Prospects for Recovery of the Real Estate Investment Market

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The turmoil in world financial markets has impacted J-REITs and private funds in Japan's real estate investment market. Meanwhile, the faltering economy has started to weigh heavily on the relatively strong real estate leasing market, creating a negative feedback loop that could further impair the real estate investment market.

1. Introduction

The global financial turmoil stemming from the U.S. subprime mortgage meltdown has rocked J-REITs (Japanese real estate investment trusts) and private funds in Japan's real estate investment market. Moreover, the faltering economy has started to affect the relatively sound real estate leasing market, prompting cash flow prediction downgrades and boosting risk premiums, and thus causing a negative feedback loop that could further impair the real estate investment market.

Based on our *Survey of Real Estate Market Conditions* conducted last October, and drawing from other recent surveys, we examine the prospects for recovery in the real estate investment market, where current sentiment is nothing short of pervasive pessimism.

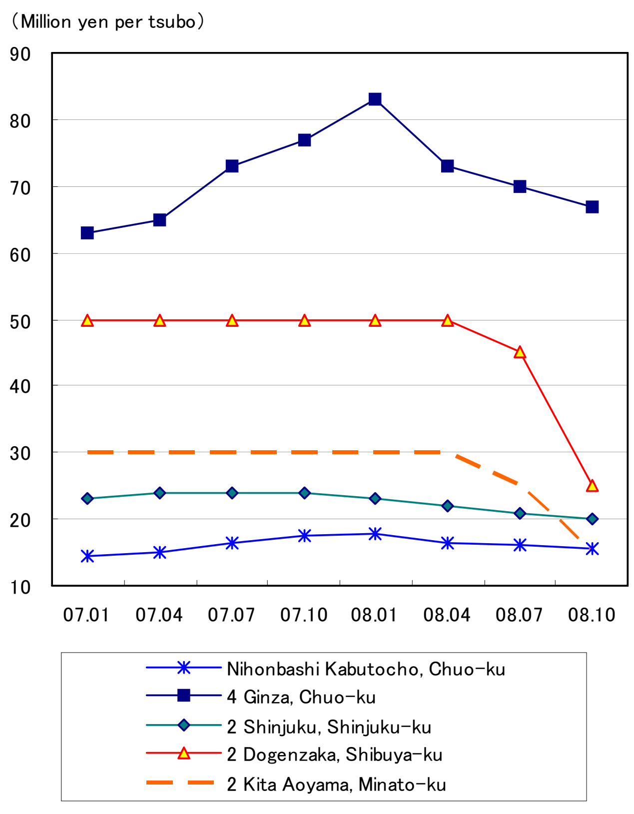
2. Plummeting Retail Land Prices, Deteriorating Market Sentiment

According to the *Trend Report of the Prices of Intensively Used Land in Major Cities: Land Price LOOK Report (Fourth Issue)*, released by the Ministry of Land, Infrastructure, Transport and Tourism, between July 1 and October 1, 2008, land prices did not increase in any of the 150 districts surveyed nationwide, and actually declined in 85% of the districts.

Additionally, market price trend data for October (released by Nomura Real Estate Urban Net Co.) shows that prime retail land prices in two Tokyo central business districts (Dogenzaka, Shibuya-ku and Kita-Aoyama, Minato-ku) plummeted about 50% in the past six months (Exhibit 1). However, in our view, since the sharp price declines seem disproportionate to any income deterioration from the economic downturn, it appears likely that no buyers would help sustain the inflated prices brought about by speculative investment funds.

