Trends in the Tokyo Investment Real Estate Market

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In Tokyo's office leasing market, demand is expected to grow as the economy recovers, but the massive supply of large office buildings that will appear from 2000 threatens to upset the market's balance.

Meanwhile, implementation of the SPC Law (Law on Securitization of Specified Assets by Special Purpose Companies) in September 1998 has spurred the development of new real estate investment products that expand investment opportunities beyond actual properties.

In this paper, we examine recent trends in the office market for Tokyo's 23 wards, the status of real estate transactions, and recent developments in the proliferating market for real estate investment products.

1. Status of the Office Leasing Market

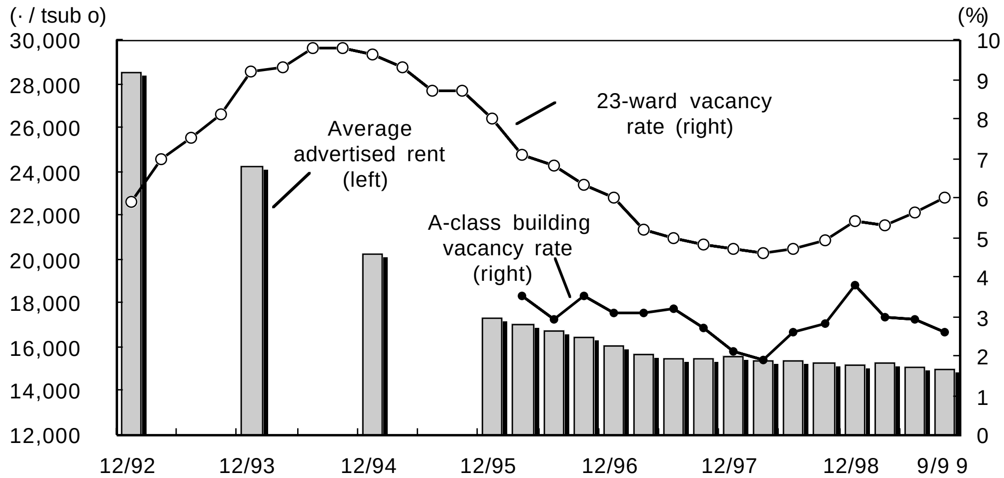
(1) Vacancy Rate and Advertised Rent

After bottoming out in March 1998 at 4.7%, the vacancy rate in Tokyo's 23-ward area rose to 6.0% by September 1999, a level not seen since December 1996.

Advertised monthly rent per tsubo (3.3 square meters), which hovered in the mid ¥15,000 range from March 1997 as the vacancy rate dropped to the 5% range, fell below ¥15,000 to ¥14,980 in September 1999.

The vacancy rate for A-class buildings has remained at approximately 3% except in December 1998, indicating the competitiveness of this market segment (Figure 1).

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



Note: A-class buildings are located in Chiyoda, Chuo, Minato, Shinjuku and Shibuya wards, have at least 10,000 tsubo in total floor space with at least 200 tsubo per floor, and were built since 1982. There are 47 buildings.
Source: Ikoma CB Richard Ellis

