How Real Estate Securitization is Stimulating Investment Transactions
— Prospects for the Formation of a Real Estate Investment Market

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Introduction

While Japan has markets for existing homes, rental housing, and offices, to date no active market exists for real estate investment.

However, since the late 1990s, developments such as the bulk sales of nonperforming loans and real estate securitization have increased the liquidity of real estate, creating prospects for a genuine real estate investment market in the future.[1]

1. The Increasing Liquidity of Corporate Real Estate

(1) Securitization Spurs Investment Transactions

With the ban lifted on real estate investment trusts (JREITs) last November, in just three years since the SPC Law's enactment in 1998 (Law on Securitization of Specified Assets by Special Purpose Companies), the types of real estate investment schemes available in Japan have almost become comparable to those in the U.S.

As a result, real estate investment alternatives, once limited to a specified small number of investors in actual properties, have expanded into whole new areas.

Investment alternatives now range from equity investments such as SPC equity certificates and JREITs, which have market listings and are aimed at unspecified and numerous investors, to debt investments such as SPC bonds and securitized products such as commercial mortgage backed securities (CMBS) and residential mortgage backed securities (RMBS).

In the past three years, all types of real estate properties have been securitized —leased office buildings, corporate headquarter buildings, department stores, shopping centers, urban hotels, rental apartments, and even gasoline stations — and the securities have been purchased by investment funds and other investors (Figure 1).

All of these schemes gather funds from numerous third-party investors. The investment transactions seek earnings distributions, and investors demand more objectivity and transparency in contracts and prices than is customary in negotiated real estate transactions, land purchases for a company's own use, or intra-group transactions to adjust balance sheets.

Figure 1 Recent Commercial Real Estate Transactions

(Since 2000, in Tokyo's 23-ward area)

