
Real Estate Opportunity Funds Outlook in Japan

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I would like to present my opinion about the outlook of real estate opportunistic investment in Japan. This opinion is mainly based on the understanding of what made real estate opportunistic investment successful in the USA by analyzing briefly the history of real estate opportunistic investment in this country. As all our readers may not necessarily be familiar with the concept of opportunistic investment, I would like first to define it.

Defining real estate opportunistic investment

Defining “the” opportunistic investment strategy is somewhat difficult due to the multiplicity of the sub-strategies implemented by the opportunity funds. We can nevertheless give some of those strategies common characteristics:

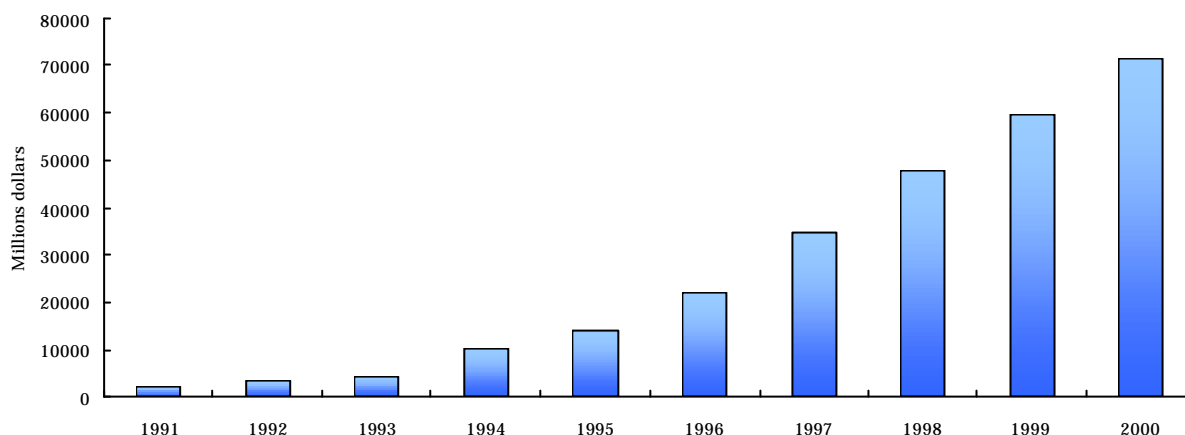
- ✓ They target returns generally in excess of 20% net IRR (Internal Rate of Return),
- ✓ They apply relatively high loan to cost ratio,
- ✓ They have relatively short investment periods,
- ✓ They acquire hard real estate assets considered as momentarily discounted to their replacement cost (distressed assets or good assets from distressed owners) and/or REOC (Real Estate Operating Companies), REIT, REIT securities, NPL and mezzanine loan, provided they consider them as momentarily discounted to their fair value, and
- ✓ They use their relationships (the “Network”) in order to source as much as possible off-market opportunities and thus avoid the public bids competition.

To summarize this definition, I believe that if the objective of the “core investment strategies” is to generate performances similar to market through diversification, the objective of the “opportunistic investment strategies” is to outperform the market. In other words, the opportunistic funds are expected to generate above-average risk-adjusted returns to the investor by mitigating the additional risk taken, thanks to the comprehensive expertise of the general partners who implements it.

In the US, in a little bit more than a decade (from 1988), opportunistic real estate private equity has become a major component of the real estate capital markets with a cumulated equity commitment of approximately 70 billion dollars. Assuming a loan to cost ratio of 50%, PCA

(Pension Consulting Alliance) estimates the market capitalization of this sector at approximately 140 billion dollars in 2000, i.e. approximately the same as the whole REIT capitalization! What fueled this incredible growth?

Equity Commitment to opportunity funds in the US



Source: Pension Consulting Alliance, in Real Estate Opportunity Funds, The Numbers behind the story

Brief history of the opportunistic investment funds development in the USA

During the 80's real estate developments were fueled by two powerful money inflows. One was pension funds' money triggered by the fear of inflation and tax incentives. The second flood of capital was the saving and loans (S&L) institutions' money that aggressively financed speculative developments during the end of the 80's.

But this capital flow was short-lived. By 1986, tax incentives were completely removed, inflation was under control and overbuilding became obvious. The real estate market collapsed and with it the solvency of the S&L. The decade of the 90's began with a tremendous amount of real estate assets waiting for financing and with nobody willing to supply it...nobody, but wealthy individuals through opportunity funds, and public market through REITs. So, opportunity funds began their rapid growth by buying through the RTC discounted packages of loans and real estate owned by the bankrupted and state controlled S&L institutions.

By the mid 90's, the commercial banks were completing their balance sheet clean up, providing additional bargains to the market. On many deals, opportunity funds and REITs were not competing as, limited by regulatory and tax requirements, REITs were unable to buy diversified portfolios, or properties with heavy CAPEX. Thus, opportunity funds were buying real estate at a discount on the private market and selling it at a handsome premium to the public market.

Approximately during the same period, Japanese financial institutions and corporations (big owners of US real estate) were already struggling with their NPLs, which forced them to quickly sell entire portfolios. Meanwhile, pension funds had integrated real estate opportunistic investment as part of their alternative investments, which resulted in more available financing.

By the end of the 90's, the amount of bargains had decreased. Opportunity funds implemented value added strategies selling by properties to the REITs and began to focus on international opportunities by creating globally diversified products exploiting local partners expertise.

What about the outlook of the opportunistic investment in Japan?

As its definition and history illustrates, opportunity investment draws its formidable power from its ability to exploit, in any economic and financial context, disruptions in the real estate market equilibrium.

In Japan, what will happen? Nobody knows for sure, but using the technique of the ancient Greek Plato, let's look on the wall of the Japanese cave and see whether moving shades can give us some reasonable clues. We can on the wall (1) banks and corporations struggling for many years with NPL; (2) a Japanese government increasing its pressure on these banks and corporations, urging them to solve the NPL problem, also reforming progressively the pay-off system and the status of the RCC; (3) a Japanese government under growing international pressure for a fast NPL resolution; (4) we can see signs of economic recovery by the second half of FY 2002; (5) we can see a developing JREIT sector; and (6) very low interest rates enabling the implementation of highly leveraged investment strategies.

No one can say which mechanism will operate, but factors of disruption of the real estate market equilibrium have multiplied and we believe that the combination of those factors will provide great opportunities to opportunity funds in Japan.