Asset Management for Real Estate Investment Trusts (J-REITs)— Issues and Prospects for an Emerging Businesss Area

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1. Operations of Real Estate Investment Trusts

The revision of the Investment Trust Law in November 2000 lifted the ban on real estate investment by investment trusts.[1] In March, the Tokyo Stock Exchange completed preparation of a real estate investment trust (J-REIT) market, and the first listed fund is scheduled to appear in September (Figure 1).

A real estate investment trust is defined here as a pooled fund of many unspecified investors that makes diversified investments in many unspecified assets. Investors are allocated the fund’s earnings, while the fund itself earns fee income from performing asset management. The investment corporation, the main entity of the fund, acts only as the issuer of securities, and is required by law to entrust asset management to a trustor (the asset management company).[2] To be approved by the Financial Services Agency, an investment company must have adequate knowledge and experience in real estate management, public trust, and a firm financial foundation.[3]

Thus the creation of a real estate investment trust market is premised on the existence of professionals who can manage real estate assets, and entails the emergence of a full-fledged real estate asset management business.

The asset management company is entrusted with the functions of making actual decisions and executing the acquisition, sale, leasing and management of real estate properties. To improve the fund’s earnings margin, the asset management company needs to define its policies regarding the selective acquisition, sale or replacement of properties, improvement of property management, renovation, and borrowing. The performance of these operations requires no only expertise in property transactions and management, but knowledge and experience in financing and risk management as well.

To operate efficiently with a small elite team, the asset management company often outsources on-site property management functions of individual properties and tenants (Figure 2).

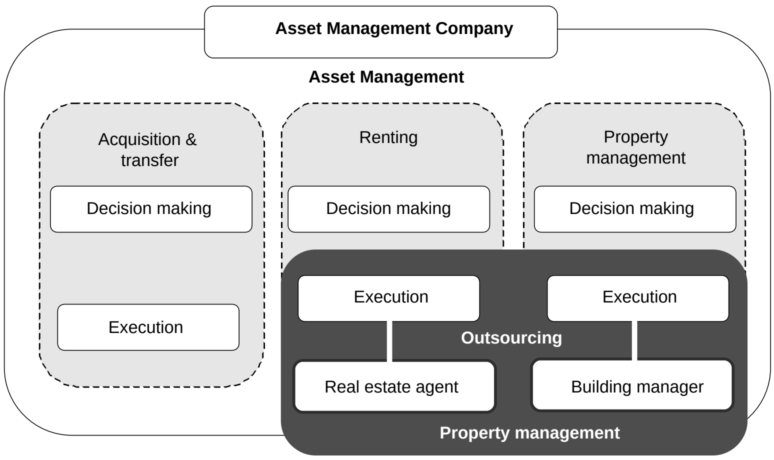
The outsourcing of operations to an asset management company has already been seen in securitizations using an SPC (special purpose company) to increase the liquidity of specified assets. However, real estate investment trusts need a more advanced and refined form of management technology because they not only must meet tax rules by distributing over 90 percent of available earnings to investors, but must also replace assets as warranted by market conditions, make additional investments, and actively seek to expand the fund's size and return.

Figure 1 Real Estate Investment Trusts Scheduled for Market Listing

Investors	Asset management company	Initial assets	Public subscription
Mitsui Fudosan, Sumitomo Life, Sumitomo Trust, others	Office Building Fund Of Japan	¥200 bil.	Undecided
Mitsubishi Estate, Tokio Marine & Fire, Dai-ichi Life	Japan Real Estate Asset Management	¥100 bil.	¥80 bil.
Mitsubishi Corp., UBS Asset Management	Mitsubishi UBS Realty	¥50 ～ 60 bil.	Undecided
Tokyo Tatemono, Asahi Life, Yasuda Life, Taisei Corp.	Tokyo Realty Investment Management	¥50 ～ 60 bil.	Undecided
Mori Trust, Daiwa Securities Group, Mitsubishi Trust	Mori Trust Daiwa Real Estate Investment	¥50 bil.	Undecided
Orix	Orix Asset Management	¥100 bil.	Undecided
Tokyu Corp., Tokyu Land Corp., Lend Lease	Undecided	¥100 bil.	Undecided
Mizuho Financial Group, Mitsui Fudosan	Wincome Property Investment Trust	¥300 bil.	Undecided

Notes: Investors refers to companies investing in the investment company. Since funds usually conduct external financing by borrowing, the size of assets differs from the public subscription (investment).
Source: NLI Research Institute

Figure 2 Operations of the Asset Manager of a Real Estate Investment Trust



Source: NLI Research Institute

2. Issues Confronting Asset Managers of Real Estate Investment Trusts

1. Avoidance of Conflict of Interest Risk

Outside management of real estate investment trusts as described above carries the risk of conflict of interest. This refers to when the asset management company, who is obligated to act in good faith, pursues its own interest or that of a third party at the expense of the interest of investors. In the past, since real estate companies were also investors who invested in real estate for their own account, conflict of interest was not a problem. However, under a securitization arrangement that allocates earnings to investors who are a third party, the interest of investors is often at odds with that of property owners, real estate companies, and management companies.

For example, when choosing a property manager, the asset management company may give preference to the real estate company, who is a shareholder of the management company, or its subsidiary, and offer more lenient contract terms than otherwise. Alternatively, the real estate company may sell its own properties above the fair market price through an asset management company that is a subsidiary, or else sell off inferior properties.

