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Slumping real estate investment market's overlooked potential

Nomura Research Institute, Ltd.

Japan's real estate investment market is in tumult. Property values are falling and the real estate industry has been beset by a spate of bankruptcies. Fundamentals, however, remain sound, particularly in Greater Tokyo. Investors should focus on such fundamentals when looking at real estate from an investment perspective.

Downturn in real estate investment market

The real estate investment market's previously robust recovery has rolled over into a downturn. The Ministry of Land, Infrastructure Transport, and Tourism's August 2008 Land Price LOOK Report revealed a distinct downtrend in land prices in major cities throughout Japan.

Since spring 2008, the real estate industry has seen a string of bankruptcies among upstart companies such as Urban Corporation and Reicof. This trend is likely to continue for a while longer. J-REIT share prices also are in a protracted slump. While the Tokyo equity market is likewise in a slump, with the TOPIX down 13.7% in 2008 through August 22, partly in response to subprime mortgage woes, the TSE REIT Index has fallen a steep 32.5% over the same timeframe.

This dramatic downturn is chiefly blamed on financial institutions' recent unwillingness to lend to the real estate sector. For the past several years, Japan's real estate investment market benefited more from leverage than most other real estate markets around the world. While real estate acquisitions in Europe and the US are typically financed at maximum loan-to-value (LTV) ratios of 70-80%, corresponding LTV ratios in Japan sometimes exceeded 90%. Real estate funds and investors that were dependent on debt financing have been hard-hit by the recent curtailment of financing.

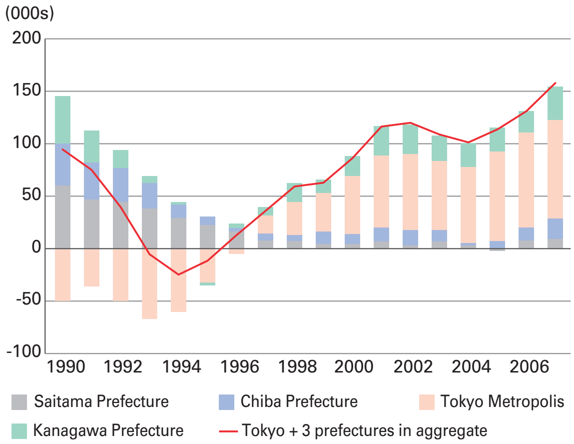
Tokyo real estate's potential from the standpoint of fundamentals

However, from the standpoint of fundamentals, the key driver of long-term real estate returns, Japan and particularly Tokyo's real estate investment markets have some tailwinds working in their favor. Analysis of the real estate market from an investment standpoint should rightfully focus on market fundamentals.

One strong tailