Japan Lesson: Real Estate

Recording new profit highs as business models change

Equities

Japan
Real Estate

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Lesson: the revival in the aftermath of the bubble economy

In Japan, the 15 years or so from the beginning of the 1990s were marked by bad debt disposals by the country's financial institutions (we discuss this in Japan Lesson: Banks). Real estate was one of the main reasons for this bad debt, and during this period the major developers also had to dispose of heavy losses on their property holdings, as a result of which their balance sheets deteriorated. However, these loss disposals peaked in the early 2000s; since then their business models have changed, and this has allowed them to achieve new record profit highs recently.

The separation of development and ownership

The JREIT market launched in September 2001 with total market cap of approximately ¥260bn, and has since grown to about ¥12trn. This market has provided a new business model for Japan's real estate companies, which is to develop property based on the assumption that it can be sold to JREITs and private funds, and to earn fees from asset and property management, thus realizing leverage and profit growth at the same time.

Demand concentrates on Tokyo

Since the middle of the 1990s, Japan's population has consistently shifted from the regional cities to the major metropolises and Tokyo in particular. This trend is likely to continue going forward. The real estate companies are seeing stiff competition in the capital, where demand is concentrating, and backed by strong fund procurement capabilities, brand strength and effective marketing the major developers are expanding their market shares. They should see further quantitative growth over the near term as they strengthen their positions further.

The real estate companies' growth strategies when the population turns down

Even in Tokyo, however, the population is likely to peak in 2020, and from 2030 the number of households is likely to turn down. It could then become difficult to expand existing operations quantitatively. In order to grow, the developers will need to earn profit not only from property leasing and development but also from real estate-related services and operations. However, the major firms could aim for business growth in overseas markets. Mitsui Fudosan (8801), Sumitomo Realty & Development (8830), Mitsubishi Estate (8802) and NTT Urban Development (8933) all look very undemanding on our estimates.

Key points: Japan Lesson: Real Estate

Q: What has happened to Japan's real estate sector over the past 20 years from a macroeconomic point of view, and what is the outlook?

The population decline and the bursting of the bubble economy have led to deflationary sentiment in Japan, prompting households and firms to accumulate large amounts of cash. Cash and deposits are expanding at a rate of ¥20trn-30trn every year, and this is a key source of future growth. If this deflationary sentiment changes going forward, the real estate industry could be invigorated. We see ample prospect that the core CPI will recover to around +0.5%, and if this deflation ends, the real estate sector should benefit. However, uniform economic growth can hardly be expected amid the decline in the population, so there could be some polarization in this growth. Meanwhile, Japanese companies are becoming more capable of generating profits from overseas markets, so their huge cash and deposit piles are likely to be used more in overseas business development.

Q: How have the major real estate companies' business models changed in the post-bubble period?

Japan's major developers continued to record losses on their investments during the bubble period in the 1980s through the early 2000s. After that, they ceased to hold all their development projects on their balance sheets, but changed their business models to developing properties on the assumption that they could sell them to the JREITs in particular, and they grew their profit as the JREITs expanded their property portfolios. With the recovery in real estate prices since 2004 and then again in 2012, they have been taking their profits to new highs.

Q: How has the change in the demographic trend over the past 20 years affected the real estate market?

Japan's population will probably continue to concentrate around Tokyo. In many regional cities, economic activity is likely to slow alongside population outflows, and as a result, job opportunities can be expected to decline, leading to a further structural shift in the population. Demand for real estate is also likely to concentrate in Tokyo, which would mean heavier supply and stiffer competition in the capital. The major developers, which are well placed in terms of their fund raising capabilities, brand strength, and marketing, should still have room for further business expansion by growing their market share in the near term.

Q: Where will the real estate sector seek growth once the population turns down?

Even in Tokyo, however, the population is likely to peak sooner or later. Once the population turns down there will be less opportunity for the quantitative expansion of existing businesses. The real estate companies should be able to expand their earnings by widening the types of property that they handle, from offices and residential buildings to logistics facilities, or by increasing their income from services and operations, as well as from property leasing and development, but there could be limitations to growing in this way amid a declining population. It is uncertain how much additional value they can continue to generate just by controlling risk, but the major developers could aim for business growth in overseas markets. Mitsui Fudosan (8801), Sumitomo Realty & Development (8830), Mitsubishi Estate (8802), and NTT Urban Development (8933) all look highly undemanding on our estimates.

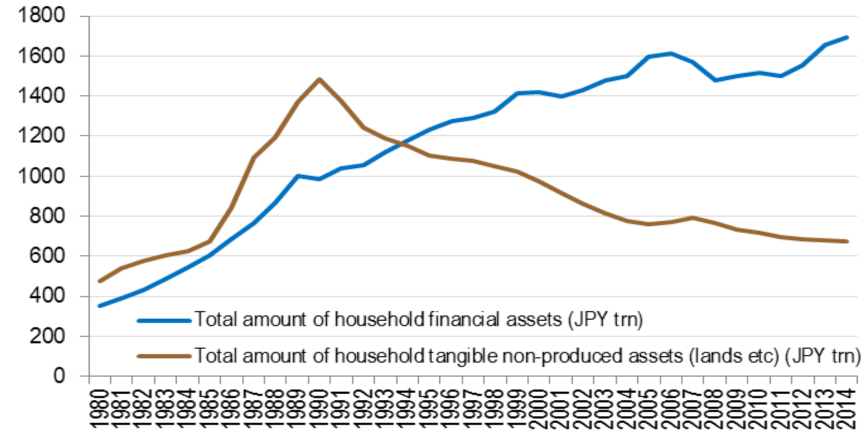
Q: What has happened to Japan's real estate sector over the past 20 years from a macroeconomic point of view, and what is the outlook?

