MIZUHO RESEARCH PAPER

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Japan's Real Property Market: another bubble in the making?

Project Team on Real Property Market Research

Mizuho Research Institute

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Summary

1. Even though overall land prices are continuing to fall in Japan, the price of land is starting to climb mainly in urban areas, fueling fears of another bubble in the making.
2. In the backdrop to the shift in land prices is the expansion of the real property securitization market. Nearly 50% of real property sold off by Japan's large corporate entities is being purchased by special purpose companies ("SPCs") and investment–purpose corporations. According to a survey by the Ministry of Land, Infrastructure and Transport, the aggregate value of real property securitization during the period from FY1997 to FY2004 is more than 20 trillion yen.
3. The expansion of the securitization market stems from factors including: (1) efforts by businesses to reduce assets, (2) development of the legal system on real property securitization such as the enactment of the so–called SPC Act ("Law on Securitization of Specified Assets by Special Purpose Companies, currently the "Law Concerning Asset Liquidation" enacted in 1998) and the Law Concerning Investment Trusts and Investment Corporations (enacted in November 2000), (3) the increase of investors, spurred by the conversion of real property into a wide range of small investment units, (4) the establishment of real property prices based upon profitability, and (5) Japan's economic recovery under an extremely accommodative monetary environment. In particular, the surge of real property investment markets such as real estate investment trusts (J–REITs) and private funds are leading to shifts in the real property market.
4. The total market value of J–REITs is growing steadily, reaching approximately two trillion yen. Given the rise of the total market value and the fierce acquisition race to secure property, the capitalization rate has dropped below 4% and fund managers are looking beyond office and residential property for lease and commercial property as investment targets. On the other hand,

many of the private funds are more varied in terms of asset value and investment scheme and offer higher profitability in comparison to J–REITs. However, it should be noted that the period of investment of most private funds is around 3–5 years, leading to concerns regarding massive dispositions accompanying its exit (return of investments) around 2007 (the so–called “Year 2007 Problem”).

5. The overall market for office and residential property – investment targets of J–REITs and private funds – is continuing to improve as shown by the fall of the office vacancy rate and the rising number of construction starts. However, a lingering bipolarization among cities and property is leading to a widespread disparity in land prices. Meanwhile, we also expect a higher correlation among both Japanese and overseas real estate–based financial products along with the development of global real property financial products.
6. Even though profitability fell sharply in the real property sector after the collapse of the asset bubble, the rate of return on assets is rising given the upturn of the inventory turnover ratio while the period of maturity of interest–bearing debt is growing shorter. Furthermore, amid innovations in real property business models along with the “unbundling” of real property businesses, there are moves to upgrade revenue bases through the expansion of fee–generating businesses such as property management.
7. Given the intense competition to acquire real property, the capitalization rate or cap rate (net operating income (NOI) divided by the acquisition price of property) at acquisition of REITs has fallen to the 4% level in some cases and even lower in the case of private funds. In view of expectations on the future rise of leases in some cases, these pricing schemes are triggering concerns on a “mini bubble”.
8. Do the foregoing trends indicate a bubble? As far as the overall real property market is concerned, the following factors provide us with reasons to believe that it is still premature to describe the current conditions as a bubble: (1) prices are determined mainly

by revenue and cash flow, (2) a higher degree of liquidity and depth of the real property market as a result of the development of small–lot financial products is facilitating the market mechanism, (3) J–REITs are acting as a benchmark of the real property market, and (4) investors are investing in various types of property varying from those selected solely for the purpose of investment by real property experts and property for other purposes, making a sharp distinction between the two. The real property market is growing more polarized and "spot–specific".

9. Judging from prospects that the Japanese economy will continue to recover and the fact that the real property market is a lagging index of economic trends, the real property market will most likely continue to follow recovery path during the next two to three years – albeit accompanying more spot–specific tendencies across the property spectrum. Even if the Year 2007 Problem and the rise of interest rates lead to selling pressures upon real property equivalent to 1 trillion yen per year, it is highly unlikely that it will lead to an adjustment of the overall real property market since the selling pressures would be absorbed by market mechanisms stemming from the depth and liquidity of the real property market
10. The Japanese economy has started to move forward on a much–awaited recovery out of a vicious cycle of asset deflation. Even though real property prices are more spot–specific in comparison with prices of stocks, these microeconomic trends in the real property market are part of the wider process of the Japanese economy's emergence out of deflation.

1. Introduction

The Japanese economy is currently pausing on the landing. Despite forecasts that the economy will gather fresh momentum and start to pick up, uncertainties linger with respect to the short–term outlook of the Japanese economy given its vulnerability to overseas economic trends.

However, on a medium–term perspective, the Japanese economy is finally emerging out of its prolonged slump after the collapse of the bubble economy in the 1990s. Excessive debt, labor and capacity (frequently referred to collectively as the "Three Excesses") have more or less abated from a macroeconomic point of view. Deflation – in particular asset deflation – coupled with the stagnant economy, was the cause of a vicious cycle. Nevertheless, the pressures stemming from asset deflation are abating. The stock market, having bottomed out in the spring season of 2003, is recovering. Even though overall land prices are still continuing to fall, signs that the market is reaching the bottom are spreading. The surge of land prices in certain urban areas is even leading to concerns regarding a nascent bubble.

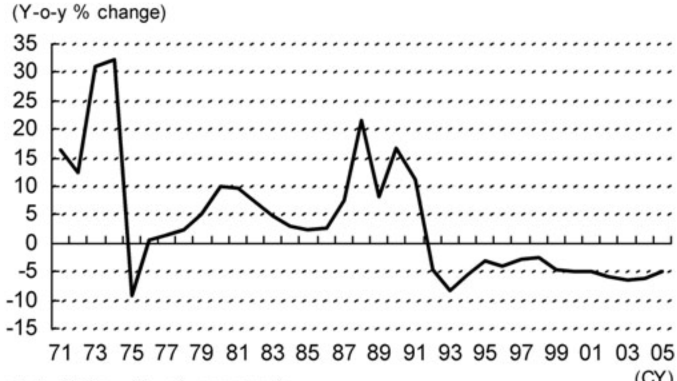
This report shall focus on the real property market, turning first to the recent trends in land prices and next to the background factors to see why the market is bottoming out. In particular, we shall look closely at the real property market including REITs and private funds that have a substantial impact upon recent market trends. The final section of the report will provide an outlook on the real property market on the basis of the foregoing analysis.

2. Trends in real property prices

(1) Published land prices in 2005

Published land prices (Note 1) in terms of average nationwide value of publicly assessed land (all purposes) fell 5.0% y–o–y in 2005 (**Chart 1**). Even though land prices fell continuously for 14 years since 1992, the breadth of the fall is narrowing for the second year in a row. The breadth of the decline is continuing to narrow in the three major cities of Japan (Tokyo, Osaka and Nagoya). Moreover, the fall of land prices in areas where declines were widening have also started to narrow. In terms of usage (nationwide basis), price declines narrowed for the third year in a row with respect to land for commercial properties and two years in a row with respect to land for residential properties. Even though the price falls of land for industrial properties continued to widen up to last year, the decline has narrowed in 2005.

Chart 1: Trends in published land prices

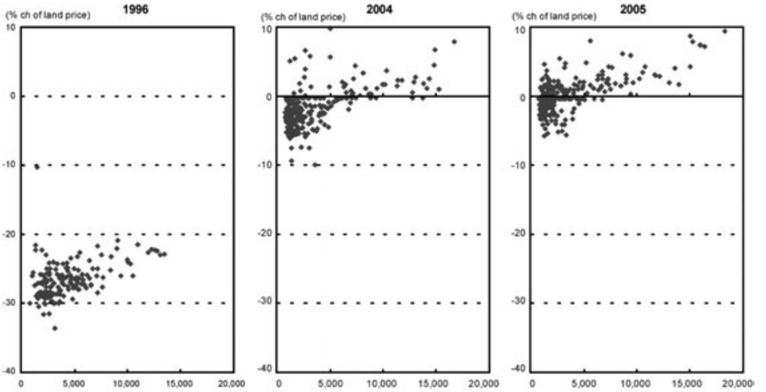


Note: Nationwide, all usage basis.
Source: Ministry of Land, Infrastructure and Transport, *Published Land Prices*.

