On the Growing Momentum of Tokyo's Real Estate Investment Market—Survey of Real Estate Market Conditions (2005)

By Toru Matsumura and Masanori Oka

Financial Research Group

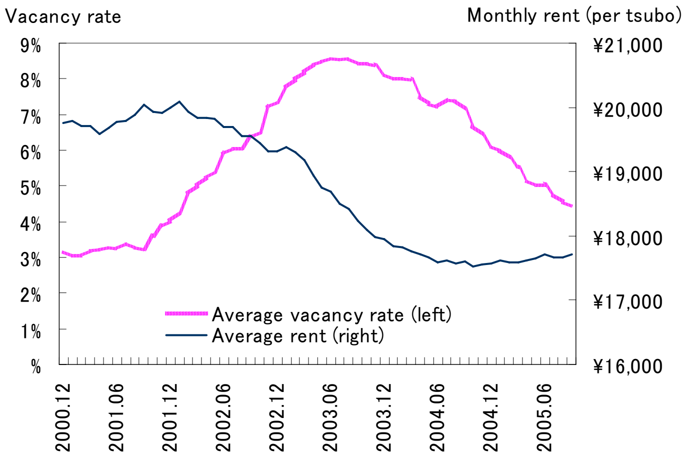
omatsu@nli-research.co.jp, oka@nli-research.co.jp

Aggressive buying by real estate funds has bid up property prices, raising concerns of a "fund bubble." Based on our survey of real estate market conditions, we analyze the current sentiment and outlook for the real estate investment market.

1. Tokyo's Rising Office Rents

Since peaking out at 8.6% in June 2003, the office vacancy rate in Tokyo's five central wards has descended to the low 4% range. Asking rents also finally bottomed out in October 2004, and have since risen modestly (Figure 1).

Figure 1 Vacancy Rate and Asking Rent—Tokyo Business District



Source: Miki Shoji

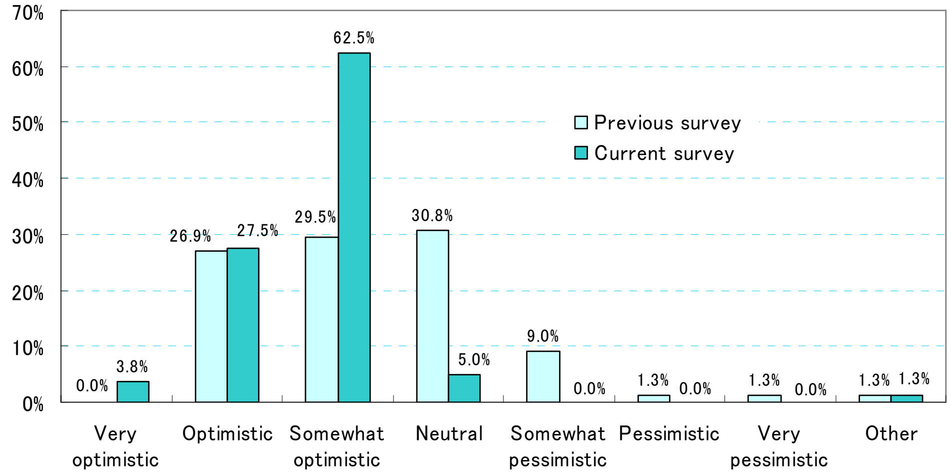
When the vacancy rate was soaring in 2003, large buildings frequently had to offer a rent-free period to attract tenants. Today, such lease concessions have reportedly disappeared, suggesting that actual rents have rebounded even more strongly than the raw data suggests.

The shift in office market conditions comes as companies complete the restructuring and profit recovery phase, and enter a new business growth phase—as also seen by the declining unemployment rate—expanding office demand in the process.

