

# Trends in the Real Estate Investment Market

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*As seen by the vigorous growth of J-REITs and private real estate funds, Japan's real estate investment market is thriving. Not only are funds pouring in from domestic and foreign sources, but real estate demand is being fueled by the economic recovery. Meanwhile, investors need to closely monitor downside risks of real estate market, including higher interest rates and an economic downturn at home or abroad.*

Investment in Japan's real estate market is thriving owing to the inflow of funds from domestic and foreign sources and robust real estate demand fueled by the economic recovery.

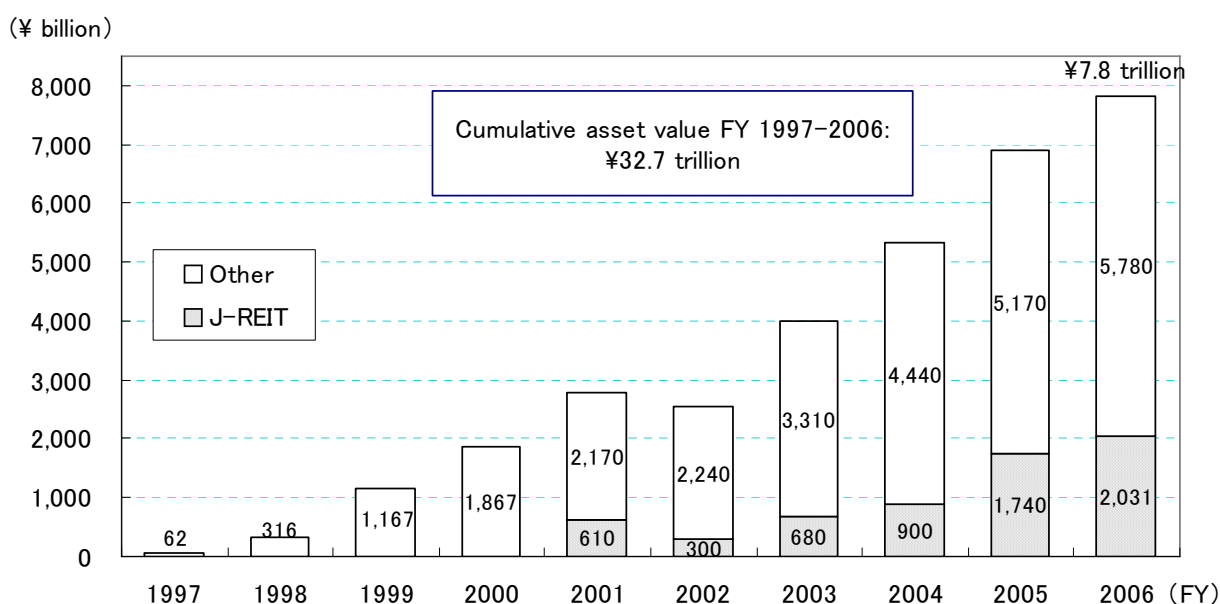
Growth has been particularly vigorous at private real estate funds and J-REITs (Japanese real estate investment trusts).

This paper examines current trends in the real estate investment market from the perspective of these two market leaders.

## 1. Private Funds and J-REITs Drive Market Growth

According to the *Fiscal 2006 Survey of Actual Conditions in Real Property Securitization* by the Ministry of Land, Infrastructure and Transport, ¥7.8 trillion of real estate assets were securitized in fiscal 2006, approximately 13% more than in the previous year, and double the amount in fiscal 2003. In the decade from fiscal 1997 to 2006, the cumulative value of securitized real estate assets reached approximately ¥33 trillion (Exhibit 1).

**Exhibit 1 Asset Value of Real Estate Securitized in Each Year**



Note: Shows preliminary figures for FY 2006.  
 Source: MLIT, *Survey of Actual Conditions in Real Property Securitization*.

