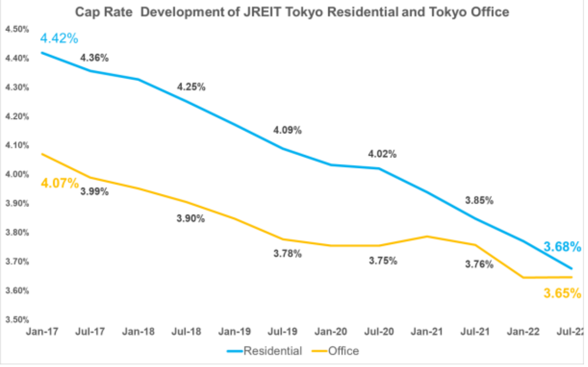
March 15, 2023

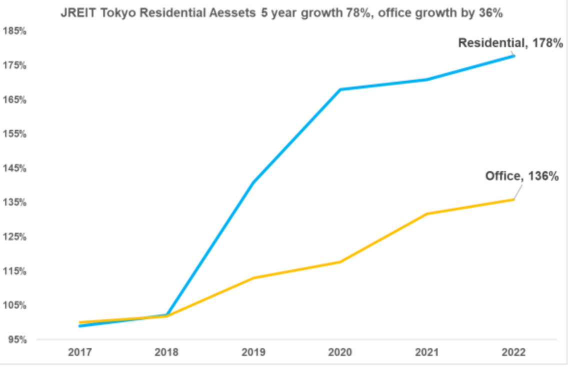
CEO Insight: The best time to enter Japan's residential real estate is coming to an end

The "window of opportunity" for investors in this market is still wide open. However, for a profitable harvest, they should sow soon.

Life punishes those who come late – this proverbial wisdom of reformer Mikhail Gorbachev (even if he said the sentence differently) certainly also applies to investments in Japanese residential real estate. Their yield advantage over the office sector has been steadily shrinking over the last few years. Slowly, a window of opportunity closes that was wide open for a long time: In the medium term, Japan investors will earn less from residential than from office, just as in other mature markets. Just six years ago, the positive yield spread of investments by listed J-REITs in the residential sector of the Tokyo metropolitan area was 35 basis points; in July 2022, it was only 3 basis points (more recent data are not available for all REITs).

The positive yield gap of residential over office shrinks with increasing investment volume





Many foreign investors have responded to the unmistakable ringing of this bell. Last year, they scaled up their investments in Japan by an impressive 12% to 1.3 trillion yen (9 billion euros). The J-REITs would also have liked to invest more but were unable to raise enough capital accordingly due to stagnating stock prices. As a result, the foreign share of the total sum grew to more than one-third. But since 2017, J-REITs had increased their investments in residential real estate by 78% overall, twice as much as in offices (see the right chart). As residential investment grew, the yield advantage over offices shrank.

Most foreign investors came from Asia. Apart from the French AXA, there were no major transactions in Japan by Europeans. German investors must therefore be careful not to miss the good times for entering this attractive market. It would be a repeat of their bad timing during the financial crisis of 2007/8 when German investors invested 65% of the total amount that flowed into Japan between 2002 and 2015 (460 billion yen, about 3.75 billion euros), although, during the same time, the investment volume in Japan already shrunk by half.

According to my observations, German investors are currently engaged in navel-gazing: They are looking around anxiously in Germany and Europe, and seeing rising interest rates, they do not move. They should notice the ideal environment for investing in residential real estate in Japan. The government is strong and stable. Inflation probably peaked in February. The cost of capital remains extremely low, as Japan's central bank is not driven by inflation data. And white-collar workers are returning to the office. According to surveys, the proportion of office workers in Japan has already reached over 90% of pre-pandemic levels. Vacancy rates in metropolitan areas are falling.

As a result, Japan continues to be the number one destination for real estate investors in Asia. With investment yields of 3.6%, borrowing rates of 1%, and conservative leverage of 50%, high returns can be achieved in Japan, while in Germany the increased cost of capital eats up returns. The Japanese market will remain attractive: The Bank of Japan's new governor, Kazuo Ueda, said in parliament that the ultra-loose monetary policy is "appropriate." Under his leadership, the central bank will not raise interest rates until wages also rise on a sustained basis. If that eventually happens, rents are likely to grow at a similar rate. A better investment opportunity in real estate than housing in Japan can hardly be seen at present.

Leonard Meyer zu Brickwedde

Dr. Leonard Meyer zu Brickwedde
President and CEO

Kensho Investment Corporation
Sanno Park Tower 3F
2-11-1 Nagata-cho,
Chiyoda-ku, Tokyo 100-6162

Tel: +81(0)3-6205-3039
contact@ken-sho-investment.com