The Expanding Market for Private Real Estate Funds—Business Model and Prospects

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1. Recent Market Trends

Investors have responded favorably to the new J-REITs (Japan-style real estate investment trust) in their first year on the stock exchange, particularly because of the high dividend yield and price stability. As a real estate investment product aimed primarily at a large number of unspecified investors, J-REITs offer exceptional quality due to their transparency and liquidity. In addition, they hold great promise as a new real estate business model that separates ownership and management.

By comparison, privately subscribed real estate funds aimed at a small number of specified investors (private funds) debuted more quietly back in 1998. Domestic firms such as DaVinci Advisors and Nomura Real Estate began operating in the shadow of prominent foreign funds, who engaged in high-profile property investments and bulk purchases from domestic banks of nonperforming loans secured by real estate. At present, a variety of foreign and domestic private funds exist, with publicly disclosed assets under management exceeding ¥400 billion for Japanese funds alone (Figure 1).

The private fund market's growth can be attributed to several factors. First, there has been a growing supply of investment grade properties. The persistent recession, asset price deflation, disposal of nonperforming loans by financial institutions, business failures stemming from excessive bubble-era investment, and financial restructuring pressure—all have prompted the sale of real estate properties and loans secured by real estate.

The market has not seen any significant increase in the supply of prime properties such as large office buildings in key locations—the preferred investment of J-REITs, who seek stable long-term management. However, most private funds prefer other types of properties that do not compete directly with J-REITs. In addition, private funds resort to their own acquisition routes.

For example, they include properties that have deteriorated due to negligence and minimal management, such as properties auctioned by and then bought by financial institutions, properties held by companies about to withdraw from business, other auctioned properties, and properties held as collateral for bad loans. Such distressed properties face serious obstacles to price appreciation and need special management expertise.

Figure 1 Private Real Estate Funds

Fund arranger / manager	Asset type; fund name; (remarks)	Asset size (¥billion)
Creed Corp., Creed Real Estate Investment Advisory	Office, apartment, commercial & retail buildings, etc.; (manages several funds)	30.0
Pacific Management Corp.	Condo; PMC1 Fund, others	13.0
	(Business investment real estate fund)	5.0
	(Nonperforming loan fund)	10.0
Kennedy-Wilson Japan	Office	50.0
	Office, apartment; (aimed at domestic pensions)	30.0
	Apartment	10.0
Mountain Trust Real Estate Investment Advisory	Office	13.0
	Apartment	5.0
RECRM Research	(Nonperforming loan fund)	10.0
DaVinci Advisors	Office; (manages several funds)	61.0
Asset Managers Co.	Apartment, etc.; (operates several funds)	30.0
Nomura Real Estate, Nomura Real	Office; Japan Real Estate Opportunity Fund, others	160.0
	Apartment; PURE Fund	50.0
Atrium	(Fund of auctioned properties)	15.0
HS Landmark Asset Management	Apartment	10.0
Marubeni Corp.	Office, apartment	10.0
Enright Real Estate Co. Japan	Office	10.0
Prospect	Apartment	3.5
Dix Kuroki Co.	Apartment	2.7
Tosei Real Estate	Apartment; Argo Fund	2.0
Dynacity Corp.	Apartment combined with commercial & retail	1.0
Hunet Inc.	Apartment; New Frontier Fund	1.0
ProLogis Japan	Large logistical facilities	120.0
LaSalle Investment Management	Office; (invests in major cities in Asia)	160.0

Notes: (1) Includes funds in the planning stage. (2) In addition to the above, Pacific Management is forming a fund of apartment properties for J-REIT listing. (3) Large real estate funds associated with U.S. investment banks such as Morgan Stanley and Goldman Sachs are excluded because asset size and property holdings are undisclosed. (4) The new J-Income Fund, formed by a joint corporation, is excluded because of its public subscription.