Moreover, J-REITs and special purpose corporations (SPC)—which are mainly investment vehicles of private funds—are now involved in approximately 70% of sales transactions of properties owned by listed companies (Exhibit 2).

As Exhibit 2 shows, private funds (which emerged in 1998) and J-REITs (launched in 2001 on the Tokyo Stock Exchange) are clearly driving the real estate market's growth.

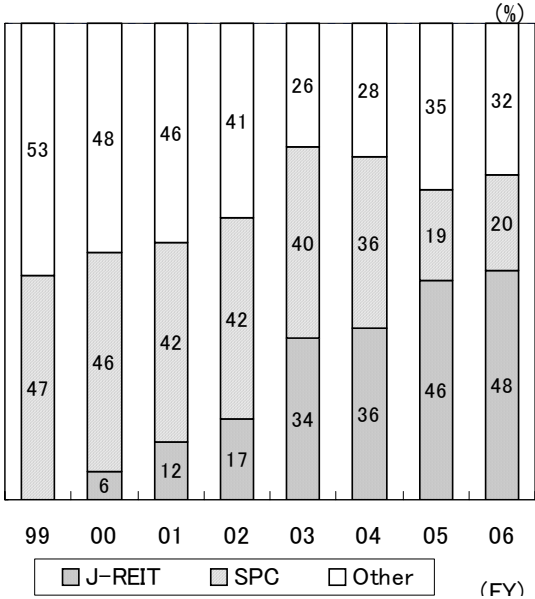
The business strategy of private funds is to take on a high debt-asset ratio for acquiring properties, develop the properties to increase their asset value, and then sell within a relatively short period of three to five years, thereby earning a high return for investors<sup>1</sup>

In contrast, J-REITs manage a stable portfolio of income-producing properties with low downside price risk. As long as they distribute over 90% of profits to shareholders, J-REITs are tax-efficient flow-through vehicles that offer a stable dividend income.

According to a survey by the Association for Real Estate Securitization (ARES) entitled *Membership Survey of Private Funds*, the second most common exit strategy of private funds is to sell properties to J-REITs (20.2%). The only exit strategy more common is to sell properties to other private funds (49.4%).

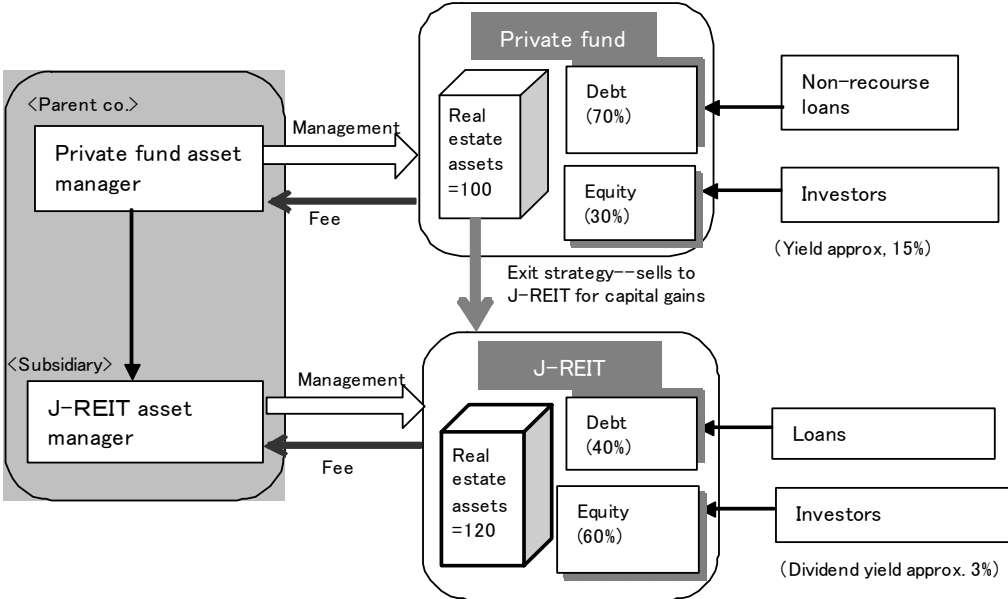
Indeed, some prominent affiliations exist between private funds and J-REITs whose asset management companies belong to the same

