

FEBRUARY 2023

THINKING OUT OF THE BOX - CORE RESIDENTIAL IN TOKYO

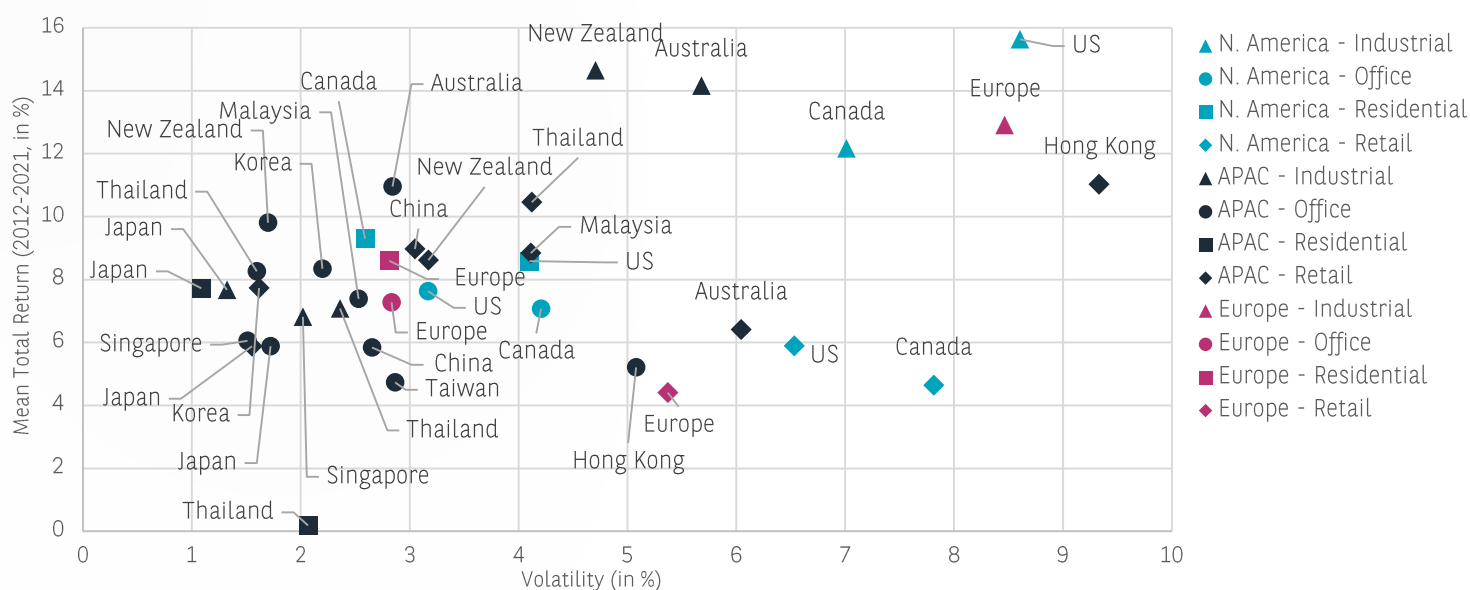
In times of high uncertainty regarding the economic development in Europe, global restructuring of economic processes, war-driven inflation spikes and the disintegration of an entire decade of low interest rates, real estate investors are starting to look beyond their local markets toward global opportunities. There is a need to diversify the existing real estate portfolio and future allocations more broadly. This analysis shows why the Tokyo residential market can be a worthwhile investment approach outside Europe and what special features need to be observed in this market.

EMBRACING INVESTMENT TRENDS OUTSIDE EUROPE

A recent real estate survey shows that the markets that some leading global investors are currently most positive about are outside Europe. This result fits in with the current uncertainty in Europe, higher expectations for long-term economic dynamics outside Europe, but also the perceived over-allocation in the European market from recent record years.

As Figure 1 shows, many markets serve similar risk-return profiles as the European markets. What is surprising, however, is the relatively high accumulation of APAC (Asia Pacific) markets in the left-hand panel of the illustration, with lower volatility in total return than in other regions. This is also the basis for investor interest – diversification and stability.

