Growth Prospects for the Newly Formed J-REIT Market

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Introduction

For the newly formed real estate investment trust (J-REIT)[1] market to win the appeal and acceptance of investors, the most critical factor is for the market to grow in size. This paper examines key factors that will influence the market's growth, and looks ahead at the market's future prospects.

1. The J-REIT Market Takeoff

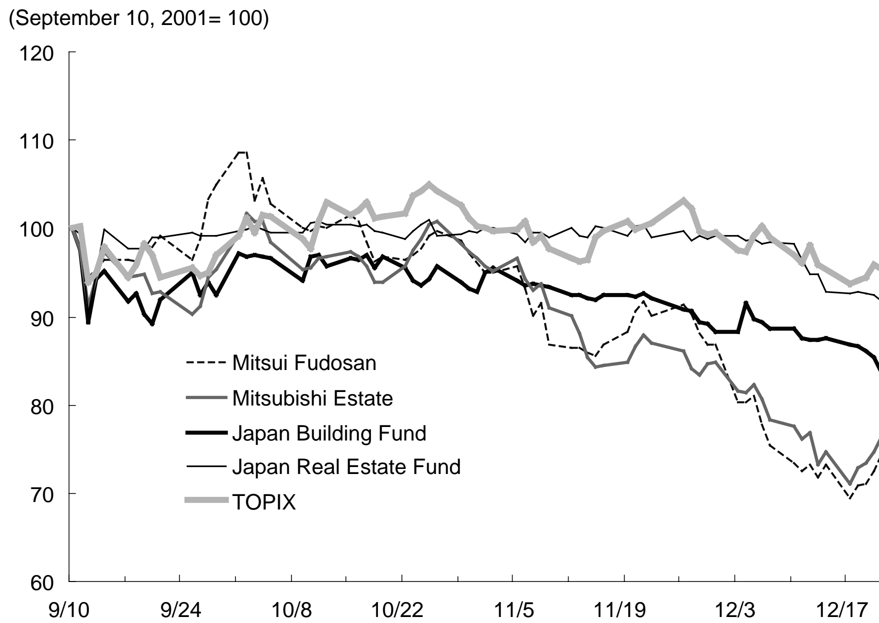
With the May 2000 revision of the Investment Trust Law (Law Concerning Investment Trusts and Investment Corporations, which became effective in November), the scope of fund management was expanded from a focus on securities to real estate and other assets. The revision enabled the formation of J-REITs, and in March 2001 the Tokyo Stock Exchange established listing and delisting criteria for a J-REIT market, forming the core institutional infrastructure for a brand new, small-lot real estate investment product that individual investors can participate in.

On September 10, 2001, with the listing of two J-REITs on the TSE — Japan Building Fund and Japan Real Estate Fund — the real estate fund market finally took off some four decades after the U.S. During fiscal 2001, three more funds are scheduled to be listed, including ones led by Mitsubishi Corp. and Orix Corp. Thus despite the poor economic and financial environment, the market's takeoff is proceeding relatively well.

With regard to the two listed J-REITs, share prices have not declined by as much as those of the companies that formed them (Mitsui Fudosan Co., and Mitsubishi Estate Co.), and their price volatility is low (Figure 1).

Thus far, Japan Building Fund's stock price is more strongly correlated with Mitsui Fudosan than with TOPIX (the TSE price index), while the stock price of Japan Real Estate is not strongly correlated with either TOPIX or Mitsubishi Estate.[2]

Figure 1 Stock Price Trends (indexed to 100 at time of listing)



Note: Shows weekly closing stock prices from September 10 to December 21, 2001.

The total market valuation of listed J-REITs is expected to reach 300 billion to 400 billion yen by the end of fiscal 2001. From fiscal 2002 forward, some 20 J-REITs are slated for listing.

Of these, the large funds formed by large real estate companies and financial institutions will have several tens of billion yen in assets, and be centered around office building management. To differentiate themselves, the smaller independent funds with several billion to 20 billion yen in assets will be centered around apartment building management.

