Recent Trends in Tokyo's Investment Real Estate Market

1. Office Market Conditions

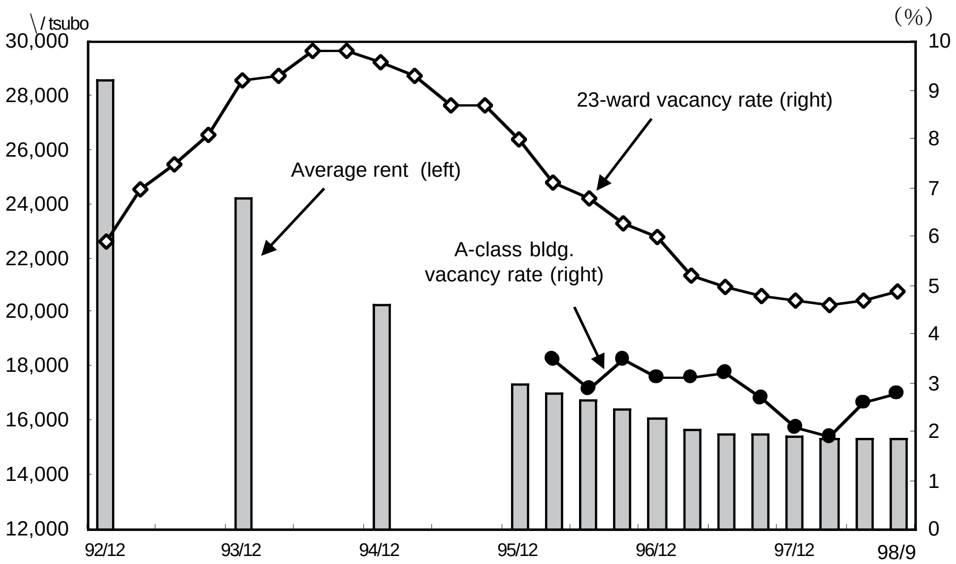
(1) The Office Lease Market

The quarterly vacancy rate rose for the first time in three years after hitting a low of 4.6 percent in March 1998. Vacancy rates are even rising among the very competitive A-class buildings after reaching a low of 1.9 percent in March 1998.

Advertised monthly rents have stayed in the mid 15,000 yen range per tsubo (3.3 square meters) since March 1997, when the vacancy rate fell to the 5 percent range. Thus far, rents have not been affected by deteriorating market conditions (Figure 1).

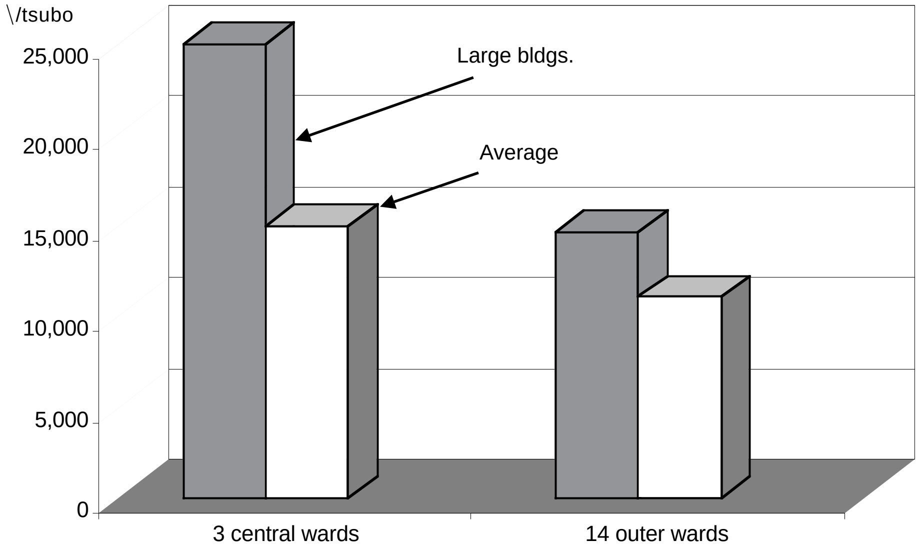
By area and size, large buildings in central Tokyo (Chiyoda-ku, Chuo-ku, and Minato-ku) command a high premium of 1.7 times the average rent, compared to 1.3 times for the 14 peripheral wards (Figure 2).