(2) Land prices are turning "spot–specific"

Although land prices are continuing to decline on a nationwide basis, the price of land in central Tokyo has bottomed out and is starting to rise. In 1996, price of land for commercial property in the five central wards of Tokyo (Chiyoda, Chuo, Minato, Shinjuku and Shibuya, referred to below as the "5 Central Wards") fell a uniform 25% y–o–y (**Chart 2**). From around the year 2000, however, land in areas with high profitability and high price levels have either leveled out or have started to climb. In 2005, the average price of land in the 5 Central Wards of Tokyo turned upward for the first time in 14 years.

Chart 2: Trends in land prices in the 5 Central Wards of Tokyo (1996, 2004, 2005)



Note: Commercial zones in 5 Central Wards of Tokyo (Chiyoda-ku, Chuo-ku, Minato-ku, Shinjuku-ku, Shibuya-ku).
Source: Ministry of Land, Infrastructure and Transport, *Published Land Prices*.

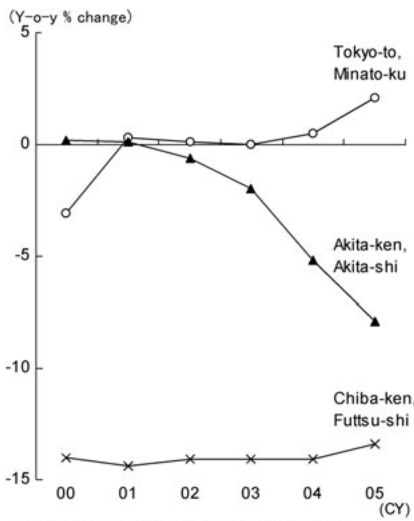
Even with respect to land for residential properties, the average among the wards including Chiyoda, Minato and Shibuya continued to rise for the second year in a row. Residential land prices also started to climb in the Chuo, Bunkyo and Taito wards. In the background was the strong demand for housing in areas attractive in terms of convenience and residential environment. In areas surrounding the 23 wards of Tokyo (referred to below as the "Tokyo 23 Wards"), land prices rose in Urayasu City and Musashino City.

The upswing in land prices is spreading from the Tokyo 23 Wards to Osaka City and Nagoya City and further beyond to major urban areas in the localities such as Sapporo City and Fukuoka City.

Even though land prices are rising across a broader geographic spectrum of the country, land prices are still falling in other areas. In some areas, the decline is even widening. In the Uchibo areas such as Kisarazu, Kimitsu and Futtsu in Chiba Prefecture, land prices are continuing to fall sharply due to a "straw effect" (Note 2) of the Tokyo–wan Odan Doro (trans–Tokyo Bay highway) (**Chart 3**). In Akita City and Matsue City, the fall of land prices is widening, reflecting the stagnation of the regional economy.

As the foregoing shows, trends in land prices differ according to geographic location. Even in the same geographic area, the level and direction of land prices differ according to its square measure, topography and adjacent streets. In the background is a stronger correlation between the profitability of each parcel of land and its price, making land prices more spot–specific – referring to a condition where the price of land differs, depending upon its exact location.

Chart 3: Land prices are "spot–specific"



Note: Residential land prices in each of the cites.
Source: Ministry of Land, Infrastructure and Transportation, *Published Land Prices*.

3. Trends in real property transactions

In this section, we shall look at the trends in land dispositions and purchases, focusing mainly upon the bottoming and upturn of land prices in central Tokyo.

(1) The number of land transactions

a. Number of land transactions involving dispositions and purchases

To shed light upon the overall scope of transactions, we shall look first at the number of transfer of title registrations. Even though the number has been falling since the collapse of the asset bubble, the curve is flattening out since the year 2002. Despite an ongoing decline in localities, the number of transactions is gradually rising in the three major cities of Japan (Tokyo, Osaka and Nagoya).

Looking closer at the three major cities, transactions in Nagoya and Osaka are still flat in contrast to a rise in Tokyo. In particular, in Tokyo–to (Tokyo Prefecture), the number has been rising since 1992 due to the increase of residential purchases in the household sector.

b. Number of notifications based upon the National Land Use Plan

In Tokyo Prefecture, we shall look at the trends in large–scale land transactions through the square measure of land and the number of notifications based upon the National Land Use Plan (Note 3). After hitting bottom in 2002, the number of notifications soared 10.9% y–o–y in 2003 and 20.6% y–o–y in 2004. In terms of the total square measure of notifications, the figure in 2004 is approximately 2.3 times the level in 2000, which is the most recent bottom. These statistics reveal the increase of not only small–lot land for residential purposes in the household sector but also the increase of large–scale redevelopment projects.

(2) Real property transactions by listed corporations

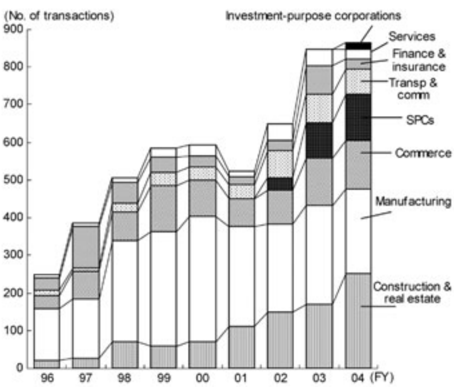
a. Disposition trends

Next, we shall turn to the trends in real property dispositions among listed corporations (Note 4).

The number of dispositions rose to 865, increasing 2.1% y–o–y in FY2004 and underscoring the ongoing upswing (**Chart 4**). Categorizing the sellers in terms of business sector, manufacturers comprised the majority of sellers from the second half of the 1990s to FY2002. Recently, the percentage of manufacturers is declining due in part to the progress of the restructuring process. In turn, more companies in the construction & real property sector are selling off property. Furthermore, SPCs are selling off more of their asset–holdings while investment purpose corporations have started to emerge as sellers from FY2004, reflecting the turnover of J–REIT assets.

As for real property transactions creating losses on the part of sellers, the percentage of loss–generating transactions took a slight dip in FY2004 after an uninterrupted climb up to FY2003. These trends reveal that loss–incurring disposals stemming from restructuring efforts have run their course and more companies (mainly major listed corporations) are adopting asset–impairment accounting methods.

Chart 4: Trends in real property dispositions



	No. of transactions		% of total	
	2000	2004	2000	2004
Construction & real estate	71	251	12	29
Manufacturing	333	225	56	26
Commerce	95	130	16	15
SPCs	0	121	0	14
Transportation & communication	36	69	6	8
Finance & insurance	30	26	5	3
Services	30	26	5	3
Investment-purpose corporations	0	17	0	2
Total no. of transactions	594	865	100	100

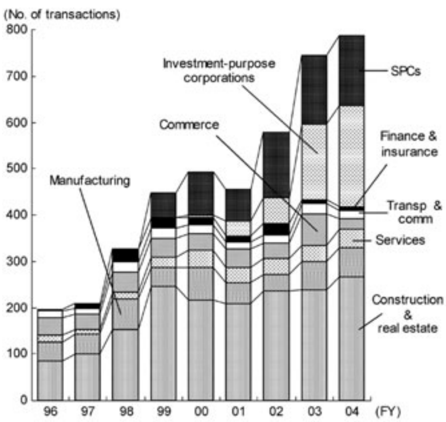
Source: Urban Research Insitute, Corp., *Fudosan Baibai Jittai Chosa (Survey on Purchase and Sale of Real Property)*.

b. Acquisition trends

Next, we shall look at the purchasers of real property in terms of business sector. As shown in **Chart 5**, the construction & real property sector consistently comprise the largest group of purchasers. Furthermore, given the sharp rise of investment purpose corporations and SPCs as purchasers of real property from around FY2000, the two combined comprise approximately 50% of real property purchases in FY2004.

