Japanese Real Estate Market will Continue to Grow but Become a Type of Mature Market

Akihiko Sato

The period where the real estate finance and securitization markets rapidly expanded has come to an end. Although the market will not shrink, it is clear that the rate of increase is dulling. As the market, which had only expanded, comes to a turning point riddled with concerns, players that have implemented strategies based on a singularly growing market have now been forced into a period of review. We are entering a period where only companies that can truly provide added value will survive.

Turning Point in Real Estate Securitization and Finance Market

There continues to be a strong motivation to invest in Japanese real estate with the entry of new investors, major transactions of 100 billion yen or more and the reporting of new development projects on an almost daily basis. On the other hand, real estate funds grew by more than 50% in 2006 but less than 20% in 2007, and many scheduled listings of J-REITs were abandoned. As for pricing, the TSE J-REIT Index peaked in May 2007 and has since continued a free fall with the year end figure for 2007 below that for the start of the year. In this way, 2007 was a year in which the sudden expansion in size of the real estate investment market slowed during. However, this doesn't mean that the market itself has shrunk, as an overall growth trend is being maintained. Some of the players related to real estate securitization and financing are facing fearful elements as they come to this "turning point" in the market.

Three elements impacting the investment market

The three major elements that impacted the investment market are as follows.

1. Rising interest rates

Rising interest rates are something that have for some time been predicted to have an impact, but ultimately has not had an impact – the rising interest rates factor. The year 2007 began with experts saying we were in a period where rates would rise, and the Bank of Japan did in fact raise rates in February. Thereafter another increase in rates was expected around summer, but was passed over due to the confusion in the financial markets arising from the subprime problem. Although many comments say an increase will be coming in the summer of 2008, the specific timing is unclear. Long-term interest rates were also perceived to increase through the summer of 2007, but in fact the rates were lowered due to the same subprime problem deteriorating the market and causing investors to move funds to safe assets.

2. Complete implementation of the Financial Instruments and Exchange Law

Industry participants had forecast for some years that the Financial Instruments and Exchange Law (FIEL) would have an impact on the market and it did. Systematic revisions of real estate financing had taken place in the form of interpreting silent partnership investments as deemed negotiable securities and changing the accounting system, and the market has shown growth by overcoming these obstacles to date. However, the complete enforcement of the FIEL has had a broader and deeper impact than before. Among the items related to real estate financing was the interpretation that all beneficiary interests in trust were negotiable securities, that collective investment structures would be subject to regulations and that each of the players related to these would need to implement a very diverse group of measures.

Of all the revisions, the largest impact was on the asset managers of real estate funds. The operations traditionally outside the scope of regulations for asset managers were now within their scope and the companies had to prepare a structure to satisfy rules and to establish operational flows as they now fell under the classification of financial instrument traders. Asset managers have been positioned as financial instrument traders with a duty of integrity to investors. The establishment of rules is of course a good direction, but the confusion surrounding implementation of the FIEL is due to the lack of clarity on the degree to which operations should be "appropriate." One of the specific points at the crux of the confusion is whether or not an asset manager should choose to be an investment manager or an investment advisor.

An analysis of the public comments by the Financial Services Agency and its Q&A reveals that in almost all cases "matters shall be handled according to actual conditions of individual cases." Thus, in the end, it is a grey area with "We will not know until we are inspected" being the one certainty. The advice from lawyer's offices is also quite diverse and difficult to base a clear decision on.

Under these conditions, the asset managers are trying to meet requirements but they are presently still unsure as to what is appropriate and so many are being forced to abide by whatever transpires or to suspend transactions. This is not just impacting the transactions of real estate funds but also the selecting and examining structures to use to originate monetization structures. Present circumstances have led to cases where structures are desired in which the applicable scope (or non-applicable scope) of the FIEL is relatively clear – such as with structures using TMKs. Another unclear factor is the future extent of the impact on codes of behavior for transactions that could lead to conflicts of interest that all market participants did not necessarily have a strong awareness about despite repeated indications of such.

3. Subprime problem

Despite initial forecasts assuming that subprime would have little or no impact in Japan, the problem has in fact turned out to have a major impact. One of the reasons this problem has had an impact on the Japanese real estate investment market is that some foreign financial institutions have lowered the pact for accumulating assets through real estate investment and financing or altogether stopped doing so. Since the major players cannot make investments or loans, it has become difficult to acquire financing. Additionally, despite not suffering major losses the concern and fears in the overall financial markets have led to Japanese banks being cautious about loans related to real estate. Of course this doesn't mean they are cautious about all loans, but they are being selective about the types of real estate, whether or not properties are in local areas, the issuing of non-recourse loans and placing greater importance on the name of the sponsor rather than the property itself. Due to these movements, there have been cases where deals have fallen through because it is impossible to get any mezzanine financing. In other cases the closing dates have been extended.

There has also been a drop in the demand for investment products as a result of fears in securitization methods and ratings methods – both fears arising from the subprime problem. It has also increased the spread in the CMBS market and made it difficult to acquire non-recourse loans for procurement costs.

2008 Trends/Restructuring of Business Strategy

Clearly there are several factors that will cause a temporary stagnation in the market. Of these, the impact of the FIEL should be overcome when the unclear hurdles that have to be cleared are clarified. As for the subprime problem, the extent of this crisis is still unknown but it should eventually calm down as long as an unexpected crisis doesn't happen in the financial markets. The real estate investment business environment was quite blessed over the past few years with the continuing low interest rate environment, the rise in rents accompanying the economic recovery, the rise in real estate prices accompanying said recovery and the market expansion brought on by the inflow of capital.

Thus the participants involved in this business expanded their businesses. However, the business direction and investment targets will not be determined based on the conditions of a rapidly expanding market, but rather we are entering a time where we should judge our actions by whether or not we can provide added value over the medium to long term. Players that can provide true added value are those that will win. In other words, we have entered a period where it is necessary to reexamine rebuilding the business, investment targets and the like. Until now there were many examples of companies from various sectors starting to invest in real estate but there have been very few cases of people leaving the industry. Hereafter however there will be an increasing number leaving the field. For example, there are already cases where a large sense of burden has developed in meeting the systematic needs of the FIEL, and funds originated by for-profit companies have sold off their real estate and withdrawn from the asset management business. There are also cases where the asset management is left to a third party and they themselves focus on the core business of being an investor and developer.

There will probably be even more cases of concentrating core businesses with other businesses being sold, proactive implementation of M&As to expand business scope and other steps emerging to rebuild businesses. This change in business strategy within an industry that had been solely aligned to growth, strongly indicates that 2008 will play a vital role.

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Sato graduated from the Faculty of Law of Kyoto University in 1984 and later entered the Industrial Bank of Japan (presently Mizuho Corporate Bank). After serving in the Financial Engineering Department, he was assigned to the New York branch and then seconded to Kogin Securities (presently Mizuho Securities). Sato oversaw real estate securitization while in charge of the structured financing division where he was constantly involved in securitization. While in the structured finance division, he worked exclusively on real estate securitization. He joined Urban Corporation in 2001 and learned the ins and outs about the origination of development. He established Ground Financial Advisory in 2002.

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