Growing optimism in the office leasing market is also evident from our annual survey of market participants. In the previous 2004 survey, many respondents expected to see "no change" (30.8%) in Tokyo's office market conditions over the next year.[1] But in the 2005 survey, sentiment has strongly shifted (62.5%) to being "somewhat optimistic," meaning that participants expect the vacancy rate to drop, asking rents to rise for prime properties, and effective rents to rise partially. Unlike the previous survey, very few respondents expect current conditions to remain the same or deteriorate (Figure 2).

The latest survey was conducted by e-mail from October 11–25, 2005. Surveys were sent to 132 market participants in real estate, construction, finance, insurance, real estate agency, property management, real estate fund, rating, investment advisory, and consulting businesses. We received 80 valid responses, for an effective response rate of 60.6%.

Figure 2 One-Year Outlook for Tokyo's Office Lease Market



Very optimistic	Vacancy rate drops, asking rents rise widely, effective rents also rise
Optimistic	Vacancy rate drops, asking rents rise for prime properties, effective rents also rise
Somewhat optimistic	Vacancy rate drops, asking rents rise for prime properties, effective rents rise partially
Neutral	Vacancy rate unchanged, asking rents stop rising for prime properties
Somewhat pessimistic	Vacancy rate rises, asking rents soften even for prime properties
Pessimistic	Vacancy rate rises, asking rents drop even for prime properties
Very pessimistic	Vacancy rate rises, asking rents drop widely
Other	Other response

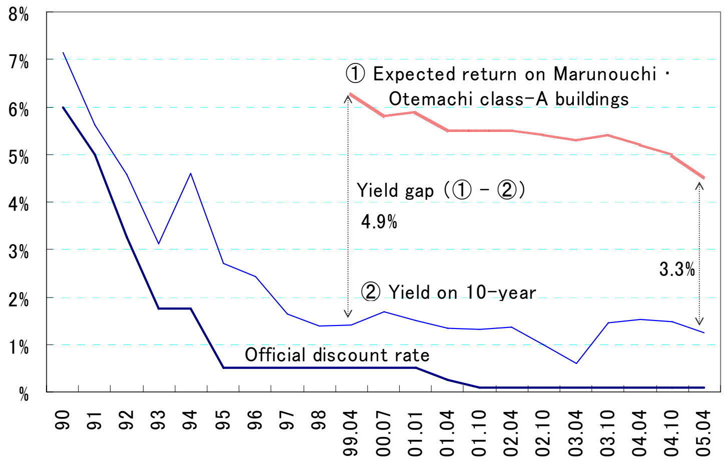
Note: Specific definitions for responses differ from previous survey to reflect differences in market conditions.
Source: NLI Research Institute, *Survey of Real Estate Market Conditions*, October 2005.

2. On Current Transaction Prices

Against the backdrop of low interest rates and excess liquidity, domestic and foreign investors remain strongly attracted to the real estate investment market, driving real estate prices up and yields down (Figure 3).

[1] "Summary of the Office Market Survey—Outlook of Market Participants," in Japanese, NLI Research Institute, October 21, 2004.

Figure 3　Short-term and Long-term Interest Rates, and Real Estate Yield

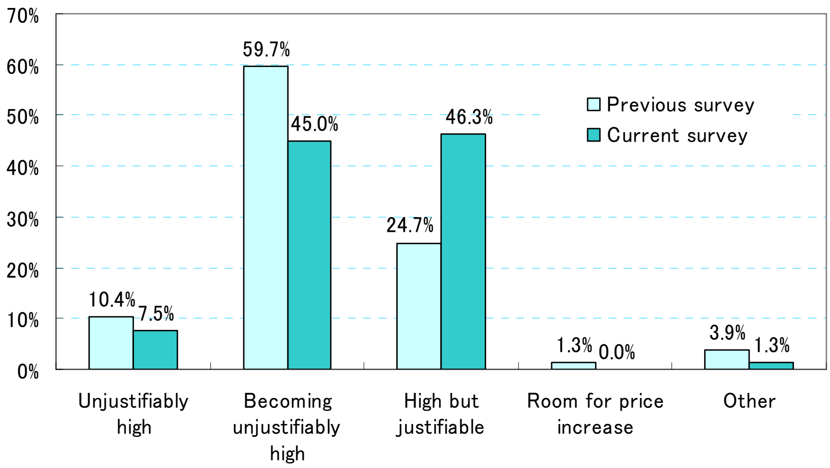


Note: Shows yearend yields from 1990 to 1998, and monthly yields from April 1999.
Source: Compiled using data from Japan Real Estate Institute.