The rise in total number of purchases since FY2000 is due largely to purchases by investment–purpose corporations and SPCs. The expansion of the real property market is leading to the vitalization of the overall market.

Chart 5: Trends in real property acquisitions



	No. of transactions		% of total	
	2000	2004	2000	2004
Construction & real estate	217	268	44	34
Manufacturing	69	63	14	8
Services	39	39	8	5
Commerce	35	24	7	3
Transportation & communications	20	16	4	2
Finance & insurance	15	8	3	1
Investment-purpose corporations	5	220	1	28
SPCs	94	150	19	19
Total no. of transactions	493	787	100	100
Investment-purpose corporations + SPCs	99	370	20	47

Note: Dispositions to affiliates are excluded.
Source: Urban Research Insitute, Corp., *Fudosan Baibai Jittai Chosa (Survey on Purchase and Sale of Real Property)*.

c. Dispositions (with or without buildings)

A breakdown of real property dispositions in terms of property with buildings and property without buildings, the percentage of the latter is rising. This phenomenon most likely indicates the decline in dispositions of idle (unutilized) real property, parking lots and under–developed property.

(3) Property–holdings (in terms of time period of acquisition)

The annual average of property such as residential land held by companies – in terms of the date of their acquisition –during the period from the so–called Bubble Period to the present remains more or less unchanged at around 40,000. Despite the acquisition of approximately 60,000 units of real property during the Bubble Period, the number of units purchased during the Bubble Period and held up to recent times has declined to 40,000.

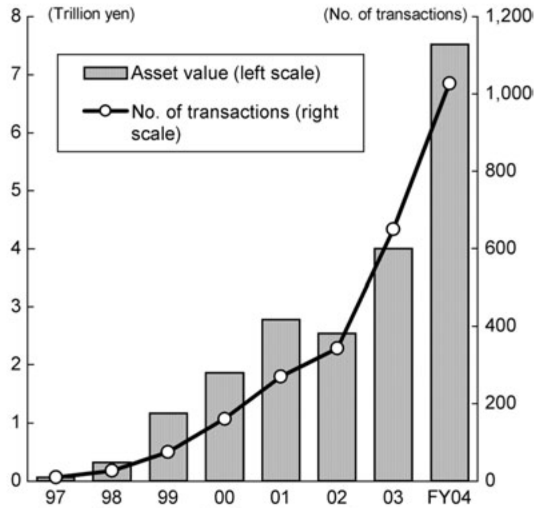
Even though the sheer number of transactions surpassed actual demand due to expectations of the rise of demand, the disposal of such property has progressed considerably.

4. Structural shifts in the real property market

The expansion of real property securitization market is a major factor behind the recent rise of activity in the real property market. Real property securitizations rose a dramatic 88% y–o–y, reaching 7.5 trillion yen in FY2004 (**Chart 6**). The aggregate sum of real property securitization since FY1997 topped 20 trillion yen, indicating the steady expansion of the securitization market.

In the background to the expansion of the securitization market are factors such as: (1) efforts by businesses to reduce assets, (2) development of the legal system on real property securitization such as the enactment of the so–called SPC Act ("Law on Securitization of Specified Assets by Special Purpose Companies, currently the "Law Concerning Asset Liquidation" enacted in 1998) and the Law Concerning Investment Trusts and Investment Corporations (enacted in November 2000), (3) the increase of investors, spurred by the conversion of real property into a wide range of small–lot investment units, (4) the establishment of real property prices based upon profitability, and (5) Japan's economic recovery under an extremely accommodative monetary environment.

Chart 6: Real property securitization



Source: Ministry of Land, Infrastructure and Transport, *White Paper on Land.*

In the following sections, we shall examine each of the major factors in the background to the growth of the real property securitization market.

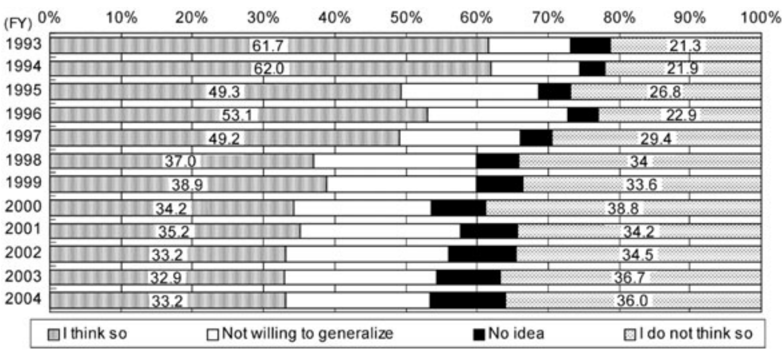
(1) Efforts by businesses to reduce assets

In the aftermath of the bubble economy, business corporations took steps to reduce their asset–holdings that had grown into a large burden. Furthermore, the change of accounting rules amid the globalization of capital markets served as tailwinds to these efforts to upgrade the efficiency of assets.

In addition to balance sheet adjustment pressures, it became difficult for businesses to procure funds on the basis of their creditworthiness amid slumping stock market conditions after the collapse of the bubble. These factors most likely compelled businesses to resort to securitization as a financing method based upon the profitability of the asset itself.

Furthermore, a change in attitude toward land–holdings is also leading to the rise in supply of land by business corporations. The prolonged decline of land prices after the collapse of the bubble, led to the demise of the so–called "land myth" in Japan, which refers to the belief that "land is a lucrative asset whose price keeps rising just by its mere possession." According to the *Research into Public Perceptions Concerning Land Problems* by the Ministry of Land, Infrastructure and Transport (MLIT), the percentage of individuals believing that "land is a lucrative asset compared to postal savings, bank deposits and stocks" declined from approximate 60% in the first half of the 1990s to approximately 30% in recent years (**Chart 7**).

Chart 7: Individual Responses to the Question: "Is land a lucrative asset compared to postal savings, bank deposits and stocks?"



Source: Ministry of Land, Infrastructure and Transport, *Research into Public Perceptions Concerning Land Problems*.

Turning to perceptions on future land ownership in the corporate sector, the MLIT's research revealed that the percentage of responses that "land ownership is concerned lucrative for the future" fell from 60% in the first half of the 1990s to slightly less than 40% in recent years. On the other hand, responses that “leasing land and buildings is considered lucrative for the future” increased from slightly less than 30% to approximately 50%. As for intentions to purchase and sell land during the coming year, even though the incentive for land purchases is rising as we write this report, the intention to sell is still strong and surpasses intentions to purchase land.

(2) Diversification of financial products for real property investment

Given the development of small-lot real property investment products, the nature of real property is changing from a good traded mainly in the real property market among those in the real property business to one that is traded in the capital markets. In addition to expectations on high capitalization rates and capital gains, the liquidity and diversification of securitized products are attracting a huge wave of investors.

In very broad terms, real property investment may be categorized into equity investment and debt investment. As for equity investment, the provision of fund-of-funds products (Note 5) incorporating REITs, made possible since July 2003, are leading to the rise of investment by individual investors. Even though foreign investors were the major players in equity investment through J-REITs and private funds, the weight of investment by domestic investors is rising along with the increase of investment by pension funds.

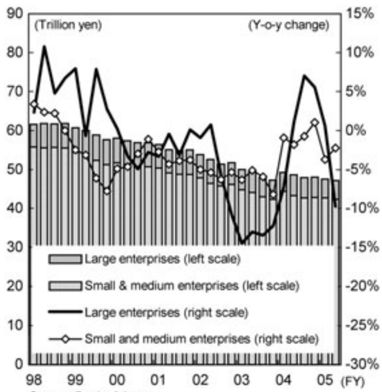
Debt investment, on the other hand, differs from conventional debt in securitization, in that they take a non-recourse format, pledging only the assets that are subject to securitization and not the debtor as a whole. As a result of the rise of debt investment, bank lending toward real property businesses has stopped falling (**Chart 8**).

