
Tokyo Real Estate Market Report Vol. 15

October 2002

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Current status of financing for real estate development projects in Japan and Trends of Accounting Practices on the part of Special Purpose Company (SPC)

Current status of Financing for real estate development projects in Japan

1. Current Status

A lot of real estate development projects (office, residential, etc.) have been available in greater Tokyo.

In many cases developers obtain financing on a corporate basis, since corporate based financing has a lower financing cost than the case for project based financing. Nevertheless there continues to be steady growth in forms of finance which make use of structured financing.

In many cases financial institutions impose the following requirements for non-recourse financing:

- (A) A construction permit from the city office;
- (B) A non-cancelable pre-lease agreement with a clause
- (C) A guarantee completion of the construction

Consequently at the present time it is extremely difficult as a matter of practice to meet all of the above requirements, and it is still not common for Japanese financial institutions to extend financing to a development project on a non-recourse basis. Moreover, with the exception of some large commercial facilities, it is very rare under Japanese commercial practices to obtain a pre-lease commitment prior to the start of the project, as set forth in (B) above. In the vast majority of cases they still rely on the credit of the developer who sponsors the project.

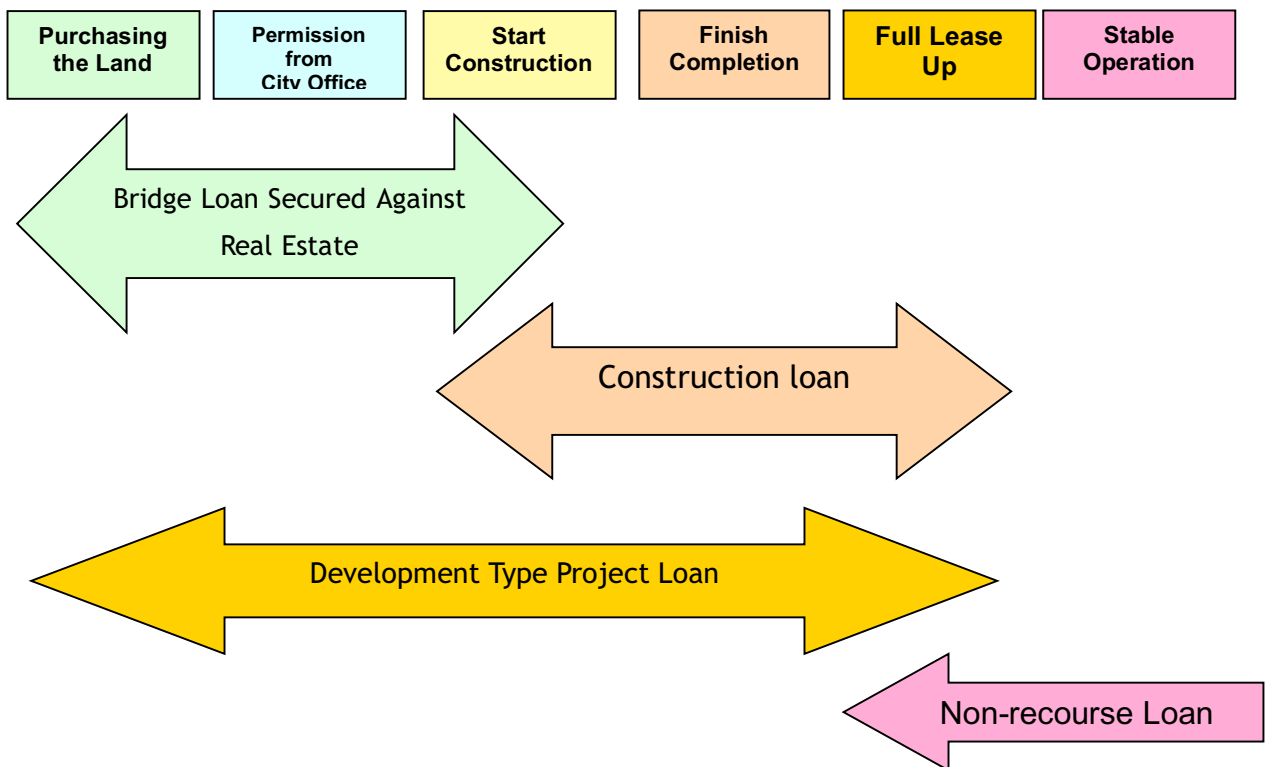
2. Forms of Financing and Credit Support at Various Stages of Development

The phases of each stage of development can be divided as follows:

Phase-1	Purchase of land - Obtaining the development permission - Starting construction
Phase-2	Starting – Completion of construction
Phase-3	Completion of construction – Full Lease Up - Stable operation
Phase-4	After the period of stable operation -

Some financial institutions are willing to provide financing on a non-recourse basis in the form of bridge loans secured against the land limited to the period of *Phase-1*. In most cases, however, financial institutions will require credit support by the sponsor (or in some cases debt guarantees) for a construction loan in *Phase-2*, or to extend project financing from *Phase-1* through *Phase-2*. In many cases financial institutions will extend non-recourse financing from *Phase-4* during which there is a stable cash flow.

Diagram: Forms of Financing in Each Stage of Development



Recourse loans are divided into *full recourse* and *limited recourse* loans, and the method of credit support will differ depending on the customer. Methods of recourse include guaranty by a guarantor, an *indemnity*, a *commitment* to make a certain level of equity financing, or a commitment to buy the completed building.

Trends of accounting practices on the part of Special Purpose Company (SPC)

Under Japanese accounting regulations, the issue of special purpose company (SPC) which should be consolidated is only discussed in abstract terms by the rules of Accounting Council. Accounting Council is an advisory committee of Financial Agency. If certain standards are met, an SPC will be excluded from the “standard of control” or the “standard of influence” which determines the scope of consolidation on consolidated balance sheets.

Since then *the “5% rule”** has come into effect, which restricts off-balance treatment from the holder of assets. Although initially this regulation was applied in a relatively non-stringent fashion, as there were strong policy demands to promote securitization, in recent times there has been a change in application particularly on the part of major accounting firms.

In the future corporations are likely to be required to consolidate those SPCs over which they have substantive control, regardless of international accounting standards.

* This rule states that a company which has sold assets to an SPC is not permitted to treat the assets that it sold as a sales transaction for accounting purposes, if that company will bear all or some of the loss in the event of a default on the part of the SPC or a decline in the value of the assets, in cases such as when the company that sold the assets to the SPC owns at least five percent of the subordinate bonds issued by the SPC.

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