Deflationary sentiment has prompted households and companies to accumulate large amounts of cash

Increasing inclination to holding cash amid deflationary sentiment

Population decline does not necessarily result in low economic growth. Over the past 20 years, however, having a smaller population amid excessive facilities and a lack of innovation has resulted in dull economic growth and prompted deflationary sentiment. The amount of cash and deposits held by households almost matched the value of tangible non-producing assets (such as land) through the middle of 1980, but it then started to diverge as land prices advanced during the bubble period. The gap narrowed after the bursting of the bubble through around 1994, but since then, cash and deposits have continued to increase, while the value of tangible assets has consistently shrunk. If the general view is that economic growth will remain weak and that Japan will continue to see deflation, many people will think it wiser to hold cash and deposits than invest in real estate or other such assets, and this sentiment has led to even weaker growth and exacerbated the deflationary shift. At present, a substantial amount of cash and deposits is owned by both households, at ¥910trn, and by companies (non-financials), at ¥252trn.

Figure 1: Household financial assets and tangible non-producing assets



Source: Cabinet Office, UBS

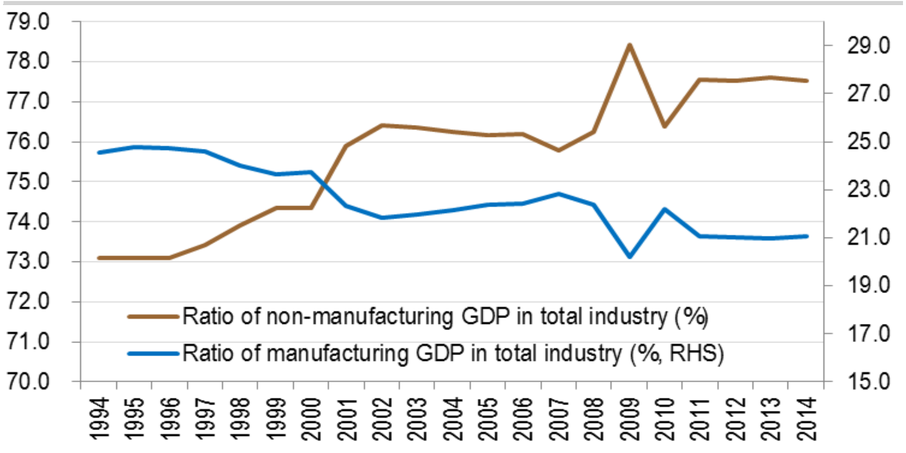
If this deflationary sentiment changes the real estate industry could be invigorated. Partly due to earnings generated from foreign assets and the effects of monetary easing, cash and deposits held by households and companies has expanded by ¥20trn-30trn every year (5-6% of the GDP) since 2010, which is underpinning growth. The core CPI recently dropped to -0.5% due to temporary impact from the strong yen, but our economic forecast factors in ample opportunity for a recovery to around +0.5%. Only if deflation ends will real estate prices benefit, in our view.

Polarisation in economic growth amid a shrinking population

Once the population turns down, uniform economic growth can no longer be expected. What is important here is which industries and regions can grow and drive prices higher. Japan's population is shifting to the Kanto region, and Tokyo in particular. In regions where the population is declining, there will be room for price rises only where tourism is expanding or where industry concentrates most heavily. Also, structural changes in consumption, such as increased active senior consumption and the shift from goods (the value of ownership) to services (the value of experience), will lead to disparities in growth and higher prices. Business formats that stimulate spending among older consumers, such as a combination of retail and service facilities and medical/nursing care facilities, or that can support higher labour participation among female workers, such as childcare facilities and good access to transportation links should drive additional value. Company investment is changing as well, from spending to expand export volumes to investment to address labour shortages and for R&D. Some regions and industries could grow strongly alongside greater urbanization and structural changes in consumption and investment, while others might continue to see negative growth. For the real estate industry, too, a polarized structure of winners and losers could emerge.

The consumption trend demonstrates the polarisation that is taking place in economic growth

Figure 2: Changes in ratios of manufacturing and non-manufacturing industries in nominal GDP



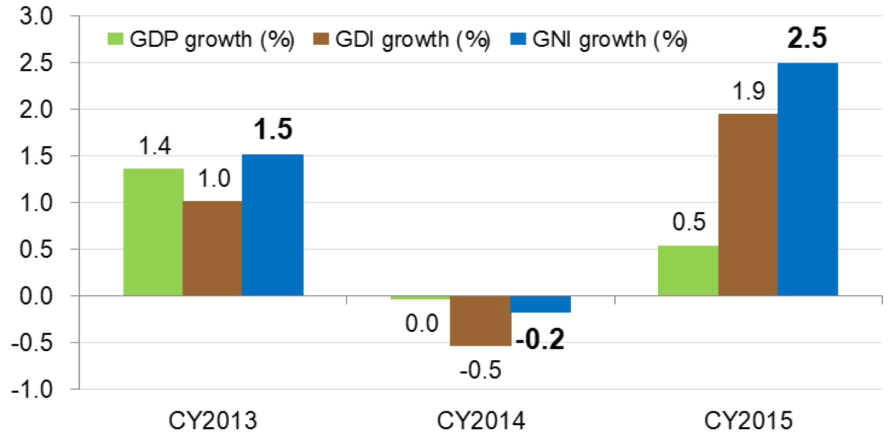
Source: Cabinet Office, UBS

What the Japanese economy is really capable of in terms of gross national income

Another feature of the economic growth seem in recent years is that Japan's gross domestic income (GDI) and gross national income (GNI) are growing at a faster pace than GDP. In 2013-2015, GDP growth averaged only 0.6%, while real GNI growth was more than twice as fast, at 1.3%. Japanese companies are likely to generate a bigger proportion of their profits overseas going forward alongside population growth in many overseas markets and the expansion of the middle income class in Asia.