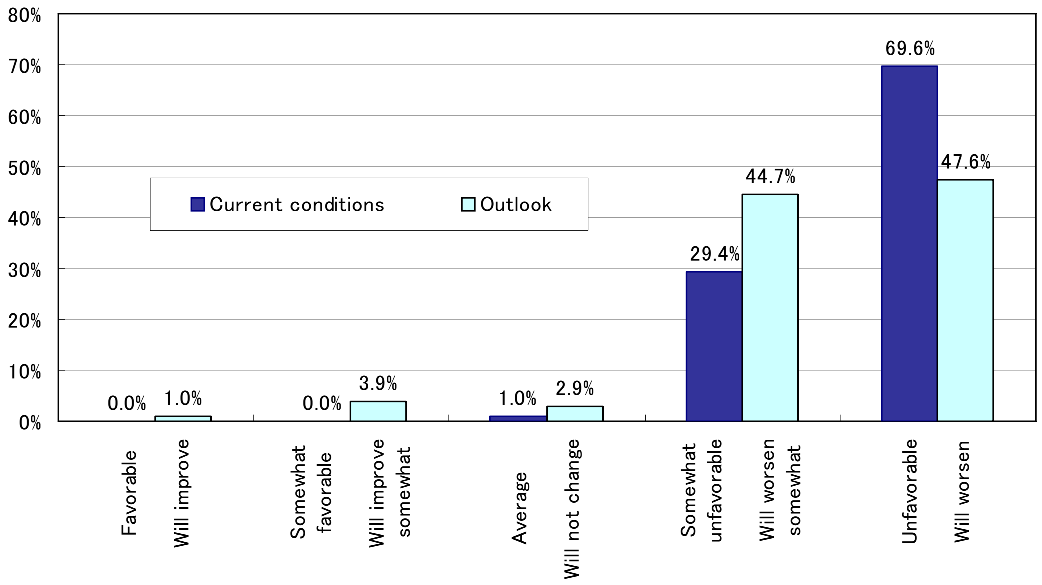
In our report released last October, we noted that the overheated real estate investment market had entered a correction phase due to the shifting credit environment after the U.S. subprime meltdown.[1] We suggested that excess funds in real estate would likely

Exhibit 1 Commercial Land Prices in Central Tokyo



Source: Nomura Real Estate Urban Net Co.

Exhibit 2 Sentiment in the Real Estate Investment Market (Current Conditions and Outlook)



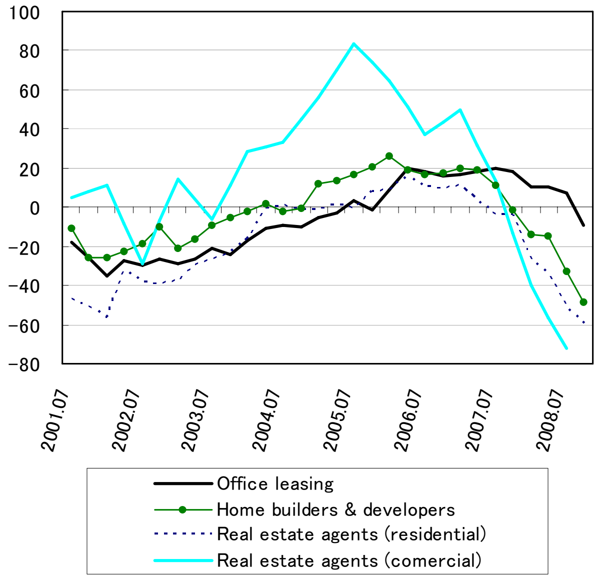
Source: NLI Research Institute, *Survey of Real Estate Market Conditions*, October 2008.

be withdrawn, bringing prices into alignment with real estate fundamentals. However, the ensuing outflow of funds and credit contraction surpassed our predictions. In fact, it would be no overstatement to say that pessimism now pervades throughout the real estate investment market.

According to our own *Survey of Real Estate Market Conditions* released in early October, 99% of respondents said current market conditions are unfavorable (69.6%) or somewhat unfavorable (29.4%), with zero favorable responses.[2] As for the future, 92.3% expressed a pessimistic outlook for the next three months (47.6% unfavorable, 44.7% somewhat unfavorable), with only 5% expecting improvement in the near term (Exhibit 2).

Another survey, released last October by the Japan Land Institute (*Survey of Real Estate Industry Conditions*), found that the diffusion index of current conditions—already unfavorable among homebuilders & developers and real estate agents since October 2007—finally turned unfavorable in office leasing as well, making the industry's sentiment unanimously negative (Exhibit 3).

