Real-estate market in the face of COVID-19
Residential properties under spotlight as defensive

Introduction

Covid-19 that reportedly originated in Wuhan in 2019 has spread all over the world in no time and is still rampant in many countries. In Japan, the government declared a state of emergency on April 7, 2020. As of May 19, eight prefectures, including Tokyo, are under the state of emergency, and when the virus will be under control is still uncertain as of May 19.

While concerns over the influence of Covid-19 has been mounting, we believe the influence is significant on hotels and commercial properties but is relatively limited on residential properties. In this report, we look into the impact of the new coronavirus on residential properties, taking rental properties in the metropolitan area as examples.

◆ Appraisal and transaction values of properties after the Lehman shock in 2008

Here, let us discuss the changes in the real-estate market after the Lehman shock in September 2008 which triggered the worldwide financial crisis. The [Chart 1] shows the comparison of appraisal and transaction values of three properties that the former New City Residence Investment Corporation sold in September 2008 immediately after the Lehman shock to raise funds. After the Lehman stopped. In fact, the Tankan Survey revealed that Diffusion Index of Lending Attitude of Financial Institutions to real-estate businesses was -16 points. Back then, New City Residence Investment Corporation was unable to finance the repayment of 12.5 billion yen which was due at the end of September 2008, and thus, had no choice but to sell these three properties. Under such challenging financing environment, the gap between the Appraisal and Transaction Values was -17%, while the gap between Appraisal and Transaction yields was 0.9% on average.

◆ Simulated purchase of residential properties in 2020 under the influence of Covid-19

We then simulated the purchase of a residential property located in Yokohama City, as the model property, in May 2020. The property was assumed to be located within a 10-minute walk from the nearest railway station, near the center of Yokohama City; has been built for less than 10 years; consist of 200 residential units in total, the majority of which are 1LDK units. The average monthly rent and occupancy rate were assumed at 150,000 yen per 54 ㎡ on average and 95% respectively, with LTV of 50% (without amortization), an interest rate of 1.5% and a

【Chart 1】Sale of properties by former New City Residence Investment Corporation (as of September 2008)

Property name	Transaction date	Year built	Transaction price	Appraisal value	Transaction NCF yield	Appraisal NCF yield	Gap in yield
New City Residence Yokohama East	2008/9	2003/3	5,840,000,000	7,153,000,000	6.0%	4.9%	1.1%
New City Residence Togoshi Ginza	2008/9	2006/5	1,800,000,000	2,060,000,000	5.5%	4.8%	0.7%
New City Residence Minami Azabu East	2008/9	2004/7	1,150,000,000	1,367,000,000	5.5%	4.6%	0.9%
						Average	0.9%

borrowing period of 5 years given the current challenging financing environment.

NCF before repayment of borrowings was assumed at 280 million yen for each year based on [Chart 2] and was assumed to remain unchanged during the 5-year period as the demand for rental residential properties is expected to remain stable given favorable social demographics in Yokohama City based on [Chart 3]. The sales price in the sixth year is estimated at 5,950 million yen, with a terminal cap rate of 4.7% by taking into account both the stability and uncertainty of cash flows from the property. Equity IRR after acquisition costs was assumed at 6%, the level of equity return expected by investors. The purchase price derived based on this equity IRR is 6,040 million yen and the yield computed based on the purchase price is 4.64%, which we believe is generally fair in view of transaction yields in recent comparable transactions and implies that the influence of Covid-19 on the real-estate market differs from that of the Lehman crisis.

◆ Future of residential properties as defensive assets

As the simulation using the model property suggests, relatively new rental residential properties for families can be deemed as defensive assets as the volatility in income from these properties is limited.

With regard to their marketability, the unit prices of J-REIT plunged on March 31, and as a result, the NAV multiple for rental residential properties dropped to 0.71. The environment surrounding the rental residential properties, however, has recovered to a level that allows investors to start acquiring newly built properties, with the NAV having rebounded to 1.06 as of the end of April (according to a survey conducted by TMAX).

However, all rental residential properties are not set to benefit from the improving market environment. Rental properties will likely become bipolarized depending on regional factors including demographic inflow/outflow, and other individual factors including location and age of properties. We therefore believe more stringent due diligence is required in selecting properties.

【Chart 2】Cash flow from the model property (as of May 2020)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
NCF before repayment of borrowings	280,000,000	280,000,000	280,000,000	280,000,000	280,000,000	280,000,000
Amount of repayment per year	45,300,000	45,300,000	45,300,000	45,300,000	45,300,000	※ Assumed to be without amortization
Interest rate	1.5%	1.5%	1.5%	1.5%	1.5%	
DSCR	6.18	6.18	6.18	6.18	6.18	
NCF after repayment of borrowings	234,700,000	234,700,000	234,700,000	234,700,000	234,700,000	
Equity yield	**7.8%**	**7.8%**	**7.8%**	**7.8%**	**7.8%**	
Equity IRR（after acquisition costs)	**6.0%**					

Calculation of reversionary value	
Period of analysis	5years
NCF in Year 6	280,000,000
Terminal cap rate	4.7%
Sales amount	5,960,000,000
Sales commission	178,800,000
Proceeds from sales	4,660,000,000
Balance of borrowings	3,020,000,000
Proceeds from sales after repayment of borrowings (attributable to equity)	1,640,000,000

Calculation of the initial amount of equity invested	
Purchase price	6,280,000,000円
Of which, the price of the property	6,040,000,000円
Of which, acquisition related expenses (including real estate acquisition tax)	240,000,000円
Borrowings	3,020,000,000円
Equity invested	3,020,000,000円
LTV	50%

【Chart 3】Demographic inflow into/outflow from Yokohama City & Excess inflow into the City