New Developments in Real Estate Investment – The Growing Focus on Real Estate Investment Trust Companies

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1. Recent Legal Developments in Real Estate Investment

Since the September 1998 implementation of the SPC Law (Law on Securitization of Specified Assets by Special Purpose Companies) – a law designed to promote the securitization of specified assets – a variety of securitized real estate products have appeared. Moreover, the institutional infrastructure for real estate investment is changing at an accelerating pace. Amendments to the SPC Law and Securities Investment Trust Law (Law Regarding Securities Investment Trusts and Corporations) have already passed through the Ministry of Finance's deliberation committees, and are planned for introduction in the present Diet session (Figure 1).

Planned revisions to the SPC Law include: (1) reduction of the minimum capital requirement, (2) expanded scope of securitizable assets to remove product design constraints, (3) enhanced characteristics of issued securities (such as interim reduction of preferred equities), (4) easing of borrowing limits, (5) simplification of asset liquidation plans, and (6) shift from an SPC registration system to a notification system.

Planned revisions to the Securities Investment Trust Law will revise the system of investment trusts and investment companies, and expand allowable fund assets to include not only marketable securities but real estate properties and products. As a result, investment trusts and investment companies will be able to set up real estate investment funds and manage real estate assets. The Tokyo Stock Exchange has announced the creation of a stock exchange for investment trust companies.

With regard to revisions of the Real Estate Specified Syndication Business Law, in February 1999 the ban on transfer of holdings to third parties was lifted, and the minimum unit of investment reduced to ¥5 million. In September, the ban was lifted on real estate contracts (investment fund businesses) that allow portfolio alterations.

Furthermore, for real estate specified syndication businesses that use undisclosed associations (*tokumei kumiai*, or TK), a revision is presently being considered to create an arrangement for bankruptcy remoteness. Presently, if the syndicator — who owns the real estate assets — becomes insolvent, the right of investors to recover their investment is not secured.[1]

These developments are creating the proper environment for real estate collective investment schemes so that many unspecified investors can make real estate investments through securities and funds.

Figure 1 Legal Developments in Real Estate Investment

1998	1999	2000
SPC Law		
SPC Law implemented in Sept. 1998		Revision planned
Securities Investment Trust Law		
Dec. 1998 revision: Ban on investment trust company is lifted; Ban on private investment trust is lifted		Revision planned: Ban on agreement-type real estate investment trust to be lifted Ban on real estate investment trust to company be lifted
Real Estate Specified Syndication Business Law		
June 1998 revision: Multiple real estate packages is allowed (for ordinary investors)	Feb. 1999 revision: Minimum investment is reduced; Ban on 3rd party transfer is lifted Sept. 1999 revision: Changes and additions in real estate portfolio are allowed	Revision planned: Construction of bankruptcy remoteness system

Source: NLI Research Institute

2. Growth of Real Estate Collective Investment Schemes

Collective investment schemes in real estate can be broadly classified into asset securitization schemes and asset management schemes.[2]

In an asset securitization scheme, investments are solicited from investors based on the underlying cash flow or asset value of specified real estate assets. From the viewpoint of the business manager (asset owner), it is primarily a financing method.[3]

An asset management scheme can be called a type of real estate investment fund. Funds from investors are pooled, the asset manager has partial discretion to invest in (unspecified) real estate assets and real estate securities, and earnings are distributed to investors.

As entities that link investment funds and real estate, both schemes need investment vehicles that efficiently distribute earnings to investors. These are used selectively according to the basic laws (Figure 2).[4]

Figure 2 Real Estate Collective Investment Schemes

Investment vehicle	Asset securitization scheme	Asset management scheme
<Contract type>		
Undisclosed association	(1) Real estate specified syndication business (Real Estate Specified Syndication Business Law)	(4) Real estate specified syndication business (agreement allows changes in investment portfolio) (Real Estate Specified Syndication Business Law)
Trust	(2) Real estate trust (small-lot trust certificate) (Trust Law)	(5) Investment trust (planned) (Investment Trust Law)
<Company type>		
Real Estate Specified Syndication Business Law	(3) SPCs under SPC Law and other SPCs (SPC Law)	(6) Investment corporation (Investment trust company) (Investment Trust Law)

Note: The relevant basic law is in parentheses.
Source: Compiled from Real Estate Syndication Conference materials.