In addition, separate from J-REITS, a large number of private subscription funds are planned that are limited to a certain number of privately solicited investors. Since private funds can later convert to J-REITs and become listed, or else take an exit strategy and sell off properties to J-REITs, the private fund market partly overlaps with the J-REIT market (Figure 2 and 3).

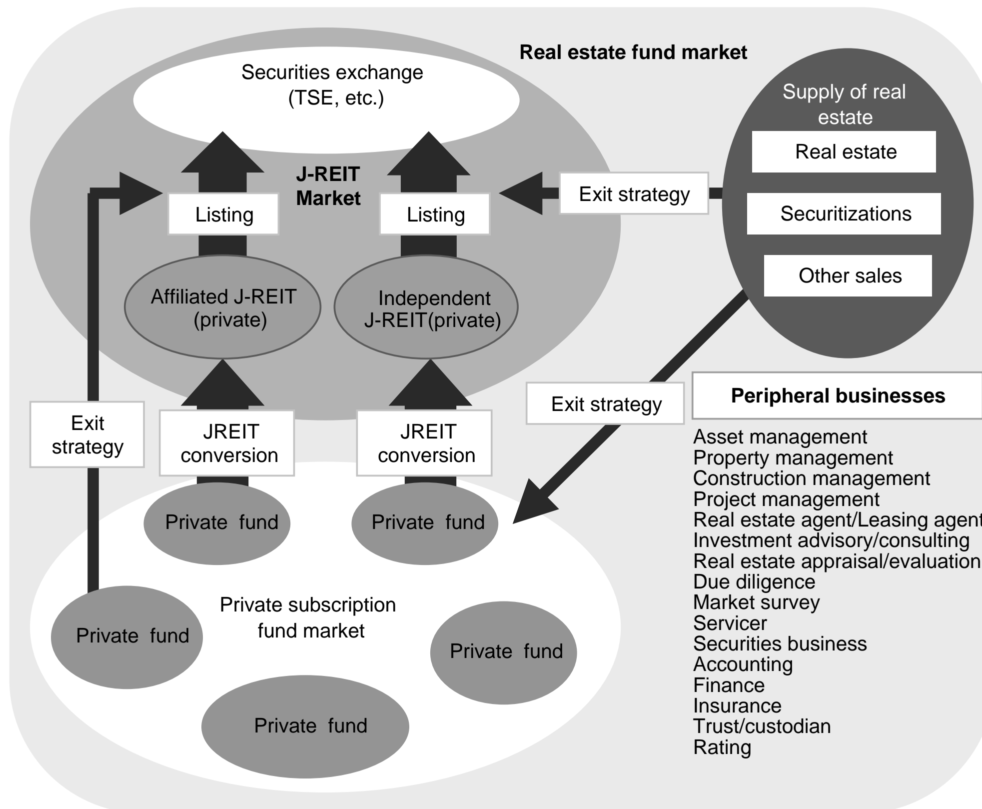
Figure 2 Existing and Planned Real Estate Funds

