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Collapse and Regeneration of the World's Largest Institutional Property Market

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1. The Land Myth

From the post World War II period to the bursting of the bubble economy, Japanese economic "principles" were backed by the land myth, which assumed that the price of land would continue to rise as land is scarce. Since the Meiji Restoration in 1868, Japan, a relatively small country in the Far East, has worked hard to catch up with the West and land had played a significant role in this endeavour. Since we are an island country, sustaining high economic growth rate and rising production volumes meant that land, a scarce resource with limited supply, had a heightened added value. Which naturally led the price of land to rise.
Particularly after the World War II, Japanese land prices rose continuously for half a century, which either kept up with or outstripped the pace of GNP growth. In contrast, and partly because they were controlled until 1980s, interest rates remained at about half the level of that of economic growth. Which meant that the more you purchased land through a loan, the more you made a profit out of it. In fact, that was the most profitable business around. This background engendered the myth that land was the best collateral for loans, which prevailed in Japanese financial markets for a long time.

2. Big Creditor Country

So why did the land myth collapse? I believe that Great Britain in the mid 19th century could offer us an answer to this question. Prior to the United States, Great Britain was the world's largest creditor. When productivity grew significantly and Britain became rich through the Industrial Revolution, the country sought to reduce domestic prices by increasing imports. Which led the British government to abolish the Corn Laws.
After about 1848, imports of agricultural product were gradually deregulated. And around that time, some 40 million emigrants made the journey from Europe to the New World. Imports of agricultural products from the New World, where the land price was almost zero, increased dramatically. Land, which was defined as a scarce asset with limited supply, was not limited any more, and as a result, Europe was importing the land as well as the agricultural products from the New World. Which stopped the income of land prices in Britain.
What happened in Great Britain was exactly what happened in Japan. In 1985, Japan took over from the United States and became the world's largest creditor nation. This transition meant that Japanese economic principles had to be changed totally. Being a major creditor meant that Japan's current account

surplus rose, and Japan would be holding claims on other countries. As the debts of the United States and other trading partners increased and the yen appreciated, Japan was in a position where it could not increase exports or even needed to decrease exports. That is why demand for industrial property fell gradually, and industrial land has changed to residential land, creating a land surplus. This trend started with major export industries, such as the automobile and electric appliance sectors, and has now expanded to materials industries, such as steel and chemicals. So, Japan too, started to import land.
The last ten-year slump in the Japanese economy was the result of a superficial understanding concerning the shift of Japan's economic principles, and errors in deciding what to do about it.

3. The Tokyo Real Estate Market

Because of the delay in recognition and the handling of the change in economic principles triggered by the fact that Japan became the world's largest creditor, the Japanese economy has remained sluggish. And real estate value in Japan also has continued to fall in general, though with one exception: the commercial real estate market in Tokyo has started to be more active since last year. Currently, the size of commercial real estate in Japan is estimated to be some 60 to 70 trillion yen (approx. 550 to 640 billion euro).
There are two major reasons for this. When the land myth was alive, a company did not need to be conscious of the financial risk of holding real estate even though they had too much real estate relative to their size. But after the burst of the bubble economy, real estate prices fell below 20% of their level of 1991, and the risk of holding real estate was recognized. As a result of changes of accounting standards to "mark to market" there is no longer the advantage in holding real estate that used to enable a company to borrow money without revealing unrealised profit or loss. That's why companies have quickly begun to shed their assets and large-scale CBD properties are being actively sold.
For example, 13 major financial institutions alone have reduced their owner occupied space by 20% during the four years between 1995 and 1999. The number of transactions involving office buildings valued at more than 5 billion yen in the Tokyo CBD area, as well as bulk sales that combine buildings in regional cities, totalled 15 last year. This phenomenon was completely non-existent three years ago.
Meanwhile, the law which enables real estate investment trusts (J-REIT) to be established was enacted in Japan in November last year. Given the risk of holding assets in the Japanese capital markets, allowing interest-bearing liabilities to increase so as to hold on to assets is a recipe for weak stock prices. So listed Japanese real estate companies have become enthusiastic about fee business, in which they can earn fees from raising capital through J-REIT and private placements by forming real estate funds and managing them. Non-Japanese investment banks have also participated in this market, and as a result, commercial properties in Tokyo are in strong demand. The cap rate for an outstanding profitable property in central Tokyo has been in the 4% range since last year, and this has become known as the "Fund Bubble."
The "Fund Bubble" that has arisen with the excessive expectations for the J-REIT market has been accelerated by the friendly treatment given to non-recourse loans,

which can be called the "easy credit" of Japanese banks. In 1998, Nomura Real Estate formed a private fund with the Starwood Capital Group, and at that time Japanese banks did not offer non- recourse loans, so we obtained loans from foreign banks at more than 4% interest with an LTV of 60% for three years. At present, some Japanese banks offer an LTV of 80% and the rate on interest is less than 3% for seven years.
The results that are generated by this phenomenon will depend on whether or not the structural reform of the Japanese economy proves successful and the economy recovers.

