Mizuho Economic Outlook & Analysis

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Reasons why condominium prices do not fall

Prices are expected to remain high due to three factors

< Summary >

◆ New condominium sales in the Tokyo metropolitan area and the Kinki region are slowing. Meanwhile, condominium prices remain high and now surpass the level recorded during the real estate mini bubble in 2007.

◆ The background to high prices seems to include (1) recovery of developers' earnings performance, (2) weak inventory adjustment pressure, and (3) rising construction costs.

◆ From these three factors, condominium prices are expected to remain high in the immediate future. However, a sharp rise in interest rates may invite a full-fledged price adjustment.

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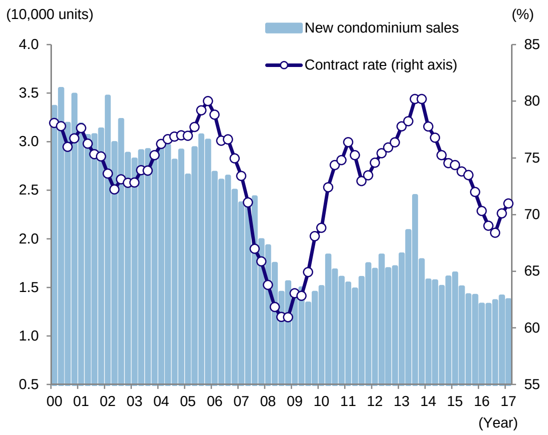
1. New condominium prices soared despite the decline in sales

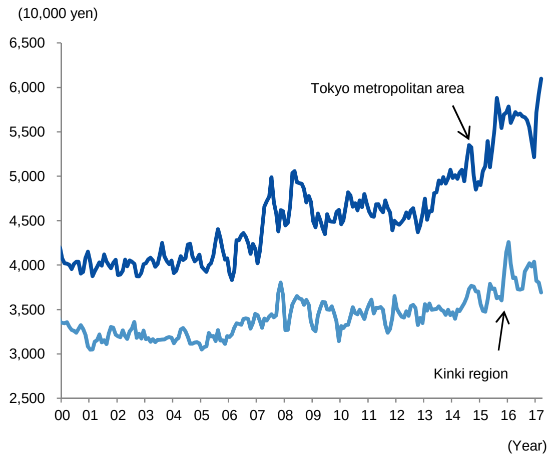
The market for new condominium sales in the Tokyo metropolitan area and the Kinki region accounts for about 70% of all condominiums nationwide, but sales continue to be sluggish after peaking in 2013 when condominium sales soared ahead of the consumption tax hike (**Chart 1**). The recent contract rate has hovered at around 70%, which marks the turning point of good and bad figures, and if we focus on the Tokyo metropolitan area, the figure was in the 60% range from January to March 2017, or three consecutive months, suggesting a slump in the market. On the other hand, prices remain at a high level despite slowing sales. In fact, condominium prices in the Tokyo metropolitan area are well over the level recorded in around 2007, which is referred to as the real estate mini bubble period (**Chart 2**). In this report, we analyze the background of the new condominium market and examine its future outlook.

Chart 1: New condominium sales in the Tokyo metropolitan area and the Kinki region and the contract rate



Note: Contract rate is the moving average of the latter two quarters' figures.
Source: Made by MHRI based on Real Estate Economic Institute Co., Ltd., *The Condominium Market in the Tokyo Metropolitan Area and the Kinki Region*, and the Ministry of Land, Infrastructure, Transport and Tourism, *Building Starts Statistics*.

Chart 2: New condominium prices



Note: Data are the moving average of the latter three months' figures.
Source: Made by MHRI based on Real Estate Economic Institute Co., Ltd., *The Condominium Market in the Tokyo Metropolitan Area and the Kinki Region*.

2. Background of condominium prices remaining high

First, high condominium prices seem to be the result of two situations currently facing condominium developers: one, they are not being compelled to mark down unit prices; and two, they are unable to reduce prices from an earnings perspective.