Japanese companies are generating more and more profit from overseas markets

Figure 3: GDP,GDI,GNI growth (2013-2015)



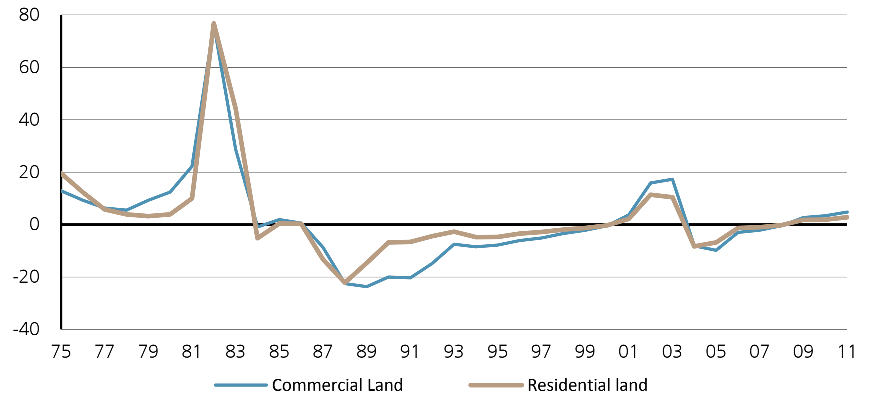
Source: Cabinet Office, UBS

Q: How have the major real estate companies' business models changed in the post-bubble period?

Loss disposals in the post-bubble period peaked in FY00-FY03

The 15 years or so from the start of the 1990s through the middle of the 2000s was marked by bad debt disposals at Japan's financial institutions (we discuss this in detail in 'Japan Lesson: Banks'). The substantial bad debt that the financial institutions built up stemmed from sharp falls in land prices, which soared during the bubble period in the 1980s, as a result of the hard landing that came with the total volume controls introduced in March 1990. Clearly, as land prices fell, the balance sheets of Japan's real estate companies, which borrow money by collaterising land to support their operations, deteriorated. Lower land prices led to excess debt at some real estate companies and bankruptcies. Even the major developers, which are competitive in terms of their cash capabilities and carried large unrealised gains because of the low book values on their land holdings, continued to record heavy losses through the early 2000s. It was in FY00-FY03, when land prices started to show signs of hitting bottom, that the major developers' loss disposals peaked out.

Figure 4: Official land prices: yoy % change in Tokyo's 23 wards



Source: Ministry of Land, Infrastructure and Transport

The major developers' business models changed as JREIT market launched

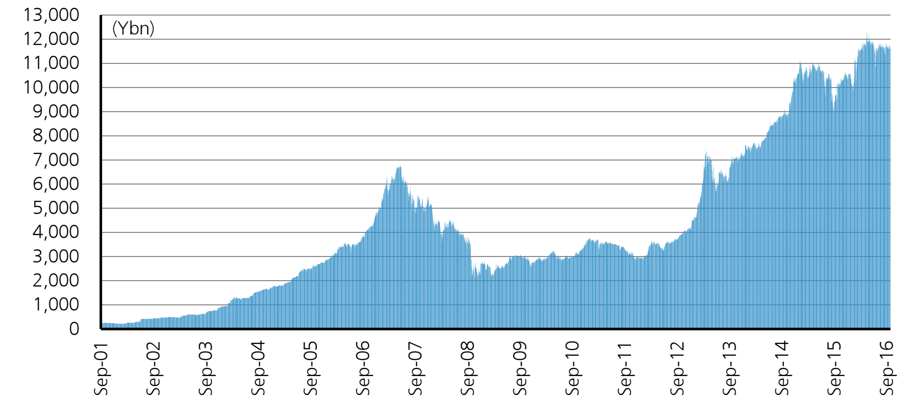
Just as the major developers' loss disposals started peaking, an important change took place in Japan's real estate industry: the launch of the JREIT market, in September 2001. This was initially a small market, with only two JREITs with market cap of approximately ¥260bn but it brought considerable subsequent change to the major developers' operations. Until then, their business model was to develop real estate, in principle through their balance sheets (sometimes via unconsolidated subsidiaries and special purpose companies, but as the parent companies have ultimate responsibility for their liabilities even they are effectively 'on balance sheet'), and to continue to hold them except to turn over condos or other assets every two or three years. Under this business model, it is necessary to constantly invest in new real estate in order to expand profit, but boosting spending too rapidly in this way leads to higher debt, and in turn sharp balance sheet deterioration. Accordingly, quite slow profit growth, depending on the real estate market cycle, has to be accepted. However, the start of the JREIT market changed things. By becoming JREIT sponsors (=originators), the developers started to contribute to their external growth. In other words, by having investors who purchase real estate ensures that there is a secure outlet for the properties that they develop. As the JREITs aim for higher equity liquidity through external growth

and the expansion of their property portfolios, their selling prices can fluctuate alongside changes in the market, but they sell property to the JREITs that they sponsor. Even after the property is sold, they generate asset management fees related to the management of the JREIT's asset, and property management fees from property maintenance and management. In this way, it has become possible for the major developers to expand their profit alongside growth in the JREITs' property portfolios without inflating their own balance sheets. In addition to this business model change, the recovery in real estate prices seen after 2004 and 2012 has enabled the three major developers to more than double their OP over the past 15 years and to achieve new record profits recently.

