

Japan Real Estate Investment Review
2001 Volume II.

Japan Real Estate Investment

REVIEW

Spring 2001



Nomura Real Estate Investment Management

NOMURA REAL ESTATE
Investment Management

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I. Economy

1. Japanese Economy

(1) Overview

There is gradually a widening consensus that the Japanese economy is "in negative trend."

According to the March Report (preliminary) of Diffusion Index announced by the Cabinet Office on May 9, 2001, the coincident index was 14.3%, below the threshold of 50% for the second consecutive month. In addition, the leading index was under 50% for the third consecutive month, and the lagging index was 30.0%, the first time in six months that it fell below 50%. It is the first time since October 1998 that the coincident, leading and lagging indices have all recorded values under 50%. Cabinet Office is indicating this situation as, "there are increasing grounds for concern, and it is possible that figures may be under 50% for April as well. Further caution is required."

Looking at a breakdown of the coincident series indicators, although the high level of production in December last year is partly to blame, the index for industrial production, electric energy consumed by large industries and other production indices have all deteriorated. The only one out of the seven indices to have improved compared to the three previous months is department store sales, aided by the last-minute demand before the enactment of the Electrical Appliance Recycling Law.

In addition, in the Monthly Economic Report

released on May 11, the Cabinet Office indicated an awareness that the economy is "further weakened," and the judgment of the underlying trend was revised downwards for the fourth consecutive month. Downward revision over four consecutive months is the first time since the six consecutive downward revisions from September 1997 to February 1998, when the economy was in recession. The Cabinet Office also indicated that "the economy is in a similar state to the initial phase of past recessions."

Key points for the future are future developments in the US economy, and whether the Japanese government's ① emergency economic measures, ② final disposal of bad debts, and ③ economic and financial structural reform are carried out appropriately and promptly or not.

Personal consumption was characterized by last-minute demand brought about by the implementation of the Electrical Appliance Recycling Law in March. However, movement of household income, which determines personal consumption, dropped for the third consecutive month, and total cash earnings dropped from the previous year for the second month running, showing a weakness in consumption.

In terms of production, judgments were revised downwards from "falling" to "falling with increase in inventories" and in terms of employment, from "less job advertisements" to "less job advertisements

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and less overtime."

With regard to the employment and income environment, the unemployment rate remains at a high level (4.7%) amid the continuing fears about the future direction of employment. In the manufacturing industry in particular, reflecting the state of production, overtime worked dropped from the previous month's figures for the fifth consecutive month, and the number of new recruitments being applied for dropped for the third consecutive month, due to a strengthening sense of excess employment.