Seller	Buyer	Description of property	Type	Location
Tokyu	JREIT	Tokyu Mita bldg.	Office	Mita, Minato-ku
Mycal subsidiary	JREIT	Harajuku Omotesando bldg.	Commerical	Jingumae, Shibuya-ku
Fujita	JREIT	HQ bldg.	Office	Sendagaya, Shibuya-ku
NKK	JREIT	HQ bldg.	Office	Marunouchi, Chiyoda-ku
Konica	JREIT	Nihombashi Muromachi Center bldg.	Office	Nihonbashi Muromachi, Chiyoda-ku
Mitsubishi Estate	JREIT	Mitsubishi Research Institute bldg.	Office	Otemachi, Chiyoda-ku
Mori Trust (planned)	JREIT	Kyobashi Chiyoda bldg.	Office	Kyobashi, Chuo-ku
Mori Trust (planned)	JREIT	ON Mori bldg.	Office	Shinagawa-ku
NEC	SPC	HQ bldg.	Office	Shiba, Minato-ku
Morinaga & Co.	SPC	Morinaga Plaza bldg.	Office	Shiba, Minato-ku
Mori Building	SPC	Ark Towers	Rental apt.	Akasaka, Minato-ku
Sumitomo Construction	SPC	HQ bldg.	Office	Arakicho, Shinjuku-ku
Sumitomo Realty & Dev.	SPC	Shinjuku Sumitomo bldg. (60% stake)	Office	Nishi-Shinjuku, Shinjuku-ku
Sumitomo Life	SPC	Shinjuku Sumitomo bldg. (40% stake)	Office	Nishi-Shinjuku, Shinjuku-ku
Snow Brand Milk Prod.	SPC	Tokyo HQ bldg.	Office	Motoshiocho, Shinjuku-ku
New Otani	SPC	New Otani Garden Court	Office	Kioicho, Chiyoda-ku
Mitsubishi Materials	SPC	Otemachi First Square (stake)	Office	Otemachi, Chiyoda-ku
Maruha	SPC	HQ bldg.	Office	Otemachi, Chiyoda-ku
Mitsui Fudosan	SPC	River Point Tower & 2 other bldgs.	Rental apt.	Tsukuda, Chuo-ku
Maruzen	SPC	Maruzen bldg. no. 2	Office	Nihonbashi, Chuo-ku
Seibu Department Stores	SPC	Ikebukuro Seibu Dept. Store	Dept. store	Minami-Ikebukuro, Toshima-ku
Hideki Yokoi group	SPC	Himonya Daiei Store	Shopping ctr.	Himonya, Meguro-ku
ANA Enterprises	SPC	ANA Hotel Tokyo	Hotel	Akasaka, Minato-ku
Natsume Shoji	Daibiru	HQ bldg.	Office	Shiba, Minato-ku
Mitsukoshi	Daibiru	Shinjuku Alta bldg.	Commerical	Shinjuku, Shinjuku-ku
Taisei Corporation	Yasuda Life Insurance	Shinjuku Center bldg. (stake)	Office	Nishi-Shinjuku, Shinjuku-ku
Ube Realty & Development	JTB Real Estate Dev.	Tennozu Isle UBE bldg.	Office	Higashi-Shinagawa, Shinagawa-ku
Nikkoso Honsha	Mitsubishi Estate	Sanno Park Tower (stake)	Office	Nagatacho, Chiyoda-ku
Taiheiyo Cement	Mitsubishi Estate	Aoyama Bldg. (40% stake)	Office	Kita-Aoyama, Minato-ku
Mitsubishi Estate	Meiji Life Insurance	Chiyoda Bldg. (land)	Office	Marunouchi, Chiyoda-ku
Tokyu Hotel Chain	Jiji Tsushin	Ginza Tokyu bldg.	Hotel	Ginza, Chuo-ku
Tokyo Tatemono	Odakyu Railway	Odakyu Halk Annex	Commerical	Shinjuku, Shinjuku-ku
Forestry Agency	Mori Building	Azabu Green Kaikan	Hotel	Roppongi, Minato-ku
Tokyo Nissan Auto Sales	Mori Building	HQ bldg.	Office	Roppongi, Minato-ku
Mitsubishi Materials	Sogei	Tsukijima Center bldg.	Office	Tsukijima, Chuo-ku
Tokyu	Toshin Real Estate	Tokyu Tameike bldg.	Office	Akasaka, Minato-ku
NCR Japan	Nippon Foundation	NCR Japan bldg.	Office	Akasaka, Minato-ku
Haseko Corp.	Heiwa Real Estate	HQ bldg.	Office	Shiba, Minato-ku
Tokyo Mutual Life	Heiwa Real Estate	Shimbashi HQ bldg.	Office	Uchisaiwaicho, Chiyoda-ku
Chiyoda Mutual Life	Prudential Life	Nagatacho Project (in progress)	Office/condo	Nagatacho, Chiyoda-ku
Chiyoda Mutual Life	Meguro-ku	HQ bldg.	Office	Kami-Meguro, Meguro-ku

Note: Includes sale/exchange of joint ownership, separate ownership, structures with leaseholds, and beneficiary rights.
Source: NLI Reseach Institute.

(2) Converting Corporate Real Estate into Commercial Real Estate

From the perspective of companies who want to sell off assets, securitization schemes provide a greater diversity of alternatives to liquidate real estate.

The number of real estate sales by business companies surged from fiscal 1998 against a backdrop of industrial restructuring in the post-bubble era, corporate restructuring, and a return to focusing on core competencies.

In particular, the new accounting standards effected in March 2000 provide several motives to dispose of real estate: to rescue subsidiaries for consolidated reporting purposes, bail out underfunded pension funds, and to move up loss writeoffs in preparation for the compulsory devaluation of real estate for sale and loss accounting of fixed assets.

In the past, since land prices in Japan had always moved upward, land was regarded as a safe investment which, regardless of how it was used, would produce capital gains far above the inflation rate.