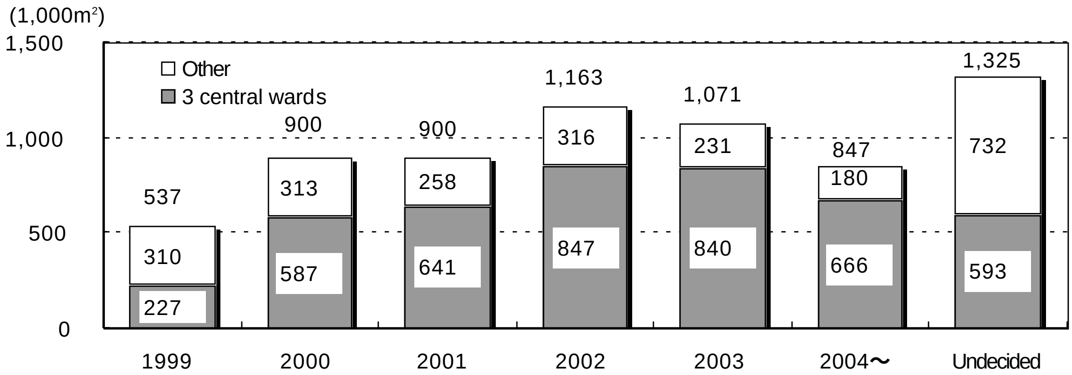
(2) Planned Construction

With regard to the planned construction of office buildings with at least 5,000 square meters of floor space (both for leasing and own use), the annual supply of new office space during the four year period from 2000 to 2003 will be equivalent to two-thirds that of the bubble era. Over 70% of this supply will be concentrated in the three central wards, and of these buildings, thee-fourths will have at least 30,000 square meters of office space (Figure 2).

The excellent locations and new condition of these large buildings will make them highly competitive in the office market, and pose a real threat to existing buildings if the demand for office space fails to expand.

The market impact of the 3.8 million square meters of office space coming on line in the next four years will be partly alleviated by the fact that one-third is slated for occupancy by owner. Still, since many of these owners are companies who will be relocating from their present leased offices, the impact will not be neutral unless vacated offices are taken off the market for rebuilding or other reason.

Figure 2 Planned Office Construction (23-ward area, 5,000 sq. meters or larger)



Note: Shows estimated floor space of office portion of buildings.

(3) Office Demand of Financial Institutions

The present price leaders in the office market are major foreign financial institutions, who have both the intention and ample means to expand their offices.

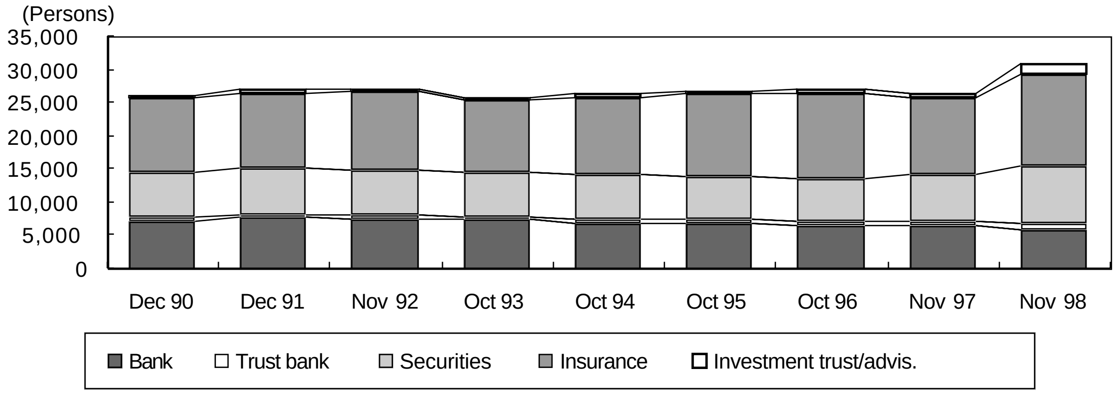
After remaining mostly level since 1990, the number of employees at foreign financial institutions (bank, trust, securities, insurance, investment trust and advisory companies) increased 16% in 1998 to over 30,000 (Figure 3). This is thought to be a result of the expanding business opportunities in the Japanese market created by the financial Big Bang, and further growth in employees is expected as these companies continue to expand their presence.

However, the rapid growth in employees is not likely to persist because in addition to the investment banks, trusts and investment advisories who mainly cater to corporate clientele, the banks, securities, insurance, and trust companies who serve individual customers are also streamlining sales operations by using information networks. In addition, the number of companies withdrawing from the market equals those who are entering.

Meanwhile, Japanese financial institutions are engaged in mergers and tie-ups, and plan to cut payrolls substantially over the next three to five years.[1] Several thousand employees will likely be affected in Tokyo due to the concentration of businesses here. The consolidation of excess and redundant offices is expected to reduce office demand. This retrenchment will impact the market significantly, since domestic financial institutions are excellent tenants with sound credentials.