Sponsor	Type of building/property	Asset size
J-REITs		
• Mitsui Fudosan, Sumitomo Life, Chuo Mitsui Trust, SMBC, etc.	Office	¥257 bil. (at listing; completed)
• Mitsubishi Estate, Daiichi Life, Tokio Marine & Fire Insurance	Office	¥113.5 bil. (at listing; completed)
• Mitsubishi, UBS Asset Management	Commercial	¥35 bil. (at listing)
• Orix	Office, apartment, commercial	¥100 bil. (at listing)
• Tokyo Tatemono, Taisei, Yasuda Life, Asahi Life, Yasuda Real Estate	Office, commercial	¥100 bil. (at listing)
• Mori Trust, Daiwa Securities Group, Mitsubishi Trust, Daibiru, Parco, etc.	Office, commercial, hotel, apartment	¥50 bil. (at listing)
• Goldman Sachs	Office	¥100 bil. (at listing)
• Tokyu, Tokyu Land, Lend Lease	Office, commercial, hotel, apartment	–
• Mizuho Group, Mitsui Fudosan	Office, apartment, commercial	¥100 bil. (at formation)
• Creed, Itochu Finance	Mid-sized commercial properties	¥3-5 bil. (at formation)
• Creed	Office, apartment	¥10-20 bil. (at formation)
• Tokyo REIT	Apartment, office, commercial	¥20 bil. (at formation)
• Prospect	Apartment	¥10 bil. (at formation)
• Ken Corporation, Chuo Mitsui Asset Mgt., etc.	Office, apartment, commercial	¥40-50 bil. (at listing)
• Recrm Research	Office, apartment, commercial	¥30 bil.
• Mori Building	Office	¥200 bil. (at listing)
• Nomura Real Estate Development	Office	¥100 bil.
• daVince Advisors	Office	–
• Dix Kuroki	One-room apartment	¥7-10 bil. (at formation)
• Hankyu, Hankyu Realty, UFJ Group	Commercial	–
• HS Securities, Landmark	Apartment	¥10-20 bil. (at listing)
• Shinwa Enterprise	1-room apartment	–
• Ryowa Life Create	1-room apartment	–
• Softbank Finance	–	–
• Asset Managers	Commercial, office	¥20 bil. (at formation)
Private subscription funds		
• Creed	Office, apartment	Several ¥ bil.
• Nomura Real Estate Dev., Starwood Capital Group	Office building	¥120 bil.
• Nomura Real Estate Development	Apartment	–
• Nomura Real Estate Development	Hotel	–
• Apamanshop Network	Apartment, commercial	¥30 bil.
• SBI Real Estate Management	Apartment	–
• Asset Managers	Apartment	Several ¥ bil.
• Insured Capital	Apartment	¥3.6 bil.
• Jones Lang LaSalle	Office	¥150-180 bil.
• Sumitomo Real Estate Sales	Office, apartment	¥1 bil. (at formation)
• Joint Corporation, CSFB	Apartment	¥60-80 bil. (in 3 years)
• Kennedy-Wilson Japan	Office	¥50 bil.
• Atrium	Auctioned properties	¥15 bil.
• IDU	Built-for-sale condo inventory	¥2 bil.

Notes: Blank in asset size column indicates that the amount is unknown or undecided. It is possible for private funds to be converted into J-REITs and listed at a later time.

Source: Compiled by NLI Research Institute from media and public sources during the one-year period from December 2000.

Figure 3 Diagram of Real Estate Fund Markets



Source: NLI Research Institute.

The J-REIT and private fund markets offer expanding business opportunities in peripheral areas of real estate management such as asset management, property management, and project management, as well as in investment advisory, consulting, real estate agency, leasing agency, administration, custodianship, and rating services.

It is also true that many companies forming J-REITs are seeking business opportunities in these peripheral areas by holding a real estate portfolio separate from their balance sheet over which they can exert influence.

Thus the J-REIT market's sound growth is essential not only for investors seeking for a new product, but for real estate businesses in search of a new business model following the collapse of the land myth.

2. J-REIT Market Growth Factor (1): Circulation of High-Quality Real Estate

Two key factors will influence the growth of the J-REIT market. First is the extent to which high-qual-

ity real estate will circulate in the market, thereby expanding the external growth opportunities for funds.[3]

To achieve long-term stability, large funds invest mostly in high-quality office buildings, which have a low price volatility. However, because of the small supply of new, large, high-quality office buildings, funds are having great difficulty making new acquisitions.

Of course, there is nothing wrong with having a diverse J-REIT market, including funds that seek internal growth by fixing up undervalued properties or changing their management company, or funds that offer high-risk, high-return performance with aggressively managed portfolios. However, for a new financial product like the J-REIT to gain broad acceptance among investors and become established, the optimal situation is to have as many funds as possible with a portfolio of high-quality properties and stable dividend.

At present, Tokyo's office leasing market, which looms large in the portfolios of large funds, faces the problem of a large supply of Class A buildings (large, new properties in prime locations) coming on line in 2003. In addition, rents and occupancy rates are soft due to the struggling economy and weak demand from foreign financial institutions, who are regarded as pricing leaders. Thus large funds engaged in office building management are exposed to a substantial risk of rent decline, which frustrates efforts to achieve a high internal growth rate based on management efficiency.