The JREIT market has grown to almost as the size of the developers' total market cap

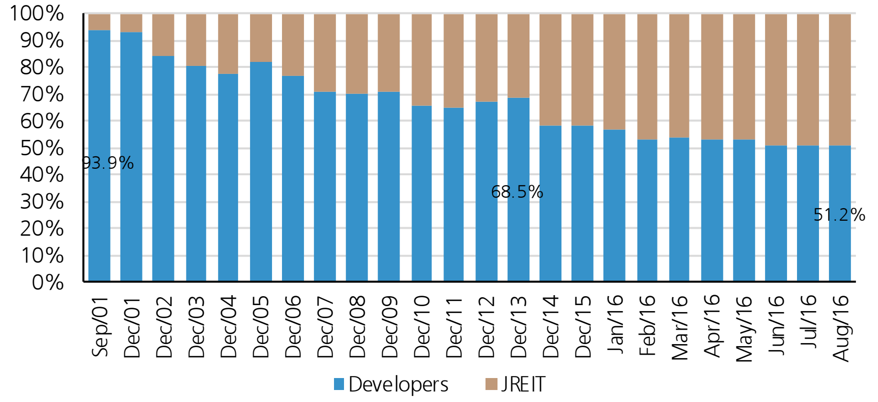
The JREIT market has expanded sharply, from about ¥260bn at the start to around ¥12trn recently, growth of more than 45-fold, making it almost as big as the TOPIX real estate index, which includes the major developers. For the past several years, funds flowing in from the capital market have shifted from the developers to the JREITs. The combined market cap of Japan's listed real estate securities including the developers and JREITs has hardly changed over the past three years or so, at around ¥25trn, but the developers' share of total market cap fell by nearly 20pts in the three years and a half years from December 2013 to August 2016, from 68.5% to 51.2%. The developers are building a business model that enables them to coexist and co-prosper with the JREITs. However, the developers' current valuations, which look very undemanding, suggest the market is not particularly satisfied with the business policies that the developers are pursuing. If they do not increase their dividends, buy back stock or take other steps to address their low share prices, there is a risk that their existence as listed real estate stocks could become less meaningful.

Figure 5: Historical market cap for the JREITs



Source: Datastream

Figure 6: Market cap share of the developers & JREITs within listed real estate securities (%)



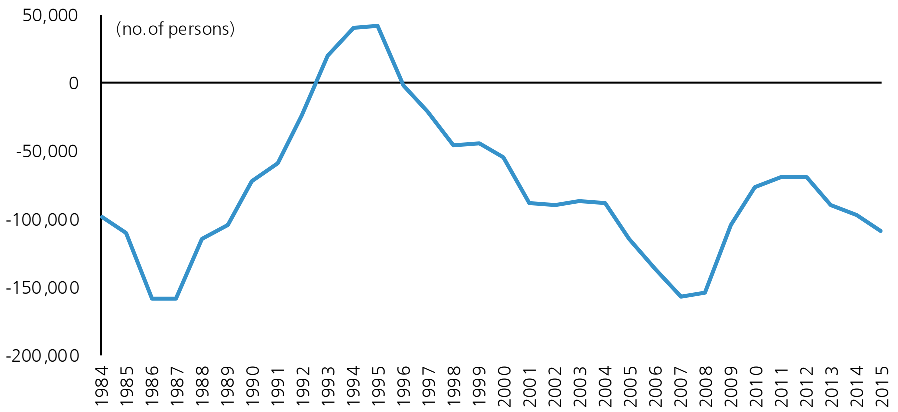
Source: Tokyo Stock Exchange, Datastream

Q: How has the change in Japan's demographic trend affected the real estate market over the past 20 years?

Over the past 20 years, since the middle of the 1990s, Japan's population has consistently shifted from the regional cities to the country's three big metropolises. The pace of this population shift slowed somewhat for several years after the 2008 financial crisis but has accelerated again recently. There has been a clear move out of the regional cities into the three big metropolises, but migration into greater Tokyo has been particularly pronounced. In the Nagoya region, population inflows and outflows have been fairly well balanced, while in the Osaka region, the trend shows a slight net outflow. The population shift to the Tokyo metropolis concentrates heavily on Tokyo itself. This has taken place from the mid-1990s to date. In Japan's regional cities, economic activity has dwindled alongside greater population outflows, and as a result, job opportunities have decreased, leading to structural and further population shrinkage. This is a trend that is likely to continue in Japan.