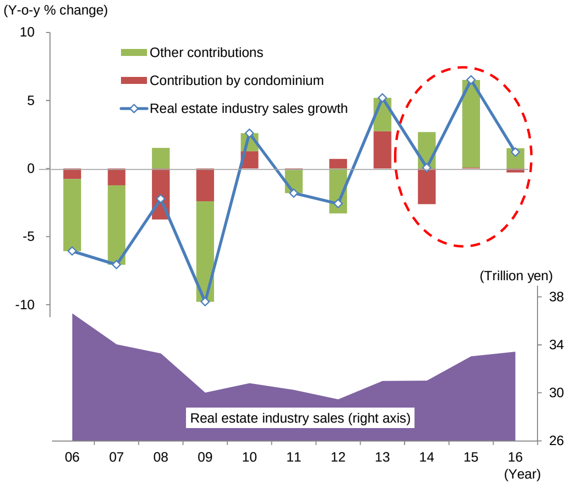
If we elaborate on these two situations, the first stems from (1) recovery of developers' earnings performance and (2) weak inventory adjustment pressure. Also, the second situation seems attributable to (3) rising construction costs. We describe the details of factors (1) to (3) in the following section.

(1) Recovery of developers' earnings performance

Even though the condominium market remains weak, the earnings performance of real estate developers continues to be favorable. Looking at their sales, unlike the situation we saw in the latter half of the 2000s when the overall real estate market plummeted, sales of the real estate industry are recovering steadily amid sluggish condominium sales (**Chart 3**). Breaking down sales contribution by category, we can see that sales of properties other than condominiums are contributing to positive sales results, and some of the leading integrated real estate developers are even registering record high profits thanks to the strong performance of office buildings and commercial facilities that has more than offset sluggish sales of residential condominiums.

Furthermore, historically low interest rates are providing a tailwind for the real estate industry burdened with a large amount of borrowings. Although outstanding loans in the real estate industry reached their highest-ever level in 2016, the interest rate coverage ratio, which represents the ability of companies to pay interest on borrowings, etc., is also at the best level in history according to the latest statistics, thanks primarily to growing profits and declining interest payments on the back of low interest rates. In addition, due to the increase in cash in hand, the quick ratio, which shows companies' short-term payment ability, is also at a superior level (**Chart 4**). In sum, real estate developers are maintaining a sound financial position despite sluggish condominium sales and therefore have little incentive to collect on their investment by slashing profits.

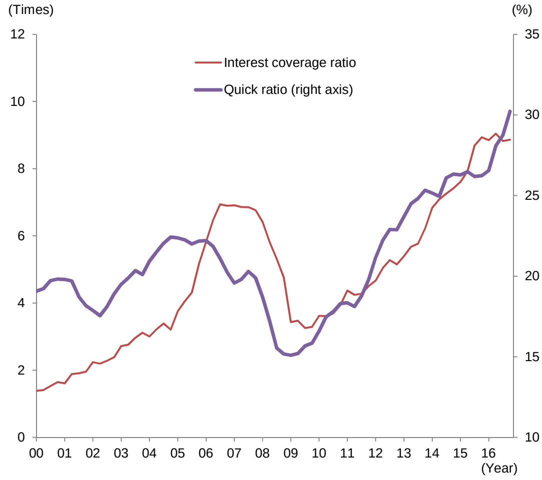
Chart 3: Real estate industry sales and contribution of condominium sales



Note: Contribution by condominium calculated based on the aggregate value of properties on sale, and not on the total value of sales contracts (nationwide basis).

Source: Made by MHRI based on Real Estate Economic Institute Co., Ltd., *The Condominium Market in the Tokyo Metropolitan Area and the Kinki Region*, and the Ministry of Finance, *Financial Statements Statistics of Corporations by Industry*.

Chart 4: Interest coverage ratio and quick ratio of large companies in the real estate industry



Note: Data are the moving average of the latter four quarters' figures.
Interest coverage ratio calculated by "(operating income + interest income, etc.) / interest expenses, etc."
Quick ratio calculated by "(cash and deposits + notes receivable + accounts receivable + securities) / current liabilities."