Furthermore, given the greater liquidity of these loans, the RMBS (Residential Mortgage-Backed Securities) and CMBS

(Commercial Mortgage–Backed Securities) market is growing steadily (**Chart 9**). A simple comparison with the amount of funding through the issuance of straight bonds and stocks – each totaling approximately 6 trillion yen in FY2004 – indicates the steady rise in prominence of the MBS (mortgage–backed securities) market in the direct financial market.

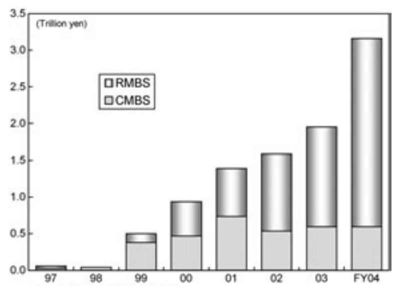
The functional expansion of the financial and capital markets is one of the underlying factors fueling the real property market.

Chart 8: Lending toward real property businesses



Source: Bank of Japan.

Chart 9: The Mortgage–Backed Securities (MBS) market



Source: Mizuho Securities Co., Ltd.

(3) Capitalized value of land

One of the underlying factors behind the expansion of the securitization market is the clarification of standards to determine land prices such as the capitalization model, leading to an overall trend to determine land prices on a spot–by–spot basis, reflecting the profitability of each parcel of land depending upon its exact location.

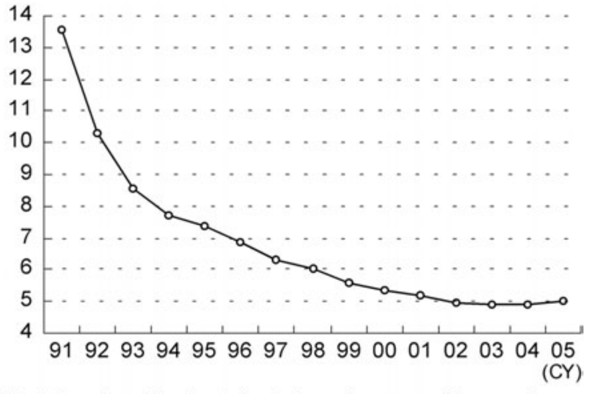
〔**The capitalization model**〕

$$P = \frac{C}{r + \rho + \tau - g} \qquad \text{PER of land} = \frac{P}{C} = \frac{1}{r + \rho + \tau - g} = \frac{1}{\textit{cap rate}}$$

P = land price、C = projected earnings in current term (office building rent)、r = interest rate of risk-free assets、ρ = risk premium、τ = effective tax rate、g= expected percentage rise of rent

An overview of trends in land prices since the collapse of the bubble using the capitalization model reveals a sharp decline of the price–earnings ratio (P/E ratio = P/C) of land after the collapse of the bubble (**Chart 10**). Looking closer at the decline of the P/E ratio of land in terms of the factors above, even though the decline of the capitalization rate on risk–free assets served to push up the P/E ratio of land, factors such as the following led to the fall of the P/E ratio of land (the capitalization rate rises): (1) the fall of the rent for office space, (2) the rise of the risk premium, and (3) the fall of the expected rise of rents.

Chart 10: The Price–Earnings Ratio of Land in Tokyo 23 Wards



Note: The price of land pertains to those in commercial zones in Tokyo 23 Wards. Rent refers to average rent in Tokyo 23 Wards. Since the gauges are not uniform, the absolute level of the graph is irrelevant.

Sources: Ministry of Land, Infrastructure and Transport, *Published Land Prices*, IKOMA CB Richard Ellis, *Office Market Report*.

Meanwhile, the recent rise of the P/E ratio of land is due most likely to the decline of the risk premium stemming from the ebb of concerns regarding deflation and the halt of the expected decline of rents amid the low level of interest rates. Furthermore, it should be noted that the expected rise of interest rates will lead to the fall of land prices unless they are accompanied by the rise of rent.

In estimations using the capitalization model, the expected rate of growth of the real property industry is frequently used as a substitute for the expected rise of rent (g), given the difficulty to gauge such a variable in reality (Note 6). Although the expected rate of growth of the real property industry was languishing in negative territory in 2002, the rate has risen to 3% in 2005. The significant upturn, even in comparison to the recovery on an all–industry basis, indicates the strength of recovery of the real property industry.

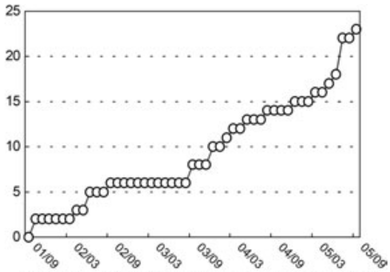
5. The real property investment market

In this section, we shall look closely at J–REITs and private funds and shed light upon how they are contributing to the surge of the real property investment market and lifting up the real property market in terms of both sector and geographic region.

(1) J–REITs

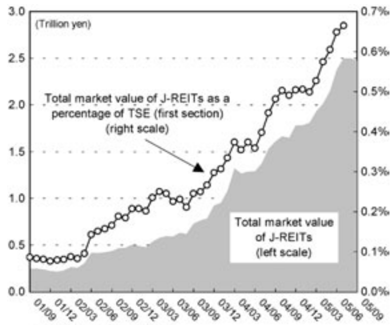
The J–REIT market has continued to grow steadily ever since the listing of two issues in September 2001. As of June 2005, the market has grown to 17 issues (**Chart 11**), totaling 2 trillion yen in market value (0.5% of the TSE's total market value)(**Chart 12**). Given the REITs' aggressive purchase of assets subsequent to their listing, overall REIT assets have doubled from the time of listing. Furthermore, judging from medium–term plans by each of the investment corporations, the voracious purchase of assets should continue. Considering the fact that 14 REITs have been granted approval, the listing of these issues would lead to a sharp rise in number of issues and assets in the J–REIT market. The current J–REIT trends lead to our view that the real estate investment market will continue to grow.

Chart 11: Number of listed J–REITs



Source: Mizuho Research Institute Ltd. (MHRI), on the basis of relevant information disclosures.

Chart 12: Market Value of J–REITs



Source: Nikkei Financial Quest.

An overview of J–REITs from the perspective of their balance sheets reveals that their total asset value stands at 2.1 trillion yen and that approximately 4% of this sum (approximately 0.8 trillion yen) is funded by interest–bearing debt (**Chart 13**). A loan–to–value rate of 40% is a sound level of debt, which means that the debtor can repay interest–bearing debt by 8.5–years worth of operational cash flow. Judging from the fact that the total market value of J–REITs has reached two trillion yen despite its net worth standing at only 1.1 trillion yen, we are inclined to believe that the pricing of J–REITs takes into account the future rise of real property prices.

Chart 13: Balance sheet of J–REITs

As of April 2005 (trillion yen)			
Liquid assets	2,204	Debt (total)	12,197
Cash equivalent	2,124	Interest-bearing debt	9,849
Fixed assets	22,354	Debt loan	8,129
Tangible fixed assets	21,997	Corporate bonds	1,720
Assets (total)	24,566	Capital	12,369
		Gross asset (total)	24,566

Note: Total of 15 J–REITs (excluding New City Residence Investment Corporation.
Source: Nikkei Financial Quest.

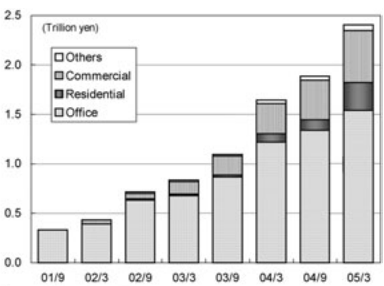
Given the rise of market value, J–REIT capitalization rates have fallen slightly below 4% as we write this report. Even so, the capitalization rate is attractive, compared to the 10–yr JBG yields mired around 1.2% (**Chart 14**). More than half of J–REIT investors are financial institutions such as banks and institutional investors. The percentage of foreign investors is currently 9.5%. The J–REIT market is growing along with the rising demand for middle–risk middle–return investment options among domestic investors.

