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Potential for Apartment REITs in Japan and Related Issues

In these two and a half years after the Japanese Real Estate Investment Trust (“J-REIT”) was created, the current market value of J-REIT shares has surpassed ¥1 trillion, and asset holdings have grown to approximately ¥1.5 trillion. Nippon Building Fund Inc. (NBF) and Japan Real Estate Investment Corp. (JRE) were both listed on the same day in September 2001, marking the beginning of J-REITs and four J-REITs were listed in the following 12 months. Due to the market conditions stagnated, however, no new J-REITs were listed during the period of September 2002-August 2003. More recently, J-REIT shares have been showing strong growth (Fig. 1), supported by vigorous investment demand from regional banks and pension funds. Along with this upturn, there has been a rush to list new J-REITs. Six new funds have been listed during the six-month period since September 2003, and the market is expanding rapidly.

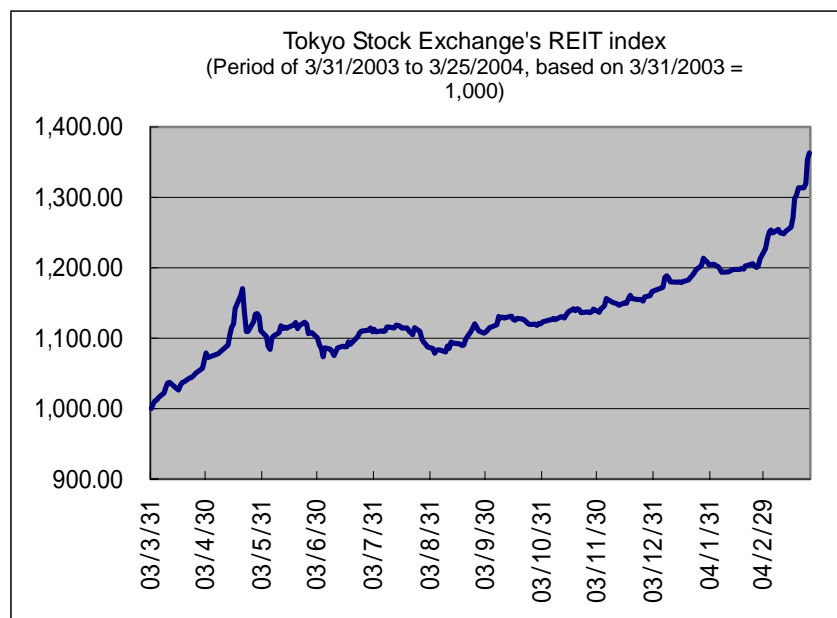


Fig. 1 Tokyo Stock Exchange's REIT index

The Table 1 shows the characteristics of existing J-REITs. There are three general categories of J-REITs, depending on the types of real estate assets they invest in; 1) specialized funds that invest only in a certain asset class such as office or retail buildings, 2) combination funds that invest in two asset classes, and 3) general funds that invest in practically all asset classes.

Looking at the overall market, office buildings currently account for the largest percentage by far of total investment (Fig.2). In the U.S., there are more specific REITs focusing on office buildings, retail buildings, housing, hotels, storage, and health care. Meanwhile, the J-REIT is just out of its infancy and is now entering a new stage of development. These funds are expected to begin investing in a wider range of asset classes in the

future. Table 1

Name	Abbreviation	Date listed	Investment asset class				Share price (yen)	Expected dividend yield (%)	Total market value (yen)	Total assets (yen)
			Office	Retail	Residential	Hotel				
Nippon Building Fund Inc.	NBF	9/10/2001					777,000	3.50	218.104 million	294.400 million
Japan Real Estate Investment Corporation	JRE	9/10/2001					829,000	3.42	215.872 million	210.400 million
Japan Retail Fund Investment Corporation	JRF	3/12/2002					742,000	3.78	162.870 million	180.300 million
ORIX J-REIT Inc.	OJR	6/12/2002					635,000	4.11	111.361 million	146.700 million
Japan Prime Realty Investment Corporation	JPR	6/14/2002					293,000	3.82	125.990 million	153.100 million
Premier Investment Corporation	PIC	9/10/2002					605,000	3.63	48.037 million	65.900 million
Tokyu REIT, Inc.	TRI	9/10/2003					663,000	4.22	64.974 million	110.200 million
Global One Real Estate Investment Corporation	GOR	9/25/2003					804,000	4.24	38.913 million	63.200 million
Nomura Real Estate Office Fund, Inc.	NOF	12/4/2003					665,000	3.53	98.819 million	127.300 million
United Urban Investment Corporation	UUR	12/22/2003					609,000	4.07	50.996 million	60.200 million
Mori Trust Sogo REIT Inc.	MTR	2/13/2004					832,000	3.61	133.120 million	107.200 million
Nippon Residential Investment Corporation	NRI	3/2/2004					595,000	3.81	29.393 million	37.600 million

* Share prices are as of March 25, 2004.