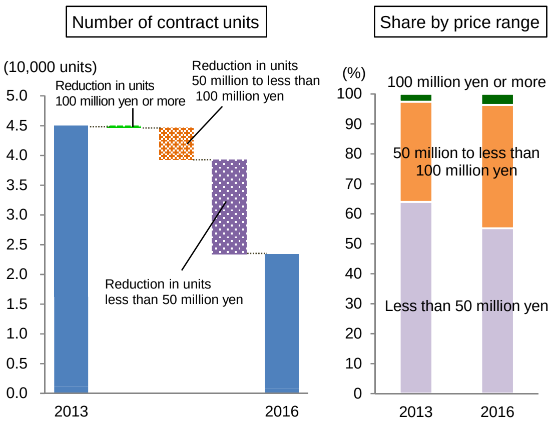
Source: Made by MHRI based on the Ministry of Finance, *Financial Statements Statistics of Corporations by Industry*.

In addition, we cannot ignore the fact that average condominium prices have been pushed up with developers strategically suppressing sales of low-priced condominiums on the back of their sound financial position. **Chart 5** compares the number of condominium sales contracts in the Tokyo metropolitan area in 2013 and 2016. It reveals a substantial drop in the sales of condominiums priced at less than 50 million yen, which account for a majority of the overall condominium units. On the other hand, the decline in sales of condominiums priced in the 50 to 100-million-yen range and "luxury" condominiums priced above 100 million yen has been limited. Statistics tell us that condominium prices have been pushed up by real estate developers trying to raise the proportion of high-priced condominiums in their total sales in order to secure profits even amid the decline in overall condominium sales.

(2) Weak inventory adjustment pressure

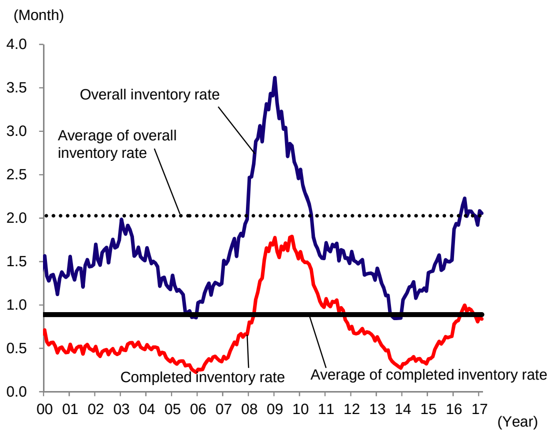
Next, we take a look at inventory adjustment pressure. Generally speaking, when sales are sluggish, inventory piles up and the inventory rate rises. But looking at the current inventory, the inventory rates for all condominiums (includes both condominiums under construction and completed) and completed condominiums remain at an average level similar to the past (**Chart 6**). The inventory rate for completed condominiums even shows a slight decline despite the slump in sales. This alone suggests that developers have been restricting the condominium supply to avoid the situation where inventory levels go up. As a consequence, developers can avoid repeating the same mistake made in the latter half of the 2000s, when a hike in completed condominium inventory led to a weakening of their financial position, ultimately leading to a clearance sale of condominiums. This seems to be one factor accounting for the high condominium prices today.

Chart 5: Breakdown of new condominium contracts by price range (Tokyo metropolitan area)



Source: Made by MHRI based on Real Estate Economic Institute Co., Ltd., *The Condominium Market in the Tokyo Metropolitan Area and the Kinki Region*.

Chart 6: Inventory rate of new condominiums in the Tokyo metropolitan area and the Kinki region



Note: (Inventory rate) = (Inventory units) / (total units sold). Data are the moving average of the latter six months' figures.
Average of overall inventory rate and average of completed inventory rate are the averages of data from January 2000 to February 2017.

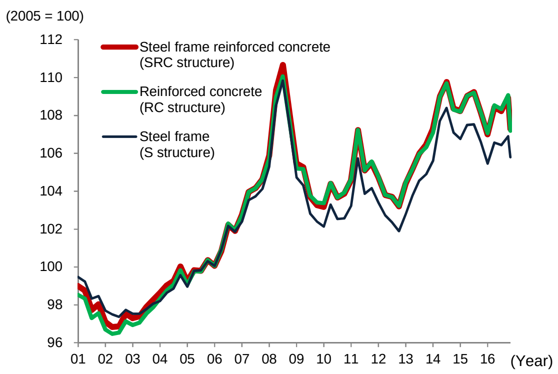
Source: Made by MHRI based on Real Estate Economic Institute Co., Ltd., *The Condominium Market in the Tokyo Metropolitan Area and the Kinki Region*, and HASEKO Corporation.