For this reason, J-REIT investment strategy needs to focus on external growth. While a large supply of Class A buildings will enter the office market, in the real estate investment market (sales transactions), although demand is strong among funds and investors for high-quality properties, the supply of Class A buildings is extremely scarce because they are seldom put up for sale.

While the first two J-REITs to become listed specialize in office buildings, their real estate portfolios are considerably smaller than those of the real estate companies that created them.[4] Moreover, they own almost no Class A buildings in Tokyo's 23-ward area, and most of the large buildings they do own are at least 20 years old.

But the real estate companies also own relatively few Class A buildings, and moreover, over half of such properties are jointly or partially owned and thus not readily saleable. Thus they are in no position to transfer Class A buildings to their J-REIT.

On the other hand, among transactions conducted since 1998, including the sale of head office buildings under the Securitization Law, many have involved Class A buildings (Figure 4).

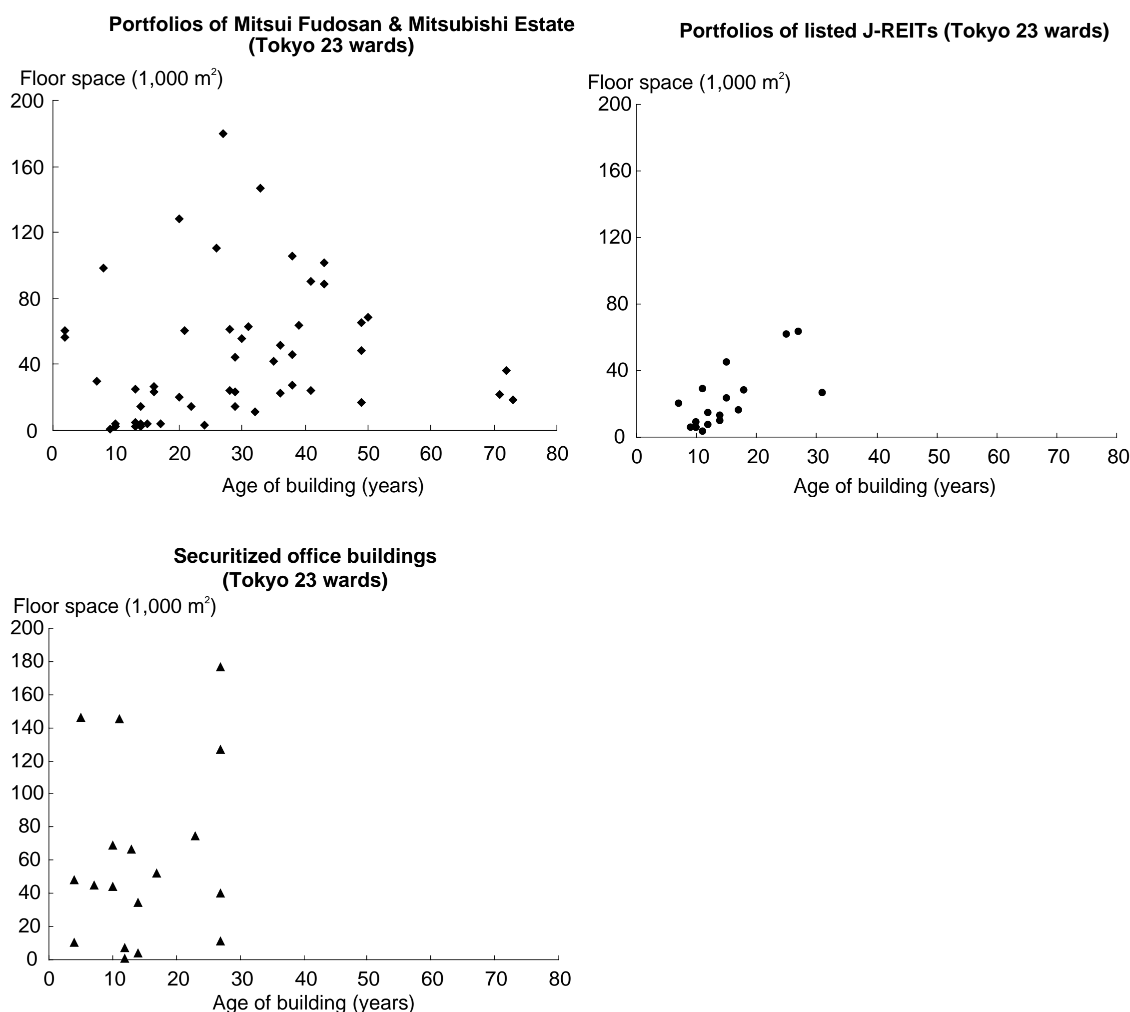
Before the lifting of the J-REIT ban, few investors had the financial means or risk-bearing capability to