Figure 1 Vacancy Rate and Advertised Rents in Tokyo's 23 Wards (Quarterly)



Note: A-class buildings have a floor space of at least 10,000 tsubo (33,000 sq. meters) and are located in Chiyoda-ku, Chuo-ku, Minato-ku, Shibuya-ku, and Shibuya-ku.
Source: Ikoma Data Service System

Figure 2 Advertised Rents by Area and Building Size



	3 central wards	14 outer wards
Large buildings	25,493	14.651
Average	14.963	11,067
Differential (Large bldg./total)	1.7	1.32

Note: Large buildings are those with a floor space of at least 200 tsubo (660 sq. meters) per floor. The three central wards are Chiyoda-ku, Chuo-ku, and Minato-ku; the 14 outer wards exclude these three wards as well as Shinjuku-ku, Shibuya-ku, Shinagawa-ku, Toshima-ku, Bunkyo-ku, and Taito-ku.
Source: Sanko Estate

(2) Ten-Year Market Trends

Over the past decade, the office lease market has experienced several demand cycles. The present market appears to have entered a down phase.

① The bubble economy (up to 1990)

New office demand (net increase in occupied floor space over previous year) exceeded the net increase in supply in 1989 and 1990, and continued to grow strongly through the end of the bubble period in 1990. By 1990, the vacancy rate had fallen to 0.6 percent, while advertised rents continued to rise.

② Collapse of the bubble (1991-93)

Demand plummeted when the bubble collapsed in 1991, turning into a net decrease in 1993. Meanwhile, supply continued to grow due to buildings coming out of the pipeline, causing the vacancy rate to surge upward. Rents peaked in 1992 before starting a downward adjustment.

Contracted floor space (newly leased floor space due to office moves and expansions) began growing in 1992 and rose sharply in 1993. This is attributed to an increase in cost-cutting office consolidations and relocations to smaller offices.

③ Demand expansion from a price effect (1994-96)

Demand for office space expanded as substantial rent reductions spurred latent demand. Companies that had postponed relocating due to cost concerns were able to move to larger spaces without increasing overall costs. Moreover, more companies relocated and consolidated their offices in new office buildings, which offered larger rent discounts and were better equipped to accommodate computer networking and other information technology needs.

