Preparing the Information Infrastructure for the Real Estate Securitization Market

by Toru Matsumura
Financial Research Group

1. The Urgent Need to Compile Real Estate Data

Following an auspicious start in 1999, the securitization market (including bonds and stocks) is predicted to exceed ¥1 trillion in 2000. Also on the increase are nonrecourse real estate loans,[1] whose securitization is expected to expand the CMBS market.[2]

Many companies plan to enter the real estate investment fund business when the ban is lifted in November 2000. Attention will focus on the Japanese version of REIT (J–REIT), a publicly subscribed fund that can be traded on stock exchanges.[3] NLI Research Institute predicts that J–REITs are a potential ¥4 trillion to ¥5 trillion market.[4]

Figure 1 Companies Planning to Offer Real Estate Investment Trust Funds

Mitsui Fudosan, Sumitomo Life, Nomura Securities	Mitsubishi Estate
Mitsui Fudosan, Mizuho Financial	Yasuda Trust & Banking
Mori Trust, Daiwa SBCM	Sumitomo Trust & Banking
Tokyu Land	Mitsubishi Trust & Banking
Mitsubishi Corp.	Chuo Mitsui Trust
Mitsui & Co.	Creed Corp.
Itochu	Quest
Orix	Marks
GE Capital	Ken Corporation
Nomura Securities	P.I. Technology
Nikko Securities	UNI-ASIA

Source: Public relations materials

While real estate securitization has largely been perceived as a new financing method for companies, there has also been growing enthusiasm from investors disheartened by low interest rates. In fact, life insurers, pension funds and regional banks now compete with each other in buying up the highly rated bonds.

Compared to direct investment in real estate, securitization offers advantages such as investment diversification consistent with risk preferences, reduced liquidity risk, and leverage effects.[5]

However, the most important point about securitization is that it introduces disclosure requirements. Investors will thus be able to make rational decisions based on the assessment of risks and returns — just as they do with other financial instruments such as stocks and bonds. Presently, because real estate investment mainly involves direct transactions between concerned parties, information disclosure is practically nonexistent.

Essentially, securitization is an arrangement that diversifies real estate investment risks to third–party investors in financial markets. It also seeks financing from a broader base of investors who have traditionally shied away from real estate investment, including pension funds, individuals, and foreigners. For these reasons, information disclosure is vital to assure transparency in the markets and products.

Full disclosure is critical for attracting investors, particularly the individual investors that J–REITs will be targeting. Meanwhile, as pension funds become more interested in real estate securitization products, trustee managers will need a reliable information infrastructure to fulfill their fiduciary responsibilities. Institutional investors will not warm up to J–REITs as long as transparency is absent in the risk–return structure of real estate investment and in relation to other financial products.

One factor that could limit the securitization market's growth is the shortage of investors for mezzanine and equity financing (the most subordinated part), which unlike preferred bonds and loans bear the risk of real estate price declines.

Until now, originators (property owners) have frequently owned subordinated bonds and equities to enhance credit ratings for bond investors.

However, due to stricter accounting rules for off–balance sheet standards that become effective in August 2000, almost all of the subordinated portion will have to be sold to third–party investors.[6] Thus the size of the pool of equity investors will affect the progress of securitization.

Experienced investors demand a risk premium when adequate information is unavailable to make informed decisions. However, since risk takers such as hedge funds and vulture funds are practically nonexistent in Japan, the pool of investors urgently needs to be expanded not only by implementing disclosure on products, but by improving the entire real estate market's transparency. The key to this lies with the implementation of extensive disclosure practices and the construction of a market information infrastructure.

2. Status and Issues Regarding Real Estate Market Data

The growth of securitization has brought with it the increasingly prevalent practice of due diligence – the comprehensive and detailed risk analysis that buyers make on real estate properties. The resulting demand has revealed the dismal state of market data on rents, transaction prices and investment yields, as well as historical income and expenditure data on individual properties.[7]

A large disparity has always existed in the volume and flow of market data between real estate on the one hand, and financial instruments with a secondary market such as stocks and bonds on the other. Compared to other financial investments, real estate investments lag behind overwhelmingly in terms of information standardization and disclosure.

The cause lies in longstanding differences in practices between real estate investment and other financial product investments. Since real estate transactions are conducted directly between buyers and sellers, even institutional investors did not have a practice of selling properties to secure investment yields or measuring performance with market valuations. In the U.S., since transactions follow a long–term market cycle, the average holding period of institutional investors who invest directly in real estate is seven to ten years. Despite this relatively long holding period, the U.S. market is more liquid than Japan's, and the information infrastructure is considerably better.