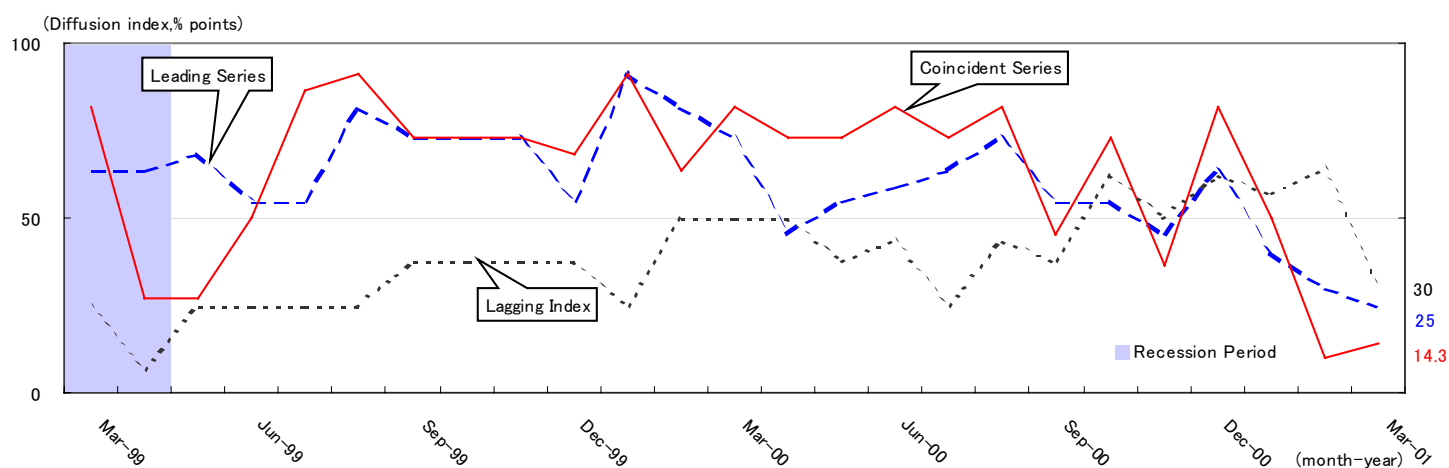
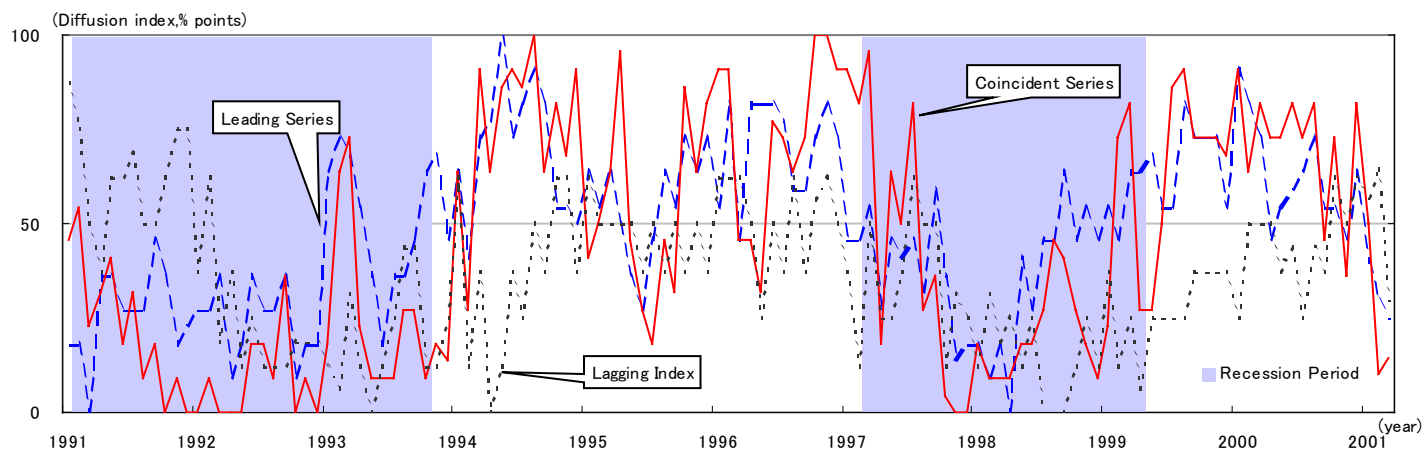
Capital investment continues to increase, centering in the manufacturing industry, and is one factor supporting the economy. For the non-manufacturing industry, according to the Monthly Statistics Report, the January to March quarter (figures based on expected performance) is positive. Nevertheless, in the Nikkei Tankan's capital investment plan, signs of slowing are evident, such as reductions in the non-manufacturing industries, meaning caution is required when viewing future developments.

As demonstrated above, capital investment is maintaining an underlying trend of increases, but

at this point almost all sectors are decelerating or starting to deteriorate. Additionally, the diffusion index resembles the economic recessions of the past, and the economy may be deemed to have entered recession (refer to the graph).

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Trend in the Diffusion Index (DI)

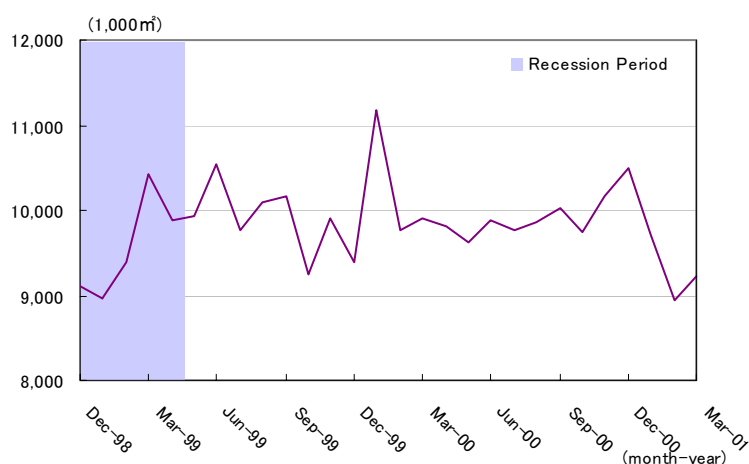


Source: Economic and Social Research Institute, Cabinet Office

(2) Trends in Indices

① Leading Series

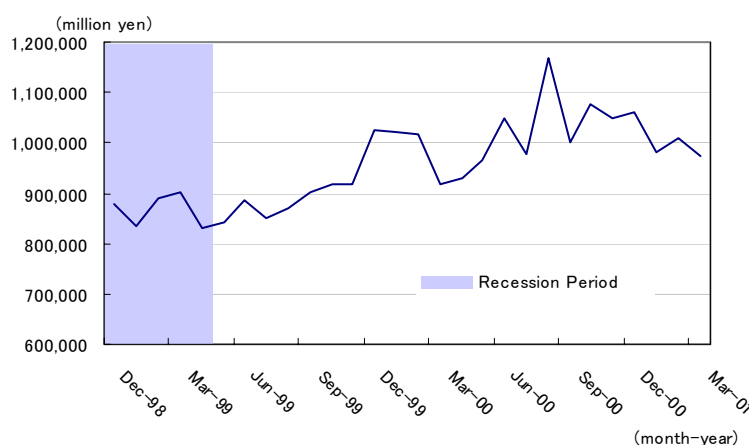
Total Floor Area of New Housing Constructions Started



