the Wild West. We very much doubt these days it counts as frontier investing, but it still offers a premium to Tokyo.

Unfortunately, there are no databases with actual transaction yields, so we have to rely on the survey yields shown in Fig. 7 to assess the opportunity set. But in relative terms, the differences between different regions and between Japanese property yields and Japanese government bond yields are represented well by the data in Fig. 7 hence the chart gives a good indication of the yield pick-up that can be achieved by leaving Ginza behind and venturing into Tokyo suburbs and regional hubs throughout Japan.

Fig 7: Regional retail yields



Source: Japan Real Estate Institute Investor Survey 2017.

[7] City subdivisions.

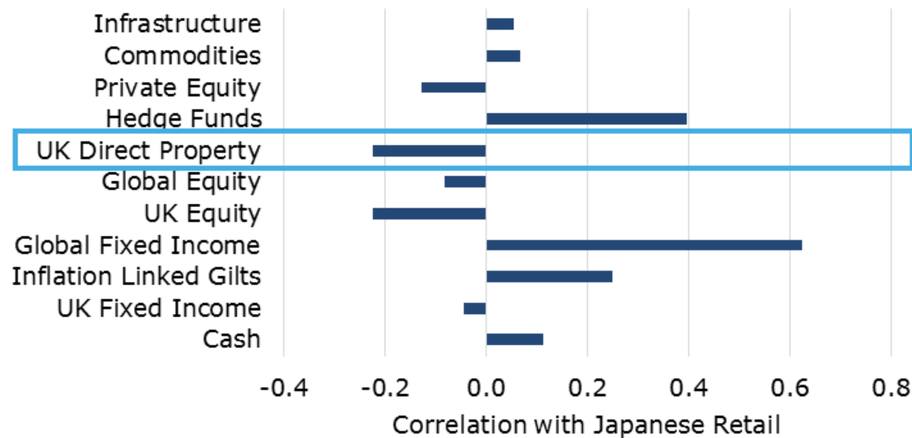
In a portfolio context

If one is but secure at the foundation, he will not be painted by departure from minor details or affairs that are contrary to expectation. But in the end, the details of a matter are important. – Yamamoto Tsunetomo, Hagakure: The Book of the Samurai

In general, European institutional investors have too great a bias to their home region and are insufficiently diversified. This is particularly true with regard to Asian real estate, according to market analyst Preqin, which notes "Asia-focused real estate fundraising has … failed to recover to its pre-crisis highs as international managers pulled out to focus on raising funds closer to home".[8] There is therefore more to be gained by increasing non-domestic allocations to alternatives.

One benefit is an enhanced risk-adjusted return. As can be seen from Fig 8 below, Japanese retail is inversely correlated to UK direct property, so an allocation to the former would lower the risk profile of the real estate portion, increasing the risk budget of the remaining portfolio.

Fig 8: Correlation with UK property

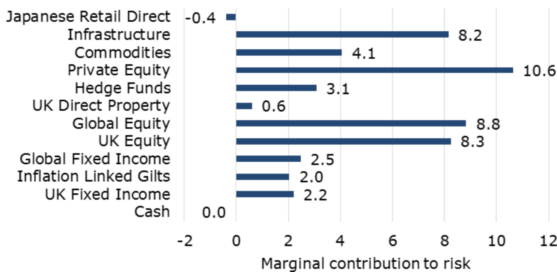


Source: Fidante Partners.
Note: All data since the beginning of the index for Japan Retail Property in June 2003. All data in GBP without currency hedging.

Japanese direct real estate can reduce overall portfolio volatility, as illustrated in Fig 9. For example, by adding 1% of Japanese direct retail exposure to the portfolio, while reducing private equity, portfolio volatility drops by 11.0bps: 10.6bps due to the reduction in private equity and 0.4 bps through the addition of Japanese retail.

[8] Preqin Special Report: Real Estate Asia, April 2018.

Fig 9: Diversification benefits

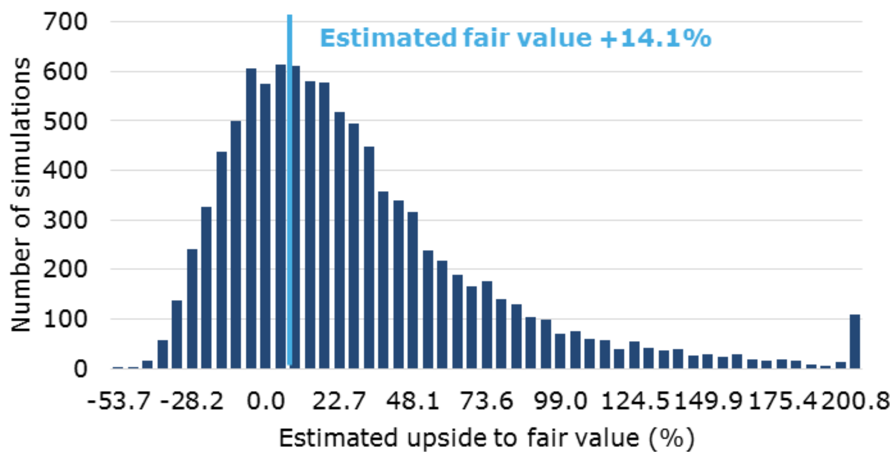


Source: Fidante Partners.
Note: This chart shows the change in volatility if 1% of a specific asset class is added to the average UK Pension Fund portfolio.

As with many real assets over the past decade, the price levels of Asian real estate remain a concern, as market analyst Preqin notes: "while presenting investors with significant diversification and potential for high returns, it remains a challenge to convince institutions that the risks are worth the reward, particularly when concerns arising from high pricing are rearing their head in the Asian market as well". The oft-stated concerns over bubbles in Chinese property are a case in point. However, Fidante's own analysis indicates this is less of a concern in the Japanese retail market, with significant potential upside (see Fig 10).

Fig 10 shows the results from a Monte Carlo simulation of the estimated fair value of a Japanese real estate index investment, based on the GPR 250 Japan index. We simulated 10,000 paths using different assumptions for inflation, interest rates, growth, and real estate risk premium. The chart shows the frequency of each valuation with the percentage upside and downside on the horizontal scale. The light blue line is the median valuation of the distribution. This provides an upside of 14.1% from current prices.

Fig 10: Fair value analysis



Source: Fidante Partners.
Note: The fair value model is a dividend discount model assuming 5% dividend yield and a growth rate of 3.0% to 3.4%. Growth rates are derived from OECD long-term growth and inflation projections until 2060. The model takes into account the estimation uncertainty around future growth and future risk premia through a Monte Carlo simulation with 10,000 simulations, thus the output is a range of fair values with a confidence interval (CI).

Conclusion

Japan's stimulative economic policy continues to promote economic growth, if rather more weakly than Prime Minister Abe would like. Government and pension fund buying activity, alongside bank lending criteria, are supportive of the real estate sector. Within this, we see trends such as increasing consumer spending and a surge in tourism as making the best case for direct retail.

With retail, it's not so much 'follow the money' as 'follow the crowds'. Over the long-term, the crowds have headed from the increasingly empty countryside to the cities. The main areas of population growth aren't central Tokyo, but certain of its suburbs and regional cities such as Hiroshima and Sapporo. Neighbourhood shopping centres in these areas should produce growing, stable returns above the average.

Other than providing these returns, allocations to Japanese direct retail offer UK and European institutional investors an asset class that has considerable potential upside to its current valuation range and – possibly most importantly – an inverse correlation to the domestic real estate portion of their portfolios.

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