**Exhibit 2 Composition of Property Sales Transactions (by value)**



Source: Urban Research Institute

**Exhibit 3 Affiliation of Private Fund and J-REIT**



Source: NLI Research Institute.

company group. Many investors prefer this arrangement because it allows the private fund to supply properties to the J-REIT without encountering market competition. However, we must note the inherent risk of conflict of interest (duty of loyalty) that lurks behind such an arrangement (Exhibit 3).<sup>2</sup>

Market growth rates have been impressive. According to ARES, private fund assets in 2006 rose 35% from the previous year to ¥8.3 trillion, while the number of funds also increased 38% to approximately 600 (Exhibit 4).<sup>3</sup>

Including private funds not covered by the

survey, some estimates value the assets under management at over ¥10 trillion.<sup>4</sup>

The J-REIT market, which began in September 2001 with a market capitalization of ¥260 billion and only two listings, has grown roughly 25-fold to ¥6.7 trillion and 41 listings (Exhibit 5).<sup>5</sup>

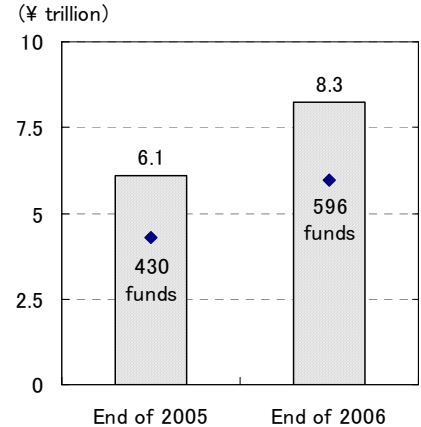
The composition of investors has shifted as well. In 2000, not long after private funds first emerged, major investors were foreign pension funds and risk money. Since then, the composition has shifted toward domestic business companies and financial institutions such as regional banks, along with pension funds investing through trust banks (Exhibit 6).

As for J-REITs, foreign investors and investment trusts have been net buyers in recent years, helping to drive up prices (Exhibit 7).

Investment trusts became prominent J-REIT investors only after the Investment Trusts Association lifted a restriction on J-REIT investment in July 2003, leading to a surge in the growth of real estate fund of funds (FOF).

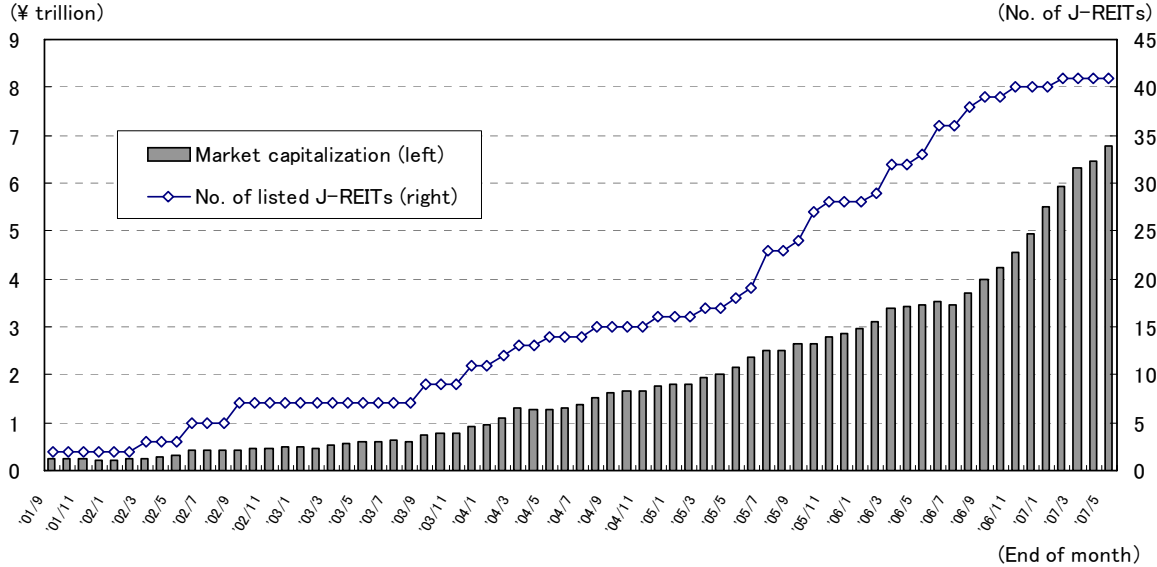
There are now 59 FOFs that invest in J-REITs, up from 28 a year ago. Their aggregate J-REIT investment has reached ¥1.503 trillion, comprising 15% of the total J-REIT market capitalization.<sup>6</sup>