(3) Rising construction costs

Thus far we have looked at reasons why real estate developers are not rushing to sell new condominiums by lowering prices, but now we want to consider why they are finding it difficult to mark down condominium prices even if they want to. The answer lies in rising construction costs. **Chart 7** depicts the price of construction works by major condominium structures. The chart suggests that the construction cost deflator is at a high level for all structures, mainly because of the soaring prices of major construction materials, such as ready-mix concrete and H-steel, affected by the recovery in commodity prices and the depreciation of the yen. Rising personnel costs resulting from the shortage of skilled workers in the construction sector also seems to be a factor behind the hike in the deflator.

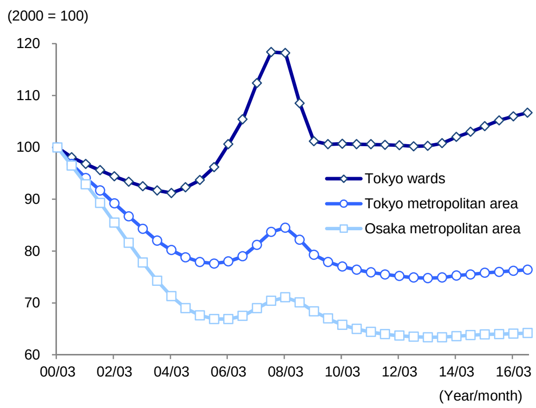
Moreover, another factor includes the situation where Japan's economic recovery, historically low interest rates, and demand related to the 2020 Tokyo Olympic Games and the rising numbers of inbound tourists have caused a serious tightening in the supply and demand of condominium sites. As **Chart 8** indicates, the urban land price index of residential sites has increased for seven half terms running in the Tokyo metropolitan area and for six half terms in the Osaka metropolitan area as of September 2016. This increase in cost to acquire sites for condominium construction also constitutes a factor preventing the decline in condominium prices.

Chart 7: Construction cost deflator



Note: Data up until December 2016 are quarterly averages; data for January 2017 is a single month's figure.
Source: Made by MHRI based on the Ministry of Land, Infrastructure, Transport and Tourism, *Construction Cost Deflators*.

Chart 8: Urban land price index (residential land)



Source: Made by MHRI based on the Japan Real Estate Institute, *Urban Land Price Index*.

3. Condominium prices are expected to stay high around the current level, but beware of shifting interest rates

As we have seen thus far, condominium prices remain high because developers are in no rush to sell condominium properties and cannot lower their prices even if they want to. While the business performance of real estate companies is recovering and demand related to the Tokyo Olympic Games and inbound tourists is expected to expand, three factors we mentioned above will likely continue to support condominium prices. It goes without saying that with sluggish sales, it is difficult to anticipate an additional price hike from the current level, but we can conclude that new condominium prices in the Tokyo metropolitan area and the Kinki region will remain high for the time being.

Our main scenario anticipates the continuation of high prices, but we need to be alert to the situation where interest rates will rise, a factor that may place downward pressure on prices. Although domestic interest rates continue to be low, they are no longer at the lowest level recorded last year, triggered by the interest rate hike in the US and other reasons. Should interest rates continue rising, the increasing interest payment burden of real estate companies and the weakening of appetite to purchase condominiums on the back of higher mortgage rates may derail factors (1) and (2) and cause prices to decline. As for factor (3), if a decline in construction demand leads to lower construction material and land costs, real estate developers will have room to reduce condominium prices. With the Bank of Japan working on monetary easing to maintain the current low level of interest rates, the possibility of a sharp hike in interest rates is viewed as limited. But we should watch the movement of interest rates as one factor that may cause condominium prices to trend downward.