Chart 14: J–REIT dividend yield and 10–yr JGB yields

Source: Tokyo Stock Exchange, Nikkei Financial Quest.

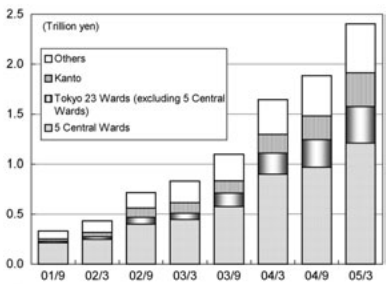
The range of property purchased by J–REIT operators is growing more diverse due partially to the fierce competition for property purchases. Even though a closer look at the types of property purchased reveals that J–REIT operators are continuing to invest mainly in office sites, the breakdown also indicates a sharp surge of purchases of residential and commercial facilities (**Chart 15**). Even though real property acquisitions are still concentrated in Tokyo, property acquisitions in other areas are also rising rapidly (**Chart 16**). As we shall comment in more detail later, it is growing more difficult to purchase property with high–capitalization rates in Tokyo, reflecting the rise of real property prices in central Tokyo. Given this mechanism, the recovery of the real property market in Tokyo is gradually spreading to other areas, and lifting the bottom line of the real property market.

Chart 15: Types of real property acquired by J–REITs (based upon acquisition price)



Source: Information disclosures by investment corporations.

Chart 16: Geographic breakdown of real property acquired by J–REITs (based upon acquisition price)



Source: Information disclosures by investment corporations.

(2) Private funds

Real property private funds are real property funds offered to a small and specified group of investors in a nonpublic private placement format, with a limited time period of investment. These characteristics set them apart from J–REITs (**Chart 17**). In comparison with J–REITs, private funds are more varied in terms of asset size and investment format.

Chart 17: A comparison of private funds with REITs

	Private fund	J-REIT
Offering	Private offering	Public offering
Number of investors	Small number of specified investors	Large number of unspecified investors
Funding method	Mainly investment by institutional investors	Stock market
Loan To Value	50～90%	40～60%
Asset value	Several billion～several hundreds of billion yen	20 billion～400 billion yen
Investment period	Approximately 2～7 years	Optional
Investment return	6～20% (IRR)	3.0～4.0% (dividend yield)
Liquidity	Low	High
Exit	Distribution of proceeds from asset disposition	Disposal on stock market

In this report, we classified private funds focusing upon the source of investment returns as follows: (1) funds similar to REITs, taking a stable investment stance, emphasizing income gains, (2) funds pursuing both income gains and capital gains, (3) funds taking an aggressive investment stance, emphasizing capital gains, and (4) development–type funds. Many of the funds classified under (1) are “would–be” REITs and funds pursuing higher returns than REITs through middle–risk investments, targeting domestic investors. Funds falling within the purview of (2) are typical private funds, in many cases pursuing double–digit returns by gearing up the leverage rate and pursuing capital gains. Funds under (3) may be categorized further into the “value–up type” and the “opportunity type”. “Value–up” refers to the act of increasing the value of real property, using methods such as: (1) improvements to make structures earthquake resistant and renovations leading to the improvement of capacity utilization and higher rents, and (2) the reduction of management costs to increase profits. Other options include conversions (of usage) to suit the location of the property. In many cases, fund operators resell the property after raising the property value by implementing these measures. In "opportunity type" funds, fund operators purchase property (for example, property related to NPLs or defective property) at a bargain price and resell them after "value–ups" or elimination of defects. Since the aim is to resell the value–added property, the period of investment is relatively short. Funds falling under (4) may be sub–categorized into short–term developments in which property such as collective residences (condominiums and apartments) are purchased and resold at a price including the development profit and, long–term developments where property such as large suburban commercial facilities and large distribution centers are developed and held.

As described above, there is a wider variety of private funds in comparison with J–REITs. However, an overall view reveals that fund types (2), (3) and (4) have a higher percentage of foreign investors who seek relatively higher returns through leveraging in comparison with type (1) funds that are similar to J–REITs. Since the investment time span of these private funds is around three to five years, the majority would reach maturity around 2007. Thus, there are concerns that the exit of these funds would trigger a selling spree around 20007. This is what is referred to as the "Year 2007 Problem" in the real property market.

The size of the private fund market has already surpassed the J–REIT market and the value of the property purchased is said to total several trillion yen on a cumulative basis. Private funds are taking an even more aggressive purchase stance than J–REITs. In addition to a general tendency toward large investments such as the purchase of property worth hundreds of billions of yen and the creation of funds worth 400 billion yen, we have also come across cases of private funds investing in property worth only several hundred million yen – hence ignored by J–REITS – but nevertheless yield high returns. Compared to J–REITs, the scope of investment by private funds is more diverse in terms of both the type and geographic area of real property. Even though J–REITs are functioning as the benchmark of the real property market, private funds may be playing a more important role in terms of expanding and raising the level of the real property market.

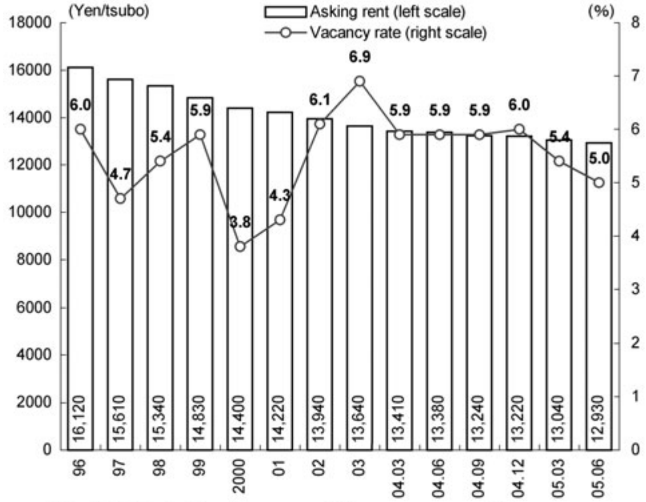
6. A closer look at the real property market

In the background to the recovery of the real property market, real property transactions and the expansion of the real property investment market is the improvement of the supply–demand balance. We shall take a closer look according to each type of property.

(1) Offices

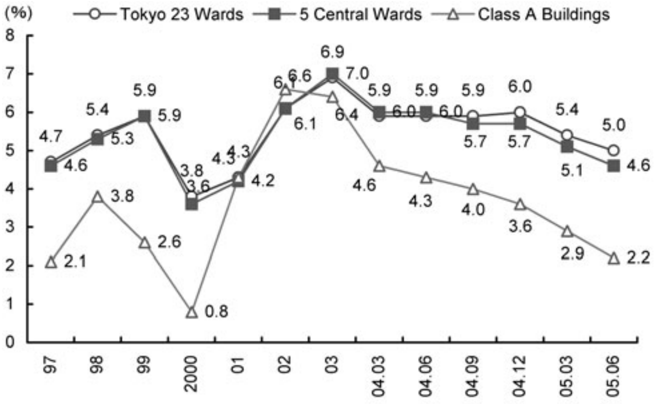
Overcoming the office supply glut in FY2003, Tokyo office market is charting stable progress in terms of demand and supply. According to IKOMA CB Richard Ellis K.K., the office vacancy rate in the Tokyo 23 Wards has been declining steadily since the peak in 2003 (6.9%), dropping to 5.0% as of June 2005. However, the asking rent (the advertised rent quoted by the landlord, and not the amount actually contracted with tenants) is following a mild downtrend (**Chart 18**). A vacancy rate of 5% is not necessarily high. Keeping in mind that a certain vacancy level is necessary for the smooth turnover of tenants, the current vacancy rate indicates that the demand–supply balance of offices is at an optimum level. The vacancy rate of Class A Buildings is down to 2.2%, revealing that buildings fulfilling these criteria are running at full capacity (**Chart 19**).

