In Conversation with Ken Chan, Founder, CEO/CIO of PCG

AMA on Japan Real Estate

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PATIENCE CAPITAL GROUP

Q: Japan has garnered a lot of attention from investors globally in the last year or so, while recent real estate investor surveys have highlighted Japan as a key target market. Why is there so much interest in Japan real estate now?

Based on my experience, Japan has been a key market for many global real estate investors since early 2000s. There were three key catalytic changes that helped drive this. First was the opening-up of the real estate market to foreign investors in the late 1990s and the set-up of the TMK structure which facilitated institutional investment into the sector. Second was the launch of J-REITs in 2001, which enabled investors to access good quality property assets via the public markets. Third was the introduction of Abenomics from 2012, more specifically the third arrow targeting corporate reform. This led to stronger corporate governance, an increased focus on profitability, debt reduction and shareholder value, and eventually the disposal of non-core businesses and assets.

Back to the question of why now. Starting with the macro, our view is that Japan still has positive long-term fundamentals. For example, despite concerns about the rapidly ageing population, Japan is expected to remain a strong economic power over the next 20-30 years. It is the world's 3rd largest economy in 2022 and forecast to be 5th[1] largest by 2050. This means that a lot of production and consumption of goods and services still must happen, and these all need real estate to various degrees. Also borrowing costs in Japan are amongst the lowest globally for corporates and investors. Unlike most other countries, Japan has maintained its historic low policy interest rates over the last 12 months, and this is unlikely to change much in the next few years at least. Another key positive is that there are signs of more sustained inflation taking hold in Japan. This combined with favourable financing terms could attract more capital to invest in real estate in Japan given its inflation-hedging characteristics.

[1] Source: BMI Report 20 June 2023 - Megatrends To 2050: How Global Economic Rankings Will Change

Investors are generally also excited about the potential growth and opportunities arising from corporate reform and restructuring. More Japanese corporates are focused on improving capital efficiency due to growing pressures on improving shareholder value. For example, the Tokyo Exchange Group set new market restructuring rules in early 2023, including one that required listed companies which are trading below a price-to-book ratio of one to "comply or explain", or else they could face the prospect of delisting as early as 2026. Then there is the intergenerational succession occurring in both public and private companies. Newer generation leaders tend to be more receptive to restructuring and growth, including partnering with like-minded long-term investors. Media attention highlighting investment intentions from Warren Buffet and other big fund managers has also helped put the spotlight on Japan.

Specifically on the Japan real estate market, it is very deep and liquid. Japan is the world's 3rd largest professionally managed real estate market[2], while the JREIT market is the second largest globally after US. Japan is also very transparent[3] in terms of property market data quality and availability, disclosure requirements for listed vehicles, regulatory environment etc, and there are no legal restrictions on foreign ownership of real estate. Finally, Japan is one of the few markets globally that still offers attractive property yield spreads given its very low cost of capital. For example, Tokyo prime office yield spreads were around 150bp[4] versus negligible or negative spreads in other major global cities like London, New York, Paris, Singapore, Sydney, Shanghai, Hong Kong and Seoul.

On the other hand, the dominance of domestic real estate owners makes it challenging for foreign investors to buy prime assets, especially in the more traditional sectors. Hence, investing in Japan requires building strong long-term relationships with the local players. To do this well, you need a presence on the ground, good people skills and time to cultivate these networks. For foreign investors, given cultural and regulatory differences, a much longer period is likely required for establishing credibility. That's one of the key reasons why I set up PCG after working at GIC for close to 20 years. I saw the opportunities to continue investing in Japan real estate, and our team's networks and relationships would be an invaluable asset for our investors.

Q: What is your view on the different property sectors in Japan?

We are currently cautious about the office sector. First, with the global economic uncertainty and tech sector downturn, there is generally less demand for expansion space. Second, with the hybrid working trend likely to linger, some companies will downsize or re-configure their space. Third, the pipeline of new office space is quite high in the next few years. Already effective office rents in Tokyo and Osaka have been falling over the last year or so.

Retail conditions have been more positive with rents rising in the prime shopping streets, as supply is very constrained and they benefit directly from spending by the large number of local HNWI and tourists. Suburban malls face more uncertainty in terms of evolving retail formats especially with the sharp rise in online retailing due to the pandemic.