purchase large office buildings of this caliber. Thus corporations seeking to raise funds by liquidating real estate had to resort to asset-backed securitization (ABS) schemes, which isolate real estate risk and issue corporate bonds or other securities in small lots.[5]

However, even with the emergence of J-REITs as a major buyer of large properties, sellers often prefer securitization using structured finance over competitive market bidding.[6] This tendency is particularly strong with high-quality properties such as head office buildings.

Moreover, chances are high that these securitized properties will be sold off to J-REITs as an exit strategy when the time for refinancing arrives in 2004 and after.

Figure 4 Size and Age Distribution of Office Building Portfolios



Notes: Includes only office buildings in Tokyo's 23-ward area. Total floor space is shown for buildings that are jointly or partially owned.

Sourcve: Compiled from various sources including *Yuka Shoken Hokokusho*, *Mokuromisho*, and *Annual Construction Statistics*.

In addition, over the long term, as bad loans are cleared off at financial institutions and loss accounting for fixed assets is introduced in March 2004, restructuring will accelerate among financial institutions and business companies, causing large amounts of high-quality and other real estate to reach the market.

Moreover, just as rental apartment buildings are being built under the assumption of their eventual sale to residential funds, the current emphasis on urban revitalization will cause more office building developments to be built with the eventual aim of being sold to J-REITs.

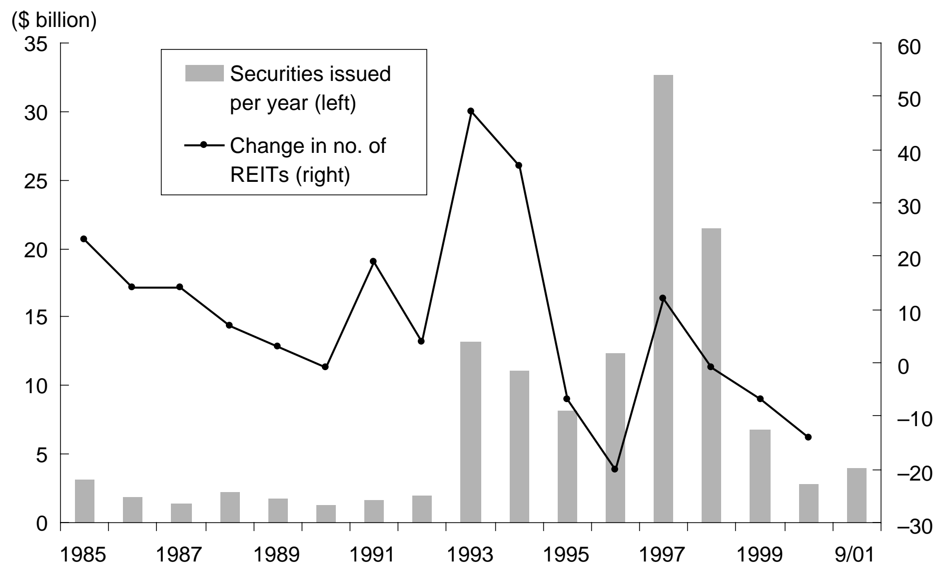
Thus over the next three to five years, the outlook is for the market mechanism to gradually alleviate the scarcity of high-quality properties.

3. J-REIT Market Growth Factor (2): Outlook for the Economic and Financial Environment

The second factor that will influence the growth of the J-REIT market is the outlook for the economic and financial environment. Below we examine the U.S. REIT market for reference.