Source: Compiled by NLI Research based on information from company web sites and publicly available materials (November 2001 to October 2002).

Second, under the ultra-low interest rate environment, the large yield gap between the lending rate and real estate investment yield makes the higher expected yield from leveraged equity investment all the more attractive. Recently, not only large foreign investors, but domestic institutional investors who seek new investment opportunities have focused on private funds, while life and casualty insurers have already shown investment results. Moreover, many wealthy individual investors have also exhibited interest following the resumption of bank deposit insurance limits and as a promising investment strategy.

Third, the infrastructure for real estate investment has been established in a relatively short time. This includes practices introduced by foreign investors such as the income approach, due diligence, nonrecourse loans (loans for which the borrower's liability is limited to the real estate collateral), and securitization schemes. In particular, nonrecourse loans are essential to private fund schemes. Specialists with experience in bulk sales of nonperforming loans and real estate securitization while working at foreign firms have been instrumental in setting up private funds.

Fourth has been the development of the J-REIT market as the final destination of properties managed by private funds.

2. Business Model

(1) The Fund Scheme

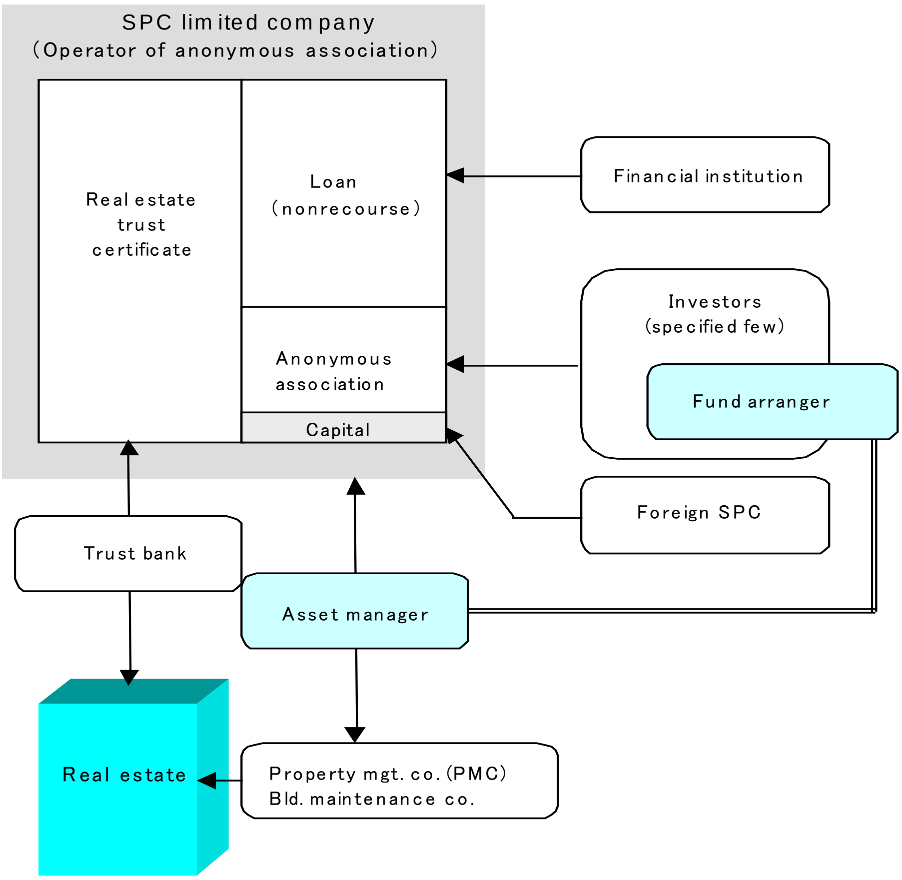
In general, a fund refers to a pool of assets gathered from investors. Many private funds that invest in real estate resemble a joint venture between the fund arranger and a small number of investors, and thus can be described as a partnership-type real estate fund.

