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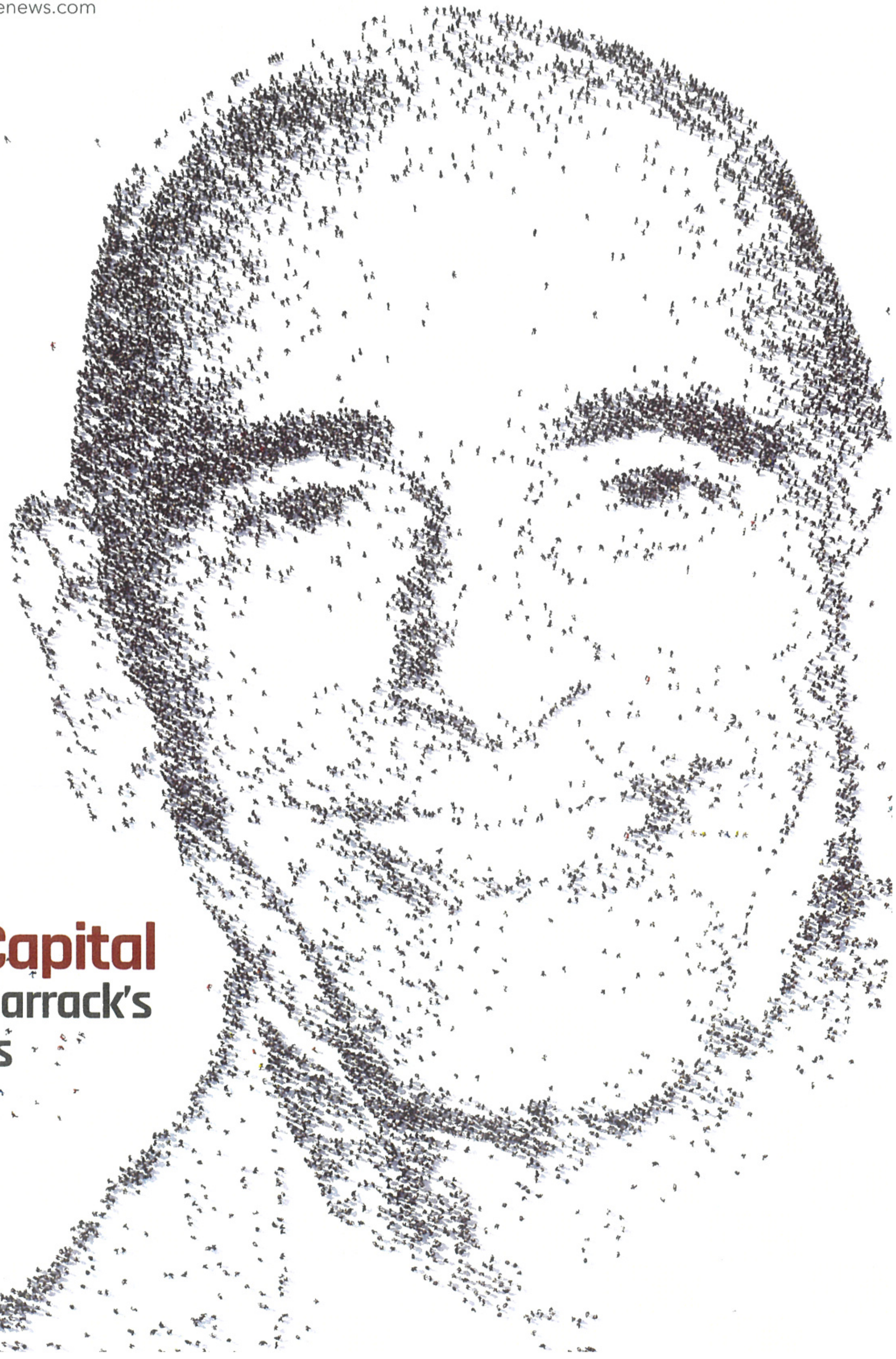

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ROUNDTABLE

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When the real estate cycle turns in Japan

Our Japan roundtable talks with Evelyn Lee about a potential correction for the country and how well it will be able to withstand oncoming headwinds

While Japan is considered one of Asia's most stable property markets, it is still subject to real estate cycles. In fact, as four property executives gathered at law firm Greenberg Traurig's Tokyo offices tell *PERE*, the currently robust market may soon be poised for a shift.