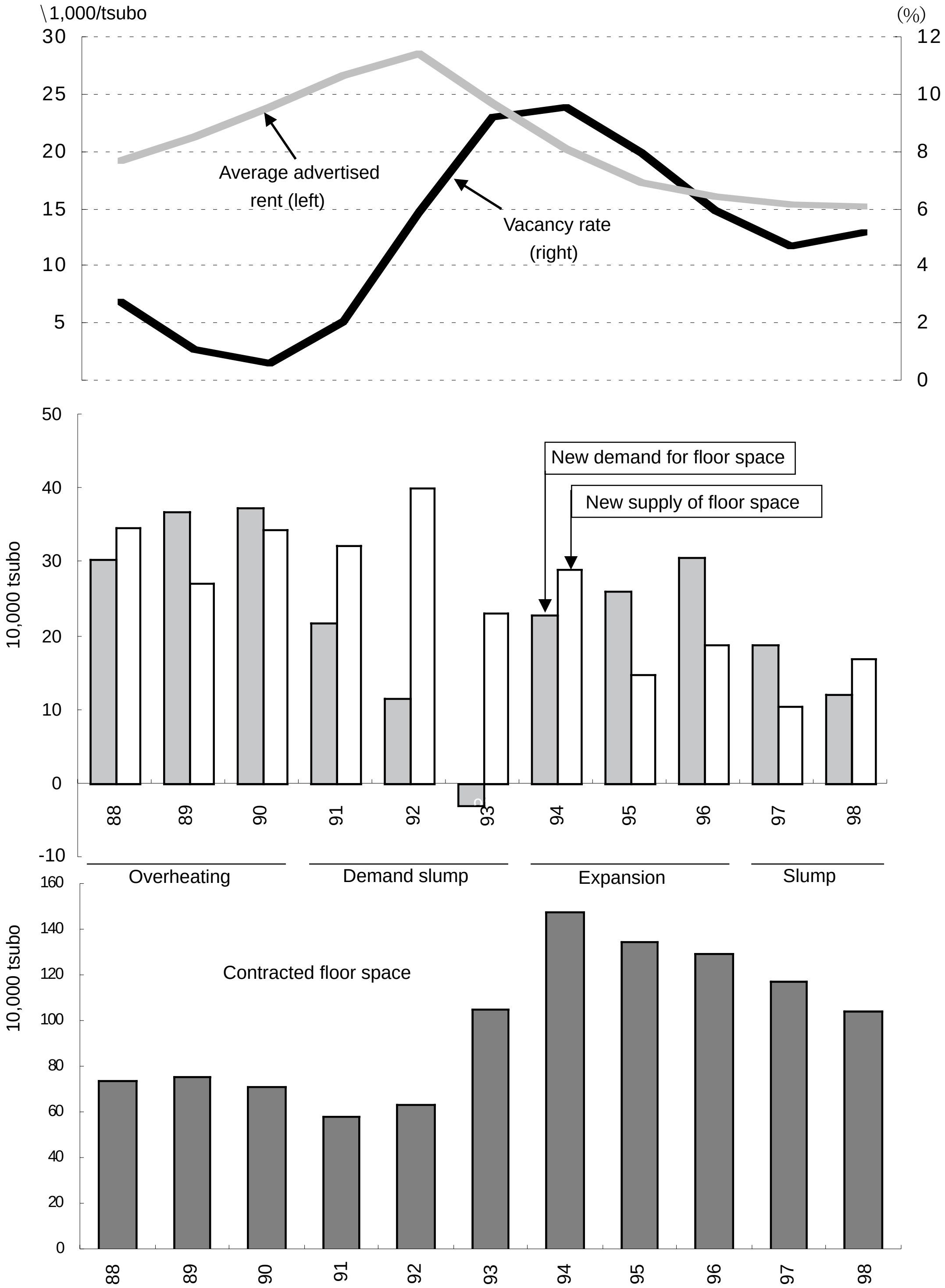
The increase in office relocations helped maintain the contracted office space at high levels. Once supply finally began to ebb, the vacancy rate peaked in 1994 and started to decline.

④ Recession dampens demand (from 1997)

In 1997, growth in office demand declined due to a decrease in relocations, fading price effects, shrinking inventories of high-grade and popular office space, as well as the deepening recession and financial crisis. However, the vacancy rate continued to fall due to the constrained supply of office space.

The vacancy rate began rising in 1998 as the prolonged recession stunted growth in office demand. Rents began moving downward again despite what appeared to be a bottoming-out in 1997 for high-grade office space (Figure 3).

Figure 3 Market Phases in the Past Decade (Tokyo 23 Ward Area)



Note: Rents for 1988-91 and contracted floor space for 1998 are estimated by NLI Research Institute. Rent for 1998 is as of September.

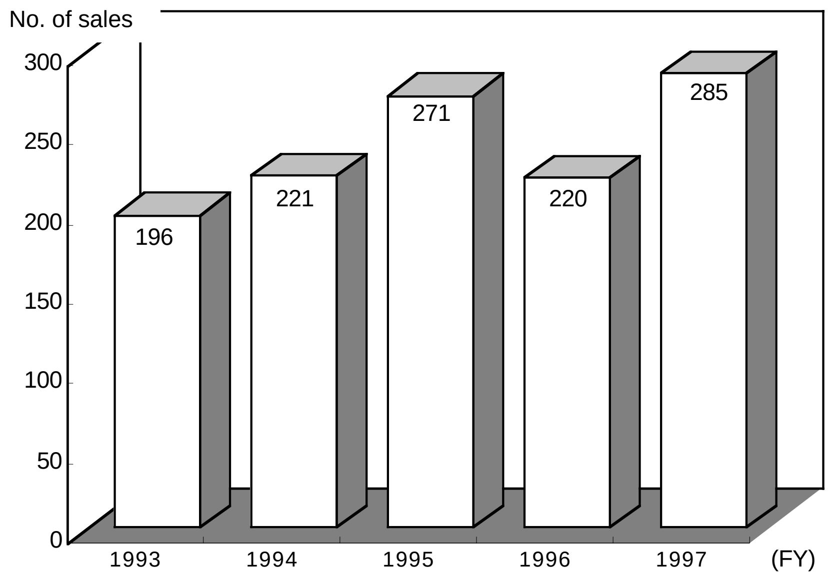
Source: Ikoma Data Service System for new demand and supply for floor space, vacancy rate, and average advertised rent; Sanko Estate for contracted floor space.