By comparison, in Japan, where permanent holdings are common, even standard financial metrics for risk and return are unclear. In particular, data is not compiled on investment yields, and investors and other market participants do not even have a consensus on risk premium levels or approaches.

However, against the backdrop of the depressed post–bubble real estate market, shortage of new investment funds, and securitization, the infrastructure for market data infrastructure has finally begun to move forward.

In addition to the conventional real estate market data for commercial land prices, office rents, and vacancy rates, a number of investment indices have been developed since the late 1990s for office buildings and luxury rental apartments.

Figure 2 Presently Available Real Estate Market Data

Type of asset	Index	Source	Frequency
Land	Official Land Prices	National Land Agency	Annual
	Land Price Survey	Prefectural governments	Annual
	Road Rating Values	National Tax Administration	Annual
	Urban Land Price Index	Japan Real Estate Institute	Semiannual
Rental office space	Advertised rent data	Ikoma Data Service System, Sanko Estate, Miki Corp.	Monthly, quarterly
	Investment yield index	Sumitomo-Life Research Institute, Sumitomo Trust & Banking, Mitsubishi Trust Banking, Ikoma Data Service System	Quarterly, annual
	Rent index	BOJ	Quarterly
Rental apartments	Contracted rent data	Ken Corporation	Quarterly
	Investment yield index	Ken Corporation, Japan Real Estate Institute	Quarterly
Condominiums	Investment yield index	Real Estate Economic Research Institute, Real Estate Appraisers' Market Rent Research Institute	Quarterly
Stores	Rent index	BOJ	Quarterly
Hotels	Rent index	BOJ	Quarterly
Parking lots	Rent index	BOJ	Quarterly
Warehouses	Advertised rent data	Ikoma Data Service System	Semiannual

Notes: 1. Shows only data related to prices and yields. Scope of data varies from nationwide coverage to the central Tokyo area.
2. Advertised (asking) rent refers to the rent posted by a property-owner when soliciting tenants; contracted rent refers to the rent that is actually agreed upon and paid.
3. In addition to the above data, the EPA is developing a real estate price index as part of its business conditions indicators. The Japan Real Estate Institute is developing an investment yield index for leased office space. Sumitomo Life, Mitsubishi Trust, and Mitsui Fudosan are planning to jointly develop a real estate investment index.

However, setting aside the almost complete lack of historical data, much of the available data does not reflect actual transactions of sales and leases. Data on office building rents and commercial land prices are particularly problematic.

Office rent data actually consists of advertised (asking) rents that prospective tenants first see, even though contracted rents have come to diverge significantly from advertised rents in the post–bubble era. According to a recent study, advertised rents exceed contracted rents by 12% on average in Tokyo.

Moreover, the rent data is a simple average of advertised rents for vacant properties, and excludes rent data from large new buildings, which are highly popular and tend to be fully occupied. The data thus tends to mislead regarding market conditions, particularly since the rents included in the data tend to decline by more than actual market rents.

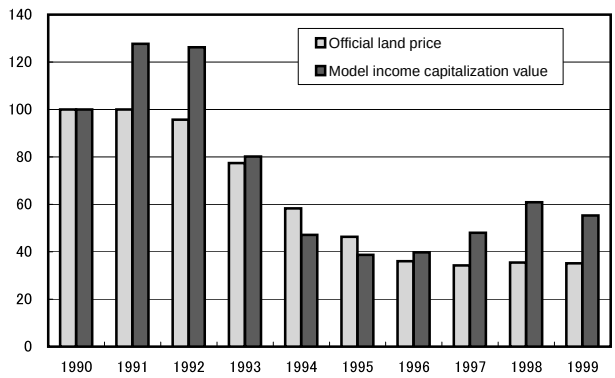
In addition, since office rents are negotiated between concerned parties in the absence of accurate market data, the present rent level may not accurately reflect a property's competitiveness or market value. For example, if adequate market data were available and rents were appraised based on location, condition of building and facilities, and quality of leased space and management services, disparities

would likely increase between different properties.

Meanwhile, the problem with using land prices as investment indicators is obvious from the existence of four price indices based on different compilation methods (the National Land Agency's Official Land Prices, the Prefectural Land Price Survey compiled by prefectural governements, Road Rating Values by the National Tax Administration, and the Urban Land Price Index of the semi–public Japan Real Estate Institute). Although future corporate accounting and risk management practices will require the adoption of market valuations for real estate, the existence of multiple standards for calculating market valuation only invites arbitrariness and compromises objectivity. Other reasons that these land price indices are inappropriate as investment indicators are that the posted prices are usually for the lots separate from the structure, data releases are infrequent, and time lags are considerable.

