The Financial Crisis and the Future of the J-REIT Market

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I. Refinancing risk spooks the Japan and US REIT markets

The US real estate crisis, triggered by the collapse of the housing market bubble, has spread to the commercial real estate and REIT markets.

REIT share price indices in the US have been in a declining trend after peaking in January 2007, although the largest declines had been confined to mortgage REITs, which are essentially nonbanks that invest in mortgage loans. Equity REITs with profitable properties in their portfolios initially experienced only moderate price declines, but those prices fell sharply. In Q4 of 2008, however, equity REIT prices fell sharply, dropping by a total of 48% over the two months of October and November.

The primary reason for this sharp fall appears to be the weakening of the real economy. Both employment and consumption data started worsening by the week around the time of consecutive major financial institution failures in September 2008, and this likely led to a rapid worsening of the earnings environment for shopping center and industrial REITs.

A second reason is deflation expectations, specifically the expectation that commercial property prices, which had been declining at a much slower pace than housing prices, are in for a major fall in the near future. Given that equity REIT income and dividends do not fall at the same rate as the prices of portfolio properties, however, it is difficult to explain this sharp decline as purely a consequence of deflation expectations.

A third conceivable reason is that the credit crunch caused a sudden increase in equity REIT refinancing risk, resulting in a vicious cycle whereby REITs become unable to obtain adequate funding. This is particularly true in the CMBS market, which has been in turmoil as a result of valuation losses and panic selling at investment banks. When US Treasury Secretary Henry Paulson announced on 12 November that the auctions under the Troubled Asset Relief Program (TARP) would be suspended, CMBS prices in the secondary market entered a free fall, and panicked banks and other financial institutions suspended nearly all commercial property lending.

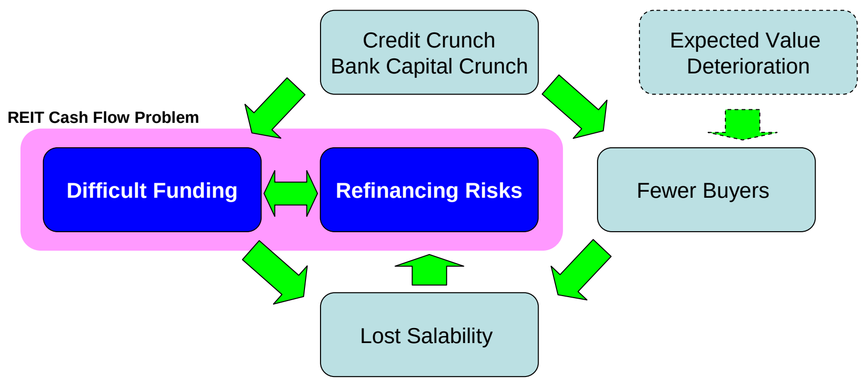
It should be relatively easy for equity REITs, which do not need much short-term working capital, to keep their business operating without defaulting on their debt, provided they can sell some of their property holdings or attract equity financing. That said, if potential buyers of those assets were unable to obtain debt financing, the assets would remain unsold, even if real estate prices had not begun declining. If concerns over an inability to refinance corporate bonds or loans gain ground, the resulting decline in real estate prices would also make equity financing more difficult. From a short-term perspective, the crisis that subsumed the US REIT market in the fall of 2008 can largely be attributed to the sudden emergence of refinancing risk, particularly at those equity REITs that had become overleveraged during the days of easy credit.

Two classic examples of REITs that were hurt by this are General Growth Properties, an owner of shopping malls, and ProLogis, an owner of distribution facilities. General Growth Properties' debt-to-asset ratio of over 70% was quite high, even compared with other highly leveraged shopping mall REITs. The REIT had been growing aggressively through acquisitions, including of the Rouse Company for $12.6 billion in 2004, but it found it difficult to refinance debt maturing in late 2008, including bonds issued by Rouse and real estate-backed loans, and its share price wound up declining from $41.18 (closing NYSE price at end-2007) to $1.38 by end-November 2008.

ProLogis grew by building a global network of distribution facilities, the driving force of which were private funds, with well-defined investment parameters, that it established with strategic investment partners in each region. ProLogis was not that highly leveraged, but its valuations dropped sharply because its development and asset management business was highly dependent on debt. The private funds it established in Japan and China were eventually able, albeit with difficulty, to obtain refinancing. The REIT's share price on the NYSE dropped from $63.38 at end-2007 to $3.83 at end-November 2008.

Thus the refinancing risk overshadowing the US REIT market was a result of a tightening of the credit market and the reduced salability of portfolio properties (Figure 1).