The fund's investment vehicle is legally separated from the arranger's own credit standing and assets, acting as a conduit to prevent double taxation. In practice, a commonly used scheme is to combine the anonymous association and limited company under the Commercial Code. But a scheme to invest in preferred securities using a special purpose company under the Real Estate Securitization Act is also on the increase (Figure 2).

Specifically, to achieve bankruptcy remoteness for the fund arranger, a foreign SPC sets up a limited company in Japan, which acts as operator of the anonymous association, and the arranger or the arranger's subsidiary becomes asset manager (also called fund manager).

To take advantage of leverage effects, the fund obtains a nonrecourse loan for 50-70% of the total investment from banks, and the remainder comes from investors. The arranger shares risks with investors, and usually invests in the fund to increase investors' confidence.

Figure 2 Private Real Estate Fund Scheme



Source: NLI Research Institute

Moreover, real estate is often acquired in the form of trust certificates. This is done to reduce taxation at the time of acquisition, and to avoid stipulations of the Real Estate Syndication Act.

While funds are usually managed at the level of specific properties and portfolios, some funds purchase a large number of individual condominiums and then quickly resell them, allocating gains on a continuing basis.

(2) Investment Strategy

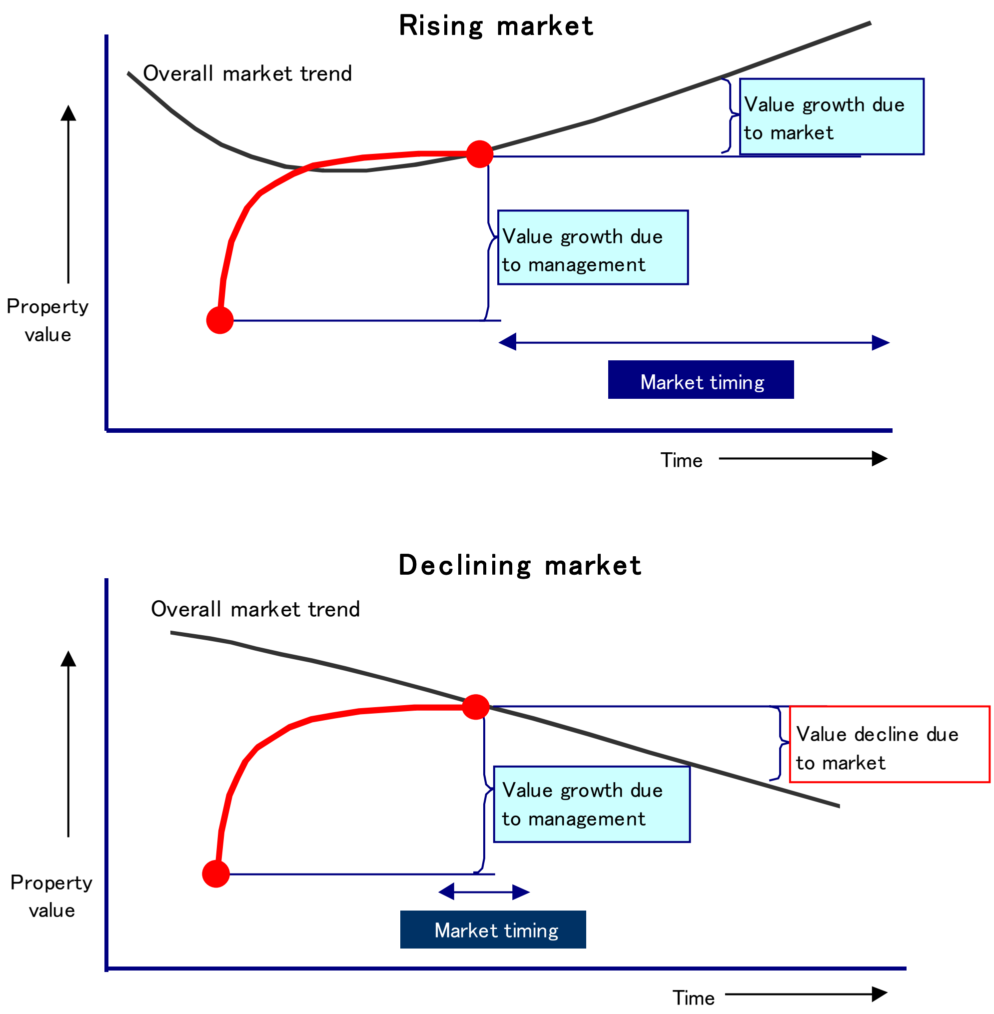
Basically, the investment strategy of private funds is as follows: (1) seek out a variety of investment opportunities, (2) buy undervalued properties that have not performed to expectations, (3) perform good property management by repairing or upgrading building and facilities, improving management efficiency and cut costs, and raising occupancy rates by recruiting tenants, (4) boost the property's market value by improving cash flow and reducing investment risk, and (5) distribute income gains to investors, while maximizing capital gains by selling properties at peak value.

