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RESEARCH NOTE

Build. Demolish. Repeat: Why the Japanese housing depreciation dilemma is so unique

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ALTERNATIVES

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- Housing stock in Japan has a 30-year life cycle, based largely on continually upgraded earthquake-resistant building standards and inferior post-war construction methods.
- More than half of the dwellings in Japan's major centers are rented, and this higher proportion gives landlords a larger pool of occupants to ensure their investment provides a potential return, though rented accommodation competes more with owner occupation.
- Opportunities do exist for international investors, provided they understand the unique quirks inherent in this market.

While Japan shares many characteristics with the West – a democratic political system and capitalist economic system among them – one area that distinguishes Japan as an outlier is the attitude the Japanese people have toward their homes. For many of us, in addition to the stability it provides, home ownership has traditionally been front and center in our plans for building wealth and planning retirement. In Japan, homes have a rapid depreciation cycle and are virtually worthless after 25-to-30 years; in most cases, a vacant plot would be more desirable than a plot with an existing structure. Land holds value. Dwellings do not.

How has this unique situation come about?

Japan sits on or near the boundary of multiple tectonic plates, making it susceptible to earthquakes and other natural disasters. Because building techniques are constantly improving resilience to natural disasters, many older homes fall outside the continually updated safety regulations and, as a result, are not trusted by the Japanese public. Japan, therefore, has a minimal secondhand housing market.

Exacerbating this view of structures as temporary is the rebuilding effort that took place after World War II. Construction quality in many cases was poor, with little earthquake resilience and lacking common features such as insulation. The practice of rebuilding every 30 years or so has lingered ever since.

What does this mean?

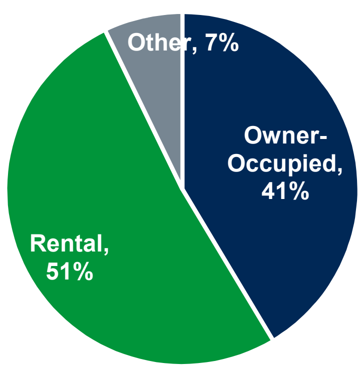
In the West, households typically build wealth through their home. With only a limited second-hand market to speak of in Japan, there is little prospect to build wealth through home ownership. Values depreciate over a 25-to-30-year period (a typical building life), and given the ever-stringent seismic regulations, housing is seen more as a commodity to meet a need, rather than an avenue to wealth creation.

This situation has resulted in a greater focus on product itself. More than half of the dwellings in Japan's major centers are rented, and this higher proportion of renters gives landlords a larger pool of occupants to ensure their investment provides a potential return. However, there is more direct competition between new-build sales and rented accommodation, with the determining factor being the property's ability to meet the occupants' needs.

The shortened property life cycle also has an unintended economic benefit for the construction sector, in that a 25-to-30-year lifecycle implies on average an underlying replacement of residential stock of between 3.3%-4.0% per annum, ensuring a base level of construction demand through the cycle. While this may create a sustained contribution to economic activity, it also undermines efforts on environmental and sustainability fronts. The construction sector consequently produces a significant amount of waste, even when materials are recycled, and consumes large amounts of energy, increasing overall emissions.

For investors in this market, particularly for multi-family, return expectations must account for discounting values back to site value in 25-to-30 years. For housing developers, it is important to offer a product that owner-occupiers will be willing to commit to for the entire economic life of the property (given the lack of secondhand market), or flexible enough to accommodate regulatory changes. This situation is clearly not optimal from an Environmental, Social and Governance standpoint; while efforts are underway to address the issue, it will be difficult to change long-term market behavior.

COMPOSITION OF DWELLINGS IN CORE MARKETS



Source: Ministry of Land, Infrastructure, Transport and Tourism & J.P. Morgan 2019

*As of September 30, 2020
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