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KEYNOTE INTERVIEW

Adding value in Japan

Some of the best real estate investing opportunities can be found in Japan, but investors need to add value in order to counter the impact of rising inflation and potential cap rate expansion, says Gaw Capital's Isabella Lo

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Japan is often seen as a market outside the normal boundaries of Asia, with its low growth and low inflation environment. However, as the country recovers from the pandemic, looking for ways to add value will support real estate portfolios, according to Isabella Lo, managing director, principal and head of Japan at Hong Kong-based real estate private equity firm Gaw Capital. There are opportunities across the spectrum of real estate sectors; however, Gaw particularly favors the rebounding hospitality sector and the industrial sector with its strong macroeconomic drivers.

Q How is Japanese real estate faring post-covid? Is it returning to 'normal' or are you seeing longer-term changes driven or accelerated by the pandemic?

Japan has done reasonably well throughout the pandemic in terms of transaction volume; there has never been a real drop off in investment activity. However, there have been changes in the occupier markets during and since. Office leasing activity slowed down during the pandemic, but office demand is now coming back. The structural reduction of office space demand is much less in Japan compared with many other countries. People value face-to-face interaction, and the residential space is comparably small. We continue to be optimistic about long term office demand. In contrast, logistics saw a leasing surge during the pandemic that has now normalized, but we still see healthy demand for logistics.

Tourism has seen a substantial recovery. Tokyo room rates have surpassed room rates before covid – and this is before the Chinese border reopened in January. Japan is surveyed to be the number one destination for outbound Chinese tourists. We have always believed in Japan as a unique and repeat destination because of the food, culture, landscape and hospitality. In addition, the cheap yen helps to attract international tourists into Japan and to keep domestic tourists within the region.

Q Japan has not recorded the interest rate hikes experienced in other real estate markets, but inflation has risen. Do you expect changes in the financing environment?

Japan has not been entirely insulated from inflation, because of the soaring energy prices and higher imported goods price. Inflation has been higher since mid-2022 but nothing like the levels seen in the US and Europe. However, in real estate, construction costs have risen significantly in the past couple of years. We anticipate higher inflation to continue but it could be a healthy level of inflation that is good for the economy.

Borrowing costs have remained stable, except fixed rates which have increased since December 2022. However, banks are still keen to offer financing options for a wide range of property types and the cost of finance remains low. We expect some increases in central bank interest rates, but we expect a gradual and controlled rise. Japan is still one of the best markets to invest in because Japan real estate offers a positive carry when many other markets' cap rates are below interest rates. While there may be a rise in cap rates in Japan, we still see plenty of liquidity going into Japan.

Q What is your view on the impact of the US interest rate hike on investment in Japanese real estate?

Rising US interest rates have strengthened the dollar against the yen, so Japan real estate is considered to be cheaper for US dollar-denominated investors. This includes Gaw Capital and many other overseas investors. On the other hand, the rapid rise in interest rates, especially in the US and Europe, has caused some concern for some investors about their real estate exposure globally. International buyers have therefore been less aggressive since the second half of last year, while domestic buyers remained strong.

"Japan is still one of the best markets to invest in"

Q How has the changing environment affected Gaw Capital's plans for Japan in 2023?

We are optimistic about Japan and its prospects. We have roughly $4 billion of assets under management in Japan and we are still very eager to deploy more capital and increase that AUM. However, in light of the prospect of higher inflation and interest rates, we focus on opportunities that have a very strong value-add angle. We are looking for deals where we can increase the net operating income. With the prospect of cap rate expansion, we focus on opportunities where the NOI and cashflow can be boosted to cover any cap rate expansion.

We also prefer deals with shorter leases, which allow landlords to capture higher rents to counter higher costs and rising cap rates. Of course, the shortest leases are in the hotel sector – where rates change daily – which makes that sector particularly attractive, in addition to the other macro factors mentioned before.

Q What sort of value-add initiatives are you considering?

We are looking at anything from leasing up to refurbishment to ESG enhancement. Building scale adds value in certain sectors, such as data centers and logistics. With scale, a landlord can provide multiple locations across the region and better services to tenants, in turn giving the landlord better leverage and rents. In the logistics sector, we are also looking at converting dry warehouses to cold storage, because we anticipate growth in the cold storage sector and higher yields. We have been doing this in China and believe we are among the first to do it in Japan.

Q What do you consider the most attractive Japanese real estate sectors for foreign investors?

We particularly like the hospitality sector, thanks to the rebound in tourism and how the sector performs in an inflationary environment. We also continue our focus on the industrial sector, because of the supporting macro-fundamentals. We are looking at hotel assets across Japan, although we particularly like foreign-branded hotels because Gaw Capital has experience in turning around under-performing hotels in that part of the market. In the industrial sector, we prefer Tokyo and Osaka, the two largest and most liquid markets. With rising demand driven by continued urbanization and e-commerce, industrial assets in Japan will continue to mature as an institutional asset class.

Q Gaw Capital has made substantial investments in the Japanese logistics, office, internet data center and residential sectors recently. What has driven these investments?

The scalability of data centers is important. It allows the company to rapidly scale its resources to meet its customer's exact requirements. It provides the advantage of high-density, power efficiency and cost reduction over the lifetime of data center investment. We made our second data center investment in Japan in early 2022, next to our first site, which offered a great expansion opportunity for tenants.

In 2022, we also bought 32 residential assets, a sector that remains a strong favorite for core investors due to its defensive qualities. Japan's residential assets, especially in Tokyo, have proven extremely resilient through several crises. Rents held up very well during the global financial crisis and the pandemic. From the perspective of a core investor looking for stable cashflow, residential sector offers a good cap rate above borrowing costs, combining yield and stability. Japan's residential sector has become very competitive, so we are selective when it comes to new deals.

We completed our first Japan logistics portfolio in 2022. In addition to the fundamentals supporting the logistics market, we saw value-add opportunities in this portfolio, such as the possibility of the conversion to cold storage, demand of which has increased substantially since the pandemics.

In 2021, we invested alongside Invesco Real Estate in the privatization of a Japanese real estate investment trust. In general, we see public markets undervaluing assets, so there may be opportunities. We continue to look at privatization opportunities where assets are undervalued and there is operational upside.

Q ESG has begun to take off in Japanese real estate. What ESG initiatives is Gaw planning for its assets in the region?

We are very excited about the prospects for ESG in Japanese real estate. ESG is a core part of our investment and asset management process. Not only is ESG the "right thing to do," it is an important aspect of value-add. As an example, for our warehouses and data centers, we are adding solar panels to reduce our carbon footprint for those assets. This helps lower the energy costs and carbon emissions. It also makes the assets more attractive to tenants, especially ESG-focused multinationals. Increasingly, we see large tenants with their own ESG objectives willing to pay premium rents at an ESG asset. We also believe we can achieve a better cap rate on an ESG asset.

In addition, we look to make value add improvements to water and energy usage where possible and to seek green certification for assets, too. A relatively new area for Gaw Capital in Japan is the social responsibility aspect of ESG. We have a very strong track record in enhancing social responsibility in our Hong Kong community malls through revitalizing the public space and the sportsground and upgrading the facilities in the public space.

Similar initiatives would also benefit our assets in Japan. We are looking at measures to improve people's well-being in offices. As mentioned, office workers in Japan are keen to return to their desks, but there is a much greater focus on employee's well-being, such as improving the air quality, allowing natural daylight penetration in the office building, and installing health-related facilities. These elements are important for both staff and tenants. This is applicable not only to offices. We are also making our logistics warehouses and data center properties better places to work, too. ■