The average fund size is one to ten billion yen, and properties consist of apartment buildings, small & medium office buildings, and commercial buildings in the Tokyo-to area.

The planned holding period is three to five years, which is short compared to the average 7-year holding period of U.S. funds. This is because Japan's present real estate market shows no imminent signs of recovery in rents or prices, making it wise to lock in gains by quickly selling off properties once they have recovered in value (Figure 3).

Using a high loan to value ratio of 50% to 70%, funds aim to meet the investors' expected annual yield of 10% to 20% (IRR) including capital gains.

Figure 3　Price Appreciation Scenario for Fund Properties



Note: Change in property valuation is the sum of change in cash flow and in property price.
Source: NLI Research Institute

Moreover, unlike J-REITs, which are traded daily on the market, private funds need to allocate returns to investors by selling off or redeeming properties after a prescribed period. Thus an exit strategy becomes vital, and its skillful execution can actually determine the success or failure of the fund. As an exit for properties in the fund or the fund itself, possibilities include: (1) selling to other investors or private funds, (2) selling to a J-REIT, (3) converting to fund into a J-REIT, (4) selling to an individual or corporate end user. Since the intent is to sell properties after their valuation has risen, it is difficult to sell to investors who seek capital gains. For this reason, the main buyers are J-REITs or individuals with a long horizon and who seek income gains, or end users.

To achieve these investment strategies, private fund operators need the following capabilities: (1) research and marketing capabilities to identify optimal investment opportunities and market timing, (2) speedy and accurate valuation of the potential value and fair cost of properties, (3) good management to quickly restore, maintain or boost property values, (4) skillful financing, and the credibility and resources to attract the best investors. In private funds, operators and arrangers are one and the same, and also often serve as asset managers.