"I think Japan has had a good run in many respects in the last number of years," says Joel Rothstein, chair of the Asia real estate practice at law firm Greenberg Traurig. "Valuations in key Japan markets may be quite high, but Japan is still attractive as it is one of the few markets in the region that offers investors opportunities for building a platform of some scale and for funding and exiting deals with comparative ease."

Adam Donahue, senior managing director at LaSalle Investment Management, is cautious on Asia overall but cautiously optimistic about Japan. He notes the latter has benefited from rising hospitality demand and immigration rates. "I think the economy overall is actually quite strong," he says. "Productivity is higher. GDP growth per capita is higher than a lot of Western countries. This economy is better placed than a lot of other economies in Asia."

> *"As long as we don't have a big shock from the outside, I don't think we'll have a price plunge or a big downturn of the market in general"*
>
> **TOMIJI HASEGAWA**
> **Tokyu Land Capital Management**

Strong economic conditions have led Japanese property investments to perform better than anticipated in recent years. "All of our investments outperformed what we underwrote three years ago for core assets projecting a moderate income and capital gain," says Shusaku Watanabe, director of Asia capital transactions at Nuveen Real Estate. "We didn't expect this kind of return. Rents are going up, which nobody expected."

Donahue agrees. "Across the risk spectrum, I think investors have outperformed over the past number of years," he says, but adds: "I don't think that continues in the future."

The total return in Japan has been steadily declining since hitting a high of 8.8 percent in March 2016, and has hovered between 6.4 percent and 6.6 percent since January 2018, according to the MSCI Annual Japan Property Index. The most recent available performance data for Japan was still below the five-year annualized return of 7.5 percent, but above the 10-year annualized return of 4.6 percent.

Indeed, Japan's good run may be coming to an end, Rothstein says: "There

PHOTOGRAPHY: KEISUKE NISHIJIMA

Adam Donahue

Head of separate accounts, Asia-Pacific, LaSalle Investment Management

Donahue leads all Asia-focused separate accounts, as well as club deals and joint ventures across the region. He is responsible for strategic direction and investment performance and is heavily involved in acquisition and asset management. He has 15 years of real estate experience and was with Lehman Brothers prior to joining Chicago-based LaSalle in 2010.

Tomiji Hasegawa

Investor relations department head, Tokyu Land Capital Management

Hasegawa joined Tokyo-based Tokyu Land Corporation Group in 2012. He was previously in charge of fund and asset management of cross-border real estate investment and renewable energy projects at Tokyu Land Capital Management. Before moving there in 2015, he was managing director of global business development, business solutions at the head office of Tokyu Livable. Hasegawa was also previously head of Japan at AXA Real Estate Investment Managers.

Joel Rothstein

Chair of Asia real estate practice, Greenberg Traurig

Rothstein advises investment banks, financial institutions, private equity funds, sovereign wealth funds, developers and investors in real estate equity, debt and capital market transactions across all major Asia markets with a focus on Japan, Greater China and Korea. He also leads the firm's practice in advising Asia-based cross-border institutional investors in equity and debt investments, including direct investment, separate account and fund investments into the US, Europe, Latin America and the Middle East.

Shusaku Watanabe

Director of capital transactions, Asia, Nuveen Real Estate

Watanabe is responsible for evaluating, structuring and originating acquisitions across the Asia region, which currently accounts for 3 percent of Nuveen Real Estate's overall assets under management but is where the manager is aiming to deploy significant future capital. He joined the business in 2016 from JPMorgan Asset Management's Singapore office, where he was fund manager for its Tokyo Recovery Fund, which was targeted at the city's office sector.

are discussions in the market about certain headwinds out there. People talk about frothy valuations, trade wars and tensions having potential impacts on the market. On top of these trends there are concerns the Japanese government's policy options to stimulate the market may be limited, due to already record low interest rates with little room to go lower, as well as mounting and burdensome government deficits."

