TOKYO OFFICE MARKET - SUPPLY GROWTH WITH COLLAPSING DEMAND

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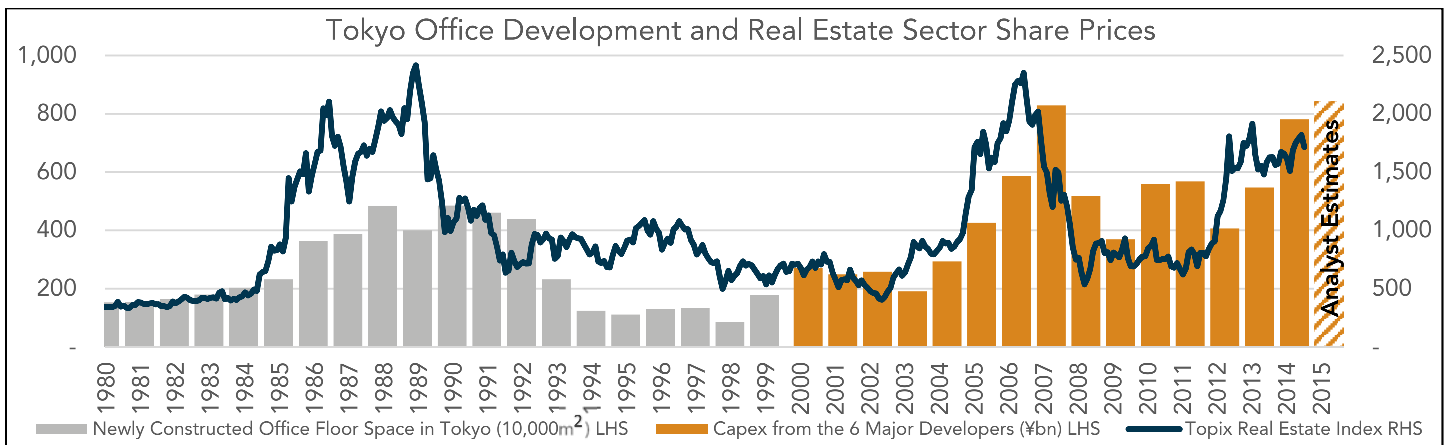
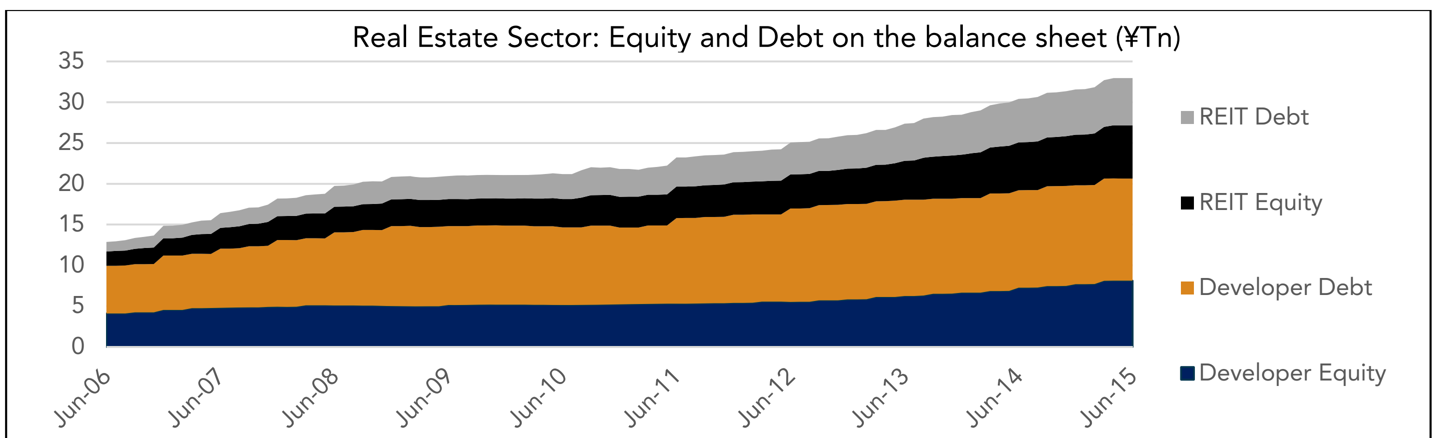
Market Views

"History shows that the initial real estate sector share price rally at the beginning of these office development bonanzas is followed by an opportunity to make significant returns shorting the sector".