It was thus common for companies in the manufacturing and service industries to acquire real estate even though they themselves were completely unrelated to property rental or real estate investment. Seeking collateral value and tax benefits from depreciated assets, and expecting unrealized gains to absorb business risk, they competed recklessly to acquire unnecessary land.

Moreover, generous financing from financial institutions enabled major retailers to expand nationwide by investing aggressively in land, while others acquired real estate and built facilities as part of a diversification strategy.

Whether it be offices or stores, since most of this real estate is categorized as fixed assets held for the company’s own business purposes, recent moves to increase real estate liquidity often involve the conversion of corporate real estate into commercial use.

By commercial real estate, we refer to real estate that is owned or invested in for the purpose of obtaining rental income — such as leased office buildings, rental apartments, hotels, and shopping centers — some of which qualify as investment-grade real estate.[2]

(3) Shift from Ownership to Leasing

A decade after the bubble economy’s collapse, a growing number of companies no longer see real estate ownership as an absolute necessity.

According to a study by the Japan Real Estate Institute, in the four-year period from 1995 to 1999, the 13 major city and trust banks reduced their land and building area for office use by 20 percent due partly to financial restructuring, while increasing their leased buildings by 40 percent.[3]

In another survey by Yasuda Trust Bank, 17 percent of companies announced that they will switch from ownership to leasing of their headquarter building in preparation for the scheduled introduction of loss accounting for fixed assets in March 2003.[4] While the largest segment will still retain ownership (42 percent), this percentage is notable nonetheless.

(4) Mounting Supply-Side Pressure

Although demand for real estate is expected to slump due to the economy's weakness and delay in economic structural reforms, supply side pressure is mounting against the backdrop of industry restructuring and accounting reforms.

For example, due to the rash of business failures, life insurers and others are selling off more of their real estate holdings, while large-scale retailers are rethinking their expansion plans and consolidating stores.

In the financial sector, as deadlines are set for the disposal of nonperforming loans, a sharp increase is expected in the sale of real estate held as collateral.

The public sector is also not immune; in response to worsening fiscal conditions, there is also sure to be an increase in real estate disposed by national and local governments and government affiliated organizations.[5]

(5) JREITs: New Buyer in the Market

In the late 1980s, the real estate market boomed as seemingly unlimited amounts of money vied for scarce land. In the 1990s, the structure of demand and supply reversed itself.

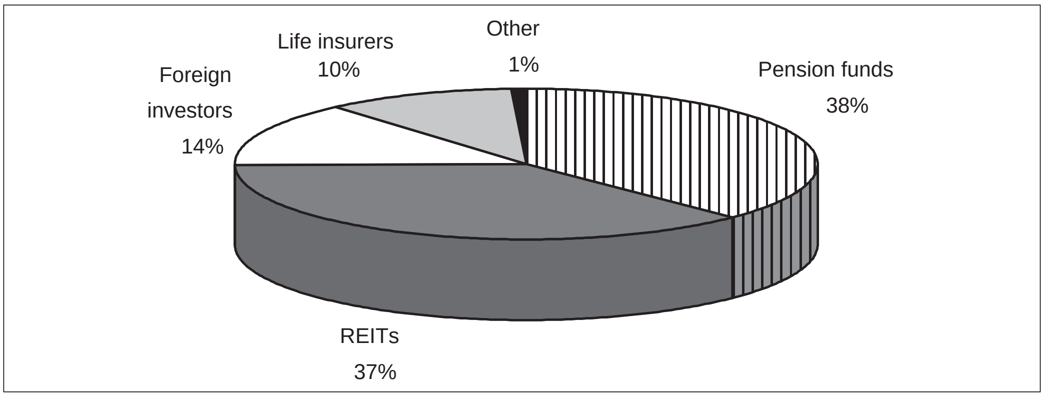
Institutional investors such as life insurers and pension funds accumulated massive amounts of unrealized losses, real estate companies turned pessimistic toward investment in actual properties, while financial institutions troubled by non performing loans squeezed credit on new real estate projects.