For asset securitization schemes, if the investment vehicle is an undisclosed association, the collection of funds depends on the type of investment. For investment trusts, small-lot sales of trust certificates are used, while special purpose companies under the SPC Law use security issues such as specified bonds and preferred equity certificates (in addition, foreign SPCs not bound by the SPC Law are sometimes used). All of these arrangements can currently be formed.

On the other hand, asset management schemes have available only real estate specified syndications that are undisclosed associations with contracts allowing portfolio alterations. The planned revision of the Securities Investment Trust Law will enable financing through two more investment vehicles: contract-type investment trusts, and company-type investment corporations.

3. Strong Interest in Real Estate Investment Trust Companies

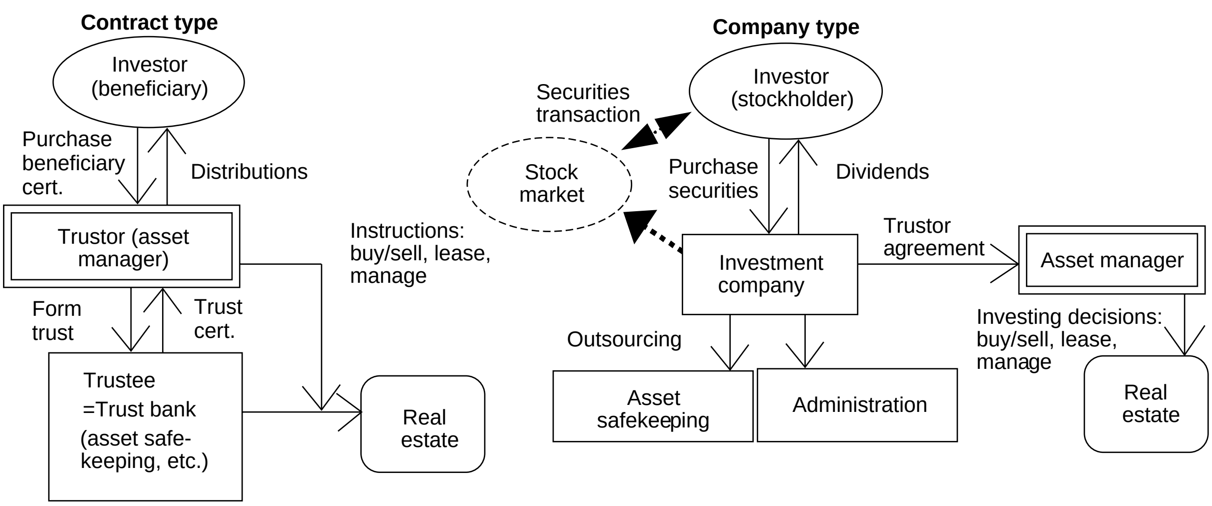
The minimum small-lot investment for real estate specified syndication businesses was reduced to ¥5 million, and while these are not marketable securities, the ban on their third-party transfer has been lifted. However, with no secondary market and limited sales channels, they carry a high liquidity risk.

By comparison, securities issued by SPCs (*tokutei mokuteki kaisha*, or TMK) under the SPC Law are specified as marketable securities under the Securities Exchange Law. Recently, institutional investors have increased purchases of specified bonds, and are showing signs of investing in preferred equity certificates, which are subordinate to bonds. However, since preferred equity certificates carry large market and liquidity risks, ambiguities continue to surround the closing out of a position (exit strategy).

In the pending revision of the Securities Investment Trust Law, the planned fund-type real estate investment schemes can be broadly classified into investment trust type (contract type) and investment corporation type (company type) schemes.

Both schemes need a manager to make decisions and execute real estate investments. While the investment trust scheme is conducted by investment trusts and trust banks, the investment company scheme is conducted by an asset management company under contract with the investment company (Figure 3).