The Japanese Real Estate sector embarked on huge Tokyo office development campaigns the late 1980's and mid/late 2000's. As the larger players upgrade their keiretsu fiefdoms with prestigious new blocks, the smaller players follow to avoid the indignity of being left behind. These periods coincide with significant debt expansion fuelled by ultra-accommodative monetary policy as well as relaxed planning policy incentivising the building of larger blocks in an attempt to stimulate short term economic activity. All of these conditions are in place again today. History shows that the initial real estate sector share price rally at the beginning of a Tokyo office development bonanza is followed by an opportunity to make significant returns shorting the sector. As the new supply of office space leads to deteriorating supply/demand balance, falling occupancy rates, falling rental rates against higher depreciation costs. The latest supply expansion phase will now also face structural demand decline as the working age population of Tokyo declines. The following chart shows major developer capex (available from 2000) and office floor space addition (1980-1999) against the real estate sector index price movements.

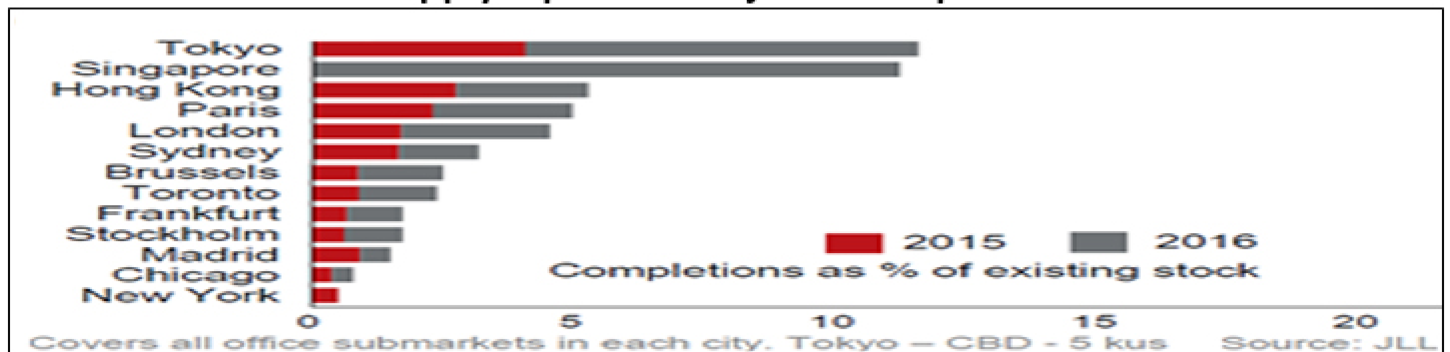


Real estate developers tend to be highly leveraged with large office portfolios, the six largest developers sport an average debt to equity ratio of 222%. REITS, which tend to be managed by these developers, have further added substantial debt and equity raising. One could argue that the equity financing was assisted by the Bank of Japan directly purchasing REIT units.