In particular, private equity funds and J-REITs have flocked to recent auctions, paying exorbitant prices and triggering concerns of a "fund bubble."

In our survey, 46.3% of participants think that prices are "high but justifiable," slightly outnumbering those who think that prices are "becoming unjustifiably high" (45.0%). By comparison, last year 59.7% thought prices were becoming unjustifiably high, while only 24.7% thought prices were justifiable. Thus the market's cautious stance toward possible overheating has apparently faded. Similarly, sentiment that prices are already unjustifiable has ebbed from 10.4% last year to 7.5% (Figure 4).

Figure 4　Opinion of Current Transaction Prices



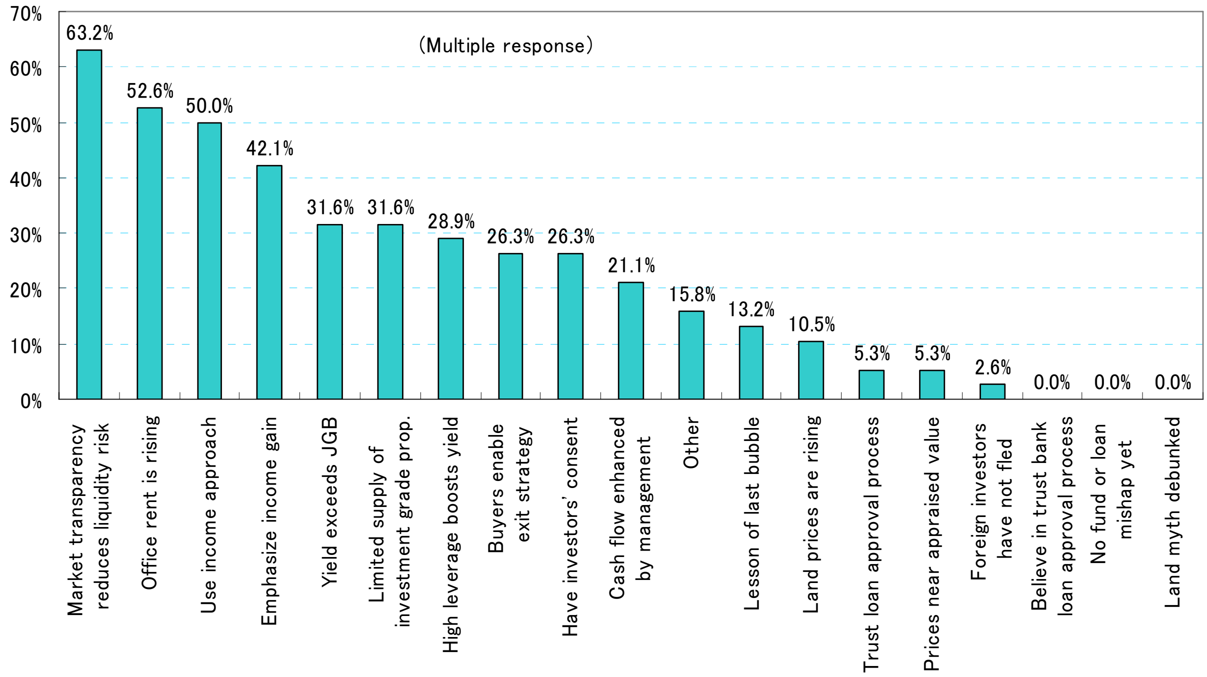
Note: Previous survey was conducted in October 2004.
Source: NLI Research Institute

Among respondents who think that prices are justifiably high, the chief reason (cited by 63.2%) is that "market transparency has increased, reducing liquidity risk." In other words, lower risk premiums for real estate have reduced yields, boosting prices. The second reason (cited by 52.6%)

is that “office rents have entered an upward phase.” This positive outlook for rents contrasts with last year’s divergent outlook between leasing and investment markets,[2] indicating that more participants now support a run-up in prices.