Chart 18: Vacancy rates and average asking rents in the Tokyo 23 Wards



Note: Tsubo is a traditional Japanese unit of area measurement where 1 tsubo = 3.3 square meters.
Source: IKOMA CB Richard Ellis, *Office Market Report*.

Chart 19: Asking rents of Tokyo office buildings and Class A Buildings



Note: 5 Central Wards (Chiyoda, Chuo, Minato, Shinjuku, Shibuya).
Class A Buildings refer to relatively new buildings in the Central 5 Wards satisfying certain conditions such as having total floor area of 10,000 or more.
Source: IKOMA CB Richard Ellis, Office Market Report.

According to the *Tokyo (5 Central Wards) Office Building Market Research Report* by Miki Shoji Co., Ltd., the office vacancy rate in the 5 Central Wards stood at 4.0% for newly constructed buildings and 5.1% for existing buildings as of May 2005. In both new and existing buildings, the vacancy rate is falling steadily. Furthermore, note also that office building rents have bottomed out in terms of existing buildings and are gradually picking up in terms of newly constructed buildings. Judging from the recent rise of newly contracted rents of prime buildings and rent hikes at the time of contract renewals every two years, the underlying trend appears to be shifting. Nevertheless, the gap is widening between prime buildings and those buildings that do not fall into this category. In contrast to improvements with respect to prime buildings, not–so–prime buildings are facing a rise of the vacancy rate and a further fall of rents. Even though the overall figures are improving, there is an increasing polarization of the office market.

The office market's survival of the supply glut of large office buildings in 2003 (the Year 2003 Problem) and the subsequent improvement of the office demand–supply balance rests upon underlying factors such as the following. Firstly, the demand for large prime buildings is rising. Secondly, the overall supply of offices has been subdued and the supply of large buildings since 2004 has been mired at a low level. Thirdly, as indicated by major property developers, would–be tenants had put off moving into new offices in view of the large supply of prime buildings in 2003, leading to the release of the pent–up demand in 2003 and 2004.

From a macroeconomic perspective, an important factor is Tokyo's economic growth from FY2003 onward, driven mainly by the non–manufacturing sector. The composition of added value by industry in Tokyo reveals a relatively low percentage of 10% among manufacturers in contrast to high levels among wholesalers (20%), services (30%) and finance and real property industries (slightly below 30%). Tokyo's nominal GDP has been growing since FY2003 due to the recovery of these sectors. Furthermore, the number of employed workers is rising in Tokyo despite a nationwide decline.

The rising number of employed workers in the information & communications, medical & welfare, services and finance & insurance sectors most likely had an impact upon the recovery of office demand. While the number of employed workers has fallen sharply among manufacturers, the trend to concentrate their headquarters in large prime buildings is propping up the demand for offices.

As the foregoing shows, the Tokyo office market is gathering fresh momentum from the combined effect of the strong demand for offices, the suppression of office supply and the growth of real property investment. Despite concerns that office demand will decline due to the retirement of the baby–boomer generation in 2007 (the other "Year 2007 Problem"), such concerns seem exaggerated as long as the current non–manufacturing sector–led growth of the economy continues.

There are signs that the office market is bottoming out in Osaka and Nagoya. In Osaka, the office vacancy rate has been gradually declining since the peak in 2003, with the vacancy rate of Class A Buildings down to 4.7% as of March 2005. The overall asking rate is also starting to bottom out. Looking closer, the recovery is spreading from Umeda to other zones. Even though the vacancy rate in Nagoya is flat, the vacancy rate for Class A Buildings has fallen below Tokyo to 2.4%. Despite the strong demand for offices in Nagoya, the massive supply of large buildings scheduled in 2007 may lead to a further market polarization between new and existing buildings. Other major cities and regional hub cities such as Sapporo, Sendai, Yokohama, Kyoto and Fukuoka are also showing increased tenant movements and a gradual decline of vacancy rates. Nevertheless, note that other regional hub cities are lagging in terms of the demand–supply balance, revealing a gap among cities.

(2) Commercial & distribution facilities and factories

REITs and private funds are expanding their target from office buildings to commercial facilities and distribution facilities such as storage and distribution centers.

As far as the overall retail sector is concerned, the number of business establishments and sales has been falling. However, the number of business establishments having selling floor space larger than 1000 square meters is continuing to increase (**Chart 20**), indicating that large supermarkets remain enthusiastic regarding the opening of new stores. In contrast to the trend among retailers to sell off large stores to SPCs around the year 2000 in a bid to reduce their assets, a rising number of these stores held by SPCs are recently being purchased by REITs.

Chart 20: Number of business establishments (by selling floor space)

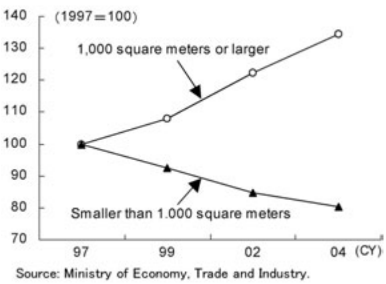
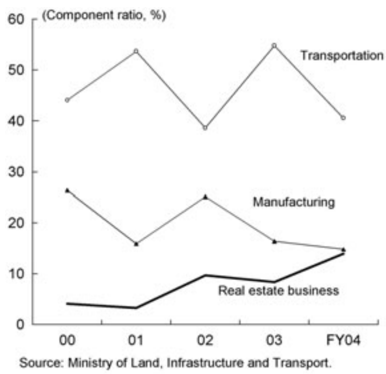


Chart 21: Construction starts of warehouses (by ordering party)



Turning to distribution facilities, construction starts of warehouses have been rising since FY2003. Meanwhile, the percentage of transportation companies and manufacturers (which includes warehousing companies) among the ordering parties of warehouse construction is declining in contrast to the rising percentage of real estate companies (**Chart 21**), revealing the increase of investment in distribution facilities by private funds. Given the growing demand for warehouses, seeking more efficient distribution facilities, overseas real estate funds are taking an increasingly aggressive investment stance and there is a rising trend toward the establishment of domestic private funds. Incidentally, warehouse rents have started to rise in Tokyo and Aichi Prefectures.

The number and area of factory sites are also continuing to rise for the second year in a row since FY2003. Even so, there is a disproportionate concentration of the number of sites in the Southern Tohoku, Kanto, Tokai, Kinki and Kyushu regions.

As the foregoing shows, despite shifting trends in markets other than the office market, the changes still fall short of drastic and also exhibit a wide regional gap. These changes, albeit slow at the moment, should spread steadily.

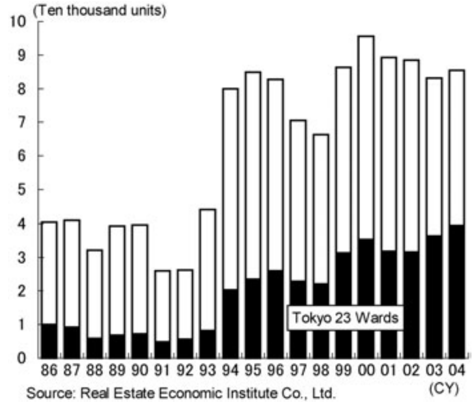
(3) The residential real property market

The bottoming of land prices mainly in Tokyo 23 Wards may be observed in commercial zones as well as residential zones. In the background is the active purchase of residences in the household sector and the growing weight of investment in rental housing among private funds.

The number of housing starts on a nationwide basis is following a gradual upward curve. In terms of owner–occupant relation, owner–occupied houses are continuing to slump while houses for rent and condominiums and built–for–sale houses are increasing. Viewed in terms of geographic region, housing starts are reaching high levels in Tokyo 23 Wards.