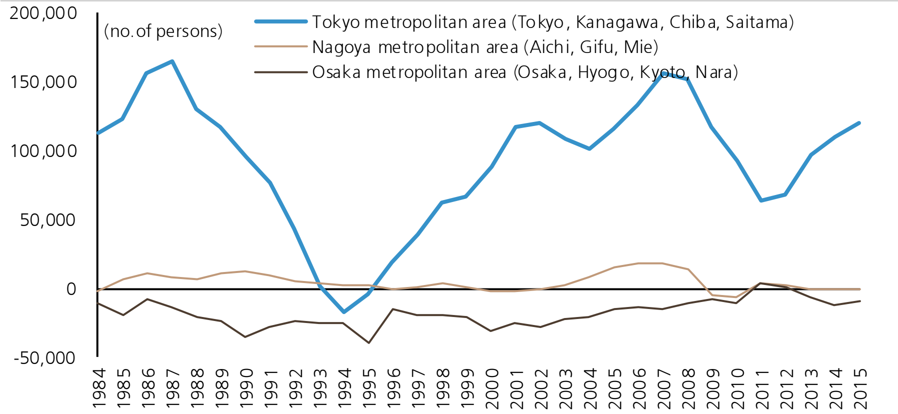
Japan's population has shifted rapidly from the regional cities to Tokyo over the past 20 years

Figure 7: Net population inflows into Japan's local regions



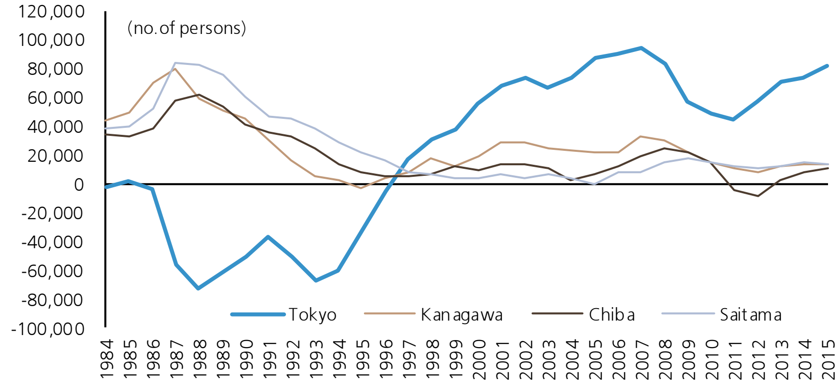
Source: Ministry of Internal Affairs and Communications

Figure 8: Net population inflow into the three metropolitan regions



Source: Ministry of Internal Affairs and Communications

Figure 9: Regional breakdown of the net population inflow into the Tokyo metropolitan area

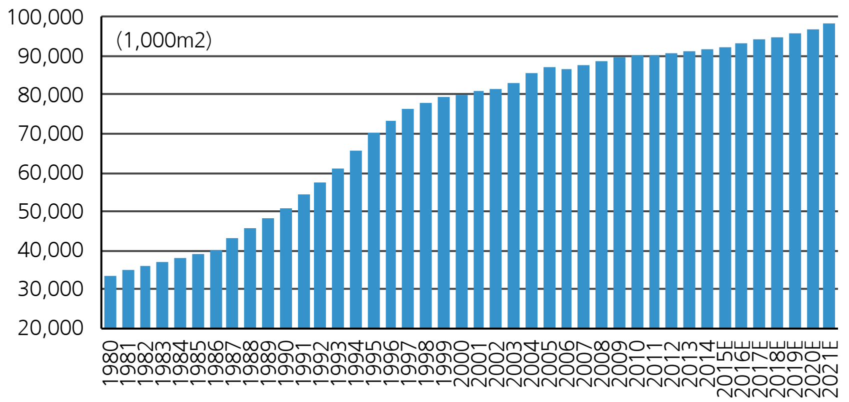


Source: Ministry of Internal Affairs and Communications

As a result of this heavy concentration of people in Tokyo, business opportunities are increasing in the capital and demand for real estate is also concentrating around the city. As of 1 January 2014, 29% of total nationwide office and shop floor space, or 251.17m square metres of a total of 876.46m square metres, was located in the Tokyo metropolis. Meanwhile, 55% of the new condominiums supplied in Japan in 2014, or 46,063 out of a total of 83,205 units, were in the Tokyo metropolis. On the other hand, this concentration of demand has also brought an increasing number of players into the market and stiffer competition. Under these conditions the major developers, which are well placed in terms of their fund raising capabilities, brand strength, and marketing expertise, are expanding their market shares. Even if the population in Tokyo peaks out sooner or later, the major developers should still have room to expand their businesses quantitatively in the near term.

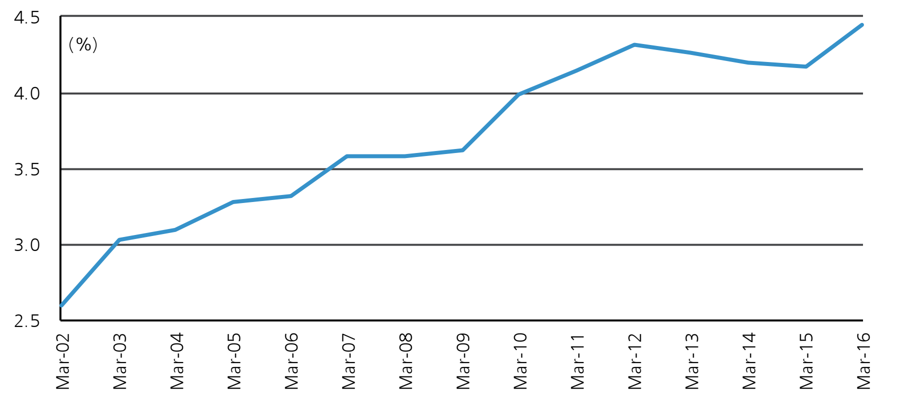
As demand concentrates in and around Tokyo, competition will increase