Because foreign financial firms are not likely to offset the decrease in office demand among domestic financial institutions, the financial services industry as a whole is not expected to contribute to the growth in office demand.

Figure 3 Number of Employees at Foreign Financial Institutions



Notes: Counts companies with a presence in Tokyo. When the current number of employees is unknown, the most recent known number is substituted.
Source: Toyo Keizai Shinposha, *Handbook of Foreign Companies.*

2. Status of Real Estate Transactions

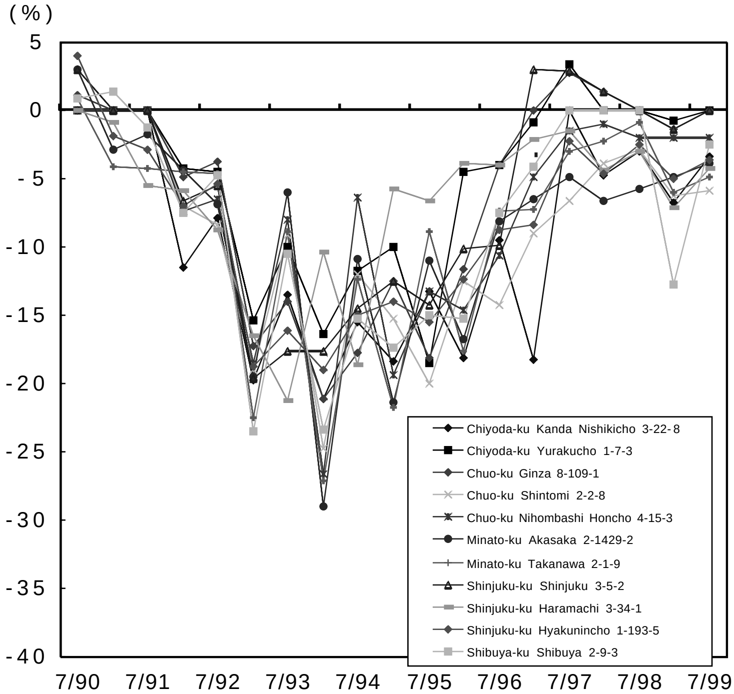
(1) Commercial Real Estate Prices

According to July 1999 benchmark land price data, of 141 monitored commercial sites in five central wards (Chiyoda, Chuo, Minato, Shinjuku, and Shibuya), none showed a price increase, compared to four sites a year earlier.

Among the eleven monitored sites common to the benchmark price survey and official land price survey (held annually in January), the continuous price decline since 1992 appeared to end in July 1997 because some of the prices had increased. But prices softened again in January 1998, and in July 1999 prices at eight sites declined (Figure 4).

However, a long time lag occurs in releasing benchmark and official land price data, and the valuation methods are unsuitable for actually making investment decisions. Market participants are thus calling for new data compilation methods that reflect actual market prices.