(3) Earnings Structure

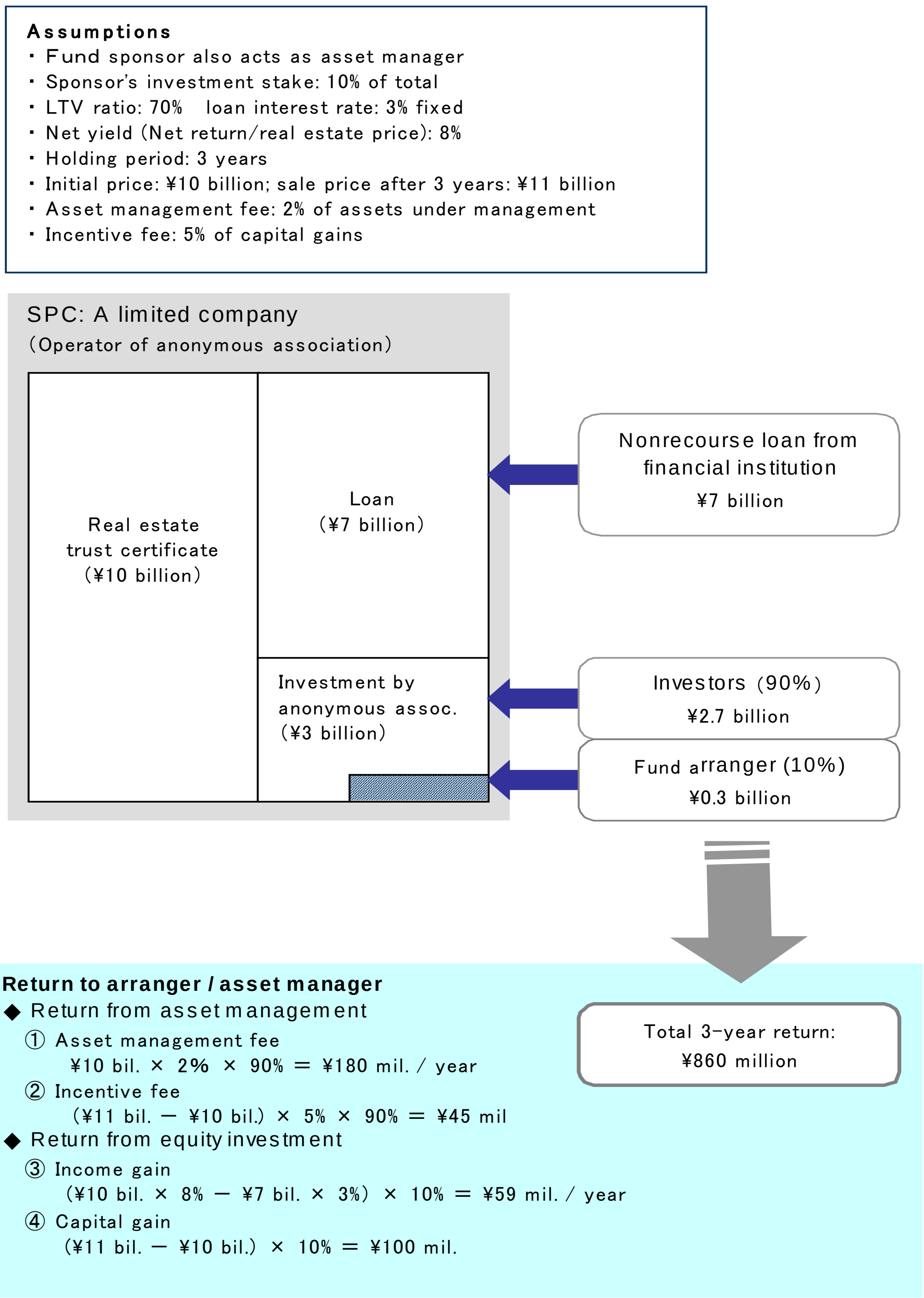
Ordinarily, earnings of private fund operators consist of: (1) compensation for fund management, (2) return on own money invested in the fund, which is done to enhance credit through risk sharing with investors, and (3) income from peripheral fund management activities (Figure 4).

Compensation for management consists of an asset management fee, which is proportional to the size of assets under management, and an incentive fee paid if the fund exceeds certain performance criteria. In addition, managers ordinarily earn an acquisition fee for purchases, and a disposition fee for sales. Specific compensation systems and fee rates differ by fund.

Earnings from equity investment consist of an annual income gain during the investment period, and a capital gain when properties are sold. Taking advantage of leverage, private funds adopt a high risk, high return investment strategy in which they sell off properties once they have appreciated in value.