4. J-REIT

In Japan today, five J-REITs are preparing for listing at this early stage. The size of the first J-REITs are estimated to be some 500 billion to 700 billion yen (approx. 4 billion to 6 billion euro). There are 4 office REITs and 1 retail REIT. The J-REIT market is expected to grow into a market of some 1 to 2 trillion yen (approx. 9 to 18 billion euro) in several years, with a potential to become a 5 trillion yen (45 billion euro) market. Other types of properties such as hotels, warehouses, and residential properties nationwide are also expected to be included in J-REITs as they expand.
The average dividend yield of J-REIT is expected to be around 5%. Partly because Japanese interest rates have been lower than the rates prevailing in Genoa in 1619, which were the lowest in history, there has been a strong interest mainly from institutional investors struggling with fund management. Given this situation, these five J-REITs are likely to have a successful IPO. There are only a few institutional investors in Japan who are capable of analysing risks and returns on real estate by themselves. Many institutional investors totally depend on security companies or trust banks for their real estate investment.
However, there are several issues to be addressed for the successful development of J-REIT market.
Overseas investors have long pointed out the lack of transparency of Japanese companies and banks. The same could be said of the Japanese real estate market. When it came to the listing standards for J-REIT, the real estate industry strongly objected to the disclosure of tenant information and lease terms per building. A fierce debate took place, with the financial sector on one side wanting full disclosure and the real estate industry on the other wanting to minimize disclosure. The debate was settled with the condition that only in circumstances where a tenant rented space exceeding 10% of the total lease space should there be discolsure
Usually, when a company is under pressure to make disclosure, it weighs the disadvantage of both cases, to disclose and not to. When the disadvantages of non-disclosure outweigh those of disclosure, the company will disclose voluntarily. So the strong objections of the real estate industry suggest that the disadvantages of disclosure are more severe than those of non-disclosure.
Before explaining why this might be, I would like to point out the characteristics of the Japanese real estate lease market. For more than half a century, Japanese lease agreements, whose term is mostly 2 years, have been extremely unfavourable for investors, even given last year's amendment to the legislation that allowed Western-style fixed term lease. And that is not the only thing. Even during the term, the lease can be cancelled at any time with either six or twelve months'

advance notice. In addition, when the quoted rents in the neighbourhood change markedly, the law grants the right to demand an increase or decrease in the rent. So from a real estate investment perspective, it is quite difficult to project cash flow. In the case of J-REITs, which are about to be listed, the real estate company that manages its own properties will also be managing the J-REIT. Their hard assets clearly include properties that have a substitute competitive relationship with the J-REIT properties. The reason why the real estate industry has objected so fiercely to the disclosure of the names of tenants and lease terms is this: if they disclose this information, tenants will be able to compare their rents with others in the neighbourhood, raising the possibility that a tenant paying a high rent may demand a reduction. Ultimately, causing the issue of conflict of interests.

The larger the Japanese real estate company, the more they tend to be driven by conflict of interests. That is because Japanese real estate companies have earned the trust of their customers by providing integrated services over a long period of time, and this has increased earnings and the returns to shareholders. But J-REIT investors are seeking the maximization of the profit of target property, not the profit of the real estate company.

Because of the change in the market mechanism after the bursting of the bubble economy, Japanese real estate companies are no longer able to run a traditional real estate business by borrowing money using hard assets as collateral. What has appeared instead of this traditional profit source is the concept of real estate business as a fee business.

Many of the real estate companies that are currently so enthusiastic about establishing J-REITs have this perspective. The J-REIT is more like the Australian LPT rather than the American style REIT, so management is entrusted to an external management company. But what Japanese real estate companies aim at is the maximisation of fees generated by their own group. So instead of allowing the management company to actually manage the trust in principle, asset and property managements are subcontracted to subsidiaries of the real estate company. In other words, some J-REITs are designed as real estate investment trusts with a structure that has reduced investor returns and is only profitable for the real estate company.

