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Japan

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An evolving landscape

Conservatism meets innovation

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KEYNOTE INTERVIEW

A unique opportunity

Japan's positive lending environment, coupled with great infrastructure and governance reforms, creates a compelling and broad investment opportunity, says BentallGreenOak's Fred Schmidt

Japan has long been a popular destination for international real estate capital looking for a positive yield spread. Even though this might diminish somewhat, the nation still offers opportunities across the risk/return spectrum, says Fred Schmidt, Asia chairman at investment manager BGO. Japan continues to evolve, with improved governance, new infrastructure and a burgeoning start-up scene adding to its traditional virtues of industry and resilience.

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Q How does Japan look for institutional investors? Is this encouraging for real estate investing?

In the US and other developed markets, rising interest rates mean it is almost impossible to get a bank loan with positive leverage.

Japan is an exception, compared with other developed markets, because there is still a positive gap between borrowing costs and real estate yields. Quite frankly, Japan is over-banked, with three mega-banks and a savings rate which has gone from 4 percent to close to 10 percent during the covid period, so there is a lot of liquidity.

So, we have ample bank financing and still a lot of liquidity for real estate. Japanese government bond spreads have been allowed to increase by 20-25 basis points, but there is still a 200-plus basis point spread available, depending on the sector.

The other factor that makes Japan attractive to institutional investors is the significant amount of pipeline and dealflow, which we continue to see, mainly from Japanese corporates selling non-core real estate. This has been going on for a decade but there is still approximately $3 trillion of non-core assets held by Japanese corporates. That was a great source of dealflow for our last fund and we expect it to be so for our latest vehicle.

For value-add investors like us, these corporate assets have generally been neglected and so also offer the opportunity to add some value, whether through leasing up or capital expenditure. We can make the buildings more attractive to tenants and raise rents. Occupiers have been increasingly preferring higher-quality buildings over the years, and that demand also contributes to making the Japanese market more attractive.

Q How is the government's recent focus on the 'G' in ESG creating opportunities?

A lot of other markets have been focused on environmental factors, and I'd say Japan is some way behind other developed markets such as the US and Europe in that regard.

However, there has been a real focus on improving governance. Companies are focusing more on their ROI and core business.

The regulators are focusing on factors that historically were impediments to dealflow for foreign investors like us, such as cross-shareholdings and management trying to protect their positions by holding on to non-core assets. We have also seen more investor activism and that activism getting results. This focus on governance is driving the sales of non-core assets – that is the big theme that continues to provide interesting opportunities in Japan.

Q What risks are on the horizon for Japan?

The main risk is further rises in borrowing costs; if the US Fed keeps raising rates and if the new Bank of Japan governor decides to raise rates too. It is not clear how far rates might rise. The risk is that this will impact pricing; investors expect a higher cost of debt, so that pushes up cap rates.

It is unlikely we will see rises anything like those in other markets, so there will still be a substantial positive

SOURCE: SS CO LTD/NAOMICHI SODE

Pasona Square, Tokyo: BGO owns offices across Japan's capital

Q How has the pandemic affected the office sector in Japan?

We are seeing the trend toward working from home having an impact on the office sector in the US and Europe, mainly in the major metropolitan markets. However, Japan has been very different. During the peak of covid-19, work-from-home policies were implemented by a lot of the major corporates but nonetheless people still went into the office if they could. Our own office was 87 percent occupied throughout the pandemic and that was not unusual. I asked some Japanese landlords about their experience and it was very similar; meanwhile in New York it was zero!

The Japanese working culture values mentorship and personal contact, so if your boss and peers are in the office, you will be too. I have probably had no more than 10 Zoom calls with Japanese clients because in-person meetings are still highly valued. Also, the Japanese are used to mask-wearing during flu season so are happy to conduct meetings wearing one. Additionally, if you have a family of four living in a 650-square-foot apartment, working from home is not an attractive option. I think all those factors mean office work continues to be very much the norm and that is why Japan's office sector continues to be attractive.

"There will still be a substantial positive spread in Japan that is not achievable in any other developed market"

spread in Japan that is not achievable in any other developed market.

Q BGO is mainly focused on the large metropolitan markets of Tokyo, Osaka and Nagoya. What is the outlook for each market and what is driving the opportunities there?

The rationale for investing in Tokyo is simple; it is the largest office market in the world. It was 800 million square feet when I started in real estate there, which seemed amazing, but it is now double that because the floorplate per employee has grown.

This expansion and redevelopment keeps throwing up opportunities. Tokyo is our main focus because it is the center of government, culture and commerce. The population is growing by around 3 percent a year, as young people move from provincial towns and cities for the prospects of high-paying jobs in the capital. That means demand for real estate is very robust.

Osaka is the second city, but it still has a large population when you consider the metropolitan area. It has historically been more of a manufacturing city, with lower rents and lower quality, older assets. I do not think rents have ever exceeded two thirds of peak rents in Tokyo.

However, there is industry there, which creates demand, and Osaka is also very well located for tourism. It is near major tourist destinations such as Kyoto, Nara and Kobe. It has Universal Studios and a host of other sights within an hour's radius. Tourism is going to be a big driver of the Osaka economy, which is positive for hospitality real estate, especially as overseas visitor numbers increase.

Nagoya is the center for Japan's motor industry; you have the entire Toyota supply chain there, which drives demand. Rents are about two-thirds of those in Osaka, so it is another tier down. These cities are part of a great metropolitan area. There is a new high speed maglev rail link coming between Tokyo and Nagoya, which will be extended to Osaka. This will substantially cut journey times so one can easily travel from one to the other for a meeting. New infrastructure such as this, and the improvements made in Tokyo in advance of the Olympics, will generate opportunities for real estate investment.

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Q Are there opportunities across all sectors in these cities?

The range of opportunities depends on the type of capital you represent. For a value-add investor like BGO, the logistics sector is too expensive and so is residential, unless you use a lot of leverage. Residential is a great defensive sector for core capital, however. In our value-add space, where we are targeting anywhere from 18 to 20 percent levered IRR, we are still looking at large office buildings. These include B-plus or A-minus buildings that require an upgrade and new HVAC systems, building maintenance systems or other capex to raise rents.

We also like the hospitality sector. Japan saw a significant spike in visitor numbers prior to the pandemic and there is potential for that to recover and grow further. There is a huge amount to see and do in Japan and the transport infrastructure makes it easy and efficient to travel around the country.

Q The traditional career path of young professionals in Japan's major cities is undergoing radical change. What is different with this generation of young people, and how do you see this impacting future demand for real estate?

The traditional career path in a large Japanese corporate is like an escalator; once you are on, you can expect a steady improvement in earnings and status. In fact, you can almost work out your career progression and lifetime earnings from the moment you set foot on that escalator.

These days, however, a lot of younger Japanese look at that escalator and decide it is not enough for them. They see opportunities to get further and earn more, faster. There are more women in the workforce, but fewer opportunities further up the hierarchy so their escalator is even more limited. So there are now a lot of younger workers who decide to step off the escalator, because they know they need to do it before they are 40.

This means we have a burgeoning wave of entrepreneurs, new start-ups, smaller firms and different working cultures. This is great for Japan because it means growth and evolution, and for real estate it means increasing demand for different sorts of workspace, catering to smaller and more dynamic companies. When you couple this with growing openness towards foreign visitors and tourism with excellent and improving infrastructure, and the traditional resilience of Japan, I believe it creates a compelling picture for investors. ■