Focus on shifting consumption patterns

Hotels have been the worst impacted as visitor arrivals plummet and events and rooms are cancelled. Retail, especially in popular tourist destinations, has seen headline monthly sales volumes declining at 30-90%.

2020 GDP Growth -0.2% lower

Oxford Economics has lowered its forecast for 2020 real GDP growth in Japan by 0.2pp to +0.2% given the negative economic impact of COVID-19. With few macro data points yet available, the Nikkei 225 index has already recorded a YTD 14% decline with the J-REIT index down 8% YTD.

Ample liquidity support

Japan’s limited fiscal flexibility, and lack of epidemic experience, has slowed response. But the market should benefit from minimal funding concerns. Loose monetary conditions should persist, with negative real short-term interest rates and slightly negative ten-year bond yields.

Investments to slow and soften

Investors should focus on long-term demand drivers as COVID-19 is likely to have an impact contained to 2020. Additional investments in warehousing can offer not only a risk management solution but also enable a welcome business expansion to access the world’s largest (China’s) e-commerce market platform.

Summary & Recommendations

The outbreak of the Novel Coronavirus (COVID-19) has resulted in increased adverse impacts on the Japanese economy. As China is Japan’s largest trading partner, representing 29% of imports and 22% of exports, we expect both demand and supply shocks in coming months.

For investors, we recommend:

- Logistics on the back of limited stock of modern logistics assets. Tokyo offices remain attractive with Asia’s widest yield spread over bonds.

We recommend occupiers to:

- Renew leases and lock in available positions with their landlords as soon as possible, since more relocation plans as well as viewings are postponed.

- Promote a flex-and-core strategy as a way to mitigate larger public safety concerns.

- Implement a flexible work arrangement in city campus format to accommodate the government’s guidance to minimise the time required for commuting.

Since the first case of COVID-19 was announced on 15 January, Japan has announced 295 infections, with 46 people, or 16%, discharged as of 3 March. Three weeks after a similar announcement in Singapore, Prime Minister Abe’s cabinet has instructed major events to be cancelled while encouraging more corporations to initiate work-from-home arrangements. Reduced activities have not only lowered tourist consumption but will likely entail greater knock-on effects on Japan’s supply chain as it relies for around 45% of total intermediate capital goods production on imports from China. We expect:

- Falling demand from China has lowered the commodity price index over 10% year to date. Reduced production of components could delay construction activities by three to five quarters, along with some input price increases.