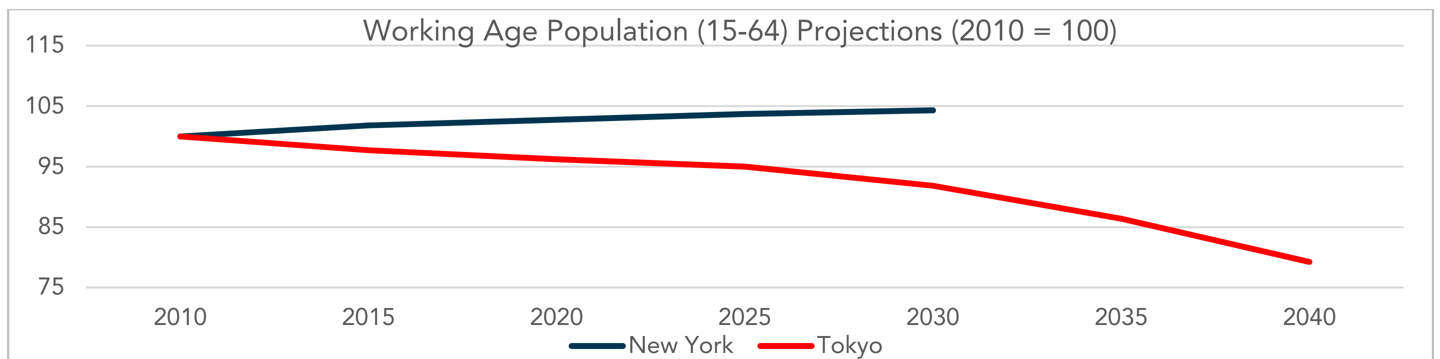


Much of this capital is being directed into the construction of office buildings in Tokyo. The chart below shows Jones Lang Lassalle forecasts that Tokyo will see larger expansion of office supply than any other major developed city in the world. Sanko Estate and Mori Building expect even greater supply expansion (link: [Slew Of New Office Buildings Coming]). The initial expansion in the Marunouchi and Nihonbashi fiefdoms of Mitsubishi and Mitsui are being followed by the expansions of Roppongi (Sumitomo), Shibuya (Tokyu), Tornomon (Mori) and Shinagawa (JR East) areas of Tokyo. Shingawa on its own will see new supply of largely commercial property, on currently unused railyard/waterworks, equivalent to half the size of Central Park NYC. The Appendix provides background on government policy encouraging development and historical context behind keiretsu competition.

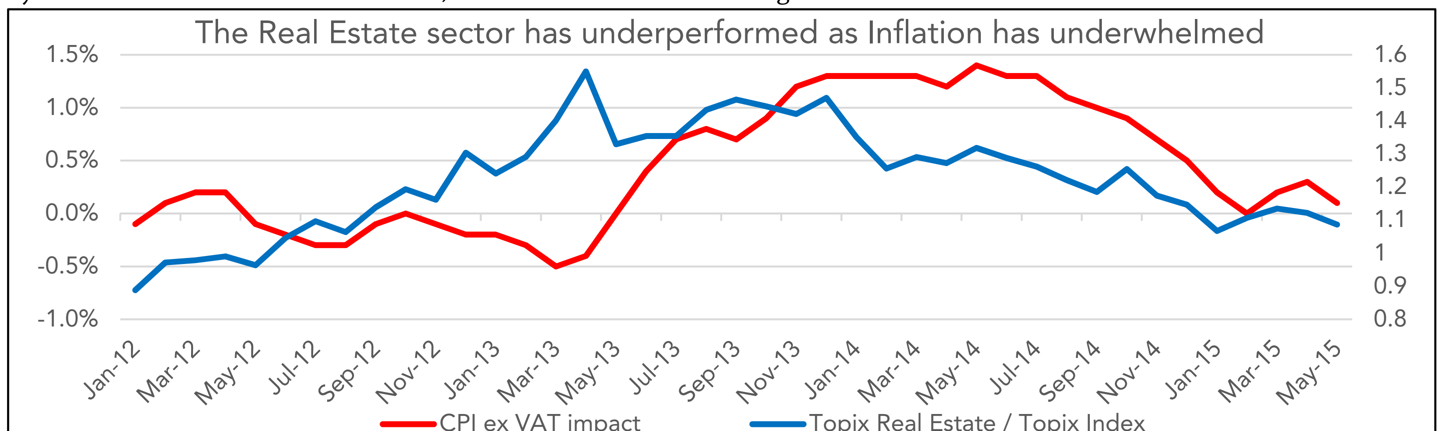
Office Supply Pipeline - Major Developed Markets



This tremendous expansion of supply is coming on whilst Tokyo's working age population has already begun to decline. The working age population in 2040 will be 19% lower than it is today, this would be the midpoint of a 50 year investment horizon for a new office block. It is difficult to see how current returns can be sustained on the existing office property stock, let alone on an expanded supply of buildings. For contrast, New York City will see far more favourable supply/demand trends. The above graph shows NYC is currently adding next to no supply, whilst as you can see below NYC will see far greater demand growth from a rising working age population. Tokyo currently has a slightly higher rental rate per square foot of office space in USD terms than NYC (Source: JLL). I struggle to see how that can remain the case. What is most interesting is what you have to pay to invest in these rental earning streams and underlying assets. The three largest listed owners of Tokyo Office property trade on an average of 39x P/E and 2.47x P/B, a weighty premium to the three largest listed owners of NYC Office property on 32x P/E and 2.14x P/B.