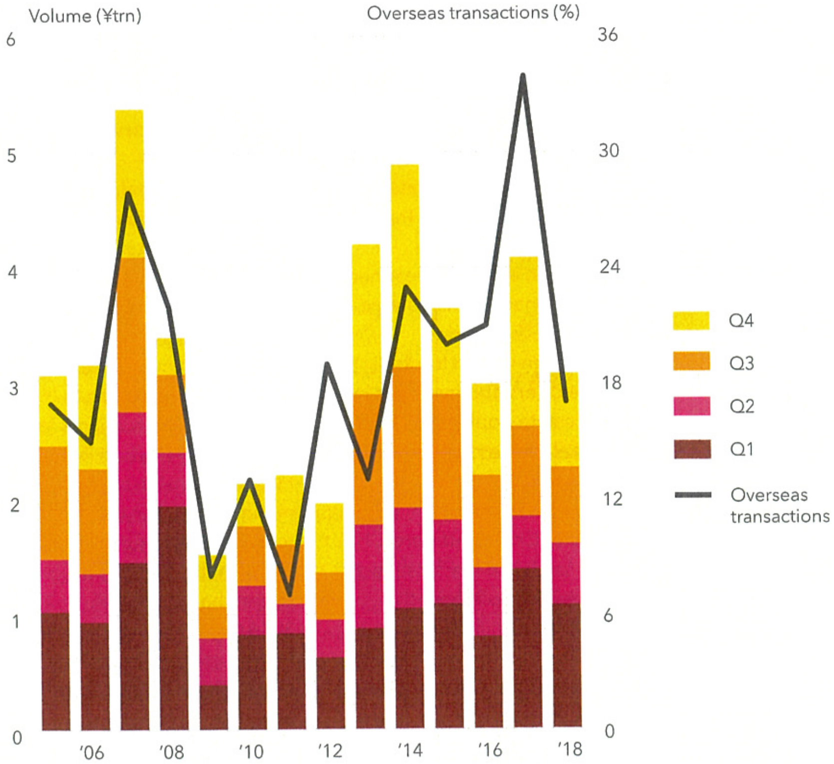
"'Low for long' has been the theme for the last 10 years," agrees Watanabe. "The feeling is the market is quite mature."

He points to the abundance of capital pumped into Japan's property market, partly in anticipation of the 2020 Summer Olympics in Tokyo next July. "That's the challenge – whether Japan has done its work to really sustain this growth in fundamentals, which has been strong," he says. "The capital markets have been much stronger than the fundamentals. So, in 2020, after the whirl of construction and infrastructure stops, there is a supply issue: is there really the demand that absorbs the supply?"

Tomiji Hasegawa, head of the investor relations department at Tokyu Land Capital Management, observes that peak real estate prices in Japan have prompted the question of when a downturn will occur, with some predicting an adjustment in prices before Olympic Games. However, he believes the trigger for a correction would be externally driven: "As long as we don't have a big shock from the outside, I don't think we'll have a price plunge or a big downturn of the market in general."

> *"Across the risk spectrum, I think investors have outperformed over the past number of years. I don't think that continues in the future"*
>
> **ADAM DONAHUE**
> **LaSalle Investment Management**

Quarterly transaction volumes in Japan



Transactions of at least ¥1bn, excluding acquisitions by J-REITs at IPO
Source: CBRE, Q1 2019

The challenges of investing in Japan

Despite its stability, Japan's real estate market remains a challenging place for international capital. "Japan is not always high in transparency," says Watanabe. "That's not because the market is not transparent. That's because I think, for offshore investors, they need to know the language and they need to know the culture. As long as you understand the language and culture, it's quite a transparent market. It's a huge market and quite liquid."

Nevertheless, those investors able to source deals find executing relatively stress-free. "Japan is one of the easiest countries from a legal perspective to execute a transaction as a foreign investor," Rothstein notes. "There are no foreign investment laws that prohibit or substantially limit the ability of a foreign investor to acquire and own real estate. Unlike some countries, there are no currency conversion and repatriation restrictions which interfere with investors funding projects or repatriating profits. If you want to do a deal in Japan, people pretty much know you have two structures you might use, a TMK or TK structure."

Other aspects attractive to foreign investors include fee simple title to property; the ability to structure tax-efficient ownership entities; and the ability to encumber and finance property in a similar manner to many developed markets. "All these factors make it relatively easy to assess, structure and close a deal in comparison to many other markets in Asia," says Rothstein. "The largest complaint we have from clients that are international investors is just finding deals."

Prime core assets in Japan are typically not readily available to international investors, he continues. "Our clients would be very interested indeed in buying these assets, but they are simply not traded very often in the general market," Rothstein says. "Sometimes you have to be creative to source deals."

For example, some foreign investors forge relationships with local market participants

Adam Donahue

Tomiji Hasegawa

Joel Rothstein

Shusaku Watanabe

and enter into forward-purchase contracts for projects that are under construction rather than signing purchase and sale agreements for a completed property. "The building might not be one of those flashy Grade A office buildings located next to Tokyo Station, but it could be a decent project in one of Tokyo's central wards," Rothstein says.