- Adverse impacts including lower investment activities, delays in signing new lease contracts, higher demand for safer asset classes and rising risk premiums in riskier assets during the COVID-19 outbreak.
<table>
<thead>
<tr>
<th>Sector</th>
<th>Initial Impact Assessments</th>
<th>Forecasts and Recommendations for 2020/2021</th>
</tr>
</thead>
</table>
| **OFFICE** | **Little impact: limited capacity to flex in tight markets**  
Investment, as well as leasing decisions, will be delayed due to a pause in relocation and expansion planning as well as inspection activities.  
**Tokyo**  
The market continues to favour landlords, with higher demand and limited supply leading to historically low vacancy rates. We expect little movement to flexible workspace with pre-commitments exceeding 85% for 2020 and 39% for 2021.  
**Osaka**  
Short-term leasing activity is likely to fall further, given reduced desire to congregate and an almost non-existent supply pipeline until 2022. Slowing activity may also result in slower rental improvements than the consensus estimate. | **OCCUPIERS**  
> Renew leases and lock in available options with the landlords,  
> Implement a flexible work arrangement in “city campus” format to accommodate the government’s guidance to minimise the time required for commuting.  
**INVESTORS**  
> Large rent gaps between offices of different grades within central Tokyo give opportunities to generate profit from better building management.  
> We still favour Grade A offices in Tokyo. These yield about 3.4% and so give a spread of 3.4pp over zero-yielding bonds. |
| **HOTELS** | **Mixed impact: market dislocation from excess supply**  
COVID-19 has exacerbated concern over hotel supply in popular tourist destinations. High supply prior to the Tokyo Olympics, equivalent to 30% and 65% of stock in Osaka and Kyoto, was a worry even before COVID-19. We see oversupply risk as limited to smaller regional hotels however, given their high reliance on total tourist consumption (29% versus 20% for all hotels). | Severe price declines are likely to be limited to hospitality assets. Tourist consumption has risen 4.2x to JPY 4.5 trillion over seven years, but supply of hotels nationally has risen 5.9x to 304,000 sq metres. High supply has softened the impact of firm demand in popular inbound destinations. |
| **INDUSTRIAL** | **Positive impact: from changing consumption patterns**  
> Demand to be anchored by long-term growth. Vacancy to remain low.  
> Rents likely to remain firm despite the record annual supply of over 2 million sq meters (21.5 mil sq feet) in Greater Tokyo. |  
> Lack of modern warehouses, only 5% of logistics stock in greater Tokyo, should continue lifting their capital value  
> Landlords to use this downtime to modernize their assets to align with rising EC demand.  
> Occupiers should reassess their current space requirements to provide business continuity against further disruptions. |
| **RETAIL** | **Modest impact: popular tourist destinations at risk**  
> Space demand to diminish among smaller players.  
> Rents under continuing pressure, accelerating the downtrend since Q1 2018. Vacancy to remain relatively low.  
> Capital values can be distressed in limited cases of small business scale and high cashflow requirements . |  
> Retailers to expand their offline-to-online strategies ahead of a likely increase in Chinese online retail spending.  
> Renewable, mostly fixed rent structure should insulate most landlords. However, some regional shopping mall owners should consider temporary rent rebates for small tenants. |
RISK TRANSMISSION CHANNELS

GDP growth

Japan’s GDP growth was not impacted by the severe acute respiratory syndrome (SARS) outbreak in 2003, although some history lessons can be gathered by looking at the impact of the Great East Japan Earthquake (2011), which saw limited factory suspensions, and the destabilizing effect on the financial system from the Global Financial Crisis (2007). To a lesser extent, economic contraction in China and increased quarantine activities will likely result in a modest global supply disruption, notably in auto and auto parts, which should reduce Japan’s original 2020 GDP growth assumption of JPY515 trillion.

Restrictions of movements

More governments are announcing travel restrictions from higher risk countries including China, Korea, Italy and Iran followed by Japan, Singapore and Hong Kong. We note, however, that inbound tourists account for less than 20% of total tourist demand, according to the Ministry of Tourism. Domestic restrictions of movements may also result in greater adverse impacts through labor supply shock with disruption in service and production activities.

Lower consumption and delayed investment spending

Travel and tourism is set to slump with Chinese tourist consumption alone reducing Q1 industry revenue by 5-10% or JPY143 billion (USD 1.3 billion)\(^1\). Adverse production impacts could total JPY284 billion (USD 2.6 billion), with the most impacting in the hospitality, retail and food & beverage sectors, followed by corporate services and the real estate industries.

Highlights on popular tourist destinations

While the overall situation remains fluid, with fading market confidence suppressing transactions, we highlight not all areas are similarly affected by the COVID-19 outbreak. Mapping Chinese tourist arrivals helps clarify the areas by the outbreak and the incidence of community transmission. With regards to the cases identified in Japan, they tend to reflect popular tourist destinations including Hokkaido, Tokyo and Aichi prefecture as shown at right.


\(^1\)Industry Impact assessments from the China Inbound Tourists from the COVID-19, February 25, 2020, Teikoku Data Base.
LESSONS FROM CRISIS RESPONSE

Equity markets see faster declines compared to global markets

The Nikkei 225 equity index has recorded a 14% contraction year-to-date, outpacing the comparable contraction of 9% for the S&P 500 and 6.5% for J-REITs. However, this fast and volatile response is yet to match the 17% contraction from the Great East Japan Earthquake in 2011 and the 42% contraction from the Global Financial Crisis (GFC) in 2008.