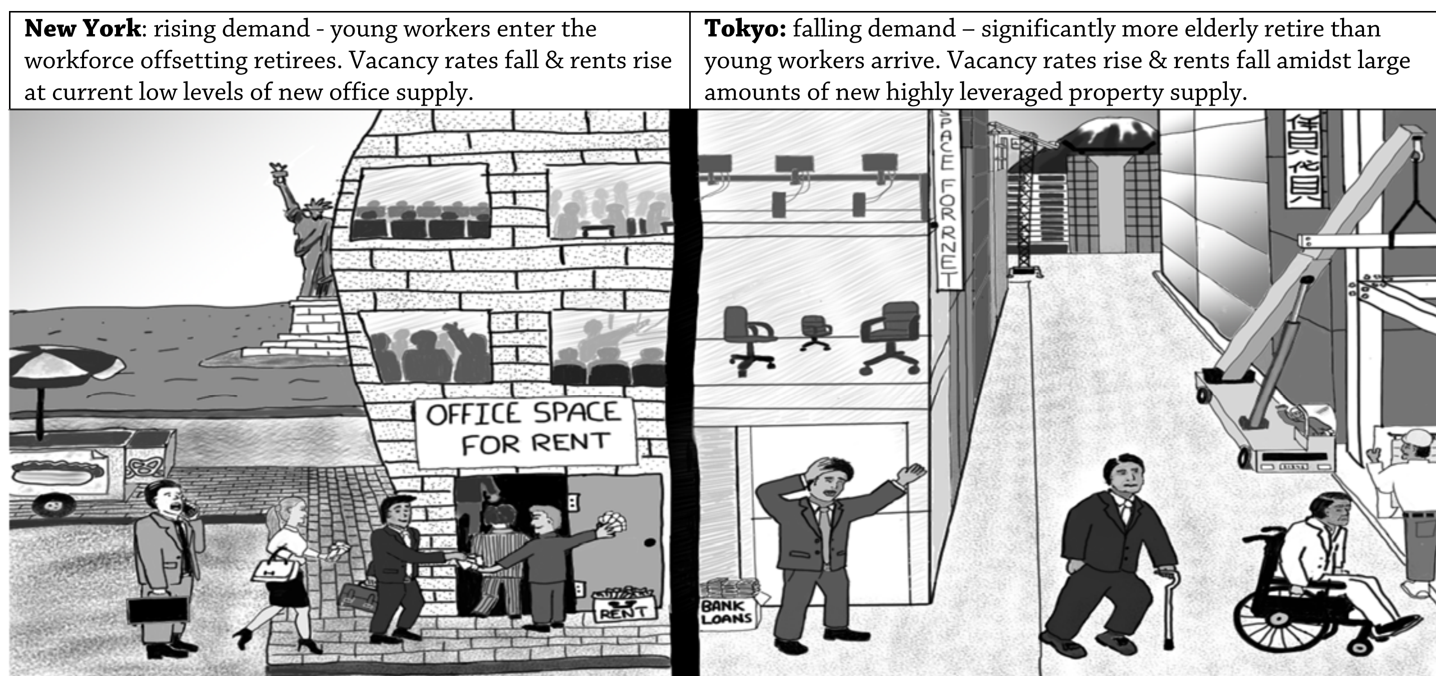
Why are Japanese real estate stocks so expensive? As holders of "real assets", they were a key focus for the "reflation" trade as investors began to anticipate Prime Minister Abe achieving his 2% inflation target. Real estate stocks saw a particularly large inflow from foreign investors and the sector tripled in value (outperforming the Topix Index by 93%) from Jan 2012 until 12 April 2013. Since the beginning of QQE implementation in April 2013 the real estate sector has fallen 8% and underperformed the Topix Index by 35%. As inflation has underwhelmed, Abenomics failed to hit its target and CPI returned to near zero.