Figure 4 Rate of Price Fluctuations in Five Central Wards

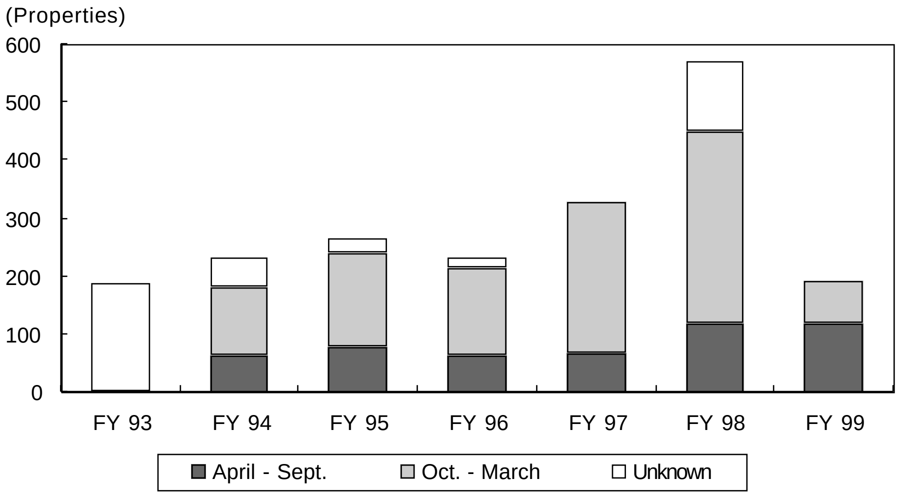


Source: National Land Agency, *Official Land Prices*, and *Prefectural Land Price Survey.*

(2) Real Estate Transactions

In fiscal 1998, companies listed on the Tokyo Stock Exchange reported 571 real estate sales transactions, marking a 75% increase of 245 transactions over fiscal 1997.[2] This pace is being maintained in fiscal 1999, indicating that companies remain under strong pressure to sell real estate (Figure 5).

Figure 5 Number of Real Estate Sales Transactions



Notes: Reflects data released up to September 30, 1999. The sale of 1,200 collective housing units by Daikyo in fiscal 1997 is counted as one transaction.
Source: Company filings to the Tokyo Stock Exchange.

The sales involved not only idle properties but many office buildings currently in use, including corporate headquarters that were sold and then leased back (Figure 6).

Figure 6 Major Sales Transactions of Office Buildings (1999)

Area	Building name	Seller	Was HQ	Lease-back	Buyer
Chiyoda-ku	Tokyo Mitsubishi Bank HQ	Tokyo Mitsubishi Bank	●	●	Mitsubishi Estate
	Tokyu Hotel Chain HQ	Tokyu Hotel Chain	●	●	Shogakukan
	Chiyoda Building	Mitsubishi Estate			Meiji Life Insurance
	Diamond Building complex	Diamond Inc., Toyo Kohan	●		Daido Life**
Chuo-ku	Tokyo Mitsubishi Bank HQ Annex	Tokyo Mitsubishi Bank	●		Mitsubishi Estate
	Mitsui Engineering & Shipbuilding Engineering Center	Mitsui Engineering & Shipbuilding		●	Unknown
	Nissin Sugar Mfg. Building	Nissin Sugar Manufacturing	●	●	Sumitomo Life Insurance
	Sumitomo Irifune Building	Sumitomo Realty & Develop.			Securitized
	Tokyu Department Store at Nihombashi	Tokyu Department Store			Org. for Promoting Urban Dev. ***
Minato-ku	Tokyo Tomin Bank HQ	Tokyo Tomin Bank	●	●	Undecided
	Shin Nikko Building	Japan Energy	●	●	AIG
	NCR Japan HQ	NCR Japan	●		Nippon Foundation
	Morinaga Plaza Building	Morinaga & Co.	●	●	Undecided
	Haseko HQ	Haseko	●	?	Undecided
	NEC Super Tower	NEC	●	●	Undecided
	Akasaka Tokyu Building	Tokyu Land			Entrusted to raise funds
	Tokyo Nissan Building	Tokyo Nissan Auto Sales	●	?	Mori Building
Shinjuku-ku	Odakyu Construction HQ	Odakyu Construction	●		Odakyu Electric Railway
	Tokyo Opera City	Odakyu Department Store			Odakyu Electric Railway
	Shinjuku L Tower	Sapporo Beer			Fukoku Mutual Life Insur.
	Shinjuku Sumitomo Building	Sumitomo Realty & Dev., Sumitomo Life			Securitization planned
Shibuya-ku	(Meiji Milk rental building)	Meiji Milk Products			Bird Feather
	Shibuya Tokyu Plaza	Tokyu Land			TEN Urban Development
	Toho Life Insurance Building	Toho Life Insurance	●	●	Goldman Sachs
	Shokusan Jutaku Sogo HQ	Shokusan Jutaku Sogo	●	●	Shokusan Fudosan Hanbai
	Tokyu Land HQ	Tokyu Land	●	●	Securitized
Sumida-ku	Isuzu Motors Tokyo Sumida Business Office	Isuzu Motors			Bell Capital
Shinagawa-ku	LTCB Office Center	Long-Term Credit Bank		●	LTCB Building
	Ube Industries HQ	Ube Realty & Development	●		JTB Group
Taito-ku	Hotel Sofitel Tokyo	Hokke Club			Accor
	Tobu Store Head Office	Tobu Store	●		Tobu Railway