The conflict of interest risk arises because the real estate company, who is a shareholder of the asset management company, owns the properties, which it manages either directly or through a subsidiary, and is thus in a competitive relationship with the real estate investment trust business. This problem does not arise in the U.S., where because the real estate company is converted into a REIT and listed on the stock market, there is no listed real estate company to compete against.[4]

In addition, there are also risks associated with the asset management company itself, such as buying expensive properties to boost the management fee, which is proportional to size of assets; turning over properties to generate transaction commissions; and giving preference to affiliated companies when outsourcing work such as construction, repair, and due diligence.

To avoid such conflicts of interest, asset management companies must not only observe the law, but establish a system of checks and balances. In addition, a further safeguard against this risk is for institutional investors and analysts to closely monitor the company's disclosures. (Figure 3).

Figure 3 Measures to Avoid Conflict of Interest

	Item	Description
Legal provisions	Trustee's duty	• Good-faith obligation of the management company
	Rules of prudent conduct (restrictions)	• Prohibits asset manager from pursuing interest of interested parties or their customers at the expense of the investment corporation's interest
	Disclosure of transactions that may pose conflict of interest	• Asset manager reports in writing to investment corporation when transacting real estate with interested parties.
	Restriction on side business	• Cannot perform business that may be lacking in investor protection
	Double checking of transaction prices	• Asset manager has duty of having transaction pricechecked by third party (lawyer, CPA, real estate assessor)
	Governance by investors	• Investors can exercise voting rights at stockholders' meeting
Organizational measures	Compliance system	• Establish standards of conduct within asset management company based on legal and social norms.
	Voluntary restriction on property transactions	• Restrict volume of transactions between parents and children.
	Clear selection procedure	• When selecting property manager, using rational selection standard such as competitive bidding.
	Separation of business interests	• Asset manager composes fund with assets of a different business area and asset type from that of real estate companies who are stockholders.
	Sharing of profit and risk	• Stockholders of asset management company become long-term stockholders of real estate investment trust, and share profit and risk with other investors.
	Performance incentives	• Introduce performance incentives into compensation system.
	Restriction on personnel exchange	• Apply the no-return rule when stockholders send personnel to the asset manager.
Monitoring by investors and market		• Analysts and institutional investors constantly monitor and provide information to the market.

2. Appropriate Disclosure

Real estate investment trusts listed on the stock market must fulfill several disclosure requirements: disclosure under the Investment Trust Law and Securities Exchange Law, the TSE timely disclosure standard, and voluntary disclosure rules of the Investment Trust Association. However, since J-REITs are a new financial product with which investors and the market are unfamiliar, attention has gathered on how timely and appropriate the actual disclosures will be.

Disclosure requirements include the appraised value of each property as well as revenue and cost breakdowns at the end of the period, utilization rates, and other details of fund management. While there is criticism that disclosure of individual data on tenants is inadequate, compared to the limited disclosures by listed real estate companies in the past, the disclosure standards for J-REITs represent a huge leap forward.

However, it is doubtful at present whether investors can effectively use all of the detailed disclosures. In particular, individual investors, who will comprise the majority, may be unable to fully digest the specialized real estate jargon and voluminous data contained in detailed disclosures.[5] While analysts and rating agencies bear a heavy responsibility in analyzing the disclosed primary data and making objective assessments, it is imperative that asset management companies also strive to provide investors with appropriate, understandable information.

3. Toward Development of the Asset Management Business

Created by the emergence of real estate investment trusts, the real estate asset management business is a new kind of specialized business in Japan, and confronting growth pains as described above.

Back when the land myth prevailed, real estate data circulated only among a small group of specified persons, and there was no risk of conflict of interest because the spheres of business (management) and investment (ownership) were fused together. Moreover, since acquired properties were seldom sold to a third party, there was little opportunity to nuture professional asset managers. However, after the collapse of the asset bubble, with the real estate business needing to attract many investors, asset management in the interest of investors has become a central concern.

Asset management companies not only need professional expertise in real estate management and risk management, but must exercise a fiduciary duty toward investors. As such, they are being called on to establish safeguards against conflict of interest, and make appropriate, timely and understandable disclosure to investors (Figure 4).

With the J-REIT market now in its formative period, another important element for the development of the asset management business is to be closely monitored by institutional investors and analysts.

Figure 4 Important Functions of Asset Management Companies

Function	Main activities
Real estate management	• Asset management • Property management (can be outsourced) • Market surveys • Risk management
Serving the interest of investors	• Investor relations — active disclosure and access to information • Compliance and other arrangements to avoid conflict of interest

Source: NLI Research Institute

Notes

1. The amended Investment Trust Law establishes two types of investment trusts: the company type, in which the asset managing entity is an investment company, and the contract type, in which the asset manager can either entrust management to a trust bank or manage assets on its own. Since the investment trusts now planned for market listing are of the company type, we limited our discussion to this type.

2. Outside management is when a fund entrusts management to another entity. The same arrangement exists in Australia's real estate funds known as property trusts. However, in U.S. REITs, on which Japan's are modeled, real estate management is conducted in-house.

3. Before being approved by the Financial Services Agency, asset managers must have a real estate broker's license, and receive approval as discretionary investment managers from the Ministry of Land, Infrastructure and Transportation in accordance with the Real Estate Brokers Law.

   Also in 2000, the former Construction Ministry established a registration system for real estate investment advisories. Comprehensive real estate advisories are authorized to give advice regarding real estate investment, make investment decisions related to real estate transactions, and conduct real estate transactions. Thus the business description is almost the same as for trustors (asset management companies). However, integration of the two systems is impeded by bureaucratic barriers.

4. REIT refers to real estate investment trusts in the U.S.

5. A huge disparity exists between individual investors and institutional investors such as life insurers and trust banks regarding knowledge of the real estate market, economic and financial environment, and tax issues, as well as analytical ability.