FIGURE 1: APAC MARKETS AHEAD IN GLOBAL CROSS-SECTOR RISK-RETURN COMPARISON



Source: MSCI Database

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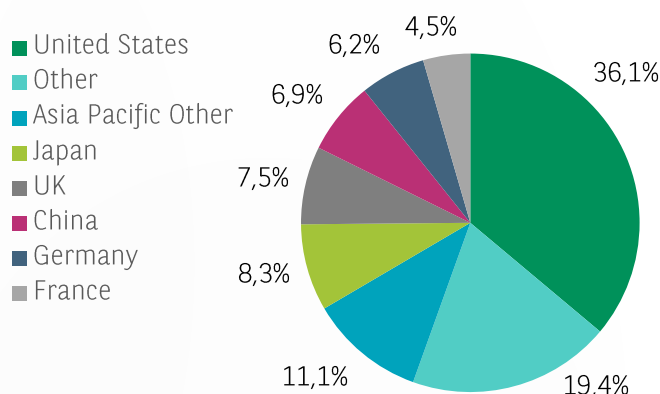
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SEARCH FOR SUITABLE NON-EUROPEAN INVESTMENT LOCATIONS

In addition to looking at the risk-return profiles of markets and types of use, further approximations can be made: The general market liquidity (see Figure 2) provides initial information on the depth and degree of professionalisation of the local investment industry, especially for markets beyond the normal investment regions. With reference to current market size estimates from MSCI, the USA, Japan and the UK form the three largest singular real estate markets in the world.

FIGURE 2: GLOBAL RE MARKET SHARES (%) – A CLEAR PICTURE



Source: MSCI database

Another possibility is to examine overlaps and cyclical synchronisation of the total return between the regions. The focus here is consequently on the most liquid markets. There is a close performance correlation between Europe and North America. However, the relatively loose correlation between the two regions and Japan is also clearly visible. At first glance, this is surprising, as Japan is assigned to the G7 and the "West", which could lead to the conclusion that the structures are the same.

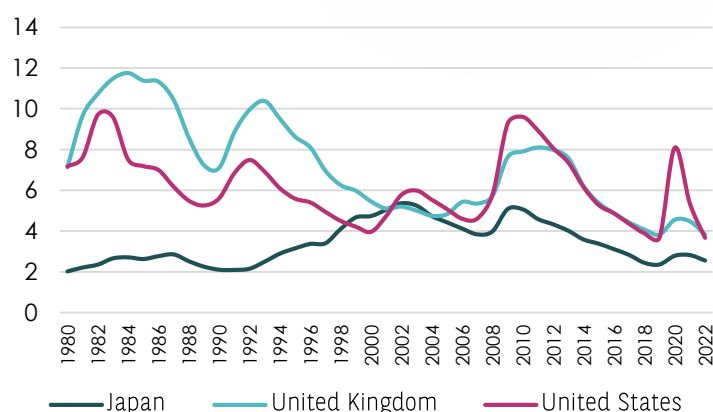
FIGURE 3: MARKET CORRELATIONS OF THE LARGEST MARKETS

10 YEARS Total return	JAPAN	EUROPE	NORTH AMERICA
Japan	1		
Eurozone	0,33	1	
North America	-0,65	-0,43	1

Source: MSCI database, total returns in USD

Geography, however, is precisely the lever that makes the difference; significant fundamental linkages are formed in Japan with a clear reference to the East Asian region or the peculiarity of Japan's physio-geographical profile and thus diverge. The low correlation in the total return is also manifested in the exchange rate, but is defined by different trade structures, significantly lower inflation, a special interest rate regime of the BoJ (Bank of Japan) and a more stable labour market (Figure 4), which in turn affects the rental markets and the income return.