Figure 1: Refinancing risks in REITs market



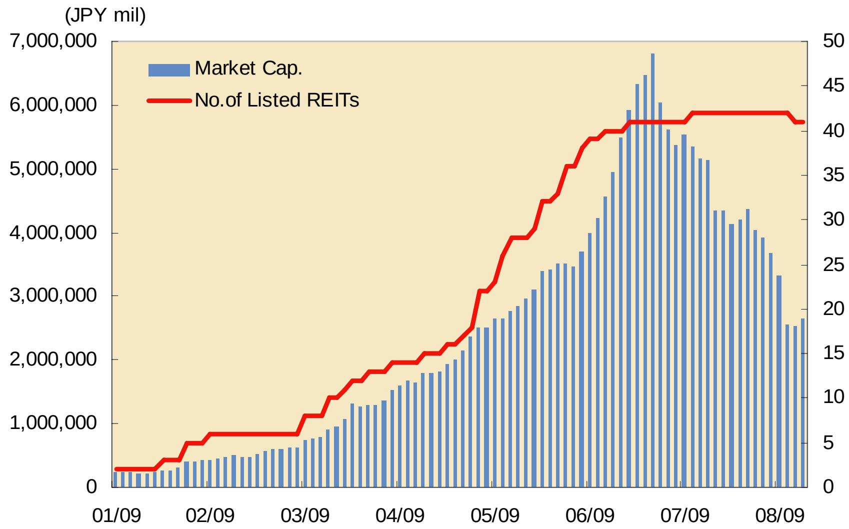
Source: Nomura Institute of Capital Markets Research

In fact, immediately prior to the US REIT market meltdown, exactly the same thing happened in the J-REIT market. New City Residence Investment Corporation, a residential property REIT, filed for protection from creditors under the Civil Rehabilitation Act on 9 October 2008, and was delisted on 10 November, becoming the first J-REIT to fail. The average occupancy rate of the rental properties in its portfolio was 93.4% at end-September 2008, which indicates a fairly strong operation. It was forced to file for bankruptcy, however, after failing to come up with the funds it needed both to pay back a ¥4.5 billion syndicated loan and to purchase a ¥27.7 billion property it had previously agreed to buy. Although a price correction in Japan's housing and condo market, which has appreciated strongly over the past several years, was already viewed as unavoidable, a series of bankruptcy filings by construction firms and real estate developers starting in the summer of 2008, along with the high-profile failure of New City Residence, shattered investor confidence in real estate. Credit risk and refinancing risk in the J-REIT market started attracting considerable attention, and the TSE REIT index, which tracks all REITs listed on the Tokyo Stock Exchange, fell sharply in October and has remained weak since then.

II. Correcting systemic J-REIT failures

The J-REIT market, created in September 2001 following the 2000 revision to the Investment Trust Act, entered a growth path from 2004 in step with the recovery in Japan's financial and real estate markets, resulting in a stream of new stock market listings and rising share prices. The total market cap of J-REITs had grown to approximately ¥6.8 trillion by May 2007, but the credit crisis has caused this to shrink back down to around ¥2.5 trillion, while also greatly dampening the market's expectations (Figure 2). There is thus considerable pessimism hanging over Japan's REIT market. That being said, we think that a detailed analysis of why refinancing risk emerged sooner in Japan than it did in the US, where the subprime crisis began, suggests that the current financial crisis may provide a favorable opportunity to correct systemic weaknesses in the J-REIT market.

Figure 2: J-REIT equity market capitalization



Source: Nomura Securities

1. Investment companies: their structure and governance

One of these systemic weaknesses is the external management structure of J-REITs. J-REITs came about when the rules were changed to allow investment trusts, previously limited to investing in securities, to also invest in real estate, and thus the fund is managed by an investment company with fiduciary responsibility.

REITs with an external management structure are said to have an inherent conflict of interest. Namely, there is concern that an asset management company compensated by the REIT based on the amount of assets under management will either acquire property without proper due diligence, thereby hurting earnings, or overinvest in new properties without the funding to support that investment, as was the case with New City Residence.

Under investment trust rules, a general meeting of investors functions as the governing body, and J-REIT investors theoretically have the authority to monitor the asset management company and, under certain conditions, to terminate its contract. The investor general meetings of J-REITs, just as those for mutual funds in the US, which are set up as companies, are largely ceremonial in nature, however, and there has yet to be a case where investors have dismissed or replaced the asset management company.

Many J-REIT asset management companies have made efforts, in part voluntarily, to make management more transparent, including by establishing investment guidelines and rules regarding debt ratios and criteria for acquiring properties. A debate over ways to strengthen the rights of investors would probably also make sense, however. These companies lack experience, both legal and practical, with protecting the rights of investors and REIT bondholders in the event of bankruptcy. The civil rehabilitation procedures being taken by New City Residence should establish a precedent, and serve as some sort of guideline, in this regard.