Figure 10: Office stock in Tokyo's 23 wards



Source: Tokyo Metropolitan Government, UBS estimates

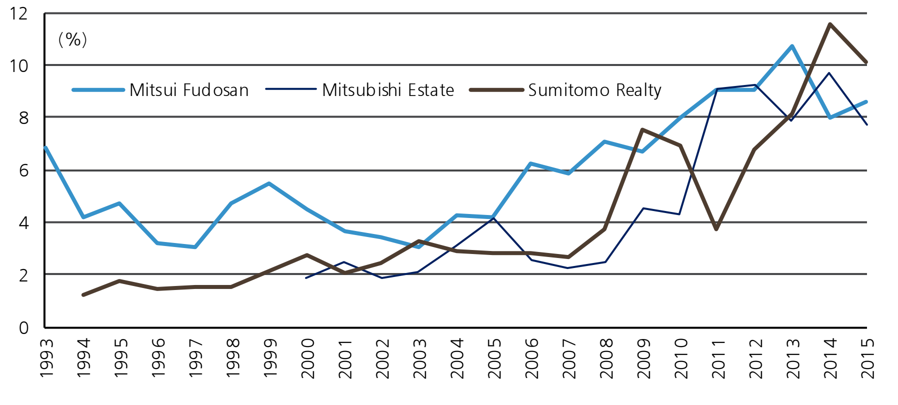
Figure 11: Share of Sumitomo R&D's rental office floor space in Tokyo's 23 wards



Source: based on data from the company and Tokyo Metropolitan Government

The major developers, which are well placed in terms of their fund raising capabilities, brand strength, and marketing expertise, are expanding their market shares

Figure 12: The major developers' share of condominium sales in the Tokyo metropolitan area



Source: Real Estate Economic Institute, Mitsui Fudosan "Japanese Real Estate Statistics"

Q: Where will Japan's real estate sector seek growth once the population turns down?

The population of Tokyo is likely to peak out in 2020 and the number of households top out in 2030

Japan's total population peaked at approximately 128m in 2008 and has since been declining at a slow pace. However, Tokyo's population is still growing due to the population shift from the regional cities, and this is enabling the major developers to achieve further quantitative growth in their businesses in Tokyo, centring on office redevelopment. Even in Tokyo, however, the population is likely to peak sooner or later. According to estimates drawn up by the Tokyo metropolitan government and announced in March 2012, the population in Tokyo is likely to peak at 13.35m in 2020 and then turn down moderately. Also, according to another forecast by the Tokyo metropolitan government released in March 2014, the number of households in Tokyo is likely to peak at 6,856,000 in 2030, and then fall slowly. The actual peaks could be later than these estimates indicate, but unless the government starts to accept immigrants from abroad, the population of Tokyo is highly likely to peak within the next five to ten years, and stop rising thereafter.

Quantitative growth in existing businesses is highly likely to peak out in 2020-2030

Once the population and the number of households turn down, it is likely to become more difficult to pursue quantitative expansion in existing operations, whether offices or condominiums, because of the nature of the real estate business. It may be possible for the major developers to maintain quantitative growth for a while after the population peaks by expanding their market share based on their fund raising capabilities, brand strength and marketing expertise, but there would be limitations to this. Quantitative growth in existing businesses is very likely to peak out at some point between 2020 and 2030.

There could be room for growth even after the population peaks

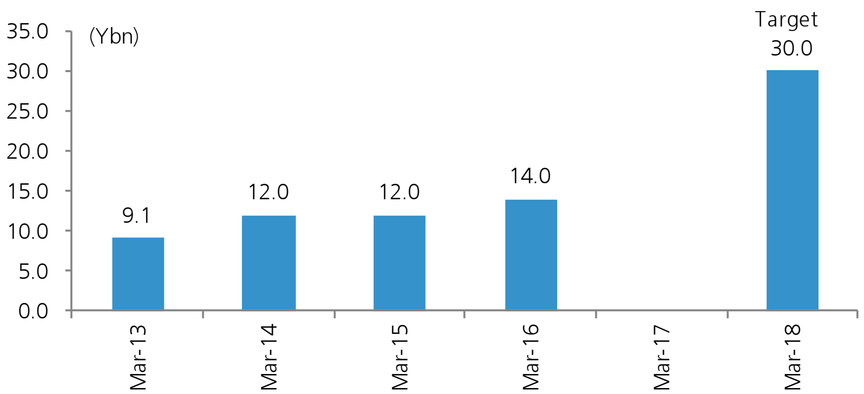
Aware that this is almost certain to happen within the next 10-15 years, the major developers are starting to take steps to continue to expand their earnings even after quantitative growth in their existing businesses peaks out. The first measure is to increase the types of property that they handle. The properties that the major developers develop or manage have traditionally been limited almost exclusively to offices and residential buildings (mainly condominiums) (Mitsui Fudosan is also heavily involved in retail facility development). Over the past five years, however, Mitsui Fudosan has expanded its logistics facility operations rapidly while Sumitomo R&D has designated hotels and rental meeting rooms as growth areas. In addition to logistics facilities and hotels, there could also be room to diversify into rental homes, nursing care facilities, luggage rooms and data centres. Business reach could be further expanded to include airports, hospitals, toll roads and other public infrastructure. The second measure is to increase income from services and operations in addition to leasing and development, which are the traditional sources of income for the real estate companies. For example, in the development of hotels, the developers usually consign hotel operations to the hotel operators and generate rental income from them. If, instead, they operated the hotels themselves, their income and profit could potentially increase. So far the developers have hardly emphasised services and operations, such as home renovation and home interior goods, and these areas also offer room to expand income and profit, in our opinion. However, there are risks in services and operations in terms of competition and securing enough human resources given the existing players that are already established in the market. In addition, once the population peaks out, there will no longer be as much room for growth. Accordingly, these companies are likely to target overseas business expansion as their third measure. Mitsui Fudosan already has overseas assets worth about

¥600bn as at the end of March 2016 and it could expand them further going forward.

