SC Capital Partners

The resilience of the living sector in Japan

Reno Sio, Institutional Real Estate, Inc's managing director, Asia Pacific, recently spoke with **SC Capital Partners'** investment team on the Japan living sector. Following is an excerpt of that conversation.

There has been a lot of activities in the market surrounding the "living sectors" in Japan. How would you describe this space?

Compared with other jurisdictions, the living sector in Japan is relatively diversified, with asset types at various stages of maturity in terms of institutionalisation. We tend to divide the sector into two major buckets: traditional and nontraditional asset types. The traditional asset types are widely sought after and held by both foreign and domestic investors, such as insurance companies, asset managers, public and private REITs, as well as a gradually growing group of retail investors. These asset types are primarily multifamily apartments and single-unit apartments.

The other bucket consists of nontraditional assets, from student accommodation to co-living, corporate housing and serviced apartments. During the pandemic, these assets were fairly well occupied, resilient for the most part, and still have much potential in terms of value contribution.

During the pandemic, there was some vulnerability in the senior housing sector because of the spread of the virus and susceptibility of the age group. Do you see any concerns in this sector in Japan?

Senior housing may have faced some issues during the peak of COVID-19, both in and outside of Japan, but there is still a very strong need for this product, and the sector is becoming more institutionalised. Currently, the bulk of these assets are master leased. Senior homes in Japan represent an inverted pyramid, in that majority of the market share is held by mom-and-pop shops, and only a small percentage of the market share is held by five or 10 companies. As such, it is important for investors to pay close attention not only to the property's underlying operations, but also to the credit behind the senior home operators.

Do you have the same concerns with operators of student accommodation? How have you overcome that in your existing assets?

SC Capital Partners has five student accommodation assets throughout Asia through its core-plus fund, including three assets in Japan with approximately 1,000 units — two in Tokyo, which are master leased, and one near Kyoto, which is operating under a management contract.

Unlike senior housing, where bulk of the operators are small and with lower credit, there are only a few large organisations managing student accommodation assets, which control the large bulk of the market share in Japan. The operators we work with are best-in-class with strong underlying credit. These operators are well-experienced, and we work with them to create a safe space and memorable experience for the students, which, in turn, contributes to the resilience of our assets. The underlying performance has been very encouraging — all three assets remained at high-occupancy levels throughout the pandemic, and we were able to increase the passing rent last year. In fact, during 2022, we posted our best-performing year since acquiring these properties.

Where do you see opportunities for foreign investors in the Japan living sector?

In terms of demand, we see a lot of foreign investment interest for multifamily apartments. There is a clear capital structure in place to transact these assets. This makes the market very competitive. We have seen many multifamily portfolios come to the market, and these are much sought after not only by foreign institutions, but also by both private and public J-REITs.

We see more opportunities in the nontraditional bucket, however, where we believe we have a competitive advantage. These include student accommodation, serviced apartments, co-living and corporate housing, which have interesting potential for growth, and we can see these asset types eventually becoming more institutionalised. SC Capital Partners has a proven track record and strong asset-management expertise in student accommodation and corporate housing. In addition, with an established hospitality platform here in Japan, we are also well-positioned to acquire serviced apartments. This places us in a unique position with superior access to opportunities in these sectors.

With the increased competition from both foreign capital and domestic players in these sectors, how are you able to generate alpha?

It is rare to see an asset-management company in Japan that not only owns real estate, but also has operational experience. We have a unique platform in Japan that, itself, creates a strong point of difference vis-à-vis our peers. On the institutional side, we tend to fight the battles that make sense. A key ingredient in our strategy is to add value through active asset management, while closely working on the operations side to create a win-win strategy for our residents, tenants and guests, for the benefit of our investors.

What would you say to investors who have concerns about property sectors that are less institutionalised?

We believe the performance of these assets speak for themselves. For example, the three Japan student accommodation assets in our core-plus portfolio performed very well during the pandemic, compared with student accommodation in other countries, whether it be Australia, in other parts of Asia, Europe or the United States, which caters primarily to foreign students who had left to return home. Japan was different – schools were closed only for a short while, and lessons evolved very quickly into a hybrid situation with both online and in-person lessons. As a result, most of the residents, who are domestic students, continued to stay in our student accommodation assets throughout that period.