2. M&A and internally managed J-REITs

In the case of a J-REIT with an asset portfolio of some value but with management problems, one possible way to engineer a turn-around in the fund's enterprise value would be to transfer management authority to a competent asset management company, while another would be to arrange for the fund's assets to be purchased by a completely different investment company or real estate investment fund. Although we think such J-REIT M&A would often be practical from the perspectives of both real estate market stability and existing shareholders, neither mergers nor buyouts are addressed under the rules for investment trusts, which are defined as collective investment schemes. Meanwhile, there appear to be numerous statutes that would stand in the way of J-REIT M&A. One of the more prominent of these, designed to prevent corporate tax evasion using an investment company, is the pass-through requirement, whereby investment companies that have large investors who own more than a certain number of investment units are subject to corporate tax.

A growing number of observers think that the next REIT crisis should be taken as an opportunity to eliminate these obstacles and restructure the industry. An emergency package to stimulate Japan's housing and real estate market announced by the Ministry of Land, Infrastructure, Transport and Tourism (MLIT) on 15 December 2008 had some changes in this direction, including a proposal to make regulations more friendly to J-REIT mergers.

The US REIT market had REITS with externally managed structures in its early years, but these began to disappear in 1986, when reforms aimed at aligning the economic interests of investors and asset managers gave REITs the right to manage and operate real estate. There have been numerous REIT mergers since 1995, and managers of smaller, low-growth REITs and REITS trading below their NAV have been subject not only to downward price pressures but also to buyout offers.

Corporate governance and consolidation pressures have thus functioned in the US REIT market as a result of REITs having been established as regular joint stock companies. Being defined as a joint stock company provides a greater range of funding options and hence more flexibility. It would be impractical to immediately and completely change J-REITs over to the same rules as their US counterparts, given J-REITs' different origins (the Investment Trust Act), but it probably makes sense to consider some bold regulatory reforms that take J-REITs beyond the strictures of the Investment Trust Act and the externally managed format, instilling greater transparency of real estate transactions while opening up new investment opportunities.

III. Financial and real estate market mechanisms to invigorate the J-REIT market

In fact, given recent conditions in financial and capital markets, a reinvigoration of the J-REIT market through a major regulatory overhaul would make a big difference.

One reason for this is that real estate transactions entered into by J-REITs are naturally very transparent, given their disclosure requirements and the price discovery mechanism afforded by the trading of their listed shares. Assuming that the turmoil in Japan's commercial real estate market can be attributed to excessive pessimism and the banking sector's reluctance to lend, market adjustments are likely to start with J-REIT valuations. Unlike during the bubble economy of the 1980s, Japan's commercial real estate is now being valued based on its potential to generate an income stream. In addition, REIT markets have been established in a number of countries, and with even Japan-based funds now investing in REITs elsewhere in the world, the flow of REIT investment funds has become globalized. Because of this, making J-REIT regulations and infrastructure as transparent and reliable as possible, and making Japan's REIT market attractive to the broadest range of investors possible, are probably necessary conditions for J-REIT prices to form in a way that properly reflects the risk of changes in cash flow.

Even if prices do not increase substantially, if price formation stabilizes, the better-managed J-REITs should be able to obtain capital in order to reduce their debt, stabilize their financial base, and, under the right conditions, acquire real estate that has become undervalued.

A second reason is that because J-REITs have strengthened the linkage between the real estate and capital markets, J-REITs should have ripple effects that reach across the entire financial and real estate market space. In fact, J-REITs played a huge role in the process of Japan's real estate market recovery that began around 2003-04, after the more than a decade-long slump that was set off by the collapse of the economic bubble in 1990. One way J-REITs did this was by establishing funds that distribute proceeds from income-generating properties based on a conservative financial strategy, thereby providing the market with price and risk/return information that could serve as benchmarks for real estate investment. Another ripple effect came from private funds that purchased, and then improved and redeveloped, properties that had lost value and idle properties owned by companies not in the real estate business. Even for the present crisis, rather than risk distorting the market by using public funds to purchase real estate, improving the capacity of J-REITs to close deals would probably be a more sound way to invigorate financial and real estate markets.

Returning to our review of the REIT market's history in the US, we note that when the refinancing of debt capital became difficult during the credit crunch that occurred around 1990, growth of the REIT market was propelled by the presence of privately held real estate operating companies that went public to obtain equity financing, as well as investment funds that bought real estate backing nonperforming loans and then used the REIT market as an exit strategy. There is even a possibility that the credit crunch will be the key to ushering in a new era for the J-REIT market. Although eliminating the concerns and uncertainty now affecting financial and real estate markets globally will not be easy, we think it is important to focus on trends in the J-REIT market, while at least recognizing that Japan's real estate market is structured quite differently now than it was in the 1990s.