It was in this situation that the framework was laid for real estate securitization with the aim of inducing new investment in real estate.

As a result, investors have stepped up their real estate acquisitions to the point that some segments of the market appear overheated. Recently, office building prices in particular are being bid up in anticipation of the JREIT market (implying a lower return on investment).[6]

Over the long term, just as REITs in the U.S. now rival pension funds as equity investors in real estate, JREITs are expected to challenge traditional real estate investors (Figure 2).[7]

Figure 2 Real Estate Equity Investors in the U.S.



Source: *Emerging Trends in Real Estate 2001*.

2. Toward the Formation of a Genuine Investment Market

(1) Alleviating the Shortage of Investment-Grade Real Estate

In Japan, while corporate ownership of real estate is estimated at 400 to 500 trillion yen, commercial real estate amounts to only 60 to 70 trillion yen. In this respect the recent conversion of corporate real estate into commercial real estate is extremely limited (Figure 3).

Moreover, considering that commercial real estate in the U.S. is estimated at over 4 trillion dollars, Japan’s commercial real estate market is minute relative to the size of its economy.[8] In particular, investment in the collective housing market,[9] which is stable in the U.S., is minor in Japan due to home ownership policies and the old leasehold law.

Furthermore, not all commercial real estate is investment grade, as many properties cannot be sold to investors due to difficulties with earthquake risk or complex agreements involving multiple owners.

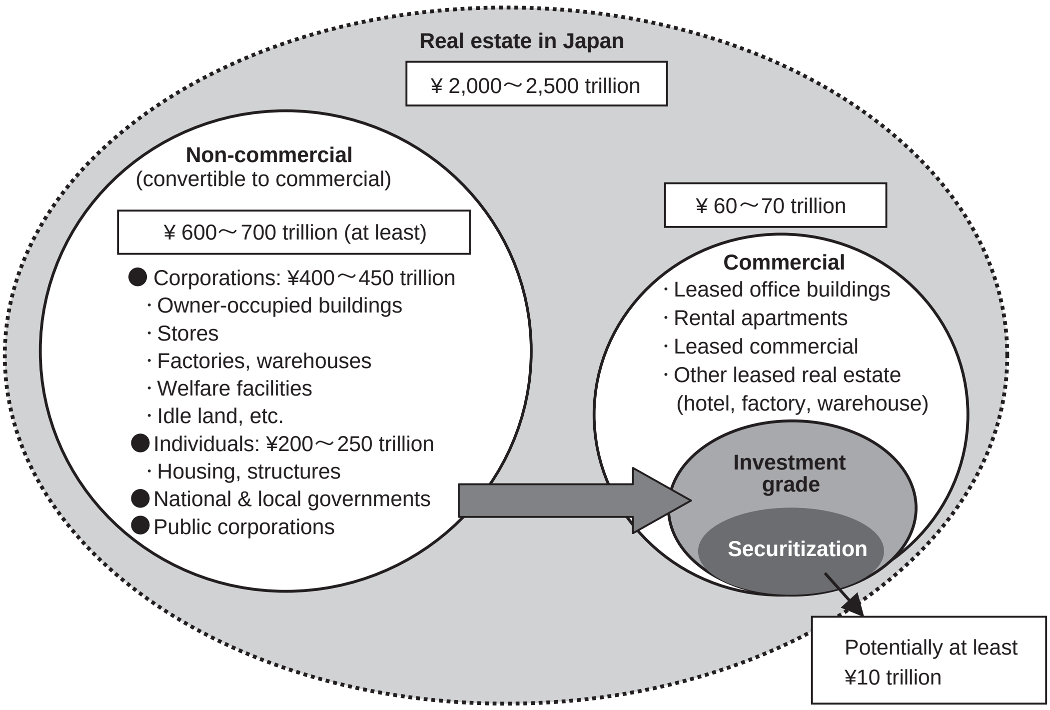
Because considerations of sale to a third party (exit strategy) have been neglected in corporate as well as commercial real estate, numerous practical problems arise with regard to enhancing the market’s liquidity (Figure 4).