**Exhibit 4 Asset Value of Private Funds**



Source: ARES

**Exhibit 5 J-REIT Market Capitalization and No. of Listings**



Source: Compiled from publicly available data.

## 2. Growth Factors and Market Outlook

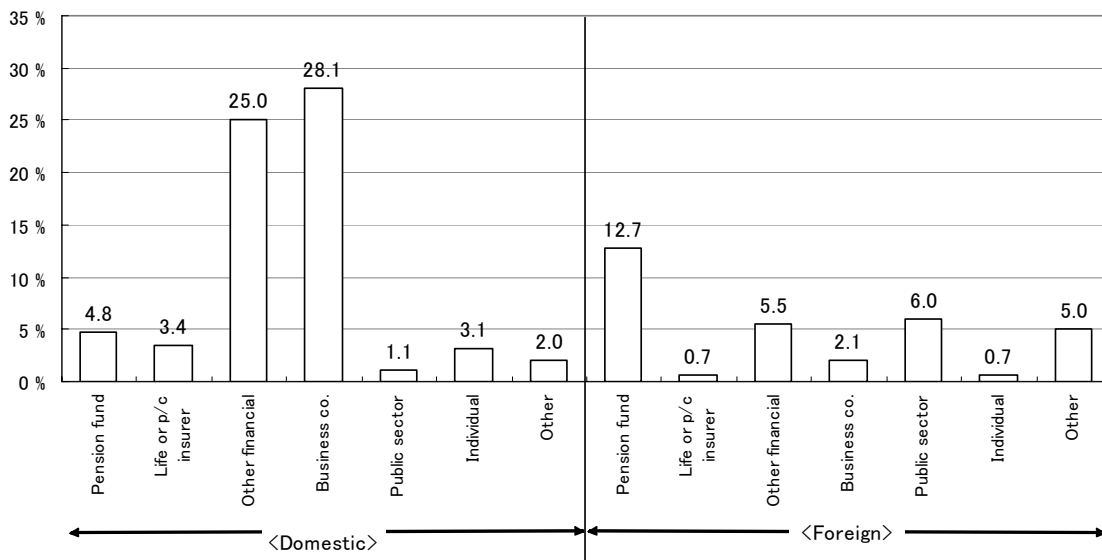
The pronounced flow of funds pouring into the real estate market from abroad can be attributed not only to the global excess liquidity, but to Japan's favorable environment for real estate investment.

According to a survey by the Japan Real Estate Institute entitled *Japanese Real Estate Investor*

*Survey*, the expected yield (cap rate)<sup>7</sup> on Class A office buildings in Tokyo's Marunouchi/Otemachi district<sup>8</sup> stood at 4.0% in April 2007, after dropping 1-percentage point from three years ago. However, the yield spread against the 10-year government bond remains a lofty 2.4% (Exhibit 8).