It seems foreign investors continue to believe in the "reflation" trade, adding positions as the stocks fell. Foreign investors are now the largest holders of the major developers as domestics investors have been sellers. I am not sure what foreign investors are anticipating, my own recent trip to regional Japan confirmed in my mind that deflationary pressures are stronger than ever, particularly in respect to land prices. 13% of houses in Japan are currently unoccupied, a number which is forecast to rise to 33% by 2032 (link: Abandoned Homes Haunt Japanese Neighborhoods), implying a significant increase in land supply on its way. The government is encouraging companies to move their offices from Tokyo to abandoned lots in regional areas (see Appendix). I certainly saw a lot of abandoned land. My trip report, with photos, highlighting my observations on how demographic decline manifests itself in the economy is available on request. Regional Japan's experience with depopulation is a harbinger of what is to come for Tokyo as its working age population also starts to decline. I wonder if there is something to be read into domestic investors, who see the manifestations of depopulation in regional Japan, selling out to foreign investors that often only travel to Tokyo, if that.

Sell-side analysts have 29 buy recommendations on the largest two listed developers on with only 1 fundamentally based sell recommendation. Their research tends to flag that the tearing down of smaller buildings to create larger office blocks is creating a better environment in the near term for landlords, without highlighting the long term structural oversupply issues this will create. Their models are often built on optically low "net supply" numbers, which remove the floor space of smaller buildings (already disclosed) without adding the newer large development's floor space (disclosed at a later date). Most analysts also assume demand will grow at the same historical rates. Unfortunately Tokyo will see hundreds of thousands of workers hitting retirement age over the next five years, almost equivalent to the number of workers in the Marunouchi CBD, with far less new entrants arriving into the workforce. There are already twice as many people over the age of 65 than people under 15 in Tokyo, a ratio set to rise rapidly. The following is the image in my mind of the most common landlord/tenant interactions to come in NYC and Tokyo.

New York: rising demand - young workers enter the workforce offsetting retirees. Vacancy rates fall & rents rise at current low levels of new office supply.	**Tokyo:** falling demand – significantly more elderly retire than young workers arrive. Vacancy rates rise & rents fall amidst large amounts of new highly leveraged property supply.



It does seem that the market is beginning to price in the structural issues as the real estate sector continues to underperform. High valuations, record foreign ownership and analyst bullishness would indicate there are still significant absolute returns to be made shorting both developers and REITS. I remain bearish on Japan and can see a number of other sectors presenting similarly high valuations with deteriorating fundamentals as levels of over-supply increase into structural demographic demand decline.

Appendix (Sector Background).

Pro office development planning and approval policies have a history of back firing.

The government has a history of enacting micro-economic policy to encourage office construction activity. Such as:

- 1986 Urban Renaissance Policy: Prime Minister Nakasone orders local governments to *"Carry Out Urban redevelopment by, relaxing regulations, increasing the ratio of building volume to lot size, changing residential areas to commercial uses and eliminate the duty of developers to obtain consent of the people living in the area"* (Link: The Impact of Minkatsu Policy 1991).
- 2002 Urban Renaissance Law: *"Enables companies to propose urban redevelopment plans. The relevant local authorities have six months to approve or refuse the plans and, in the case of a refusal, must provide a detailed justification for their decision. Approval*

opens up a number of advantages: tax credits, preferential interest rates and a relaxation of planning constraints" (*Link:* The burst bubble and the privatisation of planning in Tokyo).

Both of these periods coincided with aggressive expansion of office construction, followed by rising vacancy rates, falling rents and real estate sector stock prices eventually falling more than 75% from peak to trough. These declines both occurred whilst Tokyo's working age population was still growing. It appears that despite the new demographic decline pressures the government is pushing for another office construction bonanza.