Rents to stay steady except discretionary asset classes

Japan’s property rents have stayed steady as a result of the landlord-friendly fixed rent structure and the overall tight supply since 2000. Tokyo office rents have continued increasing since early 2013 after the previous peak in early 2009. According to preliminary data from ARES, Tokyo retail rents had lost momentum prior to COVID-19, falling by 34% from the Q1 2018 peak. Osaka hotel rents have declined by 47% after peaking in Q2 2017.

Capital value to dip early and rebound faster

Capital losses for major property asset classes were four times greater during the GFC than after the East Japan Earthquake, underscoring the fact that stability in the financial system stability has a more adverse impact than physical damage. Assets with higher link to GDP growth tend to be more impacted. Looking at price changes during the GFC, capital losses for offices reached 13% YOY, followed by retail and hotels although logistics assets remained relatively steady on the back of long-term demand drivers. We expect more limited damage to capital values from COVID-19 in 2020 because the negative impacts are largely limited to discretionary spending and market confidence.

Transaction numbers to reflect tactical position adjustments

Given the fact that transaction numbers are less affected than transaction size in sq meters, we expect a similar reduction in risk appetite, reducing the size of new transactions in the coming quarters. During both the GFC and the Great East Japan Earthquake, retail assets saw the total transaction size decline by 39% YOY and 31% YOY, respectively. However, during the same periods, the total number of transactions remained relatively firm, declining only 3% YOY and 10% YOY, respectively. Relative to other assets, logistics has remained firm throughout both crises.
A WELCOME SILVER LINING FROM CHINESE E-COMMERCE (EC)

China: the largest EC market equivalent to 11.7 times that of Japan

We expect lower discretionary spending on tourism, transportation, retail and entertainment to accelerate the growth of EC markets. China maintains the world’s largest inbound EC market, in excess of USD1.1 trillion, or equivalent to 2.4 times the U.S. markets or 11.7 times Japan’s EC market.

China’s travel bans could affect 150 million outbound tourists based on 2019 figures. However, reduced footfall could also accelerate an ongoing shift to EC.

Cross-border EC market is expected to double in the next three years

Japan’s EC market sales from China are also set to double to USD25.9 billion or JPY 2.8 trillion through the end of 2021. This contrasts to the near-non-existent EC sales from Japan to China of JPY29 billion. According to the latest PayPal survey, the proportion of internet users with cross-border EC experience was 26% in China and 5% in Japan. The latest government survey also indicates reduced retail spending by repeat travellers, down to 35% of total inbound tourist consumption against 42% four years ago.

Tourist consumption has diminished net trade deficits with China

An increasing trade relationship with China has translated to a bilateral net trade deficit hovering at around USD33 billion, after peaking at USD56 billion in 2010. With the government’s gradual relaxation of visa requirements, rising tourist consumption has offset the net trade deficit to a similar extent of increasing exports of electronic components over the past five years.

China’s net trade surplus has declined somewhat after Chinese inbound tourist consumption has more than doubled over the past four years to JPY4.5 trillion. However, assuming the current online growth rate, we expect an ongoing shift in favour of EC could replace up to 25% of inbound tourist consumption, which should translate into increase warehousing requirements in the coming years.

Comparing EC market scale by major markets

<table>
<thead>
<tr>
<th></th>
<th>Japan</th>
<th>China</th>
<th>U.S.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population (million)</td>
<td>126.5</td>
<td>1,395.4</td>
<td>327.4</td>
</tr>
<tr>
<td>Mobile phone contract # (million)*</td>
<td>164.3</td>
<td>1,364.9</td>
<td>416.7</td>
</tr>
<tr>
<td>Nominal GDP per capita (USD)</td>
<td>39,306</td>
<td>9,608</td>
<td>57,638</td>
</tr>
<tr>
<td>ICT adoption ranking</td>
<td>6/141</td>
<td>18/141</td>
<td>27/141</td>
</tr>
<tr>
<td>Internet user % adult population</td>
<td>84.6%</td>
<td>54.3%</td>
<td>87.3%</td>
</tr>
<tr>
<td>Internet user % adult population ranking</td>
<td>29/141</td>
<td>93/141</td>
<td>26/141</td>
</tr>
<tr>
<td>EC market size (USD : billion)*</td>
<td>95.3</td>
<td>1,115.3</td>
<td>454.9</td>
</tr>
</tbody>
</table>

*Latest comparable data available is for the calendar year 2017.