Hasegawa agrees: "Here it's the Japanese players that are holding those super Class A assets, like Mitsubishi Estate, Mitsui Fudosan and other large developers. They develop them and just hold. Unless they have any financial difficulty, they will not sell."

In some ways, it is even more challenging for an institutional investor to find core assets in Japan than in other developed markets where demand outstrips supply. "Asia-sourced capital has been able to successfully acquire some of the largest office buildings and historic landmark hotel properties that have traded in gateway cities in the US," says Rothstein. "That's not going to happen here in Japan where these types of assets are not readily traded and made available on the open market."

In fact, Rothstein believes a downturn would be a positive for Japan's property market: "If there was a correction in the market, it would actually spur activity… Valuations allowing for more attractive returns would create an opportunity for investors with dry powder to step in and do deals, as well as open the door to execute on some more opportunistic plays that otherwise might not be available."

Watanabe, however, says dealflow in Japan has been easier to come by in the past year and a half, especially for investors that understand local business practices and have a track record. "I think in the last 12 months, I did see more transactions taking place," he says. "I've seen more Grade A properties being traded. So, you just needed to stay in the market and get to know people... because the prices have gone up, a lot of people have felt it's a good time to sell right now."

Donahue concurs: "Japan is still such a broad and deep market that there are still a lot of off-market opportunities. There are generational transfers from families that hold real estate, or corporates that are selling out of their non-core assets. This country definitely benefits from consistent flows of product where you can refurbish or otherwise add value."

Annual real estate transaction volumes in Japan, however, fell 25 percent year-over-year and hit their second-lowest levels in six years, with a total ¥3,117 billion ($28.86 billion; €25.63 billion) of property traded in 2018, according to data provider Real Capital Analytics and commercial property services firm CBRE. Meanwhile, the percentage of real estate capital that came from overseas investors dropped from 34 percent in 2017 to 17 percent last year – the lowest such percentage since 2012, the firms said.

Japan's changing role

Some international investors are still pursuing opportunistic strategies in Japanese real estate. But compared with the late 1990s and early 2000s, when most overseas investors were seeking 20 percent-plus returns, those types of institutions are fewer today, says Hasegawa: "Looking at the overall market, that area is getting smaller, and there are more long term and stable income seekers, investors like pension funds."

What is old is new again

Among the more notable value-add deals in Japanese private real estate in the past year are transactions involving the repositioning of older assets, rather than new ground-up development

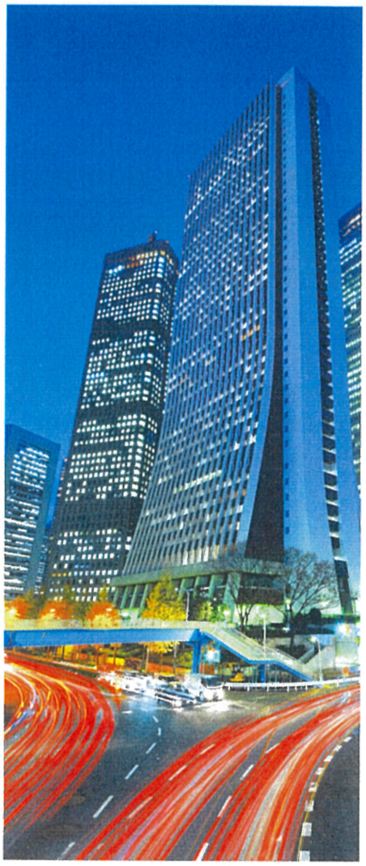
In cities like London and New York, adaptive re-use projects are fairly commonplace. Not so in Japan, where "new is good, old is not good at all," says Rothstein.

A few private real estate transactions in Japan, however, reflect changing attitudes toward investments in older properties. For example, New York-based GreenOak Real Estate sold the Aoyama Building *(pictured)*, a 302,145-square-foot office property in central Tokyo, to Hong Kong-headquartered Gaw Capital earlier this year. The building, which was built in the 1970s, was reportedly acquired in 2015 for $500 million and sold for approximately $800 million.

"When you think about Japan, it's always about building new, and this was an example of a repositioning and reimagining in a profitable way of an older and perhaps outmoded office building," says Rothstein. "With the promotion of a sustainable and more green economy in Japan, I think we will start seeing more of these types of adaptive re-use projects. These types of deals will be found, not only in Tokyo and in city centers, but also in secondary cities and outlying areas where there may not be readily available bank financing for new projects and the market may not support the high costs and expense of a complete teardown and rebuild."

