The Need to Verify the Fair Price of Real Estate

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1. The Exit Strategy of Private Funds

Private equity real estate funds aim to outperform J-REITs by using leverage to exploit the spread between real estate return and borrowing rate, enhancing property values, and then reselling to third parties. Normally, fund managers try to increase property values by boosting the occupancy rate or cutting management costs to increase cash flow. Recently, they are also benefiting from rising prices in the real estate investment market.

Amid the recent market environment and growing diversity of investors, properties are being transacted between funds managed by the same or an affiliated investment management company. These transactions occur from funds aimed at foreign and other investors with a high required rate of return, to funds for domestic investors with a low required rate of return, boosting property prices in correspondence to the difference in return.

Many private funds count on J-REITs as an exit strategy because J-REITs are known to be long-term investors who purchase superior properties with relatively low returns. As a result, investment companies with private funds are planning to launch new J-REITs, while new market entrants are forming private funds premised on a J-REIT exit strategy. Major real estate companies with leading J-REITs are also forming private funds premised on a J-REIT exit strategy.

2. Risk of Conflict of Interest

Property transactions between affiliated funds can cause conflicts of interest with fund investors. When funds pursue capital gains and commissions, transaction prices can significantly exceed levels warranted by leasing market fundamentals and expected property income. The same risk exists for investment companies that sell properties from their own account to a private fund or J-REIT.

With real estate transactions overheating and interest rates expected to rise, market risks are also growing. There is concern that rampant transactions to capture paper profits could fuel a speculative boom.

In light of the conflict of interest between funds and investors, investment companies should disclose detailed information on investment properties and transaction decisions, and explain how transaction prices reflect fair prices. This is particularly important for negotiated transactions within the same business group.

Of course, pension funds and other institutional investors with fiduciary duties must also strive to verify that their transaction prices reflect fair prices.

3. Independent Verification of Real Estate Prices

Since each investment property has unique characteristics, it is not a simple matter to determine whether transaction prices reflect fair market prices.

Investors are usually content as long as property transaction prices do not deviate significantly from the appraisal value. However, since the price may not represent a fair market price, there needs to be an internal price verification process by knowledgeable staff, or a review by a third party.

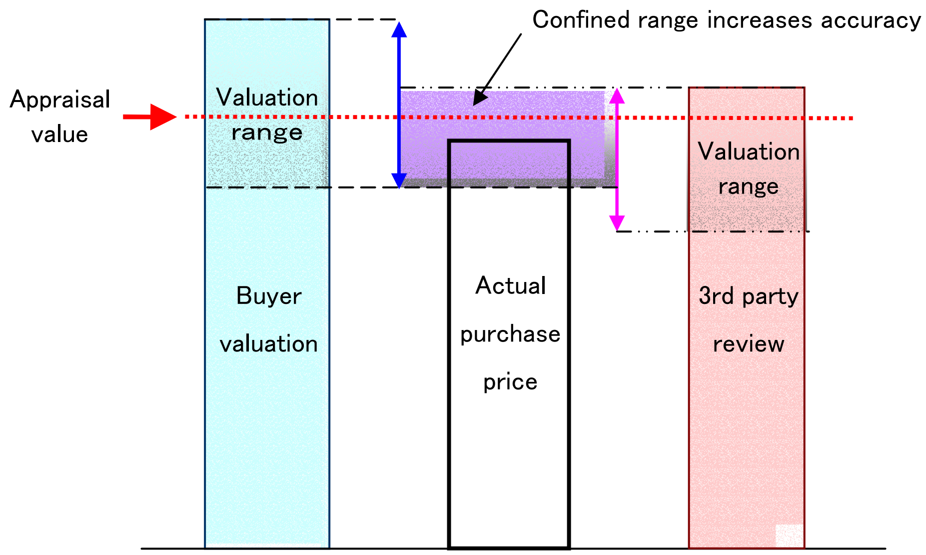
For their part, institutional investors in private funds and J-REITs must seek the necessary disclosures from the fund's investment company, and verify for themselves whether transaction prices are appropriate.

We should also note that while the appraisal value quotes a specific price, the fair market price is actually best represented by a price range. This range recognizes that the income approach value (capitalized value) varies depending on possible cash flow changes, interest rate movements, and exit strategies for individual properties. It also considers the dynamic investment practices of real estate funds and the fact that future property prices are affected by the investment company's performance.

Thus what institutional investors need from investment management companies is the disclosure of a copy of the official appraisal along with an estimated fair price range for purchased properties. If this price range overlaps with the institutional investor's independently derived appraisal range, the purchase price can be considered to be roughly appropriate. The estimated fair price range also helps clarify whether the purchase price is premised on a strong cash flow scenario (Figure 1).

As market professionals, institutional investors need to critically examine the appraisal values presented by investment companies for all property transactions, demand the necessary disclosures, and enhance their internal cross-checking process or rely on a third party review.

Figure 1 Fair Price Verification Using Third-Party Review



Source: NLI Research Institute