FIGURE 4: LONG-TERM UNEMPLOYMENT RATE BY REGION

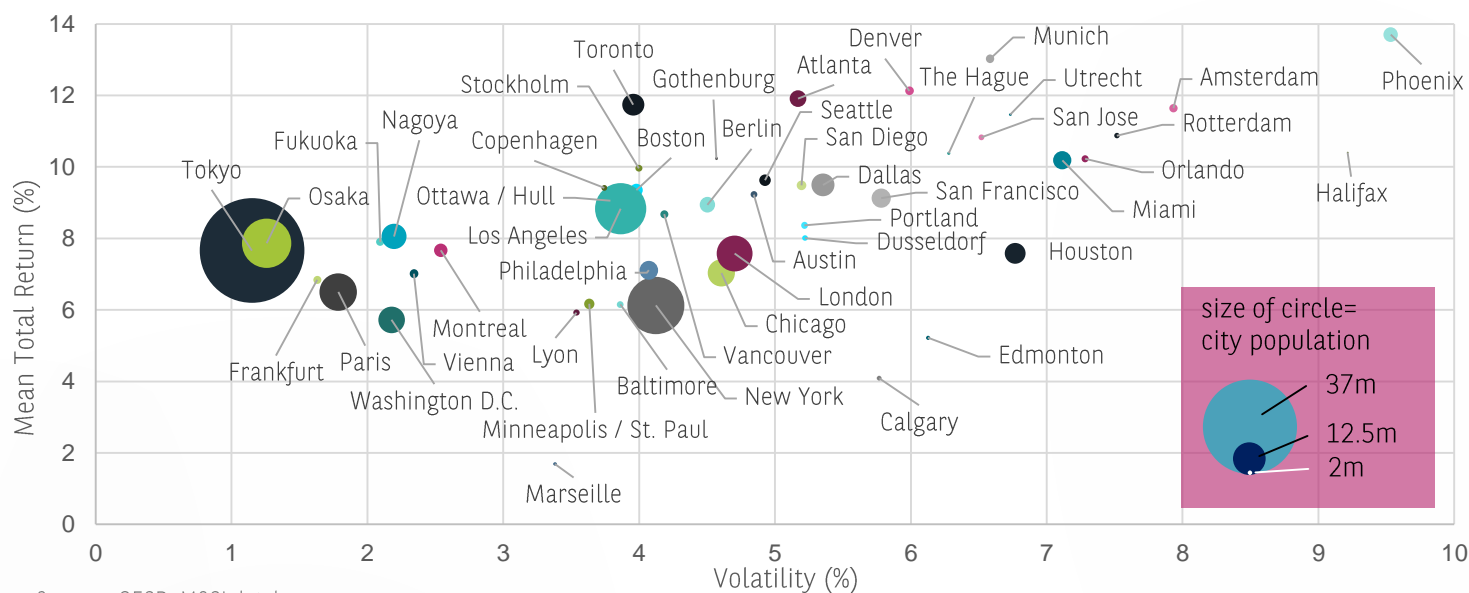


Source: PMA

Thus, based on this group of basic parameters alone, important insights into possible investment cases outside Europe can be identified. Targeting on a very liquid real estate market with low volatility and correlation to the European market, Japan should be on an investor's list.

THE LARGEST URBAN AGGLOMERATION IN THE WORLD AS AN INVESTMENT LOCATION

FIGURE 5: RISK-RETURN PROFILE TOKYO: LARGE DIMENSIONS AND LOWEST VOLATILITY AMONG GLOBAL RESIDENTIAL MARKETS



With around 37 million inhabitants, 120 universities and 34 Fortune500 companies, Tokyo is not only the largest city in the world, but also one of the most important and prosperous economic metropolises on the planet. It generates more than 30 per cent of Japan's gross value added, more than countries like Spain, Canada or Australia. This combination of market liquidity, international relevance, affluence and a certain otherness make Tokyo a market with many facets and investment opportunities, more than ever in times of WFH trends and ESG.

But Tokyo's clout does not come from its sheer scale alone (Tokyo is projected by the UN to shrink to around 36 million inhabitants by 2035). Tokyo's strength also basis on innovation: Japan ranks third in the global patent ranking. In the World Intellectual Property Organization ranking of individual city regions, the Tokyo-Yokohama region even takes the leading place.

Rather, it is the innovative strength of the established companies and research institutions, as well as the vibrant urban structure, that lend this market enormous dynamism.