2. Status of Real Estate Transactions

In fiscal 1997, the number of real estate transactions by publicly held companies rose by 30 percent (65 transactions) from the previous year to 285 transactions, the highest level since fiscal 1993 (Figure 4).

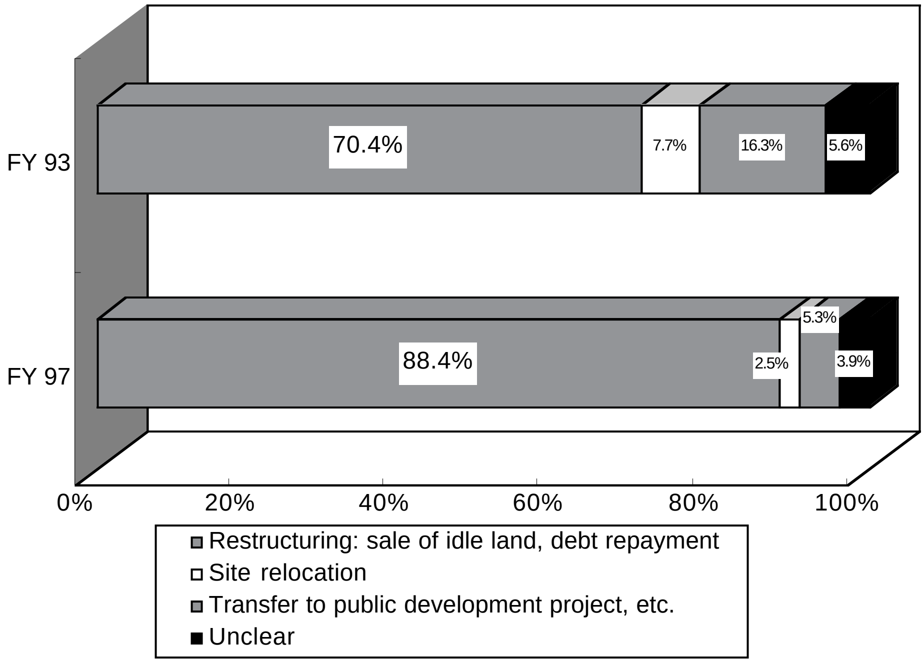
Regarding the reasons for sale, approximately 90 percent were related to restructuring such as idle land disposal and loan repayment, marking an 18-point increase from fiscal 1993. This increase in real estate transactions can be attributed the deteriorating financial condition of companies as the recession persists, reducing debt and increasing bottom lines (Figure 5).

Figure 4 Real Estate Sales by TSE Listed Companies



Note: Daikyo's sale of 1200 collective housing units is counted as one sale.
Source: NLI Research Institute, based on materials submitted to the Tokyo Stock Exchange.

Figure 5 Change in Reasons Cited for Real Estate Sales



Source: Same as Figure 4.

Corporate managements have recently shifted their attention from asset and revenue targets to improving returns on assets (ROA) and equity (ROE). As declining land prices cause unrealized real estate gains to shrivel, the rising cost of holding property leads more companies to sell off high-grade properties as part of restructuring programs and balance sheet adjustments. In particular, there has been a notable increase in sale-and-leaseback schemes, in which companies sell their corporate headquarters or branch locations and immediately lease them back for continued use (Table 1).

Kawasaki City and Yamanashi prefecture are considering selling public properties not planned for use, while other local public organizations are increasingly selling public properties to the private sector to cover tax revenue shortfalls.