According to the report released by the Ministry of Land, Infrastructure and Transport on April 28, the amount of new housing constructed in March was up for the third consecutive month, however, down 1.4% compared to the previous year, with 94,829 units, the third consecutive month-on-month increase. Converted into an annual basis it was 1.207 million units. The total floor area increased compared to the previous month, but was down 4.8% from the previous year, at 9.226 million m², the third such consecutive monthly decrease.

Taking a look at the breakdown of the number of new houses, the amount of new construction of owner-occupied houses was 32,593 units, 13.7% down from the previous year, the fourth consecutive monthly drop, with the decreasing trend continuing. On the other hand, the number of rental houses increased 3.7% to 31,230 units, the first increase in three months. In addition, the number of houses built for sale was 30,112 units, up 10.8%, also the first increase in three months.

Orders for Machinery (Private Sector Demand Excluding Shipbuilding and Electric Power)

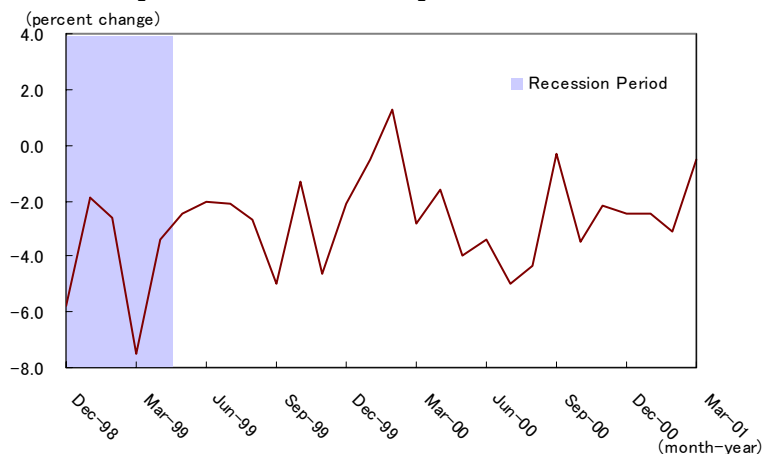


According to the Statistical Survey of Orders Received for Machinery by the Economic and Social Research Institute, Cabinet Office, machinery ordered (private sector demand excluding shipbuilding and electrical power) fell 3.6% from the seasonally adjusted figures for the previous month (an increase of 5.7% from the previous year) and has repeatedly advanced and retreated from last year.

Expectations for April to June are for a fall in the manufacturing industry, but an increase of 0.4% is expected in the non-manufacturing industry (excluding shipbuilding and electric power).

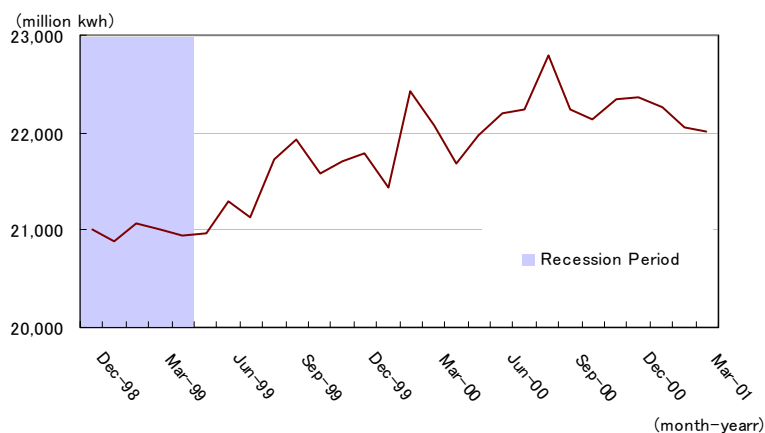
② Coincident Series

Sales of Department Stores (Compared to Previous Month)



According to the Commercial Sales Statistics of the Ministry of Economics, Trade and Industry, sales of department stores for March 2001 was 845.5 billion yen, down 0.5% from the previous year (after adjusting for the number of stores), which is the 13th consecutive month-on-month decrease. Nevertheless, the magnitude of the decrease is contracting, making it the same level (0.3%) as of September last year. The main factors at work were the sluggish sales of clothing, the core product of department stores (-7.4%), caused by the lower-than-normal temperatures, but the impact of the Electrical Appliance Recycling Law resulted in favorable sales for household electrical appliances (+ 17.8%), which resulted in a small improvement overall.