Figure 3 Real Estate Investment Fund Types



Investors in the first scheme will receive income from real properties or real estate securities (bonds or equities) in the form of certificates, and in the second scheme as stock dividends or gains from sales or redemptions. In particular, the investment company scheme represents an investment in the company's stock, and like ordinary stocks, is completely an equity investment.

For so-called real estate investment trust companies based on the investment company scheme, a stock exchange listing will make it possible to create a secondary market. Thus real estate investment trust companies are expected to solve the liquidity risk problem of existing collective investment schemes, while providing the attractive asset appreciation feature of equity investments.

Because real estate assets are highly illiquid by nature, frequent changes in asset holdings are difficult at best, and investors are unable to make additional investments or partial redemptions. Thus compared to contract-type open-end funds common among securities investment trusts, closed-end funds being traded on stock exchanges are a more familiar form for real estate funds.

Since real estate investment trust companies are closed-end and listed on stock markets, some people expect products similar to U.S. REITs (real estate investment trusts) to appear in Japan in the form of Japan REITs (J-REIT).

However, there are differences. Since REITs are defined as companies that manage real estate investment portfolios for the benefit of stockholders, they are essentially stock companies that specialize in real estate investment.

Compared to ordinary stock companies, whose after-tax earnings are usually distributed as stock dividends, REITs are exempt from corporate taxes under certain conditions. Since earnings are distributed before taxes and taxed only once as dividend income for stockholders, conduit features (relief from double taxation) can be realized.

Furthermore, REITs are an investment vehicle in which the manager has considerable discretion regarding borrowings, capital increases, and investments in kind for the purpose of improving returns or expanding asset holdings. They also have flexibility due to the pay-through function and ability to refund depreciation costs to investors.[5] If the investment vehicle becomes listed, investors can trade its stock in the same way as other stocks. The real estate investment trust company scheme being considered in Japan would require the outsourcing of operations to an asset management company, and preserve a governance system to protect investors.[6] Thus it is a different system from REITs, which depend on the manager's skills.

Nonetheless, if the pending Securities Investment Trust Law revision is enacted, the emergence of real estate investment trust companies and possible TSE listings should greatly enhance investment management type schemes, and elevate real estate financing in debt and capital markets as a viable alternative.

4. Conditions for the Development of Real Estate Investment Trust Companies

For real estate investment trust companies to become a leading type of real estate investment fund, schematic considerations and the investment infrastructure must become more sensitive to investors' needs and meet with their approval.

1. Disclosure

Information disclosure is essential in soliciting funds from ordinary investors. Unless disclosure requirements and accountability are clarified, investors obviously cannot make responsible investment decisions.

In particular, since real estate transactions in the past have benefited from the lack of disclosure requirements, we can assume that disclosure practices will tend to remain inadequate. To protect investors, regulations must be toughened to specify the fiduciary responsibility of investment trust companies toward investors, and to strengthen monitoring and enforcement provisions.[7]

2. Management Companies

Asset management companies are contracted by investment corporations to perform the following operations: (1) analyze the real estate market and individual property prices, and make investment decisions based on this analysis, (2) manage the real estate portfolio, (3) manage tenants of individual properties, and (4) perform due diligence on properties and appraisals.

Setting up and operating a high-quality fund requires extensive expertise in both real estate and investment related areas. Duties include performing a variety of detailed analyses, managing properties, soliciting good tenants, and negotiating property transactions.

Unlike financial assets, real estate assets are unique and thus heavily dependent on the quality of management for returns. Real estate management requires not only financial expertise but experience and knowledge in the real estate business. For this reason, management companies are likely to have ties with existing real estate companies.

Presently, detailed inquiries are underway to establish qualifications for management companies (property fundamentals, cash balance outlook, personnel composition, work execution system, etc.), and to prepare a new registration system for investment advisories covering registration criteria, certification types, and rules of conduct. With respect to rules of conduct, since the management of real estate assets differs from that of other financial assets, a broad range of duties is likely to be stipulated. In doing so, it is crucial that the system does not create a conflict of interest with investors.