Moreover, while not direct real estate transactions, financial institutions began aggressively promoting bulk sales to foreign financial institutions late last year of nonperforming loans such as collateralized real estate loans. These were apparently sold at 10 percent of book value or less due to profitability and risk considerations. Since the investment funds came from foreign hot money seeking short-term returns, the real estate used as collateral could appear on the market in the next two to three years.

As seen from the above, strong pressures are working to increase the supply of both good and bad real estate properties.

Table 1 Building Sales

Address	Building name	Buyer	Seller	Year
Chiyoda-ku Otemachi	Daiwa Bank Tokyo HQ (leaseback)	Kowa Kogyo	Daiwa Bank	1998
Chuo-ku Yaesu	Yasuda Trust Bank HQ (leaseback)	Tokyo Tatemono, Yasuda Life	Yasuda Trust Bank	1998
Chuo-ku Yaesu	Sakura Bank Tokyo Central Branch (leaseback)	SG Management	Sakura Bank	1998
Minato-ku Aoyama	Hazama HQ (leaseback)	Aoyama Development	Hazama	1998
Chiyoda-ku Uchisaiwaicho	Daiwa Life (partial leaseback)	Goldman Sachs	Daiwa Life	1998
Chiyoda-ku Uchisaiwaicho	Asahi Tokai (leaseback)	Miyuki Building	Tokai Bank	1998
Chuo-ku Yaesu	Sumitomo Trust Bank Tokyo Central Branch	Tozai Tochi Tatemono	Sumitomo Trust Bank	1998
Meguro-ku Meguro	Fuji Bank Tokyo Admin. Center	Nihombashi Kogyo	Fuji Bank	1998
Chiyoda-ku Marunouchi	Mitsubishi Trading Annex (leasehold)	Mitsubishi Trading	Mitsubishi Land	1998
Chuo-ku Ginza	Nissan Motor HQ New Bldg.	Mori Bldg. Development	Nissan Motor	1998
Shinjuku-ku, Meguro-ku, Taito-ku	3 Collins bldgs.; 5 total	Da Vinci One	Jukan Kiko	1998
Shinjuku-ku Takadanobaba	Takadanobaba Kayu	Rikuun Electric	Toda Construction	1998
Minato-ku	Daiichi Kangyo Bank Aoyama Branch (leaseback)	(An affiliated bldg. mgt. co.)	Daiichi Kangyo Bank	1998
Chiyoda-ku Uchisaiwaicho	LTCB HQ	Cho Building	LTCB	1998
Shibuya-ku Roppongi	(formerly) Daiichi Housing Loan (Jukan Kiko)	Saudi Arabia	Jukan Kiko	1998
Chuo-ku Nihombashi	Tokyu Dept. Store Nihombashi Store	Undecided	Tokyu Dept. Store	1999
Chuo-ku Ginza	Daiei OMC (formerly Licker Bldg.)	Undecided	Daiei	-
Chuo-ku Ginza	Daiei Ginza (formerly Kanebo Bldg.)	Undecided	Daiei	-
Shibuya-ku Jingumae	Renown HQ	Undecided	Renown	-