Japan's industrial sector has changed a lot in the last 20 years from traditional factory and warehousing to modern distribution and logistics fulfillment space. Prior to 2000s, many Japanese conglomerates used to run their own supply and distribution chains, while the quantity and quality of leasable space was limited. Subsequently, Japanese companies, in their efforts to focus on their core businesses and improve cost efficiency and flexibility, started to outsource their logistic functions to 3PL operators. This combined with the arrival of global logistics developers, helped to transform how industrial space was built and used in Japan. The rise in e-commerce further accelerated its growth. But while demand fundamentals are still healthy, cap rates for quality logistics facilities have fallen below 4% in Tokyo and Osaka as of 2Q 2023. With rising new supply, we would be selective with this sector overall.

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[2] Source: MSCI Real Estate Market Size Report July 2023
[3] Source: JLL Global Real Estate Transparency Index 2022
[4] Source: Savills – Taking Stock: Capital Markets Quarterly 1Q 2023

The residential sector has remained buoyant with interest from both individual and institutional buyers. First, demographic trends are driving housing demand in Japan, especially in the larger cities, given continued net in-migration in these cities and growing household numbers. Second, occupancies and rents have shown resilience, even through the pandemic. Third, as new house prices rise further and affordability falls, this will likely generate even more demand for rental housing.

For hospitality, the trajectory before COVID was impressive with foreign visitors rising by ~20% per year from 2012 to peak at 31.9mn in 2019. Since re-opening, inbound tourism has recovered quickly with around 15mn foreign visitors over January to August 2023, and the shortfall vs 2019 narrowing steadily every month. Despite the lagged recovery in China tourists, there has been strong growth from the rest of Asia, US and Europe. The rebound has also been reflected in hotel rates and occupancies, especially in Tokyo where top hotels charge US$1,000 and above per night due to strong demand. Assuming no exogenous shocks, we expect this demand uptrend to continue in view of the weak yen, and the government's 2023-25 plan to focus on higher spend per visitor and getting more travellers to visit the local regions. Given Japan's abundant natural resources and limited supply of luxury hotels, the hospitality sector is attractive to both operators and investors.

Q: Any specific opportunities to look out for?

I see ski resorts as a potential opportunity. Look at Niseko, which is one of Japan's most established ski resort areas. It has been highly successful in attracting tourists and investors, and even has more high-end hotel brands than most cities in Japan. There is also scope for growth in developing tourism beyond the winter season. We foresee similar potential in other parts of Japan. For example, Niigata which has significant snowfall and is just a 2-hour drive from Tokyo. In fact, we have acquired over 200 hectares of land in Myoko City in Niigata. Our aim is to work with the local government bodies, financial institutions and businesses to redevelop and reposition the area into a resort town, which can offer world class accommodation, amenities, and activities all year round, akin to Whistler in Canada. Based on our latest outreach, many global hotel brands have expressed keen interest in opening a hotel in our Myoko project.

Q: How is PCG looking at ESG?

Climate change is a key concern for companies and investors across all industries. For real estate, the impact is especially tangible when you think about the recent climate related disasters like floods, wildfires, rising sea levels etc. As the real estate sector is also the largest contributor to global warming, accounting for over a third of all greenhouse gas emissions, incorporating sustainability into the business is a must have and not a good to have.

In terms of property development, certain strategies can be applied such as using sustainable alternative building materials and construction methods to cut down on the carbon emissions. For example, alternatives to concrete include Fly Ash and Hempcrete. For energy use, alternatives to fossil fuels include solar, biomass and hydropower. With Japan having an abundance of hotspots and mountains, there is also much potential for thermal energy development.

And within PCG, we have an ESG committee, whose role is to spearhead ESG values, policies and initiatives for the company. At the deal level, ESG issues are raised and assessed during the investment analysis and decision-making processes.

Given Japan's SDG goals and pledge to be carbon neutral by 2050, ESG legislation and reporting standards are likely to tighten over time, while scrutiny by investors and regulators will increase. Hence, we expect pricing and rentals to show growing disparity in favour of ESG-orientated assets over the longer term.