The REIT market in the U.S. experienced its greatest growth period in the six years from 1993 to 1998 (Figure 5).

Figure 5 U.S. REIT Market

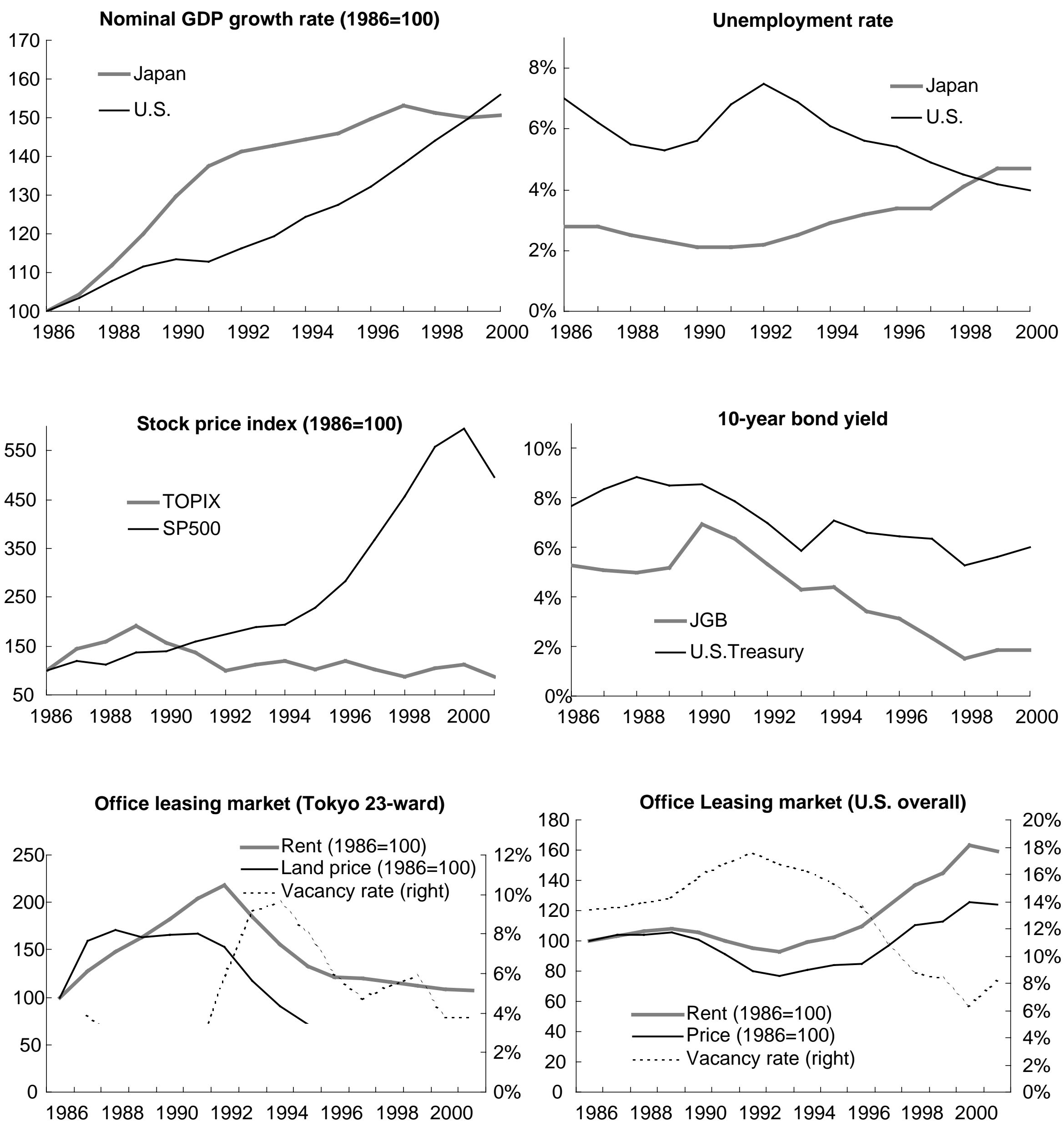


Note: Shows results through third quarter for 2001.
Source: NAREIT

One factor behind the rapid growth was the introduction of the UPREIT in 1992, which allows the capital gains tax on investments in kind into a REIT to be deferred until stockholdings are sold after listing.[7] However, another key factor was the fact that the economic and financial environment had bottomed out in 1991-92. As the economy picked up, unemployment declined from its 1992 peak, and the stock market surged from 1995. The long-term interest rate rose temporarily due to the economic recovery but then declined and stabilized. The office market, which bottomed out in 1993, saw rents and property prices enter an upward phase (Figure 6).