Source: NLI Research Institute

3. Commercial Real Estate Prices

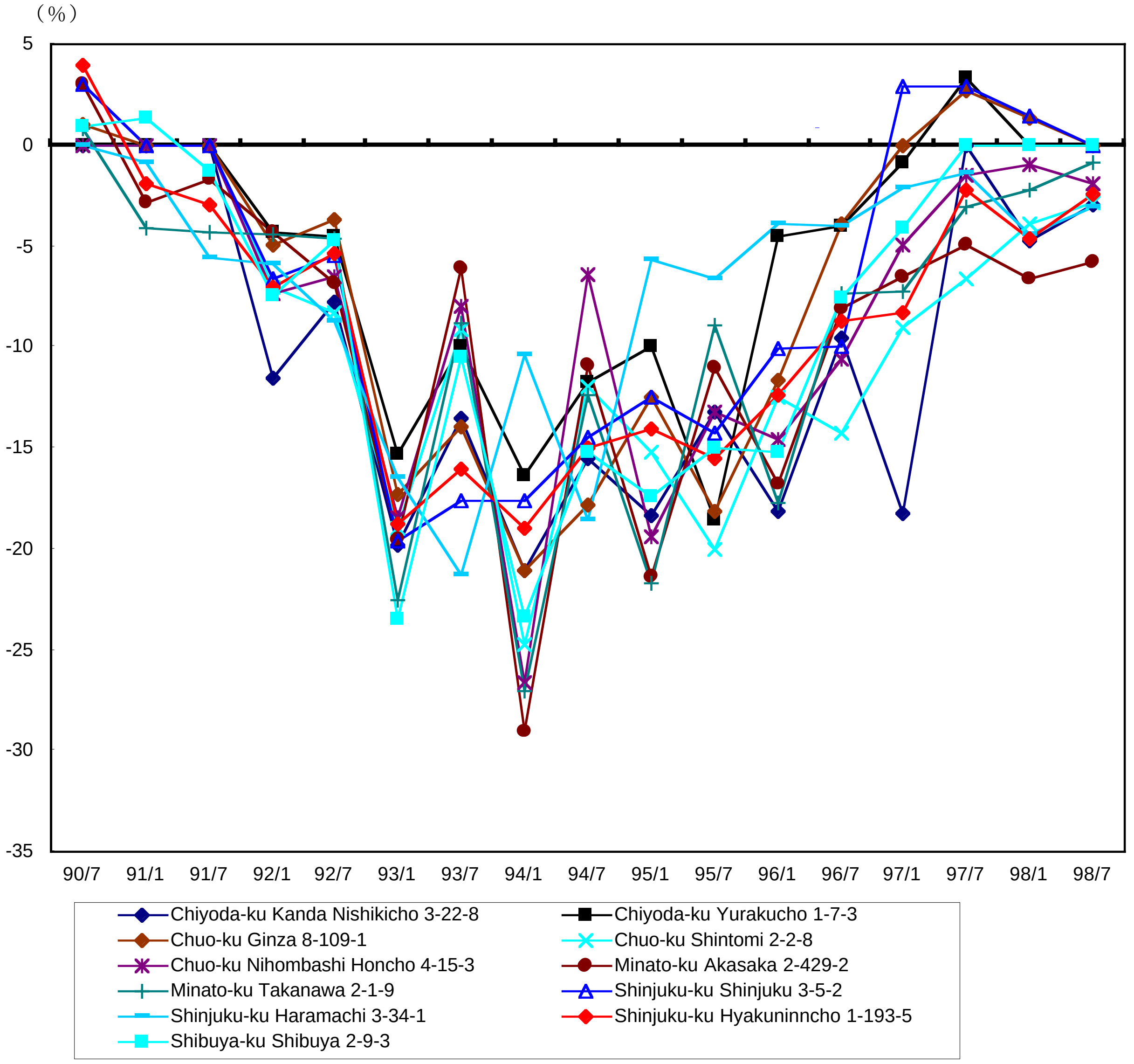
In the standard land prices posted for July 1998, of 170 commercial locations in the five central wards (Chiyoda-ku, Chuo-ku, Minato-ku, Shinjuku-ku, and Shibuya-ku), land prices rose at four locations, a decrease of six from the previous year.

Looking at the 11 locations covered by both the standard land price survey and official land price survey (conducted every January), land prices in all 11 locations fell from 1992, but in July

1997 three locations showed an increase for the first time in four and a half years, while two other locations held even. With the rate of decline also shrinking at the remaining six locations, land prices appeared to be bottoming out.

However, since January 1998 land prices have started softening again (Figure 6).

Figure 6 Change in Commercial Land Prices in Tokyo's 5 Central Wards



Source: National Land Agency, *Official Land Prices*, and *Prefectural Land Price Survey.*

In addition, due in part to investments by foreign financial institutions, it is becoming more difficult to grasp market trends based solely on official land price trends. Until now, commercial land appraisals have been based on actual transactions in nearby areas, while foreign companies base their investment decisions on return calculations. This leads to disparities with the official land prices, which are only partially based on return calculations.

Under the market data approach, since different returns can cause large disparities in market valuation despite similar assessments, converting to return-based valuation will accentuate the polarization of the real estate market.