The major developers should expand their overseas businesses going forward

It would be a logical step to seek growth opportunities overseas once the population peaks in Japan and quantitative business growth becomes more difficult. However, the track record of the Japanese developers overseas is rather poor. In addition, real estate is essentially a local business, and it is uncertain how much additional value the Japanese developers would be able to generate while having to control the risks they would face in overseas real estate development. Even so, both Mitsui Fudosan and Mitsubishi Estate have over 40 years' experience in their overseas operations, centring on Europe and the US. Mitsui Fudosan plans to take its overseas profit up from ¥14bn in FY15 to ¥30bn in FY17. If the major developers' overseas operations are to be evaluated more highly by investors, particularly foreign investors, it is essential, in our view, that they can demonstrate that they are capable of expanding their profit consistently.

Figure 13: Mitsui Fudosan's operating profits from overseas business



Source: Company data, company estimates

Valuation Method and Risk Statement

Mitsui Fudosan, Sumitomo R&D, Mitsubishi Estate, NTT Urban Development: We believe there could be downside risk for the major real estate companies if the economic recovery was to falter or a new financial crisis emerged. Our PTs are based on NAV.

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12-Month Rating	Definition	Coverage[1]	IB Services[2]
Buy	FSR is > 6% above the MRA.	45%	28%
Neutral	FSR is between -6% and 6% of the MRA.	39%	25%
Sell	FSR is > 6% below the MRA.	15%	17%
Short-Term Rating	**Definition**	**Coverage[3]**	**IB Services[4]**
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%

Source: UBS. Rating allocations are as of 30 September 2016.
1:Percentage of companies under coverage globally within the 12-month rating category.
2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
3:Percentage of companies under coverage globally within the Short-Term rating category.
4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

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UBS Securities Japan Co., Ltd.: Toshihiko Okino; Daiju Aoki.

Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Mitsubishi Estate	8802.T	Buy	N/A	¥1,865.0	11 Oct 2016
Mitsui Fudosan[2, 4, 5]	8801.T	Buy	N/A	¥2,086.5	11 Oct 2016
NTT Urban Development	8933.T	Buy	N/A	¥921	11 Oct 2016
Sumitomo Realty & Development	8830.T	Buy	N/A	¥2,506.5	11 Oct 2016

Source: UBS. All prices as of local market close.
Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

2. UBS AG, its affiliates or subsidiaries has acted as manager/co-manager in the underwriting or placement of securities of this company/entity or one of its affiliates within the past 12 months.
4. Within the past 12 months, UBS AG, its affiliates or subsidiaries has received compensation for investment banking services from this company/entity or one of its affiliates.
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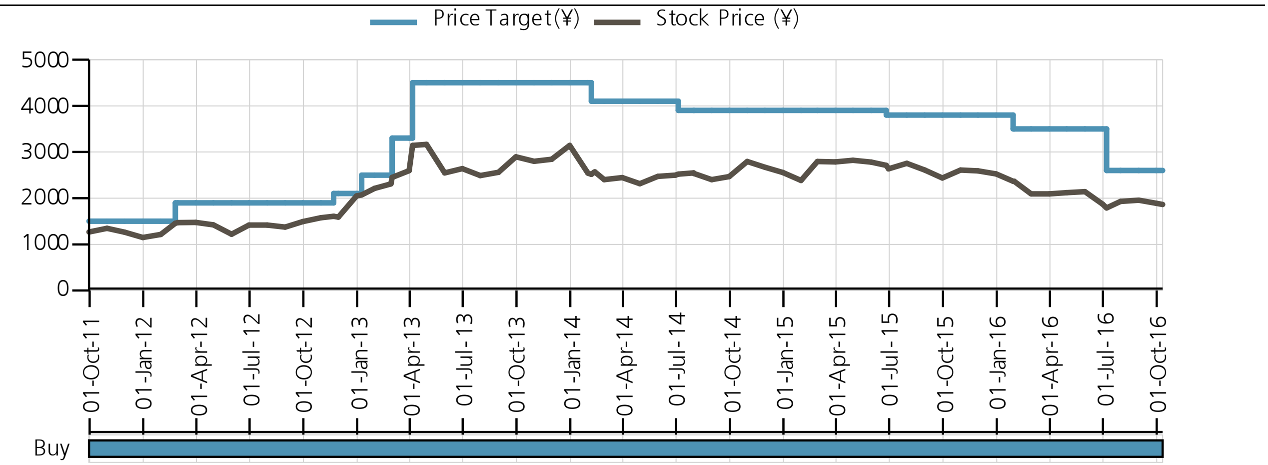
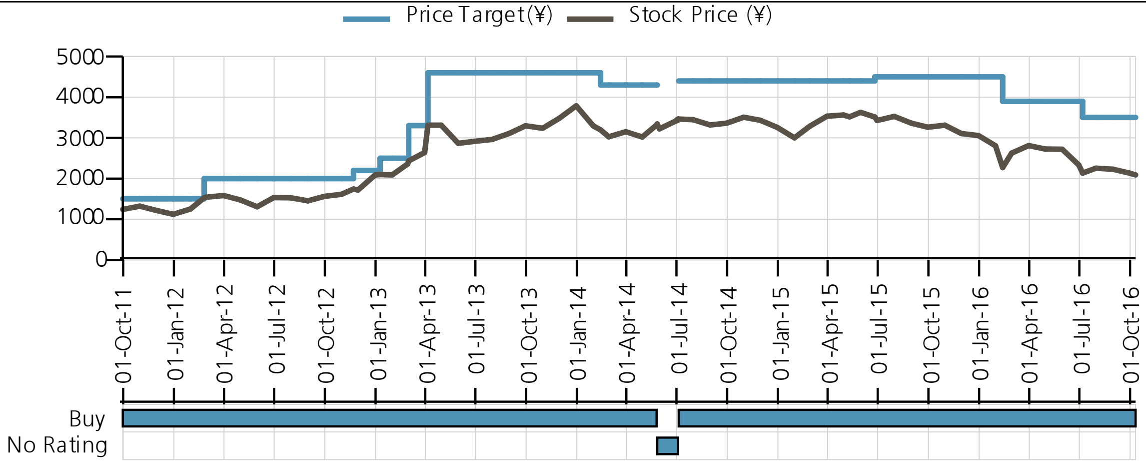
Mitsubishi Estate (¥)