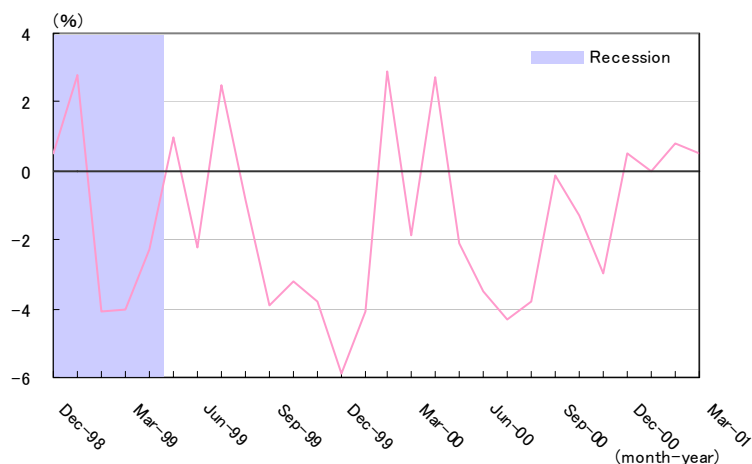
Electric Energy Consumed by Large Industries



According to the electric power demand report of March 2001 released by the Federation of Electric Power Companies on April 27, electric energy consumed by large industries was 22.1 billion kWh, down 0.3% from the previous year, the second consecutive month in which a reduction was recorded. Even by sector, textiles displayed a 7.1% reduction compared to the previous year, and all of the major sectors recorded reductions. This reflects the faltering nature of manufacturing activities.

③ Lagging Series

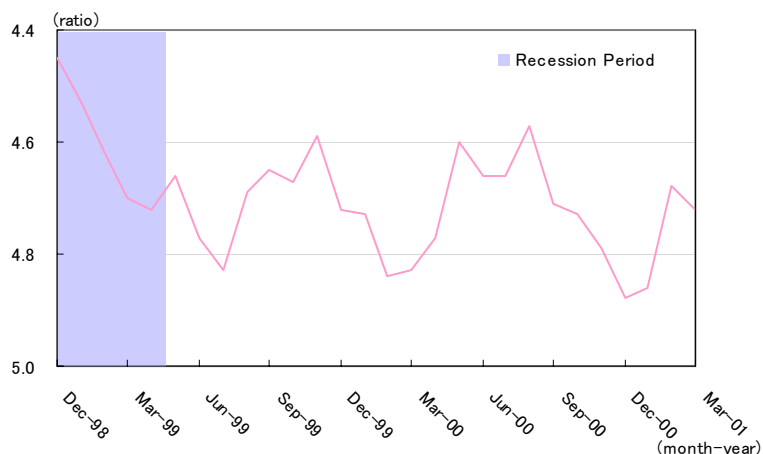
**Household Consumption
(All Working Households Across the Country)**



The Ministry of Public Management, Home Affairs, Posts and Telecommunications' Family Budget Survey Report recounts the household consumption for all households. In March 2001, for working households consumption recorded an 0.5% increase compared to the previous year in nominal terms, which translated to 1.0% compared to the previous year in actual terms, the first increase in four months.

Last-minute demand resulting from the enactment of the Electrical Appliance Recycling Law caused a leap in consumption of furniture and products to aid in household work. In addition, the continuing increasing trend in transport and communications expenses also contributed to the overall increase. However, consumption of food continues to fall, making it difficult to say that consumer spending is recovering; instead it appears to be but is instead moving sideways.

Unemployment Rate



According to the Workforce Survey (Preliminary Report) carried out by the Ministry of Public Management, Home Affairs, Posts and Telecommunications, the unemployment rate (S.A.) in March 2001 was 4.7%, the same as in the previous month. The jobless rate for males deteriorated by 0.1 percentage point to 4.8%, and for females the rate was 4.6%, the same as in the previous month.

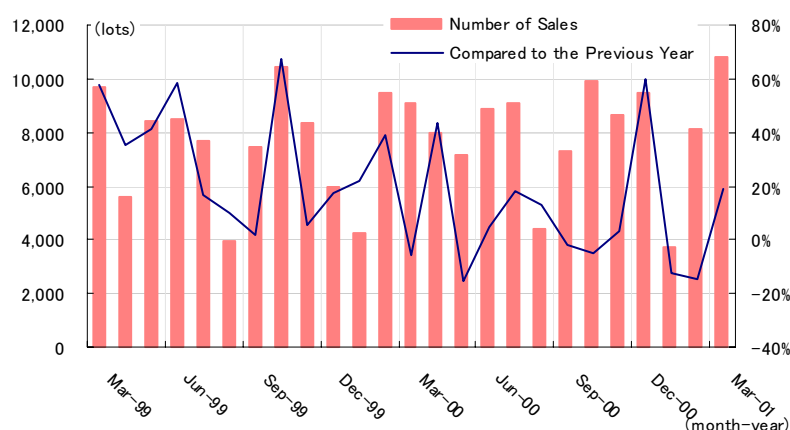
The number of unemployed decreased 60,000 from the previous year to 3.43 million, the 2nd consecutive month-on-month increase. Compared to the previous year, voluntary job-leavers and non-voluntary job-leavers and graduates without a job decreased, while the number of other unemployed people increased.