Consider the example in Table 2. If the newness of a building reflects differences in safety, functionality or grade, rents and vacancy rates are affected, while architectural design can cause differences in leased floor space (effective ratio) and thus affect total revenue. When the market valuation of both buildings are calculated, large disparities can occur even if the buildings stand next to each other, face the same street, and are equal in size.

Table 2 Real Estate Valuations with the Return-Based Method

	A bldg.	B bldg.
Land area	300 tsubo	300 tsubo
Completion year	1975	1995
(1) Total floor space	2,400 tsubo	2,400 tsubo
(2) Land coverage ratio	60%	70%
(3) Leased floor space (1) x (2)	1,440 tsubo	1,680 tsubo
(4) Rent	\10,000/tsubo	\13,000/tsubo
(5) Occupancy rate	90%	95%
(6) Annual revenue (3) x (4) x (5) x 12 mo.	\155.52 mil.	\248.98 mil.
Assume 6% expected yield		
Real estate price (6) / 6%	\2.6 bil.	\4.1 bil.

Note: Does not consider taxes and management expenses.
Source: NLI Research Institute

In actual investment decisions, it is common to make assumptions regarding factors such as future rent increases, risk of vacancies, renewal investment costs to maintain market value, and resale price, and then use a discounted cash flow method (DCF) for greater accuracy. Furthermore, valuation methods become more complex and varied when expected investment returns are categorized according to local market characteristics, tenant risk, and investment fund characteristics.

This approach seeks to appraise both the land and building, and is not intended for land valuation alone.

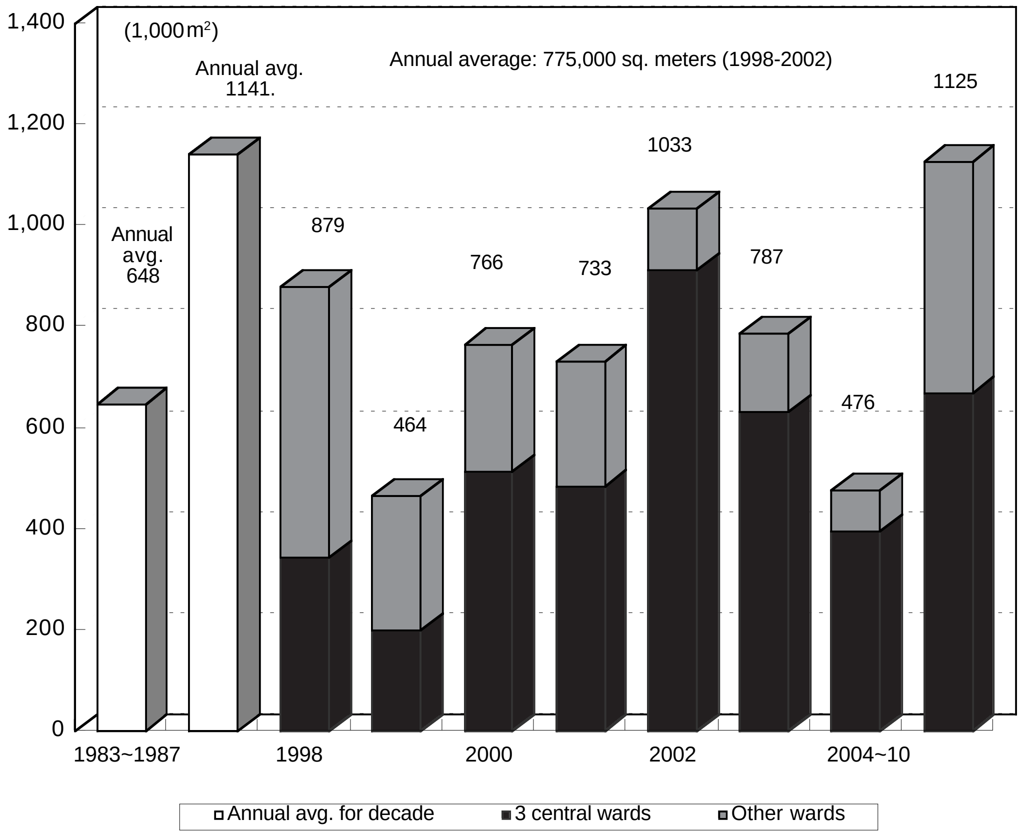
In September, the National Land Agency and the Japanese Association of Real Estate Appraisal proposed due diligence guidelines for appraising defaulted real estate held as collateral using the return method. Although the method's applicability is limited, it is expected to become common practice in the future.