As Figure 5 shows, other justifications for the high prices are: “valuation uses income approach” (50.0%), “emphasize income gain” (have no excessive expectation of capital gain, 42.1%), “purchase price contains risk premium, so yield exceeds long-term JGBs (31.6%); “limited supply of investment grade properties” (investments are more focused, 31.6%); and “expect high leverage to boost yield” (despite rising prices, financing cost is low, 28.9%).

Figure 5 Justifying the Current Price Level



Note: Counts only responses of respondents who believe that current high prices are justified.
Source: NLI Research Institute

Indeed, the methods and arrangements used in real estate investment today are rapidly converging with the global standard, while demographic and economic conditions of the market environment differ completely from the late 1980s bubble period (Figure 6).

Investors now focus on income properties, while the investment structure diversifies risk by separating ownership from management, and the market’s checks and balances work more effectively. We thus see little risk of a renewed speculative binge such as the one inspired by the land myth in the 1980s bubble. At the very least, labeling the recent real estate price run-up as a “bubble” is premature.

[2] In the 2004 survey, we concluded: “Most participants in the investment market are uneasy, but feel they have to participate aggressively for a while. This diverges from the cautious outlook for the leasing market.”

On the other hand, the development of real estate financial products has heightened market risk by creating strong links between real estate prices, interest rates, and stock and bond markets. In addition, we must be wary that the current run-up in prices will inevitably see a correction at some point, and that the danger always exists for the market to overshoot and create a bubble.

Figure 6　Comparison with the Late 1980s Bubble

		Bubble economy (1986～1990)	Present (2000～2004)
Population & economy	Population movement	Concentration in Tokyo area; outflow from 23-ku Tokyo	Re-concentration in Tokyo; return to center of city
	Population growth rate	1.60%	0.60%
	Fertility rate	1.54 (1990)	1.29 (2004)
	Ratio of elderly population	12.1 (1990)	19.5 (2004)
	Real GDP growth rate	4.8% (1985～1990)	1.3% (1999～2004)
Real estate investment	Investment environment	Land myth prevails	Leverage effect enhanced by low interest rates, yield gap
		Government predicts massive office demand	Private sector cites 2010 excess supply problem
		Growth of leasing & transaction markets	Bipolarization of leasing & transaction markets
	Investment objective	Realized & unrealized gain; tax shelter	Distribution of cash flow
	Form of investment	Direct, through own account	Indirect, through securitization, structured finance
		Corporate loan	Nonrecourse loan
	Investment criteria	Discounted payback methods; break-even analysis	Internal rate of return
	Investment index	Official land price	Cap rate; yield gap
	Investment properties, location	Mainly land	Income properties (diverse types)
		Indiscriminate, nationwide	Selective, center of major cities
	Real estate valuation	Market comparison approach	Income approach; due diligence
	Property management	Inhouse; passive	Outsourced; active
	Exit strategy	No	Yes
	Investment risk	Concentrated	Diversified
	Recognition of risk	Low	High (market, management, environment, soil, structure, etc.)

Source: NLI Research Institute

3.　Outlook for the Real Estate Market

What could trigger a correction to the booming real estate investment market? Regarding possible impediments to market growth, the chief factors cited are a “rising long-term interest rate and nonrecourse loan rate” (82.5%) and “shrinking yield gap” (63.8%), indicating that participants are quite sensitive to interest rate and yield trends (Figure 7).