2. Real Estate Market Trend

(1) Condo Market

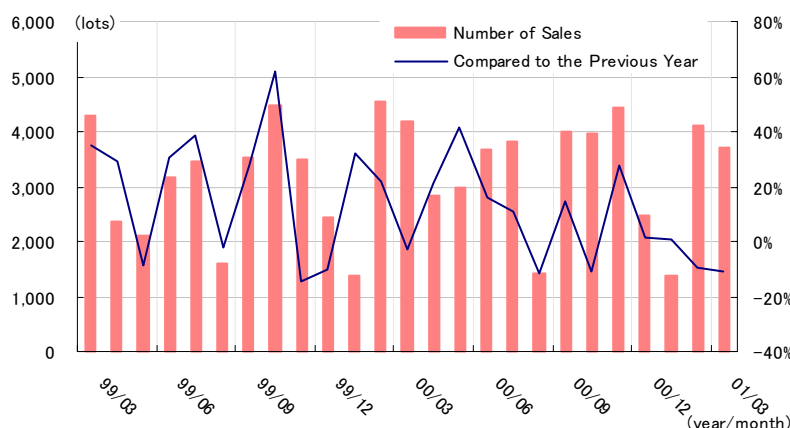
① Number of Sales & Contract Ratio

<Tokyo Metropolitan Area>



According to the Real Estate Research Institute, the number of condos sold in March 2001 was 10,819 units, the first time in three months that an increase was recorded against the previous year's figures (19.1% increase), making it the third largest supply ever recorded (a record high for March supply). This is caused by the supply of large number of high-rise condos. The number of condos sold in April 2001 is expected to be around 7,000 units.

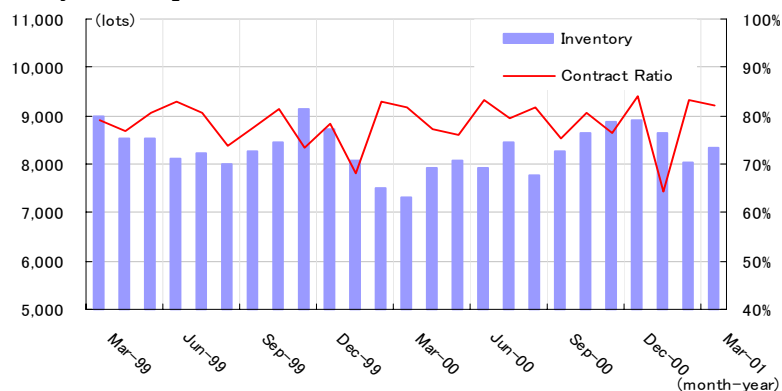
<Kinki Area>



The number of condos sold in the Kinki Area in March 2001 was 3,724 units, the second consecutive month of decrease compared to the previous year (down 10.8%). It was also the first time in two months in which sales fell relative to the previous month. The number of condos sold in April 2001 is expected to be around 2,200 units.

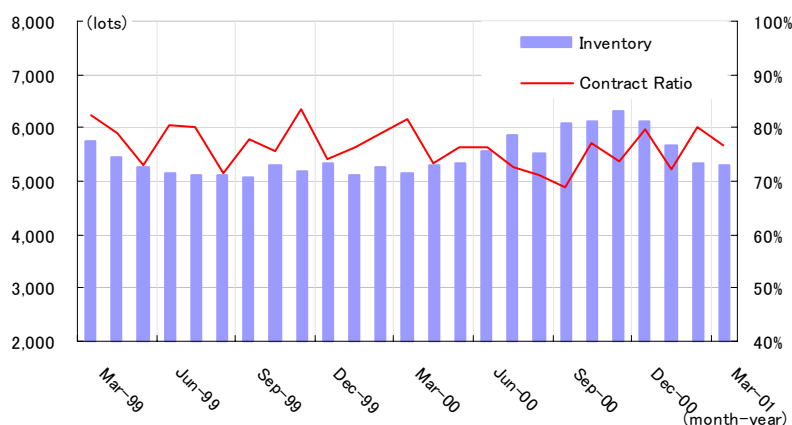
② Inventory & Contract Ratio

<Tokyo Metropolitan Area>



March 2001's Tokyo contract ratio continued to be satisfactory at 82.3%, which is the second consecutive month in which an increase was recorded compared to the previous year. The inventory was 8,323 units at the end of March (an increase of 14.0% compared to the previous year). This was also an increase compared to the previous month, the fourth consecutive month in which an increase was recorded relative to the previous year.