For one, since only investment-grade real estate is acceptable for securitization and JREITs, the scarcity of such properties restricts not only the securitization market but formation of a full-fledged real estate investment market.

However, the supply of investment-grade real estate is expected to gradually increase as more real estate holdings become available from the corporate and public sectors.

These trends must be encouraged not only by the final disposal of nonperforming loans by financial institutions, but policy measures such as tax reform for the secondary market, deregulation of real estate development, and enhancement of access to information (Figure 5).

Figure 3 Structure of Japan's Real Estate Market



Source: NLI Research Institute

Figure 4 Impediments to Real Estate Sales for Investors

Item		Examples
Structure	Earthquake resistance	• Substandard quake resistance, and necessary reinforcements are difficult to add
	Substandard condition	• Has pre-existing substandard condition, and needs permit for major renovation
	Building permit	• Illegal structure (violates Building Standards Act, local statutes, fire code, etc.) • Inspection certificate is missing • Permit application includes area outside of area in question; common area exists • Missing construction drawing • Defective construction
	Construction	• Soil contamination from heavy metals, etc.
	Soil/foundation	• Susceptibility to earthquake damage due to weak foundation
	Asbestos	• PCB, asbestos or other contaminants were used in building
Rights	Registration	• Registration does not match present status • Partly unregistered
	Ownership	• Owned by many co-owners, or individuals are also involved • Separate agreement exists among partners • Deficient rules or regulations for partitioned ownership • Preferential transfer clause exists, but owner's consent is unobtainable due to absence
	Leasehold	• Part or all of land is a leasehold, and landowner does not consent to sale, or demands an excessive consent fee.
	Property line	• Violation of property line by either side • Problem in confirming property lines • Boundary lines of urban planning plan are undecided • Unresolved disputes with neighbors • Separate agreement exists among neighbors, and its present status is unclear
Management	Maintenance fund	• Maintenance fund is underfunded
	Tenant	• Credit risk of key tenant is high • Unsuitable tenants exist • Deficient lease agreement with subsidiary who is tenant
	Illegal occupant	• Illegal occupant exists in common area
	Management contract	• Deficient provisions for management & maintenance of common area • Deficient provisions for dedicated use of common area • Deficient provisions regarding transfer
	Records	• Incomplete records on past income and expenditure, lease agreements, renovation & repair
	Management company	• Since management company was established jointly as part of a large-scale redevelopment project, withdrawal is difficult
Marketability	Location & use	• From the perspective of commercial real estate, location has been bypassed by the market, or the area is in decline. • Property has low market value in its present use—factory in suburbs, etc. • Building is designed for headquarters or other special use, and is difficult to convert to other use; high fees for services; massive rebuilding needed.

Note: Most impediments do not render sale (investment) impossible, but instead involve risks or costs that can be reflected in the sales price.
Source: NLI Research Institute