Watanabe, meanwhile, points to The Kanda 282, an 11-story Tokyo office building built in 1963, as an example of "high-frequency trading" that also involved an older asset. In the most recent trade, Alpha Investment Partners, management arm of Singapore's Keppel Capital, sold the property to Tokyo-based Dai-Ichi Life last December. But other private equity real estate owners of the asset included Hong Kong's CLSA Capital from 2015 to 2016 and Phoenix Property Investors, also from Hong Kong, from 2005 to 2008, according to data provider Real Capital Analytics.

"It's quite an outdated building so it's amazing the building traded that many times," says Watanabe. "Each [owner] probably saw a different angle and a different way of exiting."



The tourism factor

The dramatic rise in the number of visitors to Japan has been another significant demand driver for the country's property market

While a fairly robust economy and cheap financing have helped fuel Japan's strong property market, tourism has also had a healthy impact on real estate in recent years. In busy areas of Tokyo like Marunouchi and Ginza, "tourism bolsters the retail sector and hotels," says Rothstein. "Visit any major department store in Tokyo today and you hear public announcements, not only in Japanese, but also in English, Chinese and Korean. Walk down any side streets near key transit stations or retail and entertainment districts, you will find new boutique hotels of varying price points. International tourists are a more obvious presence than at any other time during my over 20 years in Japan," Rothstein notes. "Tourism is being promoted as an important driver of the economy. This is all good for real estate."

Indeed, the administration of prime minister Shinzo Abe has been aggressively pushing foreign tourism in Japan, having doubled its target for overseas visitors in 2016 to 40 million by 2020. In light of this, Hasegawa agrees hotels is a good sector for both domestic and global capital, both in major cities like Tokyo, Osaka and Kyoto, as well as the country's smaller cities. "When I heard 40 million, I thought, no way, that's impossible," he says. "But it got over 20 million a few years back and last year, 30 million. It's getting closer to 40 million. That's another way for Japan to survive in a global market."

Adds Watanabe: "I think the Olympics is a sign that the government is showing their number one priority is the economy. That has been the Abe thesis. We're benefiting from that, which is coming from the build-up of key infrastructure, Haneda's conversion to be the international airport, which I think has a tremendous effect on the tourism and placing Tokyo as a key gateway city in Asia-Pacific."

Opportunistic plays like Fortress Investment Group's $1 billion bet on low-rent apartments targeting Japan's foreign workers are few and far between, and accessible only to those investors that have the expertise or confidence to execute on difficult investments, he says. "Many players, particularly Japanese, are afraid of taking such risks," says Hasegawa.

Over time, expected returns for opportunistic strategies have come down in Japan, notes Donahue, whose firm invests across the risk spectrum in the country. "Sectors like logistics development, have more players now and they are driving down returns," he says. "Also, you have forward commitments – for something that inherently should be opportunistic, those returns are also coming down. It might even be becoming a build-to-core strategy, depending on the asset class and the location."

Investors seeking higher returns have largely avoided Japan in favor of growth markets with strong demographic drivers, such as China, he observes: "I think Japan is hurt by this misperception that it is a downward demographic, that you cannot make money here."