China-Japan : Cross-border EC market sales forecast (USD: Million)

<table>
<thead>
<tr>
<th>Year</th>
<th>From China</th>
<th>From Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017</td>
<td>100,000</td>
<td>0</td>
</tr>
<tr>
<td>2018</td>
<td>100,000</td>
<td>0</td>
</tr>
<tr>
<td>2019E</td>
<td>100,000</td>
<td>0</td>
</tr>
<tr>
<td>2020E</td>
<td>200,000</td>
<td>0</td>
</tr>
<tr>
<td>2021E</td>
<td>200,000</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: Colliers International, METI

Historical Trend : Imports & Export with China (USD: Million)

<table>
<thead>
<tr>
<th>Year</th>
<th>CIF Trade Value</th>
<th>FOB Trade Value</th>
<th>Net Trade Accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>($300,000)</td>
<td>($200,000)</td>
<td>($100,000)</td>
</tr>
<tr>
<td>1994</td>
<td>($500,000)</td>
<td>($300,000)</td>
<td>($200,000)</td>
</tr>
<tr>
<td>1996</td>
<td>($700,000)</td>
<td>($500,000)</td>
<td>($300,000)</td>
</tr>
<tr>
<td>1998</td>
<td>($900,000)</td>
<td>($700,000)</td>
<td>($400,000)</td>
</tr>
<tr>
<td>2000</td>
<td>($1,100,000)</td>
<td>($900,000)</td>
<td>($500,000)</td>
</tr>
<tr>
<td>2002</td>
<td>($1,300,000)</td>
<td>($1,100,000)</td>
<td>($600,000)</td>
</tr>
<tr>
<td>2004</td>
<td>($1,500,000)</td>
<td>($1,300,000)</td>
<td>($700,000)</td>
</tr>
<tr>
<td>2006</td>
<td>($1,700,000)</td>
<td>($1,500,000)</td>
<td>($800,000)</td>
</tr>
<tr>
<td>2008</td>
<td>($1,900,000)</td>
<td>($1,700,000)</td>
<td>($900,000)</td>
</tr>
<tr>
<td>2010</td>
<td>($2,100,000)</td>
<td>($1,900,000)</td>
<td>($1,000,000)</td>
</tr>
<tr>
<td>2012</td>
<td>($2,300,000)</td>
<td>($2,100,000)</td>
<td>($1,100,000)</td>
</tr>
<tr>
<td>2014</td>
<td>($2,500,000)</td>
<td>($2,300,000)</td>
<td>($1,200,000)</td>
</tr>
<tr>
<td>2016</td>
<td>($2,700,000)</td>
<td>($2,500,000)</td>
<td>($1,300,000)</td>
</tr>
<tr>
<td>2018</td>
<td>($2,900,000)</td>
<td>($2,700,000)</td>
<td>($1,400,000)</td>
</tr>
</tbody>
</table>

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Colliers International (NASDAQ, TSX: CIGI) is a leading real estate professional services and investment management company. With operations in 68 countries, our more than 15,000 enterprising professionals work collaboratively to provide expert advice and services to maximize the value of property for real estate occupiers, owners and investors. For more than 25 years, our experienced leadership, owning approximately 40% of our equity, has delivered compound annual investment returns of almost 20% for shareholders. In 2019, corporate revenues were more than $3.0 billion ($3.5 billion including affiliates), with $33 billion of assets under management in our investment management segment. Learn more about how we accelerate success at corporate.colliers.com, Twitter or LinkedIn.

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