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## **The Outlook for J-REITs**

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It is four months since the listing of J-REITs on September 10 of last year. Nihon Building Fund (NBF), which was offered at a price of 625,000 yen, had a closing price of 475,000 yen as at January 25 (a drop of 24%), and Japan Real Estate (JRE), which had an offering price of 525,000 yen, had a closing price on the same date of 494,000 yen (a drop of 5.9%). On January 4, UBS Warburg changed its investment assessment for NBF from "Hold" to "Buy," but the impact of this change in recommendation lasted only four days, and had little effect. In fact, since its listing, NBF has never exceed its offering price.

I can recall a similar experience that our company had to that of NBF. This was in 1996, when the office buildings we owned in partnership with Lend Lease were listed on the Australian Stock Exchange as a Listed Property Trust (LPT). This LPT dropped under the offering price from the first day it was listed, and over a period of nearly three years until the announcement of its merger with GPT, Australia's second-largest LPT, not once did it recover. This is despite the fact that dividends were paid which were no different from the prospectus or 1 Australian cent.

What I came to understand through this experience was that investors in capital markets do not base their investment decisions on the quality or otherwise of the properties that make up a trust. Rather, investors first and foremost choose trusts with high returns relative to risk. As I look back on it now, at that time the world's investment community was moving towards the IT bubble, so there was probably a flow of capital from stable LPTs to IT investments with high growth expectations.

In my view, whether an investment is a J-REIT, actual real estate, or shares in a non-REIT listed real estate company, investors review them all as belonging to the category of real estate investments. In the battle for capital within this category, J-REITs have made adequate use of their strengths. Compared to investments in actual real estate, for example, they clearly provide stability due to their liquidity and diversification. The reasons why the drop in NBF was more severe than that of JRE was not only that the premium was too high, but can also be attributed to the spread of cities in which JRE invests. Compared with shares of listed real estate companies; in relation to the opening price on September 10, Mitsui Real Estate dropped 32.5% by the closing price on January 25, and Mitsubishi Estate went down 34.8% over the same period, making J-REITs the more stable investment. The reasons why the drop in NBF was more severe than

that of JRE was not only that the premium for NBF was too high, but it can also be attributed to the high concentration in Tokyo area.

Despite these strengths, however, the two J-REITs lagged behind the general capital markets in that their performance was lower than the Nikkei Average, and this may be evidence that the anticipated continued recession in the Japanese economy and the perceived problem of a massive oversupply in the Tokyo office market in 2003 are detracting from the appeal of the real estate investment market in general.

Investment products based on the profits of real estate, such as US REITs and Australian LPTs, are often classified as the type of products which on the whole lack growth, but which pay stable dividend streams. If the return is assumed to remain constant, although this type of product may be sold if it becomes unpopular at some time, there will come a time when the return relative to risk will be considered more attractive than other yield products in the market. At this point, I believe, these products will be bought, and the price will bounce back. In other words there is what I would call a "rate of return barrier."

Taking a look at J-REITs, NBF's expected rate of return when UBS Warburg changed its investment assessment to "Buy" was 5.8%. This, to me, is quite an attractive rate of return. Despite this, at 5.8% it was deemed by investors not to correspond to the level of risk.

Japan's real estate leases, as the reader is probably aware are generally for 2 to 3 years, and if 6 to 12 months' notice is given the lease can be cancelled at any time during this period. In addition, if there is a marked gap between the subject lease rent with rents in the surrounding area, tenants may demand a downward adjustment in rent. In the Tokyo rental market, which is facing the problem of a potential oversupply in 2003, it is unavoidable that the older buildings that make up J-REITs will experience a drop in rents and large-scale movement of tenants, and these phenomena are making the "rate of return barrier" invisible.

This risk caused by the undeveloped nature of Japan's real estate market pointed out in this column on 24<sup>th</sup> Many 2001 is starting to become obvious as reality.

With regard to J-REITs, while some analysts are of the opinion that the causes of these problems are the lack of transparency and the unresolved conflicts of interest, these are problems that were pointed out quite early on, so it is difficult to conceive that they are direct causes of the drop in the J-REIT prices. As is evident in the example of Windows 95, since the 1990s, on the global market, the approach of releasing products and services onto the market as early as possible, no matter

whether they are slightly imperfect, and then improving them and developing them as the market grows, has become normal. This principle of competition was named "Innovation-Based Competition" by Dr. Frédérique Sachwald of the Institut Français des Relations Internationales, and from the awareness that we are in such an era of innovation-based competition, I believe it is extremely important that the Japanese real estate market be rapidly innovated in the direction of creating the "rate of return barrier" demanded by the market.

In March 2000, long-term fixed-term lease agreements became possible. Under today's circumstances in which the Tokyo rental market is expected to soften, while there may be a certain level of sacrifice, converting a significant number of leases to long-term lease agreements is, in my view, an effective means of creating the "rate of return barrier," and this will also enable disclosure which already been indicated as sorely lacking.

Turning to conflicts of interest, J-REITs are facing an important situation after only four months since their listing. In addition to having adopted an outsourcing methodology in the first place which is susceptible to conflicts of interest, in the current difficult situation the management of the administrative companies that are dominated by staff on loan have not provided investors with any information at all about what management prowess will be brought into play, and in what way and when.

If such innovative measures are not presented, and if spur-of-the-moment measures are taken such as increasing leverage ratios in an effort to increase dividends, I see the melt-down of the J-REIT market being unavoidable. The battle has just begun.

References:

Frédérique Sachwald, 2001, "The Challenge of Innovation-Based Competition: A Transatlantic Perspective", Institute for Economic Research