6 Japanese real-estate and investors: a passionate but unstable relationship

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The essential

The Japanese real-estate market is at the heart of the current debate on excessively low interest rates. Real-estate is an attractive asset class.

While real-estate developers are getting a clear boost from negative interest rates with the option of borrowing at low cost to invest in new construction or to enhance shareholder return, real-estate investment trusts have benefited the most as share prices are up sharply so far this year. The two highlights of the first half of 2016 – the introduction of negative interest rates and the UK referendum on leaving the European Union – confirmed demand in this sector with a considerable rally in the underlying index.

The real-estate investment trusts (REITs) index has outperformed the Topix impressively since the introduction of negative interest rates. In addition to the traditional benefits of investing in real-estate, such as leverage, tax breaks, diversification, low volatility in yields, and inflation protection, there are features unique to the Japanese market that make it more attractive. The sector is getting a boost in particular from official economic growth strategy.

As corporate profits have risen sharply in recent years, office real-estate has benefited to a certain extent from the improvement in the labour market and investment. The average vacancy rate in office real estate shrank to 4.05% in May and has fallen steadily since July 2012. Naturally, rents have risen since January 2014, and averaged 5477 yen per square meter in May 2016 for new and existing property reached (+11.5% during the period), a six-year high.

And yet, Tokyo's five CBD quarters (Minato, Shibuya, Shinjuku, Chiyoda, and Chuo) have seen less and less construction, with its number falling from 2659 units in March 2013 to 2601 in May 2016. Our impression of abundant construction is at odds with these figures, due to the fact that construction is often due to relocations into existing buildings to bring personnel together.

Foreign tourist numbers in Japan have risen constantly over the past four years, thanks to easier conditions for obtaining a visa, a wider range of goods eligible for tax deductions, the recent development of airport infrastructures for low-cost airlines, and increased per capital GDP in Asia. Based on the real effective exchange rate, the deprecation of the yen until the end of 2015 has also played an important role but tourist numbers have continued to rise since the yen began appreciating in June 2015 (based on the real effective exchange rate). Whereas demand has caught up with supply, construction of new infrastructure is being driven by the government's raising of its objective (from 20 to 40 million by 2020). Infrastructure occupancy rates in Tokyo and Osaka are considerably higher than other major cities, such as Paris and New York, which gives hotel managers greater pricing power.

> "The real estate market should continue to perform well as long as the market is supported by easy money from central banks and low real interest rates, attracting international buyers to Japanese assets"

The Bank of Japan (BoJ) has enlivened the market by deciding to invest 90 billion yen in real-estate funds annually since the launch of the second quantitative easing programme (QQE2) in late 2014.

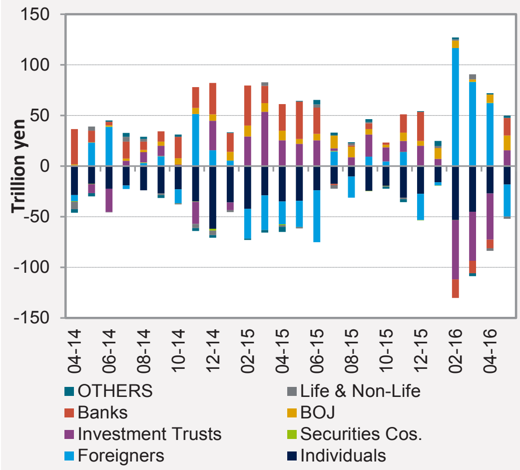
Construction starts have been favourable since February 2016, with growth of almost 9.0%, constantly beating market expectations by far. The introduction of negative rates since 29 January has had a heavy impact on the sector. In March real-estate lending hit a high since the US real-estate bubble. Total available rental surface area surged by 1.8% from January to May, vs. an increase of just 0.25% for all of 2015.

The impact of the low-interest-rate environment has thus been amplified, drawing in risk-adverse and yield-starved investors to this sector, where the 3.13% dividend yield is higher than the average of companies of the flagship index Topix (2.32% as of the end of June 2016).

However, the biggest fans are not local investors, but foreign ones, who have invested massively in this sector since February. Their investments are focused on REITs rather than real-estate developers, as they offer higher yields. At the end of June 2016, REIT dividends were 3.13% vs. 1.30% for developers.

So the question is why Japanese investors, who don't have many investment opportunities on their domestic market, did not seize the opportunity of the local real-estate market? Strangely enough, Japanese investors have stepped up their exposure in international REITs rather than domestic ones at a time when foreigners are arriving massively on the Japanese market. In March the 10 investment funds, all asset classes combined, with the largest net inflows include six REITs specialising in international assets, five of which are at the

1 **Flow of fund in J-REIT**



Source: BoJ, MOF, Amundi Research

top of the list. In addition to offering dividends that are even higher than REITs exposed to domestic assets, these funds seem to be gradually modifying their mode of remuneration from profit-sharing (based on capital appreciation) to a management bonus (based on the fund's total amount) to cope with the difficulties involved in capital gains. Moreover, there is a correlation between the best-selling funds and the level of sales commissions, which are often above 3.0%.

