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Japan

May 2024 • perenews.com

Looking up: Investors stay positive at the end of an era

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KEYNOTE INTERVIEW

Stable Japan appeals across multiple sectors

The return of steady inflation to Japan will put pressure on asset management skills, but there are opportunities across the board, says LaSalle's Kunihiko Okumura

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The return of inflation and the end of negative rates mean Japan is moving into a new era. However, it remains a beacon of stability in global real estate. While there are opportunities across all sectors, finding the right opportunity and vigorous asset management are more important than ever, says Kunihiko Okumura, co-chief investment officer, Asia-Pacific, and CEO, Japan, at LaSalle Investment Management.

Q What is the outlook for real estate now that the Bank of Japan has ended the era of ultra-low interest rates?

The change in policy has been well trailed, so I would be quite surprised if there is anybody in this market who was surprised by the recent announcement. In the past couple of years, everyone observing this market knew that our super-low-rate policy would end at a certain point, so investors became cautious and some players have slowed down their investments.

Some people might expect a change in real estate transactions and pricing as a result, but I don't think there will be much negative impact, because the policy change had already been priced in before it became official. And recently, we have started to hear from some players in the market that waiting for any significant price discount may be a waste of time. In contrast to the volatility seen in many other markets, Japan continues to look like a safe spot for capital.

Q Have Japanese domestic investors been similarly cautious recently?

We continue to see strong appetite from domestic players, including private and public REITs, domestic corporations and high-net-worth individuals. They have been very active and not just in favored sectors such as multifamily and logistics, but also in the office and retail sectors.

Q Elsewhere in the world, offices are very much out of favor. What is different in Japan?

It may be difficult for some foreign players to make office investments due to the headwinds they experience in the office sector outside of Asia. While we saw a rise in remote working in Japan due in part to covid-19, the negative impact to office demand has been limited. Japan highly values face-to-face communication, many small- to medium-sized companies were slow to adopt remote working due to the lack of infrastructure, and the small sizes of Japanese homes are a handicap for many in working from home.

The latest office return ratio is 70-75 percent and even where companies offer flexible working, it is not affecting their office space demands. We saw some decline in Tokyo office rents in 2022 and 2023 but this has been due to large new supply in the market. More recently, we are starting to see occupancy and rental levels recovering. We have been successful in crystallizing profits in office investments throughout the covid-19 period.

Q What office strategies will bring success? Should investors look outside Tokyo?

Class B offices continue to be interesting because many are inefficiently managed by local owners, who are not experienced or motivated to maximize the rental level and value of the asset. These assets can often be inefficiently marketed, which brings about attractive price discounts, after which capex can be invested in common areas and tenant spaces to modernize the workspaces and improve the value of the assets.

This fit-out office strategy has been working well in Tokyo and we believe it can be replicated in other major cities like Osaka, Nagoya, Fukuoka and Sapporo. Tenants are getting more demanding of workspaces and are willing to pay a premium for upgraded ones.

We have also been looking at the life science sector which is still a niche in Japan but with good prospect for growth.

Q Multifamily has been very popular with investors; does this sector still stack up?

Multifamily has been a favored sector and I expect this to continue. There are a few reasons. The continuing rise in condominium prices is making it more and more difficult for people to buy homes, which could be a demand driver for rental apartments.

Tenants are also benefiting from the recent rise in wages, which gives them the ability to pay more rent. We also tend to see shorter lease terms and higher turnover in multifamily leases, which give asset owners the chance to mark rents at market level.

Longer-term leases with no rent review clause, which are often seen in other asset classes and favored by core

Q How much do you expect interest rates to move?

Everyone understands that Ueda-san [Bank of Japan governor Kazuo Ueda] is very cautious so we do not expect immediate, drastic changes in the monetary policy. The Bank of Japan is closely monitoring the market to ensure sustainable wage growth and modest inflation, without which it is not likely to make a significant increase in rates. We might see a rise of 20-30 basis points in the short term, which won't make much difference to value-add players but might affect core players sensitive to dividend yield.

investors, might be more negatively viewed moving forward.

Q Logistics has been extremely popular with investors and performed well. Are there still opportunities?

Logistics has had a good run in the past several years, due to steady demand for modern logistics. It is favored by both investors and lenders and the cap rate for stabilized assets in good locations has been close to a low 3 percent.

"We continue to see strong appetite from domestic players, including private and public REITs, domestic corporations and high-net-worth individuals"

We have also seen a lot of new players, both foreign and domestic, enter the sector so competition for land has been very high. Meanwhile, construction costs have risen and oversupply in some submarkets has presented challenges in the sector, making it more difficult to secure the same development margin as before.

Those who continue to do well in this sector are the ones with strong capability in securing land at attractive entry prices, securing contractors and in leasing.

LaSalle has been developing logistics assets in Japan for close to 20 years now. Our in-house acquisition, asset management and leasing teams are our competitive advantage in the market. We will continue to be active in the sector while being selective with locations.

Q Is the data center sector also of interest to investors?

When we look at industrial land, we do also consider the potential for data center developments. The sector shows clear signs of growth but the market is very competitive. There are also many dimensions to data centers, such as securing high volume of electrical power and working with operators, that require extra effort and expertise to start with, so there is still a degree of reticence.

Q Japan's tourism market has bounced back since the pandemic. Are there still opportunities in hospitality?

We didn't see many distressed opportunities in the hospitality sector during the pandemic, as lenders were supportive of hotel owners while the market was shut down, extending loan terms and loosening covenants. As has been widely reported, tourism has returned, hotel occupancy has improved and room rates have been rising in Japan.

We believe there is still room for growth in the hospitality sector, due to the Japanese government's commitment to support the tourism industry. The key is in securing a good operator, as the best are very busy and selective. There may also be opportunities in less-known locations beyond well-trodden cities like Tokyo, Osaka and Kyoto which are gradually being discovered by travelers.

Q Has the return of tourism also boosted the retail sector?

When we talk about retail, we should distinguish between urban retail versus suburban or regional shopping centers. In both categories, we see different opportunities for investors.

We have seen a recovery in urban retail, driven in part by foreign tourists coming back to Japan and indulging in shopping activities and buying luxury goods, supported by the weak yen. As a result, owners of retail assets have been able to raise rents for spaces occupied by luxury brands. Urban retail spaces leased to food and beverage businesses have also recovered strongly due to tourism and people being able to eat out again.

However, regional shopping centers are still suffering due to limited liquidity in the market. We often see poorly managed assets losing occupancy and net operating income quickly. Consequently, they could turn up as distressed opportunities in the form of well-located assets needing better management. With a long, successful track record of managing regional retail assets, we have been closely monitoring this category.

Q Will investors need to do anything differently as Japan re-enters inflation?

In an inflationary environment, proactive asset management will be a key differentiator to ensure that rents keep pace with inflation. This is required not just in the value-add business but also the core business as well. ■