- 2013-14 Tokyo Special Economic Zone: "*The Tokyo metropolitan government has recently announced plans for six new re-development zones in Tokyo which will be the beneficiaries of construction-related de-regulation. By relaxing the Floor–Area-Ratio (ie, increasing the maximum allowable FAR), the government is essentially making it more economical for developers to build taller buildings because of the declining incremental cost of adding additional floors to a building" (realestate.co.jp)*. It will also *"accelerated urban planning decisions"* and provide *"Exemptions to the City Planning Act"*. The plans are endorsed by Abe's 2013-14 Japan Revitalization Strategy aiming to *"promote large-scale private sector urban development projects"*. As well as the Governor of Tokyo who announced plans at a speech in London to *"draw out the potential of the private sector to the maximum. One example is a redevelopment project in Tokyo's Toranomon area. With the easing of regulations in the introduction of a system for the vertical use of road space"*. The example used was the recently completed Toranomon Hills Tower, Tokyo's second-tallest building complex. *"Mori Building has said it is planning to complete (another) ¥1 trillion in projects in districts around Toranomon over the next 10 years"*. This project is to *"presaging a series of development projects ahead of the 2020 Olympic Games."* (Link: Toranomon Hills opens Olympic blitz). Toranomon is just one of the areas seeing massive redevelopment. Maps aggregating the large number of redevelopment plans around Tokyo Station, Toranomon, Shibuya, Shinbashi and Shinagawa are available on request. Tokyo may look great for the two weeks of the Olympics but this accounts for less than 0.08% of the time in a fifty year investment horizon.

Abenomics to now incentivise companies to move their Head Quarter offices out of Tokyo

Whilst incentivising construction activity in Tokyo on one hand, the Abe government is also debating a Regional Revitalisation policy designed to encourage companies to migrate offices and employees away from Tokyo into regional areas with increasing amounts of vacant land. This is not a completely unrealistic target given Tokyo actually experienced net outward migration from 1967 to 1996, partly driven by government policy. Improvements in communication and transportation increasingly make cheaper office space in other areas a realistic option. New policy plans being discussed include;

- Direct financial incentives for companies to move their head offices outside of Tokyo, including capex tax breaks.
- Direct financial incentives for companies to move their employees outside of Tokyo, including an added tax break for each employee moved from Tokyo to a designated regional town/city. (Link: Tokyo Based Companies To Get Tax Breaks For Relocating)
- Limits on enrolment at private universities in Tokyo. (Source: 22 February 2015, Mainichi Shimbun)

Real Estate companies have a history of over-competing rather than targeting long term shareholder returns

The keiretsu aligned developers have once again embraced the opportunity to over-compete and use the cheap money, relaxed planning controls and incentives to build. Choosing to target prestigious new developments rather than sweat existing assets for long term shareholder returns. As with the expansions in the 1980's and in the 2000's, this round of development has again been led off by Mitsubishi Estate upgrading its Marunouchi CBD fiefdom. Much of Marunouchi was acquired by the Mitsubishi Keiretsu after the Meiji Restoration and the area has at times been known as "Mitsubishi Fields". For a long time it has been considered the most prestigious office space. Mitsubishi Estate's "*sheer economic weight means that public and private players follow in its wake"*. The wave of construction that follows from other players can be seen as *" The key defect of the urban renaissance law, which resulted in all the major real-estate development firms renovating their respective "fiefdoms" (Mitsubishi in Marunouchi, Mitsui in Nihonbashi, Tokyû in Shibuya), leading to competition between the various renovated centres. This competition has generated an oversupply of office space that the market cannot absorb"*. *(*Link: The burst bubble and the privatisation of planning in Tokyo). There is a long history of keiretsu developers vying for prestige, some suggest that the extraordinary reclamation of 250 square kilometres of land in Tokyo Bay from the 1950's was a result of "Mitsui Real Estate launching an ambitious program of reclaiming land, partly to compete with Mitsubishi Real Estate". (Mitsui: Three Centuries of Japanese Business. J Roberts). Many smaller developers went bankrupted in their efforts to keep up with their reclamation projects. This time around there are also new large non-traditional real estate players seeking to augment their earnings, by developing land. Such as Japan Railway East adding its enormous Shinagawa railway yard/waterworks development (half the size of Central Park NYC) and Nippon Telegraph and Telephone (via its consolidated development arm NTT Urban) redeveloping near Shinbashi Station. Of course all of the traditional major keiretsu developers have substantial expansion plans not wanting their fiefdoms to be left behind.

The most critical difference this time is that previous development booms were eventually saved by the population growing into the new supply of property at a later stage .... from now on in, all existing and new buildings will be fighting for structurally falling demand as the working age population falls at an accelerating rate.

INFORMATION

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