How else is the Japanese market unique?

There is a very common phrase in Japan that, when translated, means, "I am sorry to trouble you". You hear that often in everyday conversation and come across it even in work emails. This reflects the unique characteristic of Japanese culture. As an example, even during the pandemic, rental payments by the residents were timely and in full across all our student accommodation assets.

Something else unique to the Japan market is the traditional lease structure. The traditional lease in Japan that governs tenant occupancy, whether it be office or residential, is typically two years. In other jurisdictions, at the end of the lease term, the landlord will raise rents to market levels. In Japan, however, the lease automatically rolls over with minimal or no rental increase. Hence, rental market reversion tends to occur only when the tenant leaves the property. For student accommodation, however, residents leave after living at the property for two to four years, enabling a more frequent and predictable reversion to market rate. This plays to the uniqueness and growth potential of this sector.

And hotels are even faster – you can revise your rate daily.

That is a good segue to serviced apartments. Hotels in Japan are widely held by institutions, which are large and small, but serviced apartments are just starting to gain interest in Japan from an investment perspective. This asset type targets not only inbound tourism, but also longer-term stays by foreign employees. Unlike limited-service hotels in Japan, serviced apartments provide many of the basic in-room amenities in a relatively large living space, which is more typical in a residential unit. Providing a living space for these types of residents represents a compelling story for investors.

In which Japan markets do you see potential opportunities for student accommodation? How do you go about sourcing that and identifying the right locations?

We tend to focus on locations with a large cluster of feeder universities, or areas where there is a well-known university anchoring the location. In sourcing for student accommodation assets in Japan, a key item to consider is the property's access to its surrounding universities. For Tokyo-based properties, accessibility is driven by the property's proximity to local transportation, including trains and buses, as transportation is linked to everyday amenities and social activities. For more rural locations, where local train lines are less utilised, accessibility to feeder universities – via bicycle, on foot and by bus – is an important consideration.

To what extent are these living sector assets accessible to institutions and retail investors? And how liquid is this product?

Within the Japan living space, single-unit and multifamily assets are very institutionalised. There are a number of sector-specific J-REITs that focus only on residential properties, while in other jurisdictions in Asia, there are no listed entities that purely own residential assets. The preference in Hong Kong, for instance, is to invest by owning a physical residential unit, rather than through a REIT. The nontraditional assets, such as student accommodation, serviced apartments or corporate housing, are held in some cases by J-REITs, but currently there are no sector-specific J-REITs that own these assets. As such, we believe these types of assets still have headroom to grow in terms of accessibility and liquidity.

What would you like to tell investors who are still sitting on the fence, considering whether Japan is right for them?

Japan is a safe and stable country, and its real estate legal framework is strong and reliable. In terms of sector types, the living sector has proven to be resilient throughout the pandemic – it not only survived, but thrived.

About SC Capital Partners

Established in 2004, **SC Capital Partners Pte Ltd (SCCP)** is an Asia Pacific real estate investment manager headquartered in Singapore.

The firm has a 19-year track record across Asia Pacific and has raised approximately US$3.8 billion in equity commitments from a diverse pool of institutional investors. With 56 people and presence in seven different countries in the region – being Singapore (HQ), Australia, Hong Kong, China, Japan, South Korea and Vietnam – SCCP's competitive advantage stems from being firmly embedded in local knowledge, cultures and jurisdictions, giving us the resources and networks necessary to execute successfully in the region.

SCCP manages the Real Estate Capital Asia Partners (RECAP) series of Asia Pacific opportunistic real estate funds, an Asia Pacific open-end core-plus fund, SC Core Fund (SCORE+) and a Japan Hospitality Fund. The firm also runs an Asia Pacific data centre investment programme. The SCCP Group* also includes the managers of two listed REITs, Japan Hotel REIT (www. Jhrth.co.jp/en/), the largest hospitality REIT in Japan, and TPRIME (http://en.tprimereit.com/), a commercial REIT in Thailand.

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