Exhibit 3 Real Estate Industry Diffusion Index (Current Conditions)

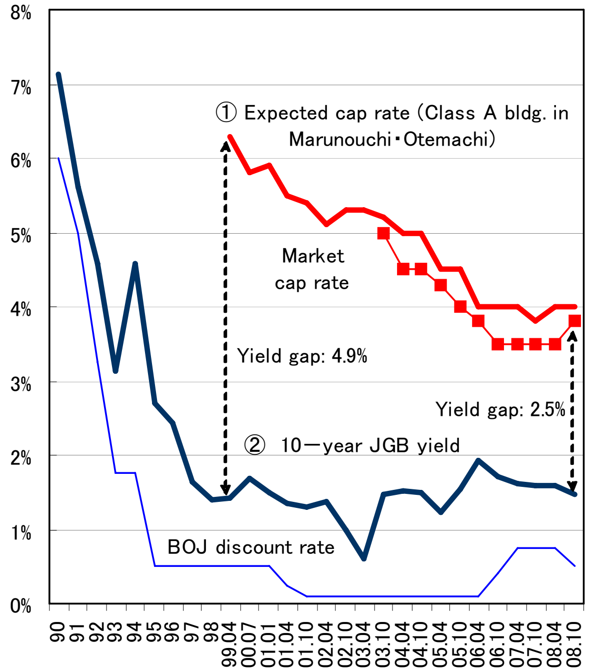


Note: Data for commercial real estate agents is semiannual (January & July).
Source: Japan Land Institute, *Survey of Real Estate Industry Conditions.*

3. Downside Risk of Property Prices

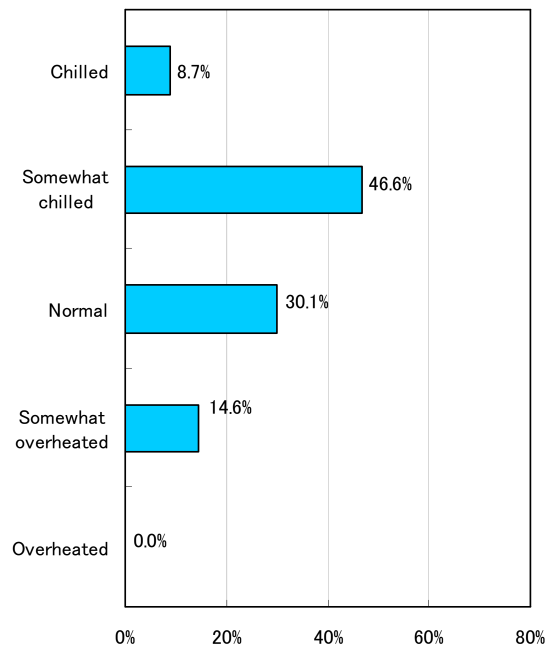
Given the unfavorable market conditions, future real estate price trends must be viewed with adequate caution. In the rental market, the recent decline of occupancy rate and newly contracted rent leads us to predict that as cash flow declines and the risk premium rises (yield gap between the expected cap rate and 10-year JGB), real estate prices will sharply correct downward. Of course, price declines will not be evenly distributed across the board due to the market's polarization.

Exhibit 4 Expected Cap Rate and Yield Gap



Note: Shows JGB yield at yearend from 1990 to 1998, and at end of month from April 1999 onward.
Source: Japan Real Estate Institute, *Japanese Real Estate Investor Survey.*

Exhibit 5 Prime Office Property Transactions



Source: NLI Research Institute, *Survey of Real Estate Market Conditions*, October 2008.

According to last October's *Japanese Real Estate Investor Survey* (released by the Japan Real Estate Institute), the expected cap rate of benchmark Class A office buildings in central Tokyo was unchanged from six months ago at 4.0%, while the market cap rate rose from 3.5% to 3.8% in the same period (meaning that prices declined; Exhibit 4).

In fact, when the market was overheating, competitive bidding drove many transaction prices well beyond levels justified by market realities and property incomes. The cap rate of these properties is expected to increase (hence prices to decline) more than the overall market average.

