Who Benefits from Japan's Negative Rate Policies?

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Japan has been a market plagued by volatility since the middle of 2015. The Bank of Japan (BOJ) instituted a new policy of negative interest rates in early 20161 that many would have thought would weaken the yen, but instead it has strengthened2. Does that mean the new policy is a failure? Not all of Japan has been trading so negatively. In particular, one area of Japan's market stands out: real estate. This discussion with **Scott Callon**, Chairman of Ichigo (a publicly traded real estate company), highlights why we think Japanese real estate could be a valuable portfolio allocation. ***Scott, tell us about the operating environment you are seeing at Ichigo, a Japanese real estate company which runs a Japanese hotel real estate investment trust (REIT), and an office REIT.*** I believe it is an extraordinary time to own Japanese real estate. For one, the BOJ's negative interest rate policy is helping a lot. One of the biggest costs for a real estate company is the cost of debt. Because real estate offers secure cash flows, you can take out loans against those cash flows. Real estate companies use these loans to buy real estate, just like people buy homes with mortgages. The BOJ's negative interest rate policy has brought down the interest rate on these loans to less than 1% for Ichigo and other big Japanese real estate companies3. This is unprecedented. What's so interesting is that while the operating environment for Japanese real estate companies is extraordinarily positive, sentiment is pretty negative—or at best cautiously positive. It is not so much what is happening in Japan that is causing worries people here are very concerned about Europe, about China and about the U.S. elections. To be fair, there are some Japan-specific worries—Is "Abenomics" ok? Are negative rates working?—but the real push-back on bullishness comes from global uncertainty. In fact, this gap between Japanese real estate fundamentals, which are extraordinarily positive, and sentiment, which is very cautious, is the biggest I have seen in my career. And it is this gap which is creating investment opportunities. Downbeat sentiment is driving down prices below where we believe they should be, given the high and quite stable returns available. ***Ichigo's weighted average interest rate on its debt has dropped from 2.5% for fiscal year 2012 to 1.41% as of fiscal year 2016, while the duration of its loans has extended from 3.6 years to 8.7 years4. Scott, do you see being able to continue to bring duration longer and rates lower at rates closer to zero?*** Yes. And yes. We are doing both. It has literally never been a better time to be a borrower, in my view.I believe the right way to take advantage of the current low-interest-rate environment is to work with the banks to lock in the low rates. So, the conversations we are having are: "We love borrowing from you at 0.5% and feel no need to go lower. Instead, let's lengthen the duration of the loan." Taking out very long-term loans (10 years or more) gives us certainty about having extraordinarily low borrowing costs for a long period of time. By the way, when I say we have one of the best operating environments in the history of Japanese real estate, it is not just low funding costs. It is also that rents are going up. The challenge in Japan over the last couple of decades is that, for example, you could invest to earn a 5% real estate yield (aka cap rate) but that yield shrank over time, because rents were going down. So at day one you may have been earning 5% on your investment, but 10 years out it likely shrank to just 4%. Your total return was not what you got at start, but the one you got over time, which was lower. And the lower return meant that the resale value of the real estate also dropped. What has changed is that now rents are turning up after grinding down since the collapse of the Japanese bubble economy in the early 1990s. There were a few periods where rents ticked higher before—going into the financial crisis, rents had been rising in 2005, 2006, 20075. But the long-term story for Japanese rents has been secular decline, and that appears to have turned. And this is in a context where Japanese real estate today already gives you a huge yield advantage over government bonds. The Tokyo Stock Exchange's REIT dividend yield is currently 3.01%. The 10-year Japanese government bond (JGB) yield is -11 bps. Therefore, the average Japanese REIT picks up 312 bps ahead of JGB. In 2003, the JGB was at 136 bps and REITs were yielding 4.26%, so the pick up over the JGB was 290 bps. Today it is 312. The key difference between then and now is that rents in 2003 were in secular decline and today rents are going up. Today rents are going up due to replacement costs going up. What has happened the last three years now, post-Kuroda, is that we had three years of very aggressive monetary policy to break the back of deflation and take us to mildly positive inflation. This shift to inflation is important to the economics of owning real estate. Rents tend not to go up in a market where wages are declining and the cost of goods is declining. Construction costs manifestly declined during Japan’s deflationary period. If a building owner tried to raise rents, tenants would go next door to a new building built at a lower cost and thus with lower rents. Now, however, construction costs are increasing. Over a period of several decades, the Japanese government has managed down the size of Japan’s construction sector, and there is now a severe shortage of labor in construction. There are also strong and positive government requirements for on-site safety, which means that you can’t have understaffed construction sites. Construction costs have gone up 20% to 30% versus pre-Abenomics levels. These construction costs are the best forecast of future rents. If buildings cost more to build, the only way to get back the extra costs is to charge a higher rent. Indeed, if you look at Tokyo rental data for mid-size offices, the average asking rent as of April was up 8% year-over-year . This was not due to a cyclical upswing in the Japanese economy over the last year. There was not one. It was due to the shift that is occurring from real estate deflation to real estate inflation. 1Source: “Introduction of Quantitative and Qualitative Monetary Easing with a Negative Interest Rate,” Bank of Japan, 1/29/16. 2Source: Bloomberg, from 1/29/16 to 6/3/16 against the U.S. dollar. 3Source: Ichigo proprietary data regarding loan portfolio. 4Source: Ichigo proprietary data regarding loan portfolio. 5Source: Japan Real Estate Institute Home Price Index (Tokyo). Data from 6/30/1993 to 3/31/2016.

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