FIGURE 6: TOKYO METROPOLITAN REGION AS THE LOCATION WITH THE WORLD'S HIGHEST INNOVATION POWER

Cluster rank	Cluster	Economy	% of Patent Cooperation Treaty filings	% of Scientific Publications
1	Tokyo – Yokohama	JP	10.9	1.6
2	Shenzhen – Hong Kong – Guangzhou	CN / HK	7.8	1.5
3	Beijing	CN	2.6	3.0
4	Seoul	KR	3.9	1.6
5	San Jose – San Francisco, CA	US	3.7	1.0

Source: World Intellectual Property Organization (WIPO)



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URBAN STRUCTURES ON THE MOVE

In addition to the high level of competitiveness, it is also clear that the Tokyo metropolitan region includes cities with millions of inhabitants, such as Yokohama, in addition to the core city. This is an important characteristic, especially for the residential property sector: if there are several strong poles in a residential region, this automatically increases the catchment area from which workers can come. There are many of these in this market. Tokyo's urban structure is characterised by various business hubs, e.g. those along the Yamanote Line, one of the elementary traffic loops of the megacity.

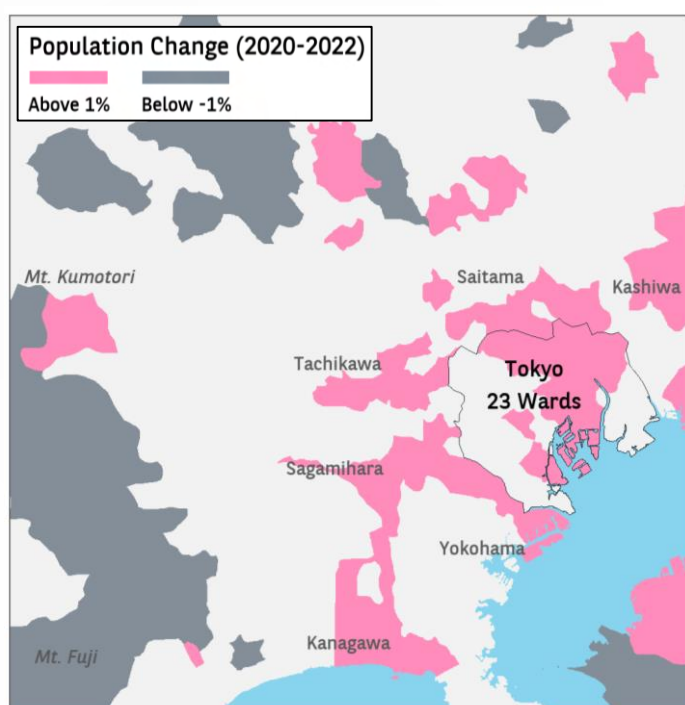
These business hubs are, for example, Shibuya and Shinjuku West in the west of the city, where, among other things, the Tokyo City Hall and some of Tokyo's most impressive skyscrapers are located, or Shinagawa in the south, where, for example, the headquarters of Sony and Microsoft are located.

Others are at Tokyo Bay, Marunouchi, in the heart of the city near the Royal Palace, or Ikebukuro in the northern part of the megacity's 23 wards.

Several of the existing hubs are undergoing expansions, new spectacular high-rises are being built and infrastructure is being expanded. As Figure 7 shows, there are very different dynamics of population development in the area around the 23 Wards. Although the city-wide population is expected to decline slightly, there are indeed many clusters of growth in the Tokyo Metropolitan Area. These are those areas of the agglomeration that are well connected to the urban infrastructure, offer local recreation areas and modern housing with more space. This is because it is precisely the equipment of the living space, whether from the point of view of sustainability or the space available, e.g. for residential housing, that makes a difference.

Since COVID, the demand for living space per capita has increased even more. This trend is more pronounced than in Europe and North America. This is because Japanese families traditionally live in much smaller flats, which often do not offer a quiet place to work. The average flat size in Tokyo is only about 66 square metres (in London, for example, it is 80 square metres), and it is traditionally standard that sleeping and living take place in the same room. Today's demands contrast with this, paving the way for new modern housing options.