Originally, the 1986 tax reform, which revised the accelerated depreciation for real estate, brought a chill to investments in real estate partnerships. During the subsequent financial crisis and real estate recession, REITS, which were able to secure financing in capital markets, continued to acquire high-quality properties at depressed prices. It was at this point in 1992 that the UPREIT was introduced and the economy turned around.

Figure 6 Comparison of Key Indicators in Japan and the U.S.



Sources: Ikoma C.B. Richard Ellis for rent and vacancy rate data; Japan Real Estate Institute for land price data; however, for rent data up to 1991, data from Tokyo Building Association was revised by NLI Research Institute.

Notes: Shows Q4 values for all years except 2001, which is Q2.

Source: National Real Estate Index (NREI).

By comparison, from 2000 to 2001, when the J-REIT debuted, the economy's growth rate was zero, unemployment rose, stock prices fell, the long-term interest rate hit a record low, and despite the low vacancy rate in the office market, rents and prices showed no sign of bottoming out.

While this situation seems to resemble the economic and financial conditions in the U.S. just prior to the REIT's surge in the early 1990s, the difference is that Japan now has little hope for a V-shaped recovery in the economy, stock market, or real estate market.

For the past decade, Japan's economy has unsuccessfully pursued an elusive soft landing. Serious efforts have only just begun on administrative and fiscal reforms, and on transforming the economic and industrial structure for a new era. Since the process of structural reform must first eliminate inefficient businesses and reduce excess capacity, the economy is expected to worsen before it recovers, and thus bring no quick relief to the J-REIT market.

However, the worsening economy will also accelerate the sale of real estate held by companies and public organizations, bringing major opportunities for external growth to J-REITs, similar to conditions in the U.S. in the late 1980s.

Created in 1960, U.S. REITs had to wait patiently until the 1990s, when the UPREIT and economic recovery stimulated vigorous growth. In the same way, J-REITs should patiently wait for economic recovery, while in the meantime pursuing steady growth by taking advantage of low interest rates to acquire high-quality properties, and refining their management competence. In addition, investors also need to adopt a long time horizon with regard to the growth of the J-REIT market.

Conclusion: Expectations for Policy

The growth of the J-REIT market is sure to improve the transparency and liquidity of Japan's real estate market, and facilitate a smooth and abundant flow of funds into the real estate industry. If policymakers recognize the potential benefits of this market, they must aggressively implement direct and indirect measures to accelerate the liquidity enhancement of high-quality real estate.

The UPREIT, which helped propel the growth of the U.S. REIT market, was designed by private financial institutions under the existing legal framework in that country. However, it is conceivable that Japan could implement tax reforms to produce a Japan-style UPREIT, or create tax benefits such as a reduced transfer gains tax for companies when they sell real estate holdings to a J-REIT.

In addition, a more indirect and long-term approach is to deregulate and simplify procedures for new office building development projects that are intended for future sale to J-REITs. Promoting such developments will lead to greater liquidity for high-quality real estate.

However, the most crucial policy for the growth of the J-REIT market is none other than to produce a strong economic recovery — pushing through the necessary structural reforms, and adapting Japan's

outdated economic and social systems as quickly as possible to the new era.

If necessary policies continue to be postponed as in the 1990s, new growth industries will be held back and the economy will lose competitiveness. With Japan's population projected to start declining as early as 2005, the dreaded scenario of a long-term decay could actually come true. But by riding through the massive yet temporary pain of the structural reforms, we can usher in the next generation of growth industries and increase the economy's potential growth rate. Then the J-REIT market will be ready to reproduce the performance of the U.S. REIT market during the 1990s.