<Kinki Area>



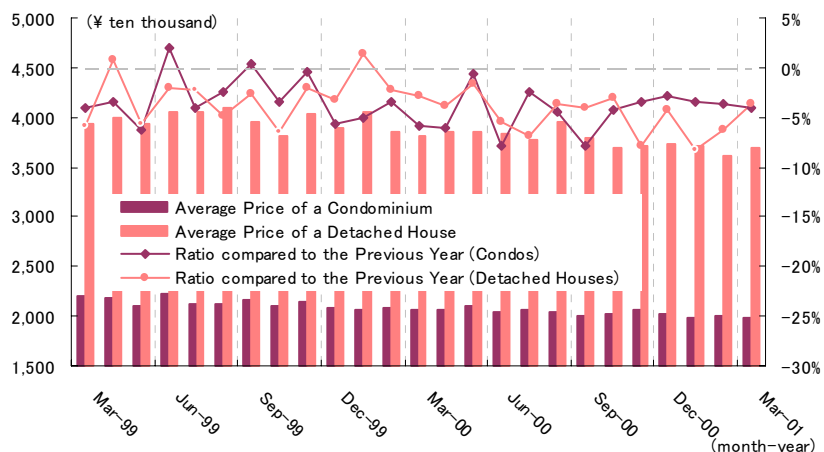
The contract ratio for March 2001 for Kinki area was 76.9%, down 4.7 percentage points compared to the previous year, the first time in two months that a drop has been recorded, but remaining at a high level. The Inventory was 5,284 units at the end of March (up 2.9% from the previous year). It is the fourth consecutive drop relative to the previous month, but actually the 11th consecutive increase when compared to the previous year.

Source: Real Estate Research Institute

(2) Distribution Market

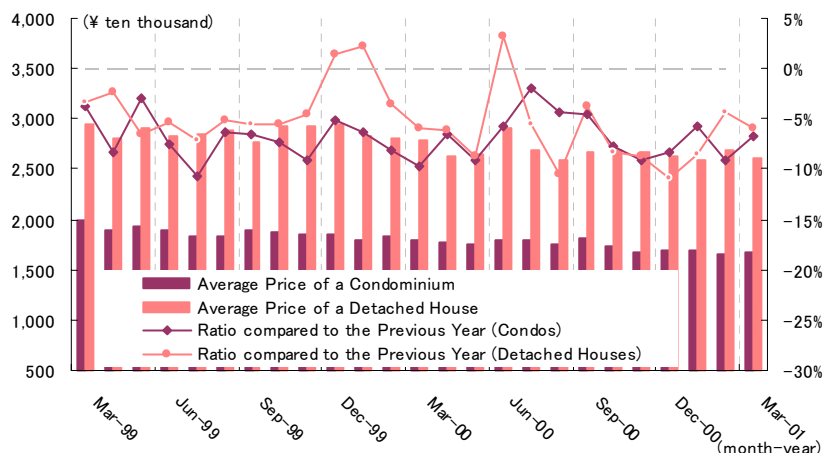
① Average Prices of Second-hand Condominiums

<Tokyo Metropolitan Area>



According to the Real Estate Transaction Modernization Center Foundation, the average price for an existing condo in March 2001 was 19.89 million yen, the 18th consecutive drop from the previous year, and the first increase in two months on a month-on-month basis. The price is expected to remain around 20 million yen for the foreseeable future. On the other hand, the average contract price for detached houses was 36.85 million yen, the 14th consecutive decrease when compared to the previous year.

<Kinki Area>

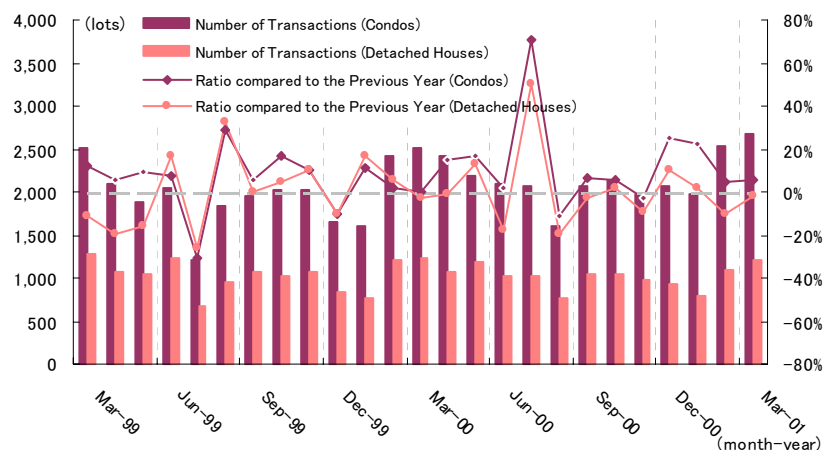


According to the Real Estate Information Network for Kinki Region, the average price for existing condos in March 2001 was 16.75 million yen, the 51st consecutive drop compared to the previous year since January 1997, but it was the first increase in two months on a month-on-month basis. In addition, the average price for a single family home recorded its 9th consecutive drop compared to the previous year, while on a month-on-month basis it was the first increase in 3 months, at 25.70 million yen.