FIGURE 7: HETEROGENEOUS POP. GROWTH IN TOKYO DISTRICTS



Source: Statistics Bureau of Japan

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CAN A SUSTAINABLE INVESTMENT AGENDA BE IMPLEMENTED?

Modern residential buildings are increasingly paying into the environmental sustainability of the segment. The spread of energy-efficient housing still offers considerable potential for growth - especially in the area of thermal insulation, as new studies show. From 2030 onwards, all new residential buildings in Japan must be zero-emission buildings (ZEH standard). Until COVID hit, ESG was only marginally established in the Japanese housing market. Sustainable construction was clearly in the background. The focus was on the safety aspect; the region is highly prone to earthquakes. Especially when it comes to new building materials (low-carbon concrete or steel and timber construction), concerns about earthquake resilience prevailed. Current ESG initiatives now focus on lowering the energy consumption and implementing renewable energy technics.

In contrast to the guiding principle of the European Commission's Renovation Wave from the European Green Deal, renovation of existing buildings in Japan has so far only taken place on a very small scale. But the picture is shifting and construction is embracing sustainability without compromising on safety.

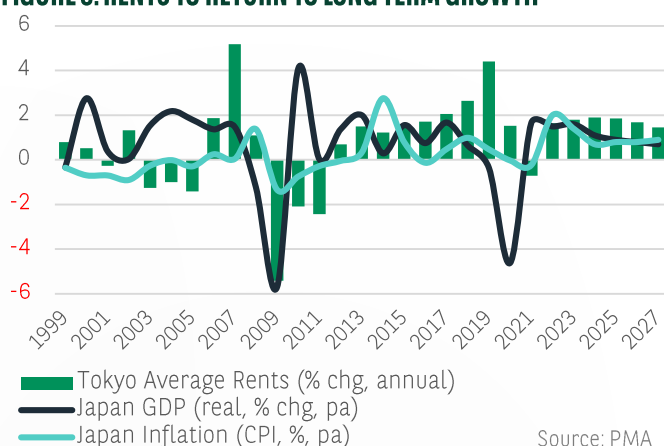
On the other hand, the recycling rate is very high at over 90% - the EU has a recycling rate of 70%. Sustainability has so far taken place on the basis of certifications (LEED, CASBEE), mostly for office buildings owned by international investors. Now, more and more tenants and investors are prioritising sustainability and starting implementation into their businesses.

Sustainability with a climate focus is also embraced by the City of Tokyo with its diverse green spaces (with a very high building density) and through the highly developed, city-wide recycling system, which ultimately also applies to the aforementioned recycling of building materials. Tokyo is also considerably affected by the heat island effect due to the high building density. To counteract this, the city is increasingly setting up so-called cool spots, which offer fine mist and green walls with covered seating. Tokyo also offers solar heat-blocking pavements and water retaining pavements at a large scale to mitigate road surface temperature rise.

THOUGHTS ON LIVING IN TOKYO

Fifty-five percent of Tokyo households rent. The European average, for example, is only 30%. This distinct feature is highly significant for residential investment approaches, as this outlines the target group. The high rate together with the trend of more single households, which is also evident in Tokyo, the high attractiveness of the city and the high demand for modern and energy-efficient flats lay the foundation for a positive rental growth trend in the corresponding properties.

FIGURE 8: RENTS TO RETURN TO LONG-TERM GROWTH



Moreover, the Japanese residential property market has structural characteristics that make it attractive for investors. These include a high income level and a very strong social security system. The latter also distinguishes the Japanese market from the US market, which is larger but offers a much lower level of social security. The Japanese level ensures a low risk of rent defaults. In addition, Japanese leases include mandatory rent default insurance, which must be paid by the tenant. If the tenant defaults, the insurance kicks in.

The cornerstones of a dedicated investment strategy come through. In particular, the focus on modern and sustainable, CASBEE-certified residential assets can currently stand out in the market. The involvement of a local asset and investment team or partner is essential. It ensures access to opportunities, to cover potential development risks and to be able to execute the letting strategy.

The market sector combination that was rated positively by most investors in the survey mentioned at the beginning was residential in Japan.

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