For example, the National Land Agency's land price index peaked in 1990 and 1991 for commercial properties in Tokyo's Chiyoda–ku and has declined since. However, if we calculate income capitalization values (value of the land and structure combined) for standard large–scale office buildings in the central city area, real estate prices have been rising since 1995, contradicting the official land price index.

Figure 3 Model Income Capitalization Value and the Official Land Price Index



Notes: 1. Indexed to base year 1990. The official land price index refers to selected properties in Tokyo's Yurakucho district of Chiyoda–ku.
2. The income capitalization value was obtained by calculating cash flow based on the market rent and vacancy rate for standard large–scale buildings in the three central wards, and then using the following capitalization rate in the income capitalization approach.

Capitalization rate = Standard interest rate (5–year moving average of 10–year JGBs)
+ Risk premium (assumed to be 250 basis points)
– Expected growth rate of asset value (revised 3–year moving average of nominal GDP growth rate)

The income capitalization approach for estimating market value, which is an international standard for valuing commercial land and buildings, is finally entering the mainstream in Japan thanks to the bulk sales of bad loans and securitization. In comparison, the official land price index can potentially mis-

lead investors not only by masking market conditions, but by causing errors in determining when the market has bottomed out.

Compared to typical commercial properties such as office buildings and luxury rental apartments, market data is even more sporadic for hotels and large–scale commercial facilities and warehouses.[8] This situation creates difficulties in identifying investment risks and thus impedes securitization.

In addition, while investment yield indices for office buildings have been modeled after the U.S. and U.K., they suffer from a lack of actual market data.[9] Yields have to be estimated using published advertised rents and official land prices. Thus they lack reliability as investment indicators, and are also inappropriate as benchmarks for evaluating real estate portfolio performance.

As the dismal situation described above makes clear, there is an urgent need to prepare a genuine infrastructure for reliable market data.

3. Toward a Genuine Infrastructure for Market Data

1. Purpose of Market Data Infrastructure

The purpose of constructing a data infrastructure is to bring transparency to the real estate market by providing investors information necessary to make rational investment decisions.

The investors we have in mind are not traditional investors who invest in real properties and negotiate transactions directly, but rather a new type of real estate investor who focuses on asset liquidity and transparency, and has an interest in securitization products.

Thus the data infrastructure we are referring to satisfies the needs of financial professionals such as institutional investors and J–REIT managers who bear fiduciary responsibilities, and real estate investment advisories.

2. Data Categories

Since 1998, the sharp rise in commercial real estate transactions has been accompanied by a significant increase in the amount of available data. But what is still most needed is data that can serve as indicators for real estate market conditions.

There is no need to compile data on all available real estate; we only need data on investment grade properties that are candidates for securitization. Much of the real estate held by business companies as

depreciable assets or to bolster creditworthiness were built in 1981 or earlier, and have a large risk of earthquake damage or other shortcoming. Thus the universe of commercial real estate properties that satisfies the due diligence of investors is quite limited.

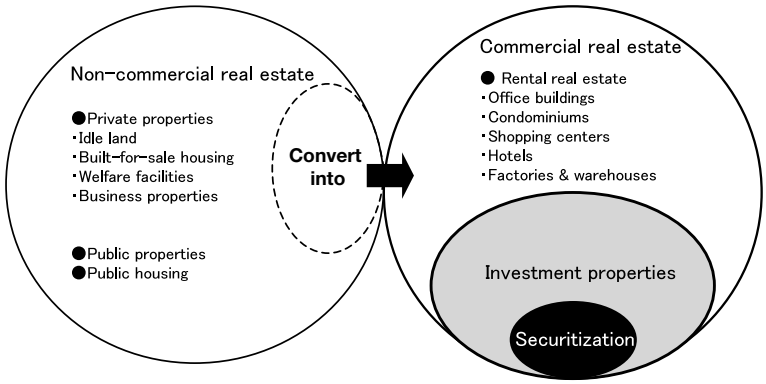
The data with the highest priority involve sources of cash flow such as contracted rents and investment yields that reflect risk premiums (such as discount rates for calculating present value).

For this purpose, it is best to obtain as much data as possible, and use statistical processes to factor out differences according to the size, age, and location of properties. Otherwise, the uniqueness of individual commercial real estate properties will render the data inconsistent as an indicator.

For investment yields, in addition to data on securitization and straightforward sales transactions, we should also periodically conduct questionnaires of institutional investors and others with significant market influence.[10] Since investment yield data has not been compiled in the past, the adequate verification of results and market feedback are essential to developing this data category.

While it is important to verify past investment yields, a clear demarcation needs to be made from the bubble era because the basic approach to real estate investment back then was completely different.