The high level of housing starts in Tokyo 23 Wards stems from the rising tendency to opt for residences close to the workplace on the demand–side and the rising supply of condominiums (**Chart 22**) and the increase of low–priced detached housing by so–called "power builders" specializing in the supply of such housing.

Chart 22: Supply of condominiums in Greater Tokyo (Tokyo, Kanagawa, Chiba, Saitama)



Furthermore, the increase of rental housing reflects the improvement of the environment for the rental housing business due to factors such as low interest rates and amendment of the Land and House Lease Law. Furthermore, private funds are incorporating rental housing in development–type investment funds, serving as one of the plausible factors for the rise of construction starts of rental housing. Housing starts of houses for rent in Minato Ward are standing at an extremely high level even in comparison to the bubble years.

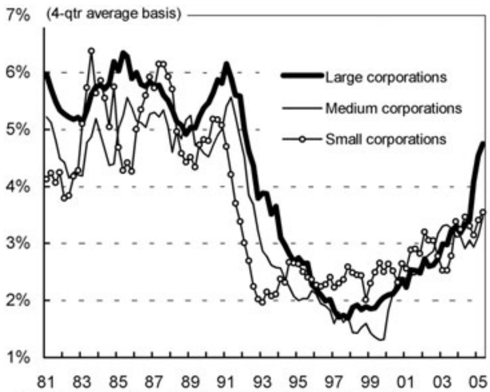
The peak–out of housing starts in the Tokyo area is spreading to peripheral areas after a time lag, leading to a bottoming out of land prices in certain regional hub cities.

7. Real property market trends

Given the foregoing changes in the real property market, the real property sector is also achieving significant progress.

Suffering major setbacks in profitability after the collapse of the bubble, the real property business sector's return on assets (ROA) continued to drop until the mid–1990s (**Chart 23**). However, ROA in the real property sector has been picking up since the end of the 1990s due to positive factors such as: (1) the fall of interest rates coinciding with the improvement of asset quality, (2) the condominium boom in the Greater Tokyo area from the mid–1990s, (3) the IT–driven recovery of the economy around FY2000 and (4) the recent improvement of the office market in major cities. Small and medium–sized real property firms with high mobility were the first to recover, followed by large firms in recent years.

Chart 23: ROA in the real estate industry



Notes: "Large corporations" refer to corporations with capital of 1 bil yen or over, "medium corporations" refer to corporations with capital of 100 mil to 1 bil yen, and "small corporations" refer to corporations with capital of 10 to 100 mil yen.

Source: Ministry of Finance, *Financial Statements Statistics of Corporations by Industry (Quarterly)*.

It is clear from the turnover rate of inventory assets that the real property sector's asset efficiency has improved. Even though total assets in the real property sector currently stands around 120 trillion yen, the value of inventory assets is a mere 11 trillion yen. An overview of the trends in turnover rate of inventory assets reveals a sharp rise of the turnover rate since the mid–1990s, reaching approximately triple the level during the property bubble with respect to large and medium–sized firms. This is the positive result of efforts such as reducing the time period from the purchase of condominium sites to the sale of the completed condominiums and the disposal of loss–carrying real property for sale in response to legislation on the compulsory devaluation of real property for sale enacted in FY2000.

Given the upturn of profitability and asset efficiency, operational cash flow has improved greatly in the real property sector. This, in turn, has enabled the repayment of debt, leading to a significant reduction of the debt burden in the real property sector. The interest–bearing debt retirement period, referring to the number of years' worth of operational cash flow necessary to pay down interest–bearing debt, has been declining steadily, reaching comparable if not lower levels than the first half of the 1980s prior to the bubble. The real property sector as a whole is no longer burdened by excessive debt.

The development of new business models is also progressing, stemming from the unbundling of real property business as a result of a division of ownership and management due to the securitization of real property. There is also a rising trend to reinforce revenue bases through the expansion of management, investment and consulting fee businesses such as property management that do not require the use of their own balance sheets.

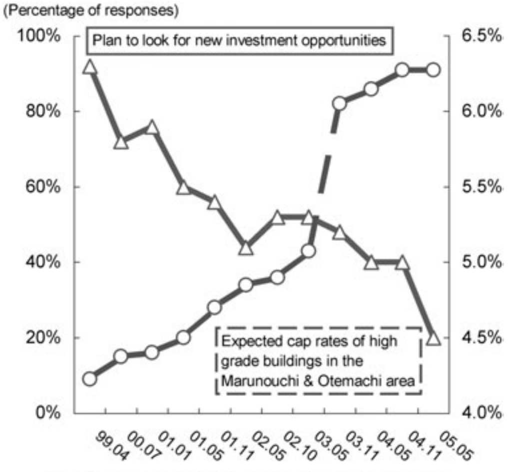
The real property sector is showing remarkable recovery even in comparison to other business sectors.

8. Recent shifts in the real property market

As reiterated in this report, J–REITs and private funds are taking an increasingly aggressive investment stance. *The Japanese Real Estate Investor Survey* published by the Japan Real Estate Institute, which conducts surveys toward these investors, also underscores the increasingly aggressive investment in real property since the second half of FY2003. Moreover, the capitalization rate of these investors has fallen to as low as 4.5% in premium buildings in urban areas (**Chart 24**).

According to office rent forecasts (by area) by these investors, forecasts on the future fall of office rent have started to ebb while expectations that rents will bottom out are spreading. Even though analysts were predicting even before 2003 that office rent would bottom out in areas such as Marunouchi, Otemachi, Shinagawa and Shiodome with a dense concentration of large prime buildings, there are rising expectations that office rent will rise in Marunouchi and Otemachi. Furthermore, forecasts on the bottoming out of office rent is spreading to other areas of central Tokyo, Nagoya, Osaka and Fukuoka.

Chart 24: The changing investment stance among real property investors



Note: Respondents include institutional investors, real estate companies and financial institutions.
Source: Japan Real Estate Institute, *The Japanese Real Estate Investor Survey*.

The foregoing reveals that (1) “expectations that office rent will fall” are retreating with respect to prime offices in major cities, (2) “expectations that office rent will bottom out” are spreading, and (3) “expectations on the rise of office rent” are building. These shifts in prospects regarding future rent have a tremendous impact upon the real property market. According to the capitalization model set forth on page 16 of the report, the profit price of real property varies greatly depending upon whether or not the expected percentage rise of rent (g) is 1% or –1%. Assuming that the current capitalization rate is 5%, if g rises 1%, the capitalization rate would be 4%. If g falls 1%, the capitalization rate would rise to 6%. The profit price in the event the capitalization rate is 4% would be 50% higher than the profit price when the capitalization rate is 6%. These changes in expectation are being factored into the current price of real property.

The current decline of the capitalization rate (price rise) of real property in central Tokyo can be explained to a certain extent if we assume that “the changes in expectations on future rent is factored into the current price of real property”. Given the intensification of competition to purchase property such as offices and residences accompanying the rise of property investment by investment funds in central Tokyo, the capitalization rate or cap rate (net operating income (NOI) divided by the acquisition price of property) at the time of acquisition is falling to levels as low as the 3% or 4% level. An overview of real property acquisitions worth 5 billion yen or over by major J–REITs since the second half of FY2004 reveals that acquisitions of property with capitalization rates at the 4% level are increasing since the beginning of the year 2005. In the case of private real property investment funds, the capitalization rate is dipping further. These pricing patterns are leading to warnings of a “mini bubble”.

The question of whether or not such pricing patterns are indeed a sign of a bubble depend upon whether the property rent will genuinely rise in the future. Considering that the capitalization rate moves as much as 2% and that the profit price fluctuates by 50% depending upon whether the rent rises or declines by 1% per year, it will become crucial to discern the future potential – the future rise of rent and cash flow – of each particular property. If future prospects are positive, investors may secure high internal rates of return (IRR) over the long term even at the current capitalization rate of around 3 or 4%. In contrast, even if the current capitalization rate surpasses 5%, if property rents do not rise in the future, the profit price will decline if future interest rates climb higher.