Furthermore, aside from real estate investment trust companies, collective investment schemes for real estate use a variety of investment vehicles such as investment trusts, undisclosed associations, and SPCs. Thus to expand and develop collective investment schemes for real estate, we need to create a full-range system of asset management companies to accommodate various investment vehicles, and to encourage the entry of a broad range of asset management businesses.

3. Specialized Institutions

Investors hope that as collective investment schemes develop, the environment improves to enable them to rationally assess risks and make relatively small real estate investments while being confident of liquidity.

However, even if adequate information does become available, ordinary investors will still find it quite difficult to grasp risk characteristics of complex financial real estate products well enough to make informed choices. Thus objective and timely product evaluations and ratings by third parties will also be needed for real estate investment trust products.

In evaluating fund management performance, a benchmark is needed against which to evaluate past fund performance. This creates the need for specialized (third-party) institutions and data management systems to provide investment related data and objective evaluations to real estate fund managers and investors.[8]

5. Impact of Real Estate Investment Trust Companies

Amid the prolonged deflation in asset prices, the legal framework for collective real estate investment schemes is being rapidly prepared to attract a broad base of investors and revitalize the floundering real estate market.

Indeed, there is a good chance that greater investment in real estate securitization and investment funds will cause funds to flow from debt and capital markets into the real estate market, and stimulate actual real estate transactions.

However, it is doubtful whether a revitalized real estate market will turn deflation around and lead to higher real estate prices.

For example, for real estate investment trust companies to grow, assets of other people must be acquired (liquidated) and brought into the investment fund. But since investment funds generally invest in superior properties that produce stable income, the universe of suitable properties is limited. The demand for investment properties with superior returns will thus widen the price gap with less competitive properties that produce low incomes or are idle.

When real estate investment trust companies become listed on stock exchanges, their stock prices will likely be valued against those of ordinary real estate companies, leading to arbitration. Investors seeking a pure play in real estate investment will prefer real estate investment trusts to real estate companies, because the latter incur more corporate income taxes and indirect expenses. Thus we must be prepared for the likelihood that the business performance and stock prices of real estate companies may not improve significantly.

Notes

1. Bankruptcy remoteness: Since collective investment schemes are products that rely on the credit strength of invested assets, if for example the originator (owner of underlying assets) becomes insolvent, the invested assets are isolated to avoid conflict of interests between investors and the bankruptcy administrator or a third party (creditors, etc.).

2. Asset liquidation scheme and asset management scheme are collective investment categories for real estate used by the Financial System Research Council, and also used in this paper.

3. However, for real estate specified syndication businesses, in addition to the financing aspect for business managers, there is a syndication business aspect for investors.

4. Investment vehicle refers to an entity established for convenience to issue securities backed by transferred assets, and can take the form of an SPC, association (*kumiai*), or trust. Investment vehicles serve two functions: (1) tax sheltering (avoiding double taxation from corpo-

rate income tax and personal income tax on dividend and interest income), and (2) bankruptcy isolation.

5. The pay-through function is an investment vehicle in which the cash flow from assets is paid out to investors in a particular order to avoid double taxation. In contrast, a pass-through investment vehicle pays out the cash flow from assets directly to investors.

6. Unlike ordinary companies, a securities investment company is characterized by: (1) extremely limited scope of operation (Article 63) that prohibits functions other than asset management, and establishing offices or hiring people other than at the main office, and (2) work related to administration, asset management and asset safekeeping must be outsourced.

7. Fiduciary responsibilities include exercising prudence, preventing conflict of interest, and acting in good faith with regard to asset management instructions and executing other functions.

8. Devising a useful index for measuring total rate of return or evaluating performance requires that real estate market valuations be available. However, such information is scant due to the real estate industry's business practice of concealing accurate information, and the large gap between official land prices and actual land prices.

For further reference, see Matsumura, Shinohara, and Oka, *Introduction to Real Estate Securitization*, Sigma Base Capital, 1999.