Notes: 1. Includes transactions and exchanges involving joint ownership, separate ownership, leaseholding, and trust certificates, and cases where buyer demolishes existing building to erect a new one. Securitization is indicated in buyer column.
2. Daido Life Insurance will build a new headquarters building after tearing down the New Diamond Building and Nippon Kohan Building, which are adjacent to the Diamond Building.
3. After the building is torn down, the vacant site will be sold to the Organization for Promoting Urban Development. Tokyu Corp., Tokyu Land, and Mitsui Fudosan then plan to erect a building and purchase it from the organization within 10 years.

Source: NLI Research Institute

One factor behind the sharp increase in real estate sales has been a growing emphasis in corporate management to improve asset management practices by relying on indicators such as return on assets and return on equity. In shifting from indirect financing to direct financing methods, to obtain better financing terms in debt and equity markets, are striving to improve their financial condition to improve ratings.

In addition, restructuring, mergers, and tie-ups are adding to the pressure to sell real estate by accelerating the sale of redundant business properties and employee welfare facilities and the disposal of bad debt.

In March 2000, when financial Big Bang accounting reforms put in place consolidated accounting practices and expand the scope of consolidated companies, profit taking from asset sales to related companies will lose their meaning. According to the TSE filings mentioned above, the ratio of real estate sales to related companies fell from 43% in fiscal 1997 to 36% in fiscal 1998, while sales to third parties increased.[3]

Meanwhile, following its decision on the treatment of depreciation of fixed assets, the International Accounting Standards Committee (IASC) has turned its attention to the adoption of market valuation accounting for investment real estate (decision scheduled in December). If this standard is adopted in Japan, it will prevent companies from selling land with low book values to boost net profit, and thus increase pressure to sell idle assets at the time of its introduction.

Opinions regarding depreciation and market valuation practices for real estate tend to be conservative due to their impact on corporate profits and to technical issues with valuation. But since it is futile to try to stem the disclosure movement aimed at increasing investor confidence, real estate cannot remain the exception forever.

3. Expansion of Investment Opportunities in Real Estate

Since the implementation of the Special Purpose Company Law in September 1998, the emergence of real estate investment products has increased investment opportunities beyond actual real estate properties.

(1) Securitization of Real Estate

The first application of the Special Purpose Company Law occurred in November 1998 when some apartments for foreigners were securitized. As of the end of September 1999, there were 18 registrations under the law, eight of which involved the securitization of real estate or real estate trust certificates (Figure 7).

Figure 7

Reg. Date	SPC name	Originator	Specified asset type	Asset description	Security issued	Value (max.)
11.26.98	Takanawa Apartment SPC	Morimura Sangyo, Forest Village (Tokyo Tatemono)	Real estate	Rental apartment	Specified bonds, preferred equity certificates	¥6.53 bil. (¥7 bil.)
1.28.99	Somenoi SC SPC	Tokyu Land	Trust certificate	Large retail outlets	Specified bonds, preferred equity certificates	¥5.417 bil. (¥9 bil.)
3.10.99	Network Capital SPC	Sumitomo Bank	Trust certificate	Bank branches (20)	Specified bonds, preferred equity certificates	¥27.1 bil. (¥44 bil.)
6.18.99	Pacific Century Residential One SPC	City Light Development Group Ltd.	Trust certificate	Rental apartments	Specified bonds, preferred equity certificates	n/a (¥16 bil.)
6.30.99	Kyodo Jutaku Securitization SPC	Starts	Trust certificate	Rental apartments	Specified bonds, preferred equity certificates	n/a (¥270 mil.)
8.31.99	News SPC Kurinomi	Sakamoto Kensetsu	Real estate	Rental apartments, parking lots	Specified bonds	n/a (¥500 mil.)
9.10.99	Star Capital SPC	Nippon Life Insurance	Trust certificate	Rental office buildings	Specified bonds, preferred equity certificates	n/a (¥50 bil.)
9.2.99	Tropical Holdings SPC	Nihon Building Project	Trust certificate	Stores, office buildings, collective housing, parking lots	Specified bonds	n/a (¥14 bil.)