Ordinarily, private fund operators invest in their own account, and also have independent units that perform due diligence, transaction intermediation, property management, investment advisory, and other peripheral real estate management functions. While conflicts of interest may exist, this operating structure offers synergistic effects in fund operations. Recently, fund operators have begun developing properties tailored to fund management, and participating in corporate restructuring by evaluating nonperforming loans and managing or selling real estate held as collateral. Figure 5 compares the business model of private funds with that of J-REITs (Figure 5).

Figure 4 Earnings Model of Private Real Estate Fund



Notes: (1) Excludes compensation related to property transactions. (2) The incentive fee is usually a percentage of performance exceeding a prescribed level (such as expected IRR), but is excluded here.
Source: Compiled by NLI Research Institute, based on materials from Creed (www.creed.co.jp).

Figure 5 Business Model Comparison of Private Fund and J-REIT

	JREIT	Private real estate fund
Size		
Assets under mgt.	¥50～300 billion	¥1～10 billion
Investment properties		
Type	Large office buildings, commercial facilities, apartments	Apartment buildings, small & med. buildings, etc.
Distribution	Mainly Tokyo area, with many properties in major cities	Specific individual building(s) in Tokyo
Investment structure		
Vehicle	Investment corporation	Mainly limited co. × anonymous associations (YKTK); SPC (TMK) also
Holding period	Long term	Mostly 3～5 years
Exit strategy	Asset turnover is expected, but no transactions have been made so far	J-REIT, individual and other long-term investors, end users (companies & individuals); may convert to J-REIT in future
Expected return	Focus on income gain	10～20% IRR
Financing		
Equity		
Investors	Many unspecified investors	Few specified investors (mainly foreign investors, wealthy individuals, companies, domestic institutional investors, etc.)
Subscription	IPO, PO	Private subscription
Participation right	Based on securities held	Based on invested proportion
Minimum amt.	¥200,000～¥600,000	¥10～100 million
Secondary market	TSE	None
Debt		
LTV	30～50% under normal conditions	50～70%
Asset manager		
Establishing sponsor	Fund arrangers (several companies)	Fund arranger (often same as manager)
Own investment	None	10～50% of total investment
Income source	Management fee Transaction fee	Management fee Incentive fee Transaction fee Investment gains & administrative fees (if arranger is manager)

Note: The private real estate fund described is a composite image of independent Japanese funds, and does not resemble large funds of U.S. investment banks and Nomura Real Estate.
Source: NLI Research Institute

3. Growth Scenario for the Future

Sustained growth in the private fund market depends on several factors: growth in real estate supply, growth in investors, revision of real estate tax measures, and a clearer economic outlook.

In the future, with the concentrated disposal of nonperforming loans and introduction of loss accounting, financial institutions and businesses are sure to increase sales of real estate. However, due to the growth in new J-REITs and private funds, with each fund expanding its assets, competition for properties may not abate even if the market expands.

Moreover, regarding the accelerated disposal of nonperforming loans and industrial revitalization, with long-term interest rates expected to remain low, the present yield gap is likely to shrink drastically. Given this situation, if existing funds can achieve a track record of successful exit strategies, massive amounts of risk money could flow in from life insurers, pension funds and other large domestic institutional investors. Participation of domestic institutional investors will reduce the expected yield of funds and promote long-term and stable management, creating a secondary effect of expanding the fund market further.

At present, real estate related tax measures are being reviewed as part of the policy to combat asset deflation. If large cuts are made in the real estate acquisition tax and registration and license tax, fund performance is expected to improve.

While the accelerated disposal of nonperforming loans will be a drag on the economy, looking further ahead, what is important is whether corporate activity can revive enough to turn around the economy. If economic uncertainties can be dispelled, real estate prices should rise based on both management factors and the market trend.

Conditions for growth of the private fund market overlap with those of the J-REIT market. Given the exit strategy of private funds, growth of both the private fund market and J-REIT market are intricately linked.

However, regardless of the external environment, if private funds are to succeed, operators will need to continue meeting the expectations of investors, and strive to gain the confidence of a growing segment of investors.