However, the latest data, from May 2016, point to a return by local banks and investment trusts, with net positive inflows, whereas foreign investors appear to have become impatient after a large profit-taking resulting in negative net outflows. After three months of massive inflows (with a second all-time record in February), following the introduction of negative interest rates, foreign investors did not see domestic inflows onto the market, except those of the Bank of Japan (BoJ) (see chart 1).

Meanwhile, the recent expansion raises the matter of an overheated market with excessive valuations. Indicators such as price/book value (P/BV) and price/earnings (P/E) ratios may seem relatively high in comparison with their average since the launch of quantitative easing. However, this is true only for REITs (current values of 1.52x and 31.9x for mid-sized ones of 1.4x and 30.8x, respectively), while real-estate developers are also benefiting from the current environment even through their payout to shareholders is not as high.

Meanwhile, as cross-border inflows and outflows have increased recently, an international comparison is worth making. In terms of indices and on a standardised basis, while the US market is far above its peak reached during the real-estate bubble of February 2007, the Japanese market still offers some upside potential.

Fundamental ratios tell us a little more, with a study by the US firm JLL. Of the 15 major cities concerned, Japan ranks sixth in terms of price/income ratio, behind Hong Kong, Singapore and New York, which may seem high. However, Japan ranks 11th in price/rent ratio, thus suggesting that the market is relatively undervalued and highly competitive.

There is still some room for the vacancy rate to improve. The latest release is still 159 basis points above the 2.46% record of November 2011. Office real estate accounts for more than 46% of the exposure of the 54 REITs located in Japan, making the vacancy rate an important contributor to rental pricing power.

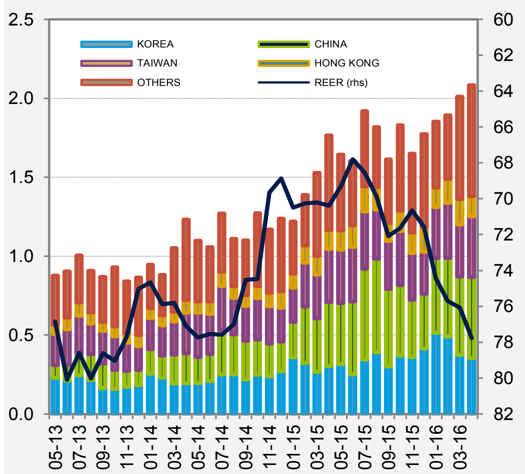
The average expected rent is at a high since May 2010 and has risen sharply since Prime Minister Abe took office, driven by inflationary pressures. So a key item will be whether rents can continue to rise.

We believe the sector still has some upside potential in an advantageous environment. The 2020 Olympic Games will provide support to construction and renovation for at least the next two years. Beyond 2020, there are doubts on the ability to maintain growth in the number of visits after the "last" inflow that Japan will probably have reached during the Olympics.

Meanwhile, in an environment in which investment opportunities are becoming scarcer, investors are seeking assets that add fixed income streams to their portfolios. Generally speaking, the search for higher yields makes investors turn toward other asset classes, such as high yield bonds, high-yielding equities, or preference shares. Real estate can also serve as an alternative asset class.

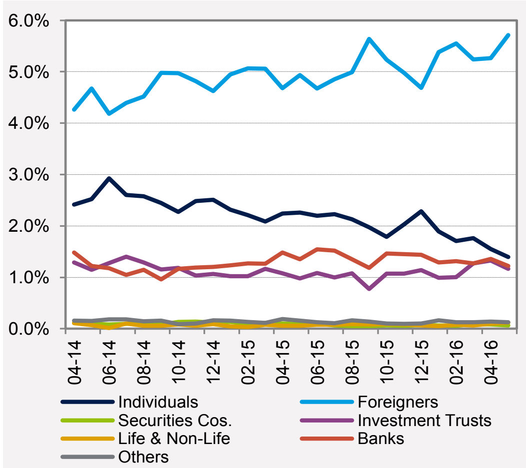
The introduction of negative interest rates has amplified this effect and domestic investors such as trusts and regional banks are taking an interest in this type of investment. As regional banks are less exposed than "mega-banks" to brokerage activities and loans to foreign clients, their lack of diversification in terms of business lines makes them more likely to take on exposure to this attractive sector, given the current environment.

2 Evolution of number of tourists and real effective exchange rate



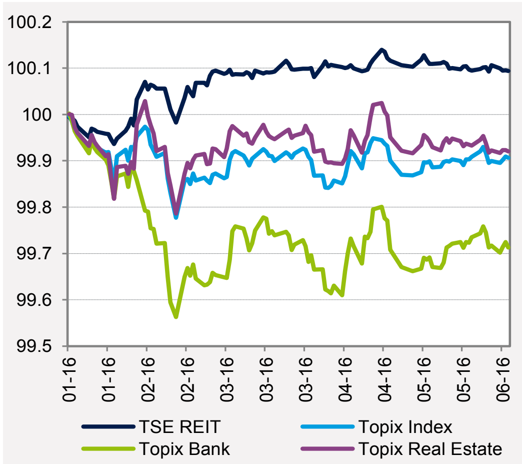
Source: JNTO, Bloomberg, Amundi Research

3 Trading share by investor type



Source: TSE, Amundi Research

4 Indicies performance (100 basis)



Source: Bloomberg, Amundi Research

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