Figure 5 Factors Contributing to Expansion of the Commercial Real Estate Market

	Factor	Description
Supply side	Sale of corporate real estate	• Final disposal of bad loans held by financial institutions • Increased pressure to sell off assets from industrial/corporate restructuring process • Increased pressure to sell off assets from accounting standards reform (depreciation of fixed assets, compulsory devaluation of real estate for sale, emphasis on consolidated reporting, underfunded pensions) • Increased pressure to sell off assets to improve asset efficiency • Tax incentives to sell assets such as deferred capital gains tax
	Sale of publicly owned real estate	• Increased pressure to sell off assets due to worsening fiscal condition of national, local government • Redevelopment of public land using PFI
	Promotion of new development projects	• Promotion of rebuilding & redevelopment through deregulation in urban planning or construction standards • Reduced discrepancy between development law and its implementation, greater transparency of administrative guidance • Rationalization of official paperwork
Investment funds	Establishment of collective investment schemes for real estate	• Reform of SPC Law, removal of ban on JREIT • Reform of real estate distribution tax (reduction or elimination of acquisition tax, registration and licensing tax)
	Enhancement of real estate market data	• Promotion of disclosure regarding real estate securitization • Enhancement of market data, transaction based investment indexes
Demand side	Creation of new demand for commercial real estate	• Creation of new industries and market expansion through promotion of economy's structural reform • Stimulation of latent demand for rental apartments by reforming home ownership policy and fixed term leasehold law • Promotion of separation of ownership and management in service industries such as retail and hotel

Source: NLI Research Institute

(2) Access to Real Estate Data

In the decade following the bubble, real estate valuation methods have shifted from a comparable-sales basis to a return basis. Particularly in the late 1990s, spurred by the bulk sales of nonperforming loans and securitization, the preferred method of valuation for investment purposes quickly converged on return on investment.[10]

Nonetheless, because of the small absolute number of investment transactions and a strong reluctance to disclose information,[11] the return-based method is impeded by difficulty in objectively assessing the capitalization rate and discount rate needed for the approach. The formation of a reliable real estate investment index is difficult for the same reasons.

Still, with investment transactions anticipated to increase, the formation of the JREIT market should advance information disclosure and access by third parties, and lead to some kind of market consensus regarding acceptable investment returns and appraisal of facilities and functions.

Market participants need to pursue information disclosure and enhancement of market data, while the government can enhance its disclosure of real estate tax assessments and the analytical results of transaction data used in determining official land prices.

In sum, the key to increasing investment transactions lies in enhancing market data and thus enabling greater objectivity and transparency in real estate valuations.

Notes

1. In Japan, the enhancement of real estate liquidity (*ryudoka*) refers to the act by companies of selling real estate or moving it off balance sheets. In addition to securitization, methods include sale by auction and voluntary sale.

2. Commercial real estate is often referred to as commercial properties in the U.S. Real estate refers to land and structure, while real property refers to land, structure, and associated rights.

3. Japan Real Estate Institute, *Survey of Trends in Land and Structural Assets in Japan's Financial Industry*, in Japanese, December 1999.

4. Yasuda Trust Bank, *Real Estate Topics 12*, in Japanese, December 2000.

5. Based on a survey of the use status of owned land and structures, in fiscal 2000 the Tokyo Metropolitan Government formulated a comprehensive plan for the utilization of assets in which it aims to sell or convert to other use 329 items totaling 1.15 million square meters of land, selling over 100 billion yen in the three-year period from fiscal 2000-2002.

6. JREITs, which avoid overheated bidding and compose a fund by combining the real estate holdings of companies invested in, and funds that invest in properties in local cities where risk evaluation is difficult but competition is relatively low, or in commercial properties other than office buildings.

7. Figure 2 excludes commercial properties owned not by institutional investors but by individuals or companies managed by individual proprietors.

8. According to the same source as in Figure 2, total real estate investment is 4.3 trillion dollars: 378.7 billion dollars in equity and 1.55 trillion dollars in debt by institutional investors and 2.37 trillion dollars by non-institutional investors.

9. NLI Research Institute estimates that the commercial real estate market consists of 35 trillion yen in office buildings, 2 trillion yen in rental apartments, 7 trillion in shopping centers, and 8 trillion yen in hotels.

10. In March 2001, the Ministry of Land, Transport and Infrastructure announced it would review the real estate appraisal standards (revised in 1990). However, this can be seen as a confirmation of the present status.

11. NLI Research Institute estimates that investment transactions involving commercial real estate in Tokyo's 23-ward area amount to 100 transactions a year at most, equivalent to only 0.2 percent of total stock. By comparison, the figure is 5 to 10 percent in the U.S. and U.K.