Securitization under the SPC Law has been criticized for shortcomings such as limits on borrowing and inability to replace assets, and revisions are being debated. But a number of sales of superior properties have already occurred premised on securitization, and combined with securitization cases using foreign SPCs, indications are that the securitization of real estate properties will move ahead.

(2) Securitization of Real Estate Loans

The first domestic issue of a commercial mortgage backed security (CMBS) occurred in February 1999. Upon acquiring 1,200 condominiums from Daikyo, Morgan Stanley securitized a non-recourse loan (in which the lender has rights only to the specified real estate) extended from a foreign bank.

In June, Sanwa Bank issued the first domestic mortgage backed security (MBS), which quickly sold out after generating demand of three times the offered amount.

In October, Nomura Securities, a major player in developing the U.S. CMBS market, announced plans to move into the securitization of real estate loans by starting up a company specializing in non-recourse loans and CMBS by yearend.

However, there are no cases of securitization based on the SPC Law.

(3) Small-Lot Real Estate Products

In February 1999, the Real Estate Syndication Act reduced the minimum small-lot investment amount from ¥10 million to ¥5 million. Small-lot products sold by large real estate companies have been well received by individual investors suffering from low interest rates. Sumitomo Realty & Development’s offering, which stressed safety by combining preferred and subordinated equities, gathered ¥6.5 billion from individual investors within one month, and was followed by a second and third round of products.

In September, the law was revised by administrative ordinance to allow changes and additions to the securitized real estate. By increasing the freedom of product composition, this move should lead to the emergence of investment fund products under this system.

(4) Real Estate Investment Funds

A real estate investment fund is a collective investment arrangement that pools funds from investors, and invests in and manages real estate.

Previously, the leaders in this area were Nomura Real Estate Development Co. and Davinche. Following the removal of a ban in December 1998, the first real estate fund organized as an investment trust company was launched last October. In addition, Mori Trust and Nomura Securities have announced plans to jointly form a ¥200 billion real estate fund.

The SPC Law has typically been used to securitize real estate debt with what are called asset backed securities (ABS). In many cases, the originators (owners of the underlying assets) often retain their equity interests. These equities may in the future be included in real estate fund portfolios.

The Financial System Council, an advisory organ to the minister of finance, has been studying the preparation of a legal framework for collective investment schemes. As a result, attractive real estate fund products should grow in the future.

With the introduction of project finance and construction loans to real estate developers, financing methods for real estate projects are diversifying, and in the process expanding real estate investment opportunities for investors as well.

Notes

1. As of March 1999, revitalization plans of the 15 major banks called for payroll cuts of approximately 20,000 employees by 2003. But since then, plans have been accelerated and expanded due to mergers. For instance, the operational integration of three non-life insurers (Mitsui Marine & Fire, Nippon Fire & Marine, and Koa Fire & Marine) alone calls for personnel cuts of 3,000 persons within five years. In addition, with the complete liberalization of stock trading commissions, the three major securities firms (Nomura, Daiwa, and Nikko) plan to shed over 2,000 employees in fiscal 1999.

2. Sales figures are based on disclosure statements submitted to the TSE by listed companies. Not all sold properties are included. Disclosure standards regarding the transfer of fixed assets are as follows.
   (a) Transfers that fall under key stipulations in ordinances.
   (b) Transfers with a gain or loss comprising at least 30% of current profit or net profit for the most recent operating year.

3. Sales to related companies include cases in which the buyer is known to be a related company, and assumed to be a related company based on the company name.