In our survey, the current condition of prime office property transactions (defined as large new office buildings in Tokyo's central business district) was described by 55.3% of respondents as subdued (46.6% somewhat chilled, 8.7% chilled).[3] However, as many as 30.1% of respondents characterized current transactions as normal, and 14.6% as even somewhat overheated. Thus conditions seem to be less pessimistic for prime office properties than for the overall market (Exhibit 5).

Furthermore, in the JREI survey, the expected cap rate rose for benchmark Class A office buildings in other major cities while remaining flat in Tokyo, thus indicating a widening regional disparity.

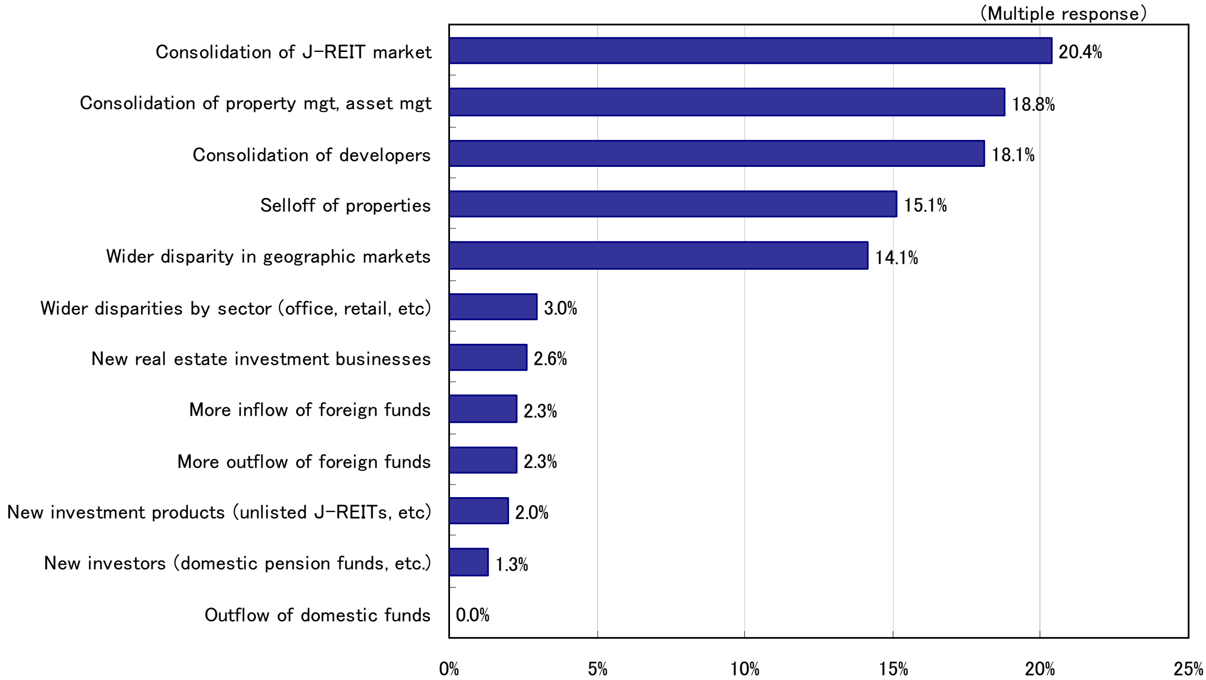
4. Outlook for Recovery of the Real Estate Investment Market

1. Continued Severity in the Near Term

Since last summer, the credit contraction stemming from the financial crisis has caused spectacular failures of large new real estate companies in Japan, along with failures or perilous conditions at U.S. financial institutions. Since the first failure of a J-REIT occurred in October, the J-REIT market has reached new lows.

Our survey asked about likely events that might occur in the real estate investment market in the coming year. Most responses cited further consolidation and restructuring in the real estate investment market, including the J-REIT market (20.4%), property managers and asset managers (18.8%), and real estate developers (18.1%), along with fire sales of properties (15.1%). Thus the consensus outlook calls for a hard landing with significant pain in the near term (Exhibit 6).