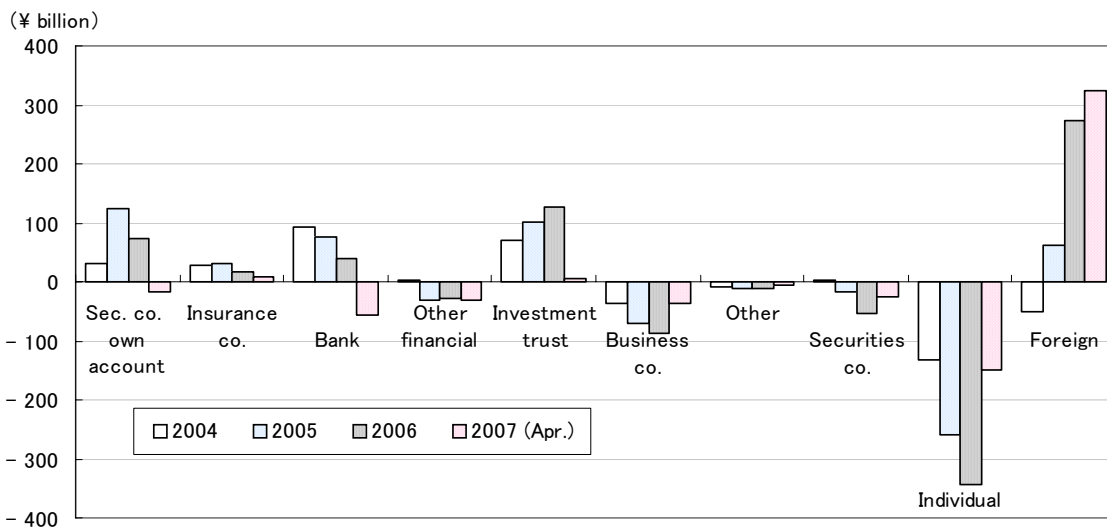
By comparison, yield spreads in other major cities across Europe and the U.S. are much lower—approximately 1% in Frankfurt and Paris,

**Exhibit 6 Composition of Private Fund Investors**



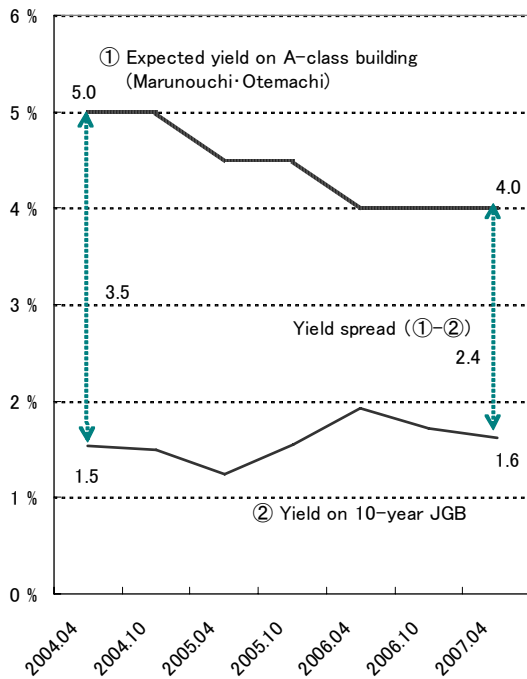
Note: As of December 31, 2006; shows weighted average.  
Source: ARES, *Second Membership Survey Regarding Private Funds*.

**Exhibit 7 Composition of J-REIT Investors**



Note: 2007 data covers from January to April.  
Source: Compiled from publicly available data.

### Exhibit 8 Real Estate Yield Spread



Source: Compiled from JREI and other sources.

and nearly zero in New York and London.<sup>9</sup> Thus from this perspective, Japan still offers an attractive investment environment.

As for J-REIT dividend yields, the yield spread against the long-term government bond yield fell to 0.91% at the end of May 2007 down 0.7% from the previous year. However, due to strong expectations of capital gains, J-REITs are still

considered attractive in light of low domestic interest rates (Exhibit 9).