Figure 4 The Universe of Real Estate Properties Eligible for Investment and Securitization



3. Organizations for Compiling Data

Market data must be compiled by third parties with no direct stake in any specific securitizations or fund management. However, it would be undesirable to rely on government agencies authorized to compile data for specific purposes such as the tax–oriented official land price index.

One desirable form would be an unaffiliated company established by a broad range of market participants such as investors and real estate operators, armed with the commitment to conduct rigorous data management.

The best candidates for leading this effort while diligently expanding their own disclosure practices are institutional investors such as life insurers, and real estate and securities companies aggressively forming J–REITs: institutional investors stand to benefit the most from real estate securitization, while J–REITs must attract as many investors as possible in the stock market. In both cases, disclosure is critical for satisfying outside analysts and ratings agencies.

Assuming the absence of legally mandated data collection, it will be important for other market participants to actively cooperate. Unfortunately, real estate owners and transacting parties are adamantly opposed to supplying discrete data to the outside.

However, we need to emphasize that the purpose of compiling market data is not to release specific real estate data, but to process the data and develop investment indicators. Moreover, real estate securitization proponents need to convince the broader market that unlike in the past, the lack of disclosure does not create profitable opportunities, but instead stifles market activity and could endanger the overall market.

Today, Japan is trying to do in three years what took the U.S. over three decades in nurturing the real estate securitization market. Having chosen to pursue securitization and seek investment funds from the broader financial markets, market participants now must be prepared to do whatever it takes to achieve success.

Notes

1. In a nonrecourse loan, the borrower's liability is limited to the loan collateral. Thus in the event of default, the lender can only seize the collateral, and bears the risk for the value of the loan in excess of the collateral. In the past, collateralized real estate loans in Japan were generally recourse loans in which lenders could seize assets other than the collateral. Nonrecourse loans were seldom used.

2. A commercial mortgage backed security (CMBS) is backed by a nonrecourse loan that is secured by commercial real estate. Mortgage backed securities (MBS) and residential mortgage backed securities (RMBS) are backed by residential mortgages.

3. The ban on corporate real estate investment trusts will be lifted in November 2000. Since they will be listed on stock exchanges and have a secondary market, they avoid the liquidity risk problem that has hindered securitization thus far, and are also expected to produce capital gains as an equity investment. They are called J–REITs (Japan REIT) for their similarity to REITs in the U.S. However, while the U.S. REIT specializes in managing a portfolio of real estate investments in the interest of its stockholders, the J–REIT will outsource management functions to a third party. Thus technically speaking, the J–REIT is closer to its pre–1986 precursor, before the law was amended to allow REITs to engage in management.

4. The U.S. REIT market, which grew rapidly from 1993, comprises approximately 1.0% of the U.S. stock mar-

ket. Applying this ratio to the Japanese stock market, the J–REIT market is a potential ¥4.4 trillion market as of 2000.

5. The leverage effect occurs when borrowing increases the return on equity. The larger the ratio of loans, the larger is the anticipated leverage effect. But if rental income or real estate resale prices decline, there is also a larger risk of a fund shortage or negative cash flow. In real estate securitization, equity investors and association investors seek a leverage effect from loans and bond issues.

6. In June 2000, the Japanese Institute of Certified Public Accountants announced a draft accounting rule for securitization involving special purpose companies in which real estate sales would not be recognized if the issuing company holds more than 5% of the subordinated portion, which carries a higher default risk. Working guidelines could be released as early as August 1.

7. Due diligence refers to the prospective buyer's responsibility to hire experts to investigate economic, legal, and physical factors that could affect the value of the property in question. When ratings are being determined for securitization products, the due diligence report becomes the basis for risk evaluation. Due diligence reached Japan in 1997 when foreign companies began investing in bad loans. In the U.S., the practice is well established not only in real estate investment, but in the areas of nonrecourse loans for real estate, bad loans, corporate mergers and acquisitions, and project finance.

8. Commercial property refers to income producing real estate in which cash flow is generated from rental income: office buildings, rental apartments, hotels, shopping centers, etc. It is also called income producing real estate or investment real estate.

9. For domestic and foreign real estate indices, see the Real Estate Syndication Association, Real Estate Syndication Handbook 2000, pages 68–69. See also Chuo Mitsui Asset Management, Real Estate Securitization: Design and Methods, Chuo Koronsha, pages 251-252; and Real Estate Evaluation and Renovation Research Group (translator), Information Disclosure Standards for Real Estate Investment, Seibunsha.

10. Presently, the Japan Real Estate Institute conducts a Survey of Real Estate Investors.