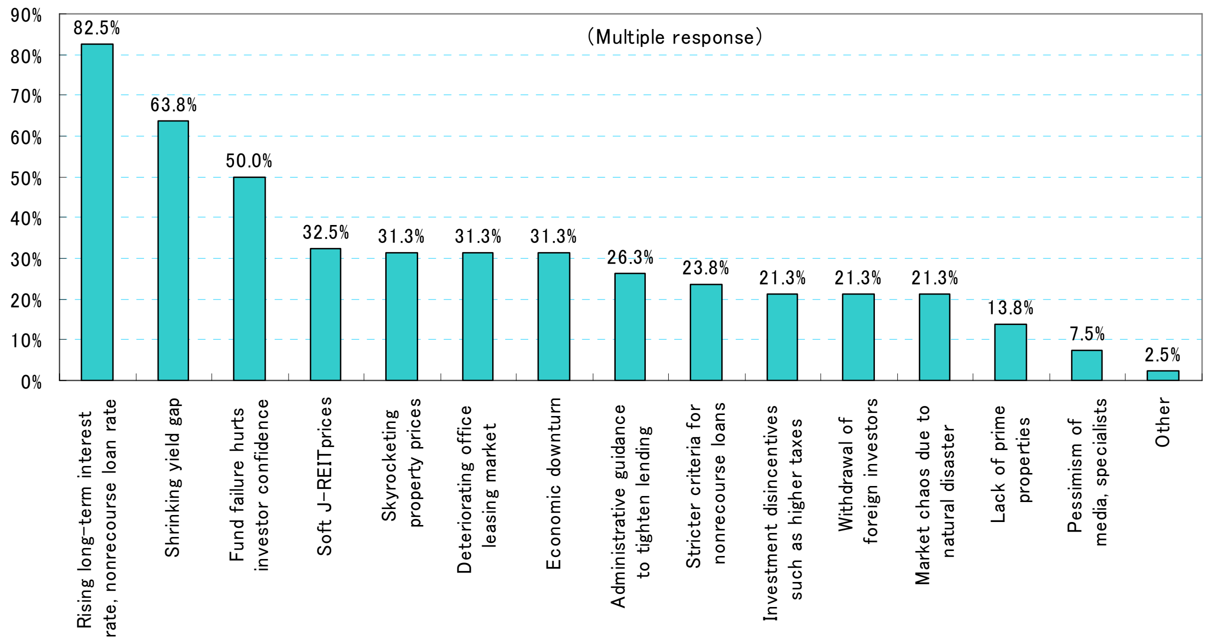
An interesting point is raised by the third factor cited (50.0%): “lower investor confidence due to fund failure or conflicts of interest.” While funds are now the main vehicle for real estate investment, they are still relatively young, and improprieties at one fund could threaten to impair overall market confidence. One respondent notes that the increase in market players has led to a growing number of inexplicable, heavy-handed transactions, which may rattle investor confidence at some point.

Factors 4 to 7 reveal a sensitivity to economic and market conditions: “falling or sluggish J-REIT prices” (32.5%); “skyrocketing real estate prices” (31.3%); “deterioration of office leasing market” (31.3%); and “economic downturn” (31.3%).

Meanwhile, factors 8 to 10 raise concerns about policy changes: “stricter administrative guidance of financial institution regarding loans” (26.3%); stricter criteria for nonrecourse loans” (23.8%); “policies to discourage investment such as stricter development regulations and heavier tax on real estate” (21.3%). These concerns may stem from the bitter experiences with the FSA regulations on real estate financing introduced in March 1990, and the land-holding tax of January 1992.

It is difficult to predict whether the next market correction will be a gradual and incremental soft landing, or a jarring and precipitous hard landing. In any event, investors will need to keep a close eye on interest rates, market conditions, and economic trends.

Figure 7 Perceived Impediments to Market Growth



Source: NLI Research Institute