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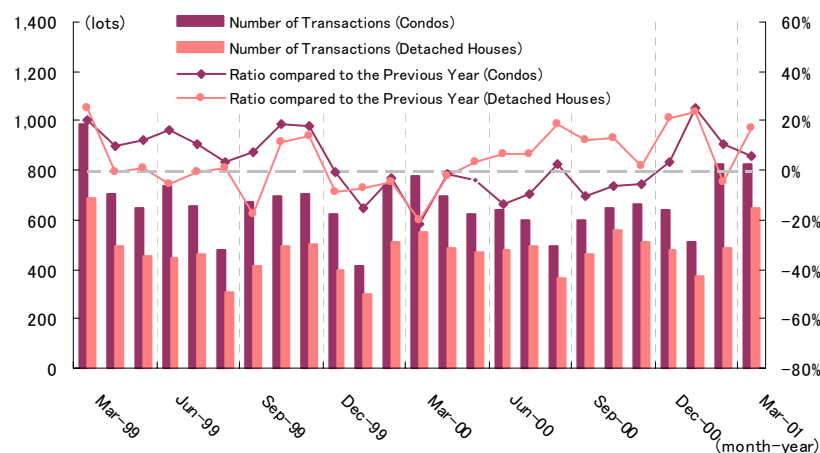
② Number of Contracts

<Tokyo Metropolitan Area>



According to the Real Estate Transaction Modernization Center Foundation, the number of contracts signed for existing condos in March 2001 was 2,666. This was the fourth consecutive increase compared to the previous year, and the second consecutive month-on-month increase. The number of contracts signed for detached houses was 1,207 units (down 2.2% from the previous year). Although this was down from the previous year's figures, it was the second consecutive month-on-month increase.

<Kinki Area>

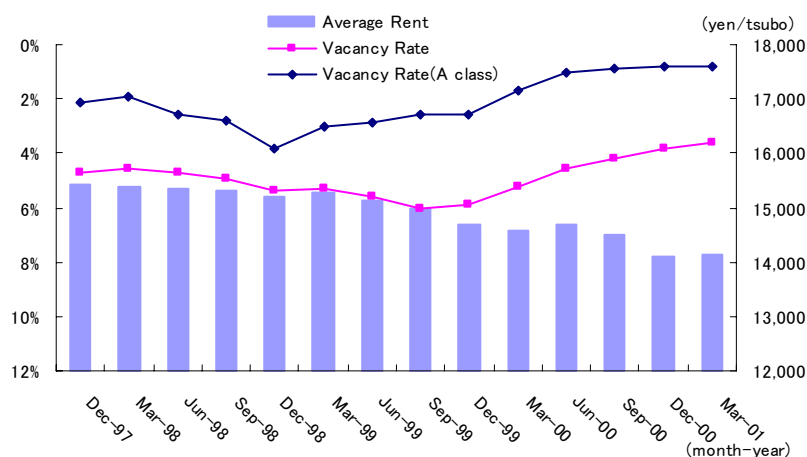


According to the Real Estate Information Network for Kinki Region, the number of contracts signed for existing condos in March 2001 was 673 units, up 3.7% from the previous year. This was the first increase in three months compared to the previous year, but a drop compared to the previous month. On the other hand, the number of contracts signed for detached houses was 477 units. This was the first drop in three months compared to the previous year (2.9% drop), but the second consecutive month-on-month increase.

Source: Real Estate Information Network System

(3) Office Market

<Tokyo 23 Wards>

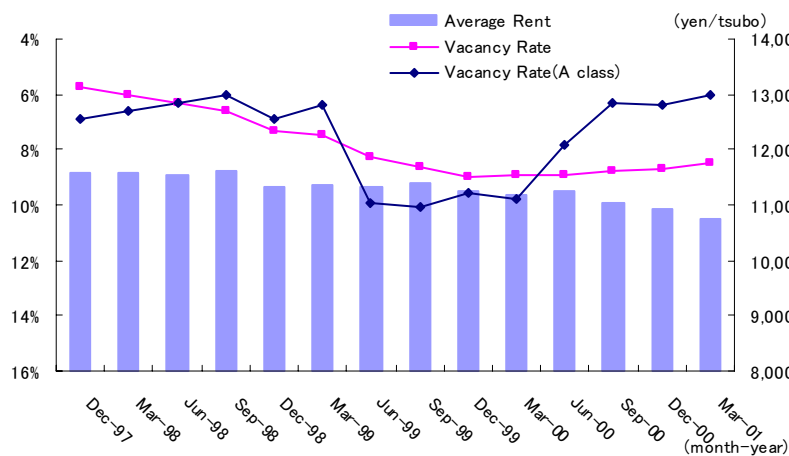


According to Ikoma CBRE, the average office vacancy rate for March 2001 for Tokyo was 3.6%, up 0.2 percentage point from the previous month.