Exhibit 6　Predicted Trends in the Real Estate Investment Market



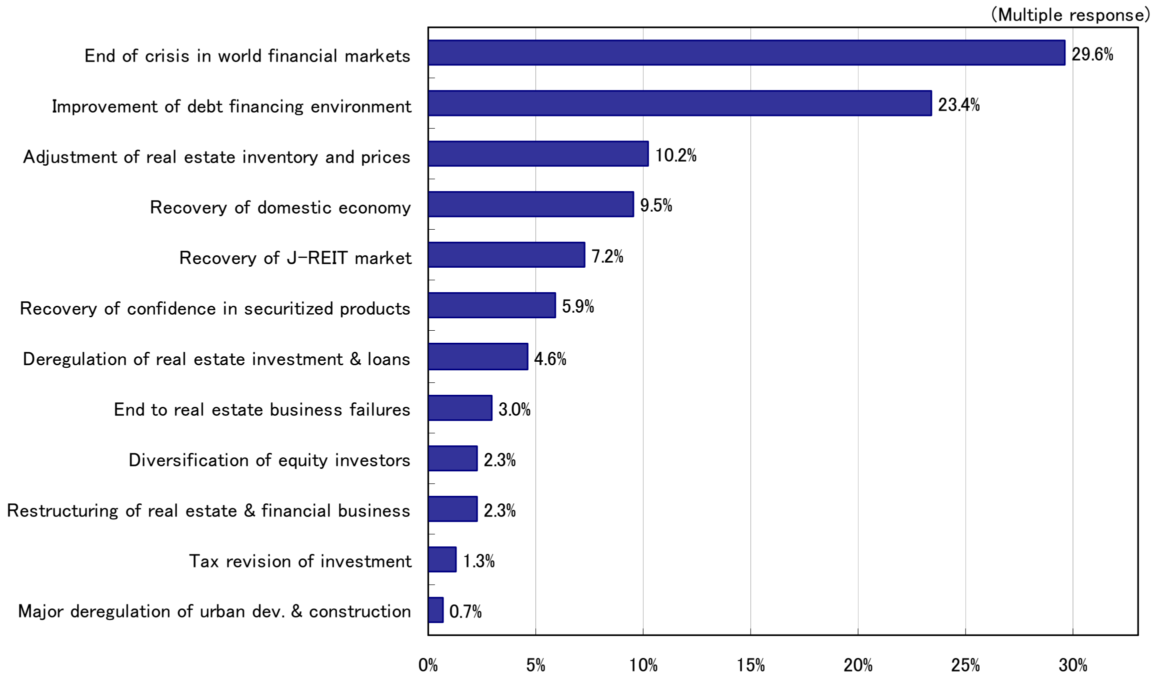
Source: NLI Research Institute, *Survey of Real Estate Market Conditions*, October 2008.

We believe the downside risk of real estate prices is considerable. With financial and capital markets in turmoil and the economic downturn not likely to ease up soon, we expect conditions in the real estate investment market to remain grim.

2. Real Estate Fundamentals Show Less Volatility Compared to Previous Bubble

Our survey also asked about the necessary conditions for a full-fledged recovery of the real estate investment market. The two leading responses by far were for an end to the global financial market crisis (29.6%), and improvement in the debt financing environment (23.4%). These results reveal a strong perception that the real estate investment market malaise came as a result of the financial

Exhibit 7　Conditions for Recovery of the Real Estate Investment Market



Source: NLI Research Institute, *Survey of Real Estate Market Conditions*, October 2008.

