
NPL and Market Value of Real Estate

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The Koizumi Cabinet is urging companies to depose non-performing loans (NPL) and clear their balance sheet within three years. Various analysts and economists view this reform to have a large effect on the macro economy, such as “Even though it would increase deflationary pressure and cause enormous pain, the structural reform is crucial for Japanese economic recovery” and “direct disposal of NPL by the banks will increase unemployment and bankruptcies.”

Let's leave the economics to the economists and look at the business point of view. For the lenders, the most important thing is to collect the loans, whether that is through legal liquidation or voluntary disposition. In order to pay back the debts, borrower must either gain profit from the business or sell its collateral. No need to say that the best way is to pay back from its profit, but if that was possible, there will be no NPL issues. Therefore, the only way is to sell the collateral, which in most cases are real estates.

Table 1 indicates the loans issued by the Japanese financial institutions to construction industry, real estate industry, and retail industry. Total loan amounts to 531 trillion yen. According to NREIM's calculation, some 327 trillion yen consists of liquid commercial real estates (excluding the rental residential properties). Therefore, about 60% of loan is covered by the market price of commercial real estate. This seems to be a healthy level considering that facility investments and individual residential investments are also included in the loans.

However, when we focus on the three industries of construction, real estate, and retail, the healthiness of the loan becomes quite questionable. Table 2 indicates the total debt of 30 major problem companies according to the Economist. Even though the total of the three industries debts amount to 34% of total debt in Japan, these three industries amount to almost two third of total when it comes to major problem companies. How is this possible?

According to our analysis, 47 trillion yen out of real estate industry's 65 trillion yen is the market value of rental office buildings. Considering the fact that the most debt of real estate industry is issued for the rental office building and that loan term is long to refund from the rent, it seems very difficult to pay back this difference of some 20 trillion yen merely from the cash flow. The

debt of retail industry is 79 trillion yen while the market value of retail real estate is about 40 trillion yen. This also seems considerably difficult to refund considering the depression that retail industry is experiencing. Even though the commercial real estate holdings by the construction industry are not clear, large portion of them may be unprofitable hotels, golf courses, and undeveloped lands. Together with the structural reform and decrease in public constructions, this debt also seems to be difficult to pay back. These are creating the large NPL in the three industries.

The enormous NPL total of corporate Japan is clearer when we study from the market value of real estate. The liquidation of Japanese real estate is said to be over 2 trillion yen in past five years. I believe that the structural reform will bring about structural reform to the real estate ownership as well through the disposal of NPL.

(Table 1) (¥100million)

	Construction	Real Estate	Retail	Total (incl. Others)
City Banks	103,840	292,368	338,147	2,119,505
Trust Banks	12,882	51,181	34,068	312,361
Long-term Credit	11,179	39,299	25,070	296,067
Sub-total	127,901	382,848	397,285	2,727,933
Regional Banks	109,591	129,608	224,690	1,349,871
Regional Banks II	43,916	51,997	69,667	464,798
Sub-total	153,507	181,605	294,357	1,814,669
Banking Accounts	281,408	564,453	691,642	4,542,602
Trust Accounts	2,217	15,042	5,572	111,611
Shinkin Banks	78,300	71,861	101,502	661,880
Total	361,925	651,356	798,716	5,316,093

(Source: Bank of Japan)

(Table 2) (¥100million)

	Construction	Real Estate	Retail	Total (incl. Others)
30 Major Problem Co.	39,011	12,190	80,300	208,742

(Source: Shukan Economist 7 Aug. '01 edition and NREIM)