* Expected dividend yield was calculated as follows. (Expected distributions are doubled for conversion to an annual rate.)

$$\text{Dividend yield} = (\text{Expected distributions} \times 2) / \text{Price}$$

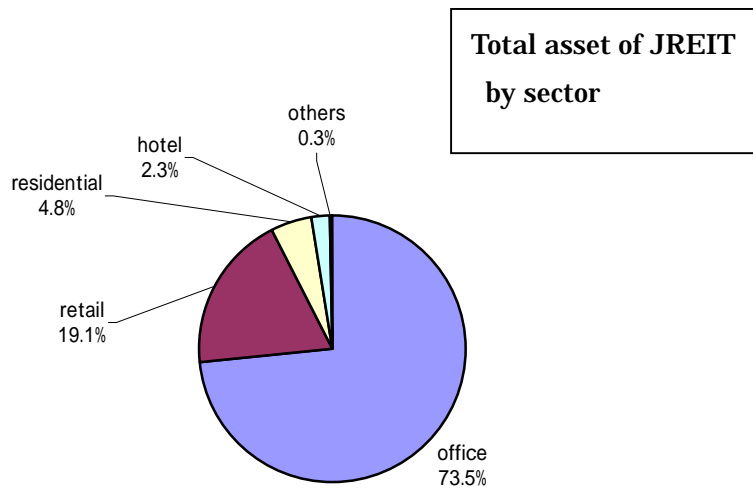


Fig. 2

One major difference between REITs in the U.S. and J-REITs is the size of the housing sector. In the U.S., housing is perceived as an asset class with very stable profitability, and investment in residential buildings is a major sector of the REIT market on the same level as retail buildings, both ranking second after office buildings. Meanwhile, Japan's first REIT fund specializing in housing (NRI) was only launched in this March. It is surmised that other similar REITs specializing in housing may appear in the future, but it seems likely that a considerable length of time will be needed before this sector accounts for a major share.

This delay in housing investment by J-REITs is the result of differing circumstances between Japan and the U.S. Below, we will examine the potential for establishment of the housing sector as a significant presence in the J-REIT market in the future.

Looking at the relative advantages of investing in office and retail buildings versus housing, the following points are recognized in the U.S. as definite merits related to housing.

- (1) Tenants are small-scale and dispersed, so income is stable, without large fluctuations.
- (2) Lease periods are short, so rental prices accurately reflect market conditions and it is possible to value assets with a high degree of accuracy. (However, rent controls exist in some areas.)
- (3) It is easier to predict repairs and other expenditures than for office buildings, and these costs tend to be lower.
- (4) It is easier to predict demand based on population trends for housing than other asset classes.

Points (1), (3), and (4) are characteristics of housing as an asset class, and they are applicable in Japan as well. However, there are some rather troublesome problems related to point (2) in Japan. These problems are related to the Japanese system of rental housing.

In Japan, tenants are protected under the Land and Housing Lease Law, a law whose basic objective is tenant protection. Even when a lease expires, the lessor cannot refuse to renew the lease without "a legitimate reason." During periods of inflation, in particular, long-term tenants obtain an economic advantage due to the discrepancy between market rates and the rent they are actually paying. In many cases, landlords who wish tenants to vacate from the premises need to pay a hefty eviction fee to the tenants.

In the Japanese legal system, once a real estate property has been leased, it is not easy for the landlord to obtain vacant position.. This is a major difference compared to the U.S., which has a short leasing cycle. This system has been criticized as one factor which obstructs growth in the real estate market; for example, by making it difficult to predict cash flow. In 2001, however, "Fixed-Term Lease" was introduced as a new type of lease agreement. It is expected that the conventional lease agreement will gradually be shifting over to "Fixed-Term Lease" upon its expiry.