Given the decline of capitalization rates accompanying the intense competition to acquire offices and residences in central Tokyo, real property funds are widening their scope of investments to commercial & distribution facilities and hotels and regional offices and residents having high capitalization rates and stable cash flows. In this way, the upturn of the real property market in central Tokyo is spreading to other areas, raising the overall level of the real property market. This clearly indicates a shift in the real property market.

9. Concluding remarks

In our final analysis, we shall discuss whether we need to be concerned about a bubble in the recent real property market and provide an outlook toward the future.

(1) Do we need to worry about a bubble?

There are mounting concerns regarding a mini bubble, stemming from the surge of real property prices and falling capitalization rates in central Tokyo. However, despite scattered evidence of transactions of the foregoing nature, we believe that it is still premature to describe the overall real property market as a bubble because of the four following reasons. We shall discuss each of these reasons along with a comparison with the second half of the 1980s when a bubble actually emerged in the real property market.

The first reason is that the mainstream pricing mechanism in the current real property market is based upon earnings and cash flow. Even in recent cases of high property prices and low capitalization rates resembling a mini bubble, most are profitable pricing schemes on a medium term perspective owing to the future rise of rent. Even though there may be cases where the future rise of rent is overestimated or where the rise of rent is factored into property with slim prospects of higher rents ahead, as far as property appraisals by J–REITs are concerned, we found that the overwhelming majority are profit prices backed by rational explanations. This differs greatly from the pricing mechanism during the bubble years disregarding profit prices in which "prospects of higher prices spurred acquisitions and acquisitions drove prices higher". Property prices based upon the profit price would facilitate the price adjustment mechanism, and hence raise the possibility of restraining excessively high prices.

Secondly, the securitization of real property into small–lot financial products has triggered the participation of a wider array of investors in the real property investment market, leading to the enhancement of the liquidity and depth of the market and hence facilitating the proper functioning of the market mechanism. Investment lots were larger and the investment risks were difficult to control given the necessity to hold real property during the bubble period. During the property market slump in the aftermath of the bubble, the decline of market liquidity led to larger–than–expected losses on disposal of property when attempting to sell off property in a bid to cut losses. However, these problems improved greatly with the conversion of real property into small–lot financial products. We are thus inclined to believe that the real property market is gaining more depth and liquidity capable of absorbing adjustment pressures to a certain extent through its market mechanism.

The third reason is the existence of the J–REIT as a benchmark of the real property market. J–REITs are open to market scrutiny through the detailed disclosure of information such as profit/losses, cash flow, details of property held and the appraisal of selling prices.

As a result, J–REITs are capable of functioning as a benchmark of the real property market. In the past, the real property market did not have a benchmark reflecting prevailing market trends given the gap between the published price of land and the standard price of land and the lack of information on individual transactions. The existence of a benchmark will contribute to effective pricing in a market with an increasing volume and array of financial products. Furthermore, since many of the private funds place emphasis upon the disposition of property to J–REITs as part of its exit strategy, the importance of J–REITs as a benchmark should increase in the future.

Fourthly and lastly, experts in the field of real property investment are making a clear distinction between property for investment purposes and property for other purposes, resulting in the polarized and spot–specific nature of the real property market. During the bubble, the rise of commercial and residential sites in Tokyo from 1986 spread to regional areas in two to three years time, leading to a double–digit rise of land prices on a nationwide basis. Even land incapable of generating cash flow was traded at a high price. Such trends coupled with expectations on the rise of prices led to the expansion of transactions not based upon actual demand. During those years, individuals and business enterprises – both amateurs in real property – invested in actual property by borrowing part of the necessary investment funds, hence inflating the bubble. In contrast today, prices are rising mainly with respect to property in major cities, which are capable of generating stable cash flow and a certain capitalization rate. The price of property in other areas is continuing to drop. In short, there is a sharp distinction – in a healthy context – between investment–purpose property and other types of property. The active purchasers of property in the real property investment market are real property funds that are experts in real property investment. Amateurs are only engaged in indirect investment through small–lot financial products.

Hence, we do not believe that it is necessary to label central Tokyo real property prices as a “mini bubble”. However, in view of the intense competition to acquire real property, it will become increasingly important to discern the genuine value of real property.

(2) The future of Japan's real property market

As far as the period up to FY2006 is concerned, we expect the Japanese economy to follow a self–sustained recovery and that an accommodative monetary policy and low interest rates to persist even if the central bank ceases to take a quantitative monetary policy stance. Keeping in mind that the real property market is a lagging indicator of macroeconomic trends, we believe that real property prices will bottom out and that signs of recovery will spread, keeping the real property market in recovery mode during the coming two to three years, albeit with a certain level of adjustment and polarization and spot–specific nature of the market.

The real property investment market will continue to expand, driven mainly by J–REITs and private funds. The investment drive seeking higher capitalization rates and thus reaching a wider range of investment targets in terms of the type and geographic region, will serve to raise the level of the real property market.

The main concern is the so–called "Year 2007 Problem" which refers to the mass unwinding of property accompanying the maturation of private funds and the impact of the rise of interest rates expected after the termination of the quantitative monetary easing policy. It is true that "value–ups" will gradually lose their impact in boosting cash flow, given the difficulty to acquire under–valued property in central Tokyo. In the event interest rates climb higher, the odds are high that the price of property with slim prospects of higher rents commensurate to higher interest rates will fall. Furthermore, highly leveraged funds will be subject to the adverse impact of higher funding costs. Therefore, around the year 2007, each of the real property funds will be put to the test, leading to a wider disparity among funds. As events unfold in this manner, it is highly likely that private funds will come under selling pressures and lead to a shakeout of certain private funds. However, J–REITs listed so far possess high quality property and sound financial grounds capable of withstanding such aforementioned hardships and to function as market benchmarks or as purchasers of real property. Even if the Year 2007 Problem and the rise of interest rates lead to selling pressures upon real property equivalent to 1 trillion yen per year, it is highly unlikely that it will lead to an adjustment of the overall real property market since the selling pressures would be absorbed by market mechanisms stemming from the depth and liquidity of the real property market

On a macroeconomic perspective, the real property market is emerging out of a vicious cycle coupled with the slumping economy because of the alleviation of asset deflation pressures due to the improvement of economic growth expectations. However, given the strong "spot–specific" nature of the real property market – even more so than the stock market – prices of property in certain locations could rise whereas some prices could keep falling in other locations. These micro–level trends in the real property market may be perceived as a normal process of the overall economy's emergence out of deflation.

* * * * * * * * * *

Notes:

1. In Japan, land is regarded as a separate asset from buildings. Therefore, the term "land price" is used instead of "property price", not only for agricultural land but also for developed land. (Ministry of Land, Infrastructure and Transport, *Summary of White Paper on Land*).
2. The "straw effect" refers to the phenomenon where the construction of transportation networks such as roads and railways creates a "straw" with which purchase activity and industries are sucked out of small cities along the transportation routes to large cities, resulting in the decline of small cities.
3. The size (area requirement) of transactions are as follows: (1) areas designated for urbanization (2,000 square meters or larger), (2) city planning area excluding (1) (5,000 square meters or larger), and (3) areas other than city planning areas (10,000 square meters or larger).
4. Based upon the *Fudosan Baibai Jittai Chosa* (Survey on Purchase and Sale of Real Property) by the Urban Research Institute, Corp. A collection and analysis of data such as the seller and purchaser, location, land area, disposal value, gains/losses from transfer of property regarding land and buildings disposed of or acquired by listed corporations on the basis of disclosures to the Tokyo Stock Exchange and media coverage.

5. A fund of funds is a mutual fund which invests in other mutual funds. These funds enable an even greater diversification of risks than traditional mutual funds through the diversification of investment assets.
6. For example, Cabinet Office, *Annual Report on the Japanese Economy and Public Finance 2002.*

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