When it comes to the question of conflict of interest, the other issue that we must not forget is the fact that many of the companies that plan to list J-REIT and control the management are also listed real estate companies with significant holdings of hard assets in the form of real estate for profit. It has been suggested that a conflict of interest could arise between shareholders and J-REIT investors. As yet, no solution has been offered to this problem.

However, having said that, I am not a pessimist. Japanese companies are improving the disclosure level and governance. I believe that this trend should be accelerated once the J-REIT is actually listed in the market, since the J-REIT has to increase the comfort of global investors when they are making the investment decisions. Nomura Real Estate is also looking into J-REIT and seriously considering these issues. From our experiences from the overseas investment, we believe that disclosure of our partners, such as Lend Lease in Australia and Simon Properties of the US, would be required since we ourselves felt very comfortable in investing with them.

5. Nomura Real Estate's Achievements in the Fund Business

Nomura Real Estate has formed private real-estate funds with overseas as well as Japanese investors, such as Starwood, and has been managing them since 1998.
At present, the total value of assets under our management in the fund stands at 112.5 billion yen (about 1 billion euro). The target areas for investment are the two major cities of Japan, the Tokyo and Osaka metropolitan areas, and the fund focuses primarily on office buildings. The strategies are tailored to the policies of the investors. In total we have 205,432.35 square meters. This month, we will launch into a residential fund business with a total amount of 50 billion yen (450 million euro). One of major securities companies will underwrite this fund through a private placement. This will be the first residential fund in Japan. Major institutional investors with expertise on real estate show strong interest in this residential fund. There are a lot of data on residential market, so they can analyse their investment risk with these data.
The average leveraging in the 1 billion euro fund is 56.6 % and, for the last year, a 19.4% cash-on-cash annual dividend was distributed to our investors. No other real estate fund in Japan is paying a dividend of 20%.
The investment criteria differ depending on the investor. Since we operate a private fund, we ask our investors to define the investment policy in order to avoid the conflict of interests. While some are opportunistic funds that focus on relatively short-term investments, other investors want a stable investment for the long-term, even if it means a lower yield. At the end of this month, an investor looking for a long-term investment on a lower risk, lower return basis will be added, so dividends are expected to be around 16% in total in this fiscal year.

6. The Future of the Japanese Real Estate Market

Our experience in managing these private funds has revealed that it would be essential for the Japanese real estate market to build a business that attracts investors.
Investors have shown an interest in 12-month trailing performance as well as the cash flow and dividends generated by a property. But the kind of vague expectations about the future potential of a property that real estate companies used as a sales point in the past will no longer suffice. In the past, institutional investors allocated money in real estate by setting up a special budget, based on the grounds that, "real estate is special", or "the business practices are different."
J-REIT is surely the vehicle in the real estate market for accepting capital directly from the capital markets. Their success will enable a strong flow of capital into the real estate market. But on the other side of the coin, the fact that real estate businesses are raising capital with the participation of the capital markets means that their special budgets will disappear and they will have to compete for their capital with other industries and businesses.
The nature of commercial real estate differs from, say, the IT sector or the financial services industry, in that earnings aren't supposed to improve every quarter and profit margins don't improve dramatically with technological innovation. In what is almost completely at odds with past approaches, in the last several years

investors have begun to make their investment decisions using accurate data and advanced methods of analysis. The Japan Real Estate Institute, Japan's leading real estate appraiser organization, is working hard to create a real estate index under the direction of IPD. For investors with these advanced analytical capabilities at their disposal, real estate needs to be an attractive investment target. In the real estate market of the past, the entire potential buyer had to do was to look over the property, noting factors such as the location, the surrounding environment, and the building grade. Now, however, with the introduction of J-REIT, it is necessary to attract the interest of capital market investors on a daily basis. In other words, real estate has become business that needs to win a daily beauty contest.

Japan's real estate market has been experiencing rapid change. Three years ago, due diligence was not practiced as part of real estate transactions in Japan, but now it is a common practice in commercial real estate deals. And deals involving high-rise buildings in Tokyo's CBD occur with a frequency that could not have been foreseen just three years ago.
In terms of J-REIT, as noted earlier, many issues remain to be addressed. But given the rapid pace of change taking place in the Japanese real estate market, these issues should be resolved in the near future. A lot of J-REIT products will be created from now on, with Nomura Real Estate contributing its share. If European investors, who come from highly-advanced real estate investment markets, choose to invest by making an appropriate evaluation of issues such as conflict of interest and transparency, then the recovery of the Japanese real estate market will be steady as well as rapid.