Notes

1. REIT, which stands for real estate investment trust, is a leading real estate securitization product in the U.S. The market surged from 1993, reaching a valuation of $144 billion as of September 2001. REITs are listed on securities markets and are highly liquid, making them popular among both institutional and individual investors. Japan's real estate investment trusts (J-REITs) are basically modeled after REITs, and anticipated to achieve comparable growth.

2. For the period from September 10 to December 21, 2001, Japan Building Fund's correlation coefficient is 0.54 versus TOPIX, and 0.84 versus Mitsui Fudosan. For Japan Real Estate Fund, the correlation coefficient is 0.64 versus TOPIX, and 0.65 versus Mitsubishi Estate. However, these correlation coefficients may change as time passes.

3. For investors, J-REIT growth means growth in cash flow per share. Cash flow growth is achieved through internal and external growth. Internal growth is achieved by increasing the return on real estate owned by the fund, which increases cash flow. It involves management improvements: for example, raising rents or occupancy rates, trimming management or borrowing costs, or making costs grow less than revenue. Another important method is to make building improvements at reasonable cost so that properties become more competitive in the market. External growth involves expanding asset holdings through additional acquisitions, or increasing cash flow by improving capital efficiency. Additional acquisitions are financed by borrowing, bond issuance, or issuance of new shares (capital increase). With a capital increase, unless cash flow increases to maintain the same level of cash flow per share, the value of existing shares or the allotment to all shares will decline. Thus the fund manager needs to time additional acquisitions carefully so that properties exceeding the fund's present return are purchased at a low financing cost.

4. Portfolio often refers to the broad composition of holdings among stocks, bonds, and real estate. Here, however, we use the term real estate portfolio to refer to the composition of specific asset holdings.

5. An asset-backed securities (ABS) scheme refers to securitization using investment vehicles such as an SPC, based on the cash flow of specific real estate assets.

6. Since corporate pension funds suffered large losses from the post-bubble real estate price decline, they currently own very little real estate, and are unlikely to resume investing in real estate, which involves large price and liquidity risks. This contrasts sharply with the diversified investment strategy of large U.S. pension funds, where over 3% of invested assets are in real estate (over 4% if real estate loans are included). Moreover, until

the collapse of the real estate bubble, the main investors in large rental properties such as office buildings were real estate companies and life insurers. At present, however, real estate companies have revised their business strategy in response to the changing market structure, and are aggressive in J-REITs and fee-charging businesses, but conservative regarding new investments for their own account. Life insurers, whose assets are no longer growing, are also refraining from new investments, and busy improving the efficiency of their current real estate portfolio. Thus J-REITs, which are accessible to a large number of investors and seek long-term growth, have attracted attention as a new buyer in the real estate market. In the U.S., pension funds and REITs are the two largest real estate investors, and together own three-fourths of all investment real estate. In Japan, if the J-REIT market expands smoothly, J-REITs are likely to become the largest buyer of real estate properties.

7. One reason REITs bought up real estate and began growing rapidly in the 1990s was the introduction of the umbrella partnership REIT (UPREIT). The UPREIT, which private financial institutions devised in 1992 under the existing legal framework, allows originators (property owners who invest in kind in the REIT) to defer the capital gains tax. Stock companies that want to acquire a REIT qualification become the general partner in a limited partnership (especially an operating partnership, or OP), and originators receive units that are convertible into REIT shares one for one. When the OP makes an initial public offering premised on REIT qualification, the funds raised are applied to improve returns, which tends to cause stock price increases and thus bring further gains. While units cannot be converted into stock for one year after listing, the capital gains tax (on unrealized gain from the investment in kind, IPO gain, and stock price gain) can be deferred until the conversion. For originators, this arrangement is preferable to a simple transfer because (1) they can choose when to pay the capital gains tax, and (2) the public offering can increase the unit's conversion value. The UPREIT scheme is based not on tax law, but on the fundamental tax concept of deferring taxation until a capital gain has been established (see T. Matsumura, F. Shinohara, and M. Oka, *Introduction to Real Estate Securitization*, Sigma Base Capital).