4. A Forecast

For office buildings with a floor space of at least 5,000 square meters (both for lease and own use), current plans indicate that over the next five years supply will amount to two-thirds the level of the bubble period.

Many are large-scale projects in the three central wards, such as previously canceled redevelopment projects and development projects on land owned by the JNR Settlement Corporation. These buildings will not only have good locations, but are predicted to excel in design and functionality, including earthquake resistance and information technology applications (Figure 7).

Figure 7 Future Office Building Plans



Source: NLI Research Institute

These new buildings signify a huge future supply of buildings that will outdo today's most competitive buildings in terms of location (central city, near train stations), newness, and large size. As long exorbitant rents are not set, these new buildings are practically assured of achieving high occupancy rates immediately upon completion.

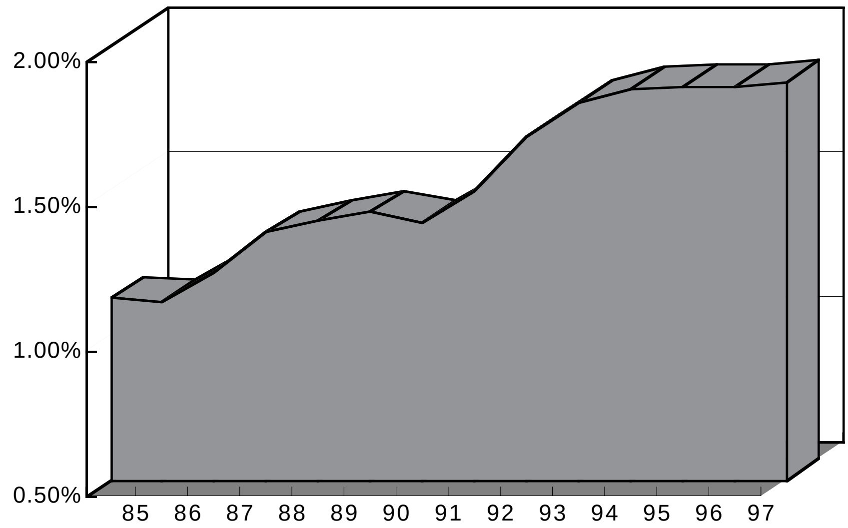
This type of new supply can be expected to stimulate the market by spurring demand and encouraging companies to relocate in the central city area. However, if the economic recovery is delayed further and demand does not expand as much as anticipated, it will be a zero sum game.

In any event, the new supply of large buildings is certain to impact existing buildings and intensify competition between new and old.

On the other hand, amid corporate and industry restructuring centered around the financial sector, downswing and streamlining will keep office demand from expanding sharply. Moreover, there is a growing awareness of costs and effective use of assets. In the fiscal year ending March 1999, declines in operating and current profits are predicted to decline less than revenue. This is because companies are cutting fixed expenses such as personnel and rent deep enough to more than offset revenue declines.

For example, in the non-manufacturing sector, the ratio of movable and real estate rents to revenue has remained high since 1993. But as aggressive investment in information technology causes OA equipment leasing fees to rise, it will become more difficult to raise office rents (Figure 8).

Figure 8 Ratio of Rent Expense to Sales (Non-manufacturing)



Note: Includes leasing fee for movable assets.
Source: MOF, *Annual Statistics of Incorporated Enterprises*.

In the future, if the recession persists and office demand slumps, the gap between supply and demand could expand and pull rents and land prices downward in a vicious cycle.

However, investment opportunities can also be seen as expanding from the disposal of high-grade buildings and land due to corporate restructuring, low interest rates, falling land prices and the growing acceptance of strict return-based valuations. The problem lies in financing. New direct financing methods such as securitization and nonrecourse loans are needed to attract domestic and foreign investors.

Business opportunities are also expanding in the real estate industry due to institutional improvements aimed at invigorating real estate investment, including implementation of the Special Purpose Company Law (SPC) and establishment of a servicer law.