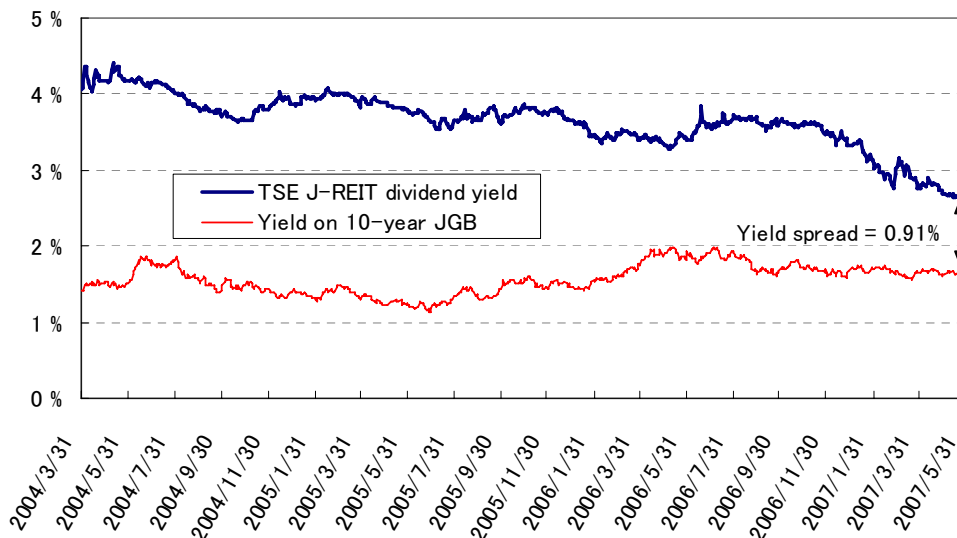
We predict that the real estate investment market will continue to grow due to the strong real estate market and abundant inflow of domestic and foreign funds. However, amid the accelerating pace of real estate securitization and global fund flows, investors must be aware that the real estate investment market is growing more sensitive to movements in global interest rates and equity markets, and becoming increasingly volatile as a result.

In particular, the growing presence of foreign funds, which are especially sensitive to changes in the global investment environment, could become a destabilizing factor to the market.

In addition, investors need to be aware that the real estate asset class is characterized by large price swings, and the market is prone to overshoot. If the market reverses course, buyers will head for the exit in droves.

Thus in the current fund boom, investors are advised to closely monitor external factors for changes that could affect the real estate investment market, including economic conditions and interest rate trends both at home and abroad.

### Exhibit 9 J-REIT Yield Spread



Source: Compiled by NLI Research Institute.

## End notes

1. Asset value can be increased by improving cash flow (raising rents, improving occupancy ratios, reducing management fees, etc.), and reducing or eliminating risk factors (enhancing earthquake resistance, etc.).
2. Managers may be inclined to overpay for properties if compensation is based on asset value, or to churn assets to generate commissions.
3. According to the ARES survey of 209 member companies (including group companies), 70 companies said they managed 596 funds as of the end of 2006.
4. In Exhibit 1, when the ¥6.2 trillion of J-REIT securitized assets is deducted from the ¥32.7 trillion cumulative total, ¥26.5 trillion remains. However, not all of this belongs to private funds.
5. As of May 31, 2007.
6. As of end of April 2006. Real Estate Economic Institute Co., *Fudosan Keizai Fund Review* (May 25, 2007).
7. Class A office building criteria include: location within five-minute walk from nearest train station, 50,000 square meters of floor space, building age less than five years, and high-specification facility and equipment.
8. Investors widely regard the cap rate as a gauge for the expected yield of an income producing property. It is used to calculate property prices based on income generated (property price = net operating income ÷ cap rate).
9. Jones Lang LaSalle, *Global Real Estate Capital*, May 2007.