There are several hurdles in the way of establishing residential REIT in Japan, in addition to the Japanese system of rental housing. The following points can be noted in comparison to the U.S.

- (1) Compare to commercial buildings, residential buildings are relatively smaller in scale, which makes it very difficult to build up a portfolio for a fund with sufficient asset value..
- (2) There is only a small market for high quality rental housing that is suitable for investment.
- (3) There is competition from demand for condominium market.

Large-scale, community-type developments of rental housing, as seen in the U.S., are practically nonexistent in Japan, and apartment buildings are usually very small in scale. One indirect reason for this situation seems to be the high price of land. It is not profitable for developers to buy land and develop it for operation as rental housing, so there has been practically no supply of high-quality, large-scale private rental housing in the past. Rent paying capabilities are limited with regard to middle-income family housing, a segment of particularly high volume demand; so for reasons of profitability, developers have chosen the path of condominium housing instead of developing rental housing. In Japan, government policies including tax measures have traditionally promoted home ownership, and this has been another factor behind the preference of developers for condominium housing. Japan has no areas that are zoned for rental apartment development only, as in the U.S. In fact, it is only in the niche market of high-rent properties for high-income tenants located in desirable urban areas that rental housing is more profitable than condominium housing.

For these reasons, private developers have not become a major player in the development of rental housing in Japan. For many decades, the main players in rental housing development have been large landholders with extensive land holdings and the public housing corporations or "Kodan," which are states owned developers. As one way of using their land effectively, large landholders have tended to build small, cheaply constructed buildings as rental housing which the landholder can then operate personally as a micro-enterprise. Since they do not incur real land costs for this rental housing, they can charge less for rent than private developers. This has given large landholders a competitive advantage. However, these buildings are generally of poor quality, and most of them are not of the proper specifications for REIT investment properties.

Meanwhile, Japan's states owned housing corporations have functioned as the suppliers of large-scale rental housing for middle-income families, a segment which is not easily supplied by private developers. In the postwar period, these corporations served the social mission of alleviating a serious housing shortage. However, the existence of these special players, which need not concern themselves with profitability because of their public nature, has hindered the development of a competitive environment for private developers in the Japanese rental housing market. (See note.)

For these reasons, there has been very little development of quality properties that are suited to REIT investment by private developers in Japan. Therefore, there are very few suitable properties on the market for use in forming a housing J-REIT, and those that are available tend to be small in scale, making it difficult to amass an appropriate amount of assets. If properties owned by public housing corporations were to come onto the market, however, the situation would be different.

As we have seen, the Japanese rental housing market presents a variety of challenges. Still, there is growing interest in the formation of housing J-REITs which will boldly tackle these challenges. Now that NRI has become listed as the first such fund, potential followers will be watching with concern to see how it is received in the future market. Although it calls to mind the question of which comes first, the chicken or the egg, the very existence of housing J-REITs is expected to encourage developers to develop rental housing. This kind of reaction is already gradually beginning to occur. The role of states owned housing corporations is also changing, and they are starting to encourage private development of rental housing by first purchasing land and providing the infrastructure, and then entering into long-term leases with private companies. Quality rental housing based on these kinds of arrangements has a great deal of potential to contribute to the growth of housing J-REITs.

Incidentally, Tokyo Tatemono already supplies rental housing that totals about ¥20 billion per year, and it has attained the status of a major private developer. Tokyo Tatemono is considering a variety of endeavors based on its development capabilities, including the formation of a housing J-REIT.

Note:

It would not be factual to state that private developers in Japan have not supplied any rental housing at all. Some companies have been actively involved in rental housing for many years. Representative examples include the Homat series of luxury rental housing for foreigners by Kowa Real Estate and the Mansions series by Sogo Jutaku. Also, in some cases of multipurpose redevelopment projects, rental housing units are developed along with offices and commercial facilities in an integrated manner. These projects include Ark Towers, a luxury rental apartment building in Ark Hills, a redevelopment project by Mori Building; Ebisu Garden Terrace in Ebisu Garden Place, a redevelopment project on the former site of a beer factory of Sapporo Beer; and Okawabata River City 21 Pier West, a facility undertaken by Mitsui Real Estate within River City 21, a coastal development project in Tokyo.

Nevertheless, none of these examples are aimed at a broad market of general households. They tend to be expensive properties for wealthy tenants, a category that has no competition from public housing.

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