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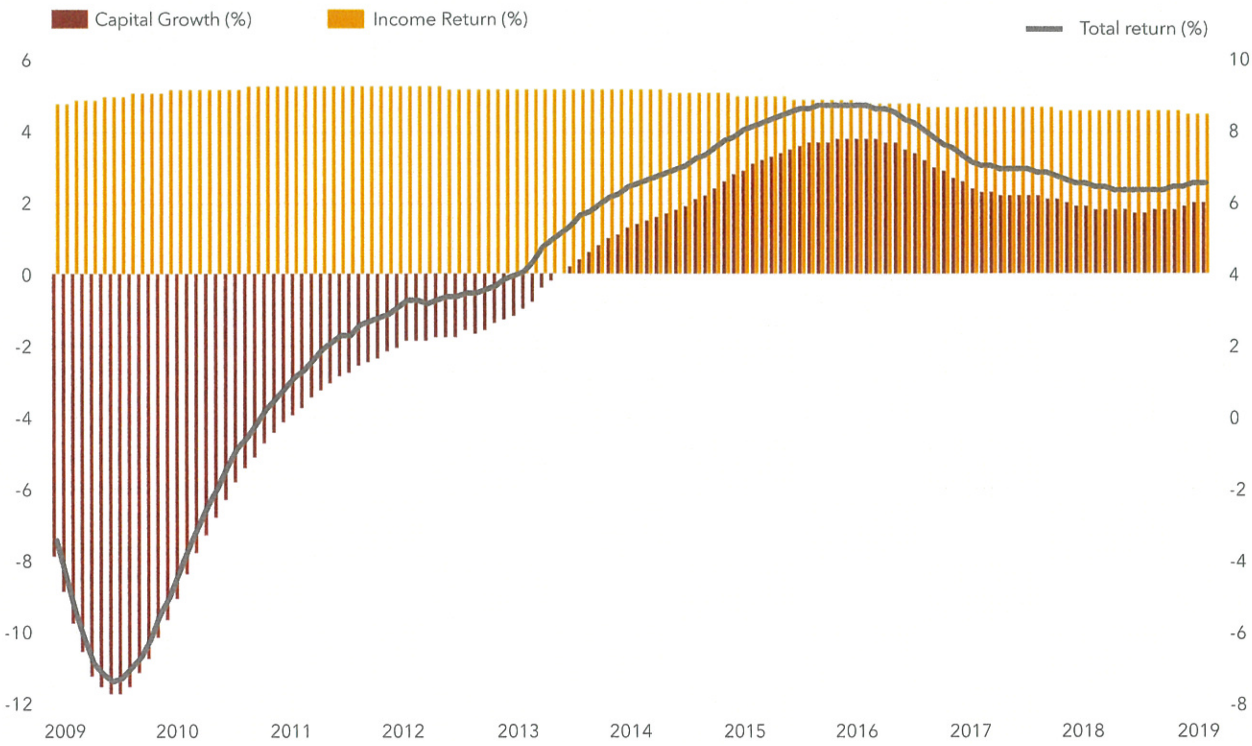
> **SHUSAKU WATANABE**
> **Nuveen Real Estate**

However, he believes Japan will be better able to weather a downturn than other Asian markets: "With the positive yield spread, you can generate a good cash-on-cash yield, whereas a lot of other Asian countries – Australia, Singapore, Korea, Hong Kong -- they are more capital gain-based and likely have negative borrowing costs. You have to think about how to drive the rental growth and-or cap rate compression. Japan is more attractive from that perspective; you can get long, 10-year debt here, so you're protected on the downside quite a bit."

While capital growth for Japan peaked at 3.8 percent in April 2016 and had declined to 2 percent by February 2019, income returns remained in the range of 4.5 percent to 4.8 percent over the same period, according to MSCI data.

Relative to Singapore, Shanghai and

Total returns according to the MSCI Japan Annual Property Index (Unfrozen)



Source: MSCI

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> **JOEL ROTHSTEIN**
> **Greenberg Traurig**

Hong Kong, the price per pound is almost the same in Japan, but the yield in Japan is almost double that of the other three markets and the yield gap is greater, adds Watanabe. "Singapore, Shanghai and Hong Kong are more expensive than Japan and rents are still not catching up, with a lower economic growth sighted," he says. "Even though there has been huge growth in China, the risk-adjusted return for core assets lags behind Japan. You're taking more risk, I think, because you still need to expect the China market to continue to grow and that's what you're pricing in when you're buying into China."

Hidden opportunity

But while an aging population has given Japan the reputation of having declining growth, that demographic trend has a silver lining for more forward-thinking property investors.

"I do think Japan is going to be the first country that's going to have autonomous cars on the roads here because you have the most acute demand for it in addition to having the technological innovation in Japan," says Donahue. "The massive number of senior citizens here, and necessity of cars to get around suburban areas, demands that there's a solution to that."

Meanwhile, e-commerce demand has been driven in part by seniors choosing to buy online over face the logistical or physical challenges of purchasing in-store. That has in turn fed into the modernization of logistics facilities. In the case of LaSalle, that has meant going from properties with higher ceilings, two ton-per-square-meter floor loads and column-less areas to multi-floor buildings with truck ramps, to the latest generation, where assets are being built for more automation, with more density, higher pallets and closer truck berths. "So the aging demographics is probably a hidden opportunity for Japan to be a leader in how real estate is developed and used," he says.

Adds Rothstein: "Aging demographics is a global trend at which Japan is at the forefront. If you are a Japanese developer and you are designing and building projects that address issues raised by aging demographics, you can export this expertise and go global." ■


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