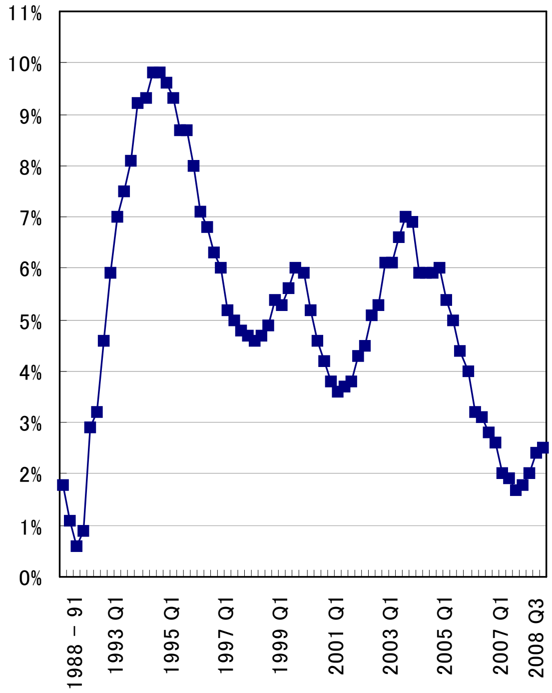
crisis. Other conditions such as adjustment of inventories and prices, which ranked third at 10.2%, drew mixed responses (Exhibit 7).

Even prior to the turmoil of overseas financial and capital markets, domestic financial institutions were tightening their lending stance and risk controls, and limiting the issue of new debt financing. Following the economic downturn and numerous business failures in the real estate industry, and with the media adopting a pessimistic outlook on real estate fundamentals, lending stances have tightened further. However, we believe the fundamentals are deteriorate less severely, and are less volatile now than after the previous land bubble.

For example, when the land price bubble burst in the early 1990s, the office vacancy rate in Tokyo's 23 wards surged from below 1% in 1990 to 10% in 1994. However, since then the vacancy rate has not risen above 7%, nor fallen much below 2% even in the recent boom (Exhibit 8).

In addition, the high-end office rent, which peaked at 100,000 yen per tsubo in the last bubble, has since hit a ceiling at 60,000 yen to 70,000 yen. Moreover, in the Tokyo central 3 wards, the average market rent has stabilized between 15,000 yen to 20,000 yen.[4]

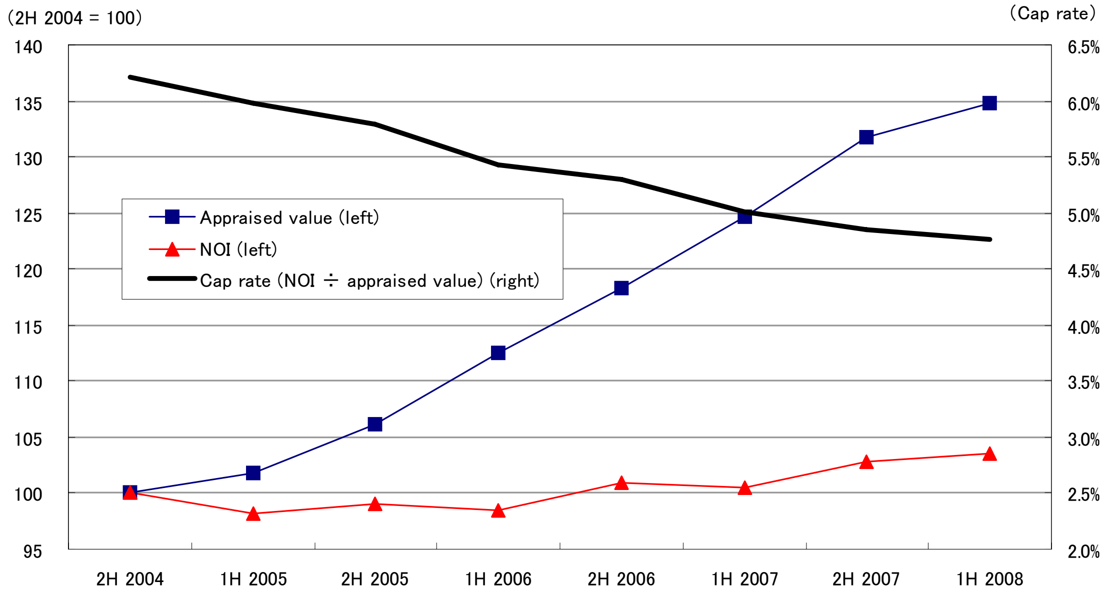
Exhibit 8 Office Vacancy Rate in Tokyo 23 Wards



Note: Show values at end of year from 1988 to 1991, and at end of quarter from 1992 Q1 onward.
Source: Compiled using data from CB Richard Ellis Research Institute.