The average asking rent was also up 0.1% percent to 14,120 yen per tsubo per month. On the other hand, the vacancy rate for class A buildings was 0.8%, the same as the previous month.

The improvement in the vacancy rate was the sixth consecutive, but the size of the drop in the vacancy rate is becoming smaller. This is due to the dramatic drop in vacancy of buildings with high levels of equipment which allow for a considerable size, which has suppressed demand.

<Osaka City>



According to Ikoma CBRE, the average vacancy rate for March 2001 for Osaka improved by 0.2 percentage point to 8.5%. However, the average asking rate dropped 1.7% to 10,740 yen. On the other hand, the vacancy rate for class A buildings improved by 0.4 percentage point from the previous month to 6.0%.

The factors behind the drop in the vacancy rate are increased demand due to transfers caused by reconstruction or sale of leased buildings, and transfers in of large tenants from outside Osaka.

At this point in time, there is hardly any new construction or relocations due to expansion, so it is difficult to say that the situation in Osaka City has fully recovered.

Source: Ikoma CB Richard Ellis

II. Report -

Real Estate Ownership of Investors and the Impacts

The US commercial real estate market is inseparable from the capital market. According to Lend Lease Investment Research, the overall market value of US commercial real estate at the end of 1999 was approximately \$4 trillion. Lend Lease also provided a detailed report of where the sources of funds are for both equity and debt investments into real estate.

Until recently, participants in the Japanese real estate market were not familiar with such data, and often found it hard to understand. This can be attributed to the small number of transactions in the Japanese commercial real estate market, the lack of data to indicate the size of the market, and that the few institutional investors who invest in property transactions had only a small share of the market.

In the US, some 45% of the \$4 trillion market, or \$1.79 trillion, is held by institutional investors. However, in Japan, we estimate that institutional investors hold less than 10% of the commercial real estate market in Tokyo. Japan has a tradition of real estate investment by life insurance companies, however, more than half of these assets are owner occupied, and/or utilized for branch offices. Therefore, excluding these holdings real estate investment is not very large. Furthermore, Japanese pension funds have started real investment only recently.

Currently, as all of our readers are well aware, real estate investment in Japan, including foreign funds, is very active. Both equity and debt portions of the properties are sought by institutional investors. This indicates that the Japanese real estate investment paradigm is becoming very close to that of the US.

We believe that this type of investment activity will increase dramatically, and this change of ownership will bring a fundamental change to the Japanese real estate market.

What would this change of investment structure bring about in the Japanese real estate market? I believe that the following three points are crucial when studying these fundamental changes in the Japanese real estate market (however, these may seem quite obvious to US and European investors).

1) Revitalization of Japanese real estate market. As more and more investors come to Japan seeking opportunities, and as more and more product is brought to market, transactions will be more open. When these investors begin to understand the vitality of the market, prices will rise, and the decline in land values will be over.

2) Property management could be valued in the form of cash-flow. Conventionally, building owners managed their properties with an eye on future appreciation, and were not focused on day-to-day cash-flow (however, this does not mean that they did not take cash-flow into account). However, once third-party equity and debt are used to finance the asset, the asset managers must manage the properties very seriously and strict attention is necessary. It will enable the performance of asset managers to be evaluated very severely through comparisons with other properties. The negotiation process with tenants must also be conducted differently to maximize cash flow. This would also effect the traditional office building rental market.

3) Through direct financing using debt, the real estate market will be directly affected by its impact. For instance, properties must be managed in a manner that will enable the debt to be serviced.

The debt portion of real estate investment is being increasingly financed by the banks' non-recourse loans. If the claimable assets are to be securitized as is the case in the US, the real estate market and the fixed-income market will be linked directly, and impacted directly by the capital market. If the Japanese CMBS market develops as in the US, the impact will be more apparent and measurable.

Currently, Japanese banks are actively issuing non-recourse loans, however, in many cases they are still holding them for their own account. Therefore, this makes it very hard to predict whether the securization market would grow into the size of the US CMBS in the future. In any case, the flow of capital is clearly changing gradually from the old Japanese way of conventional indirect financing.

Investors should keep a close eye on the changes in the Japanese real estate market, and should keep the above three points in mind.

The Japanese real estate market is undergoing fundamental changes, and we see a large opportunity here.