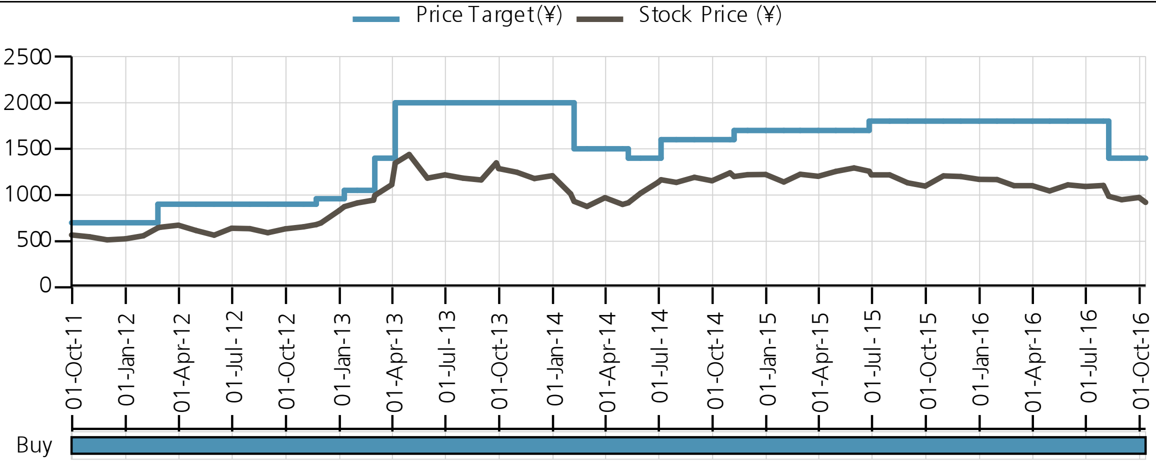
Source: UBS; as of 11 Oct 2016

Mitsui Fudosan (¥)



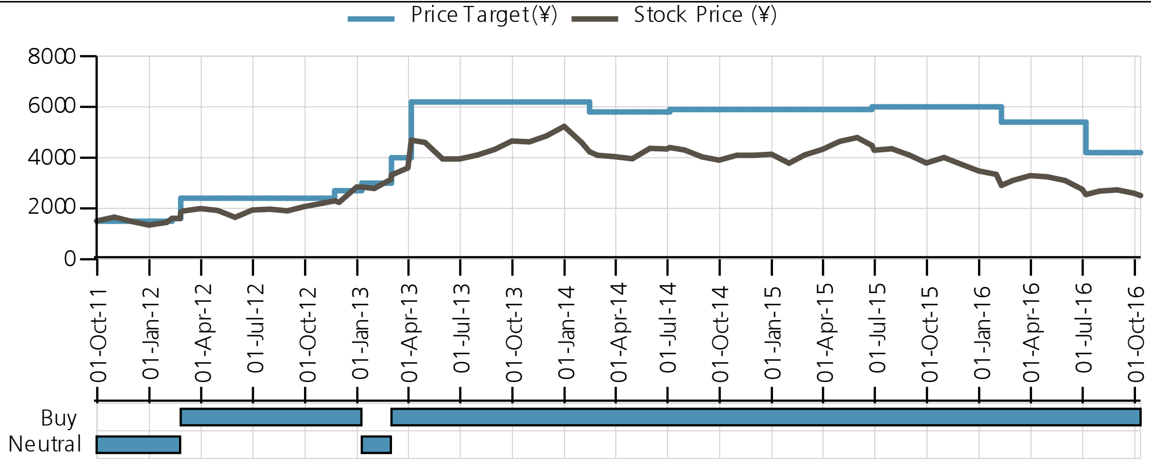
Source: UBS; as of 11 Oct 2016

NTT Urban Development (¥)



Source: UBS; as of 11 Oct 2016

Sumitomo Realty & Development (¥)



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