Trends in appraised values and net operating income of J-REIT properties are also revealing. While appraised values rose 35% between 2H 2004 and 1H 2008, NOI edged up only about 4% in the same period. In view of the current gap between newly contracted and renewed rents, even if newly contracted rents decline at an accelerating pace, we expect NOI to remain stable and not deteriorate significantly (Exhibit 9).

Exhibit 9 NOI and Appraised Value of J-REIT Properties



Note: Shows aggregated NOI and appraised value of 184 J-REIT properties for which data is available since the first half of 2004.
Source: Compiled from disclosures and other materials.

While keeping in mind the risk of declining property prices in the near term, if we can accurately determine the property market's bottom line with respect to fundamentals, it would prompt financial institutions to rethink their lending stance on real estate and ease up the credit contraction.

3. Urgent Need to Restore J-REIT Market Confidence

Although ranked only fifth in our survey results, we believe that recovery of the J-REIT market and restoration of investor confidence are especially important for the recovery of the real estate investment market. This is because growth of Japan's real estate investment market is inconceivable in the absence of J-REITs as end buyers. The real estate investment market needs J-REITs to restore liquidity.

Unfortunately, the global turmoil of financial and capital markets has seriously impaired the financing environment of J-REITs by triggering the outflow of foreign funds, which account for over half of transactions in the J-REIT market. At the same time, however, we must note that the J-REIT market slump has been exacerbated by a lapse of discipline stemming from conflicts of interest. To restore confidence among lenders and equity investors, the problem of fiduciary responsibility must be kept from spiraling out of control and dragging down worthy J-REITs. Since this matter lies beyond the control of asset managers and J-REIT sponsors, we call on supervisory authorities to immediately demonstrate a firm commitment and to present effective policies for restoring confidence in the J-REIT market.[5]

5. Conclusion

Due to the U.S. subprime meltdown and ensuing crisis in world financial and capital markets, the soft landing we predicted last October for Japan's real estate investment market has failed to materialize.

However, compared to other countries, Japan's real estate investment environment remains relatively attractive, with not a few foreign and domestic equity investors looking for investment opportunities. In particular, we hope savvy lenders and investors will emerge who can endure the short-term downside risk. Looking ahead, once the expanding financial crisis turns around, the pessimism pervading the market will start to shift. Eventually, we expect that as debt financing grows, the real estate investment market will bottom out led by prime office properties.

End Notes

1. For more information (in Japanese), see Toru Matsumura, "Correction Phase of the Real Estate Investment Market: Heightened Sensitivity to Risk Helps to Correct the Deviation from Fundamentals," in *Real Estate Investment Report*, NLI Research Institute, October 29, 2007. (www.nli-research.co.jp/report/misc/2007/fudo071029.pdf)

2. For more information (in Japanese only), see Masanori Oka, "The Sharp Deterioration of Market Sentiment, and Preconditions for Market Recovery: Results of the Fifth Survey of Real Estate Market Conditions," in *Real Estate Investment Report*, NLI Research Institute, October 5, 2008. (www.nli-research.co.jp/report/misc/2008/fudo081105.pdf)

3. Due to the tightened lending stance of financial institutions and diminished risk tolerance of investors, it has become extremely difficult to finance transactions of properties that are small to medium-sized, for non-office use (residential or retail), or located away from Tokyo. Thus we asked specifically about transaction trends of prime office properties located in Tokyo's central business district.

4. Data was obtained from our proprietary research database.

5. For more information (in Japanese), see Hiroto Iwasa, "After the First J-REIT Failure: Averting the Spiraling Loss of Confidence?" November 21, 2008. (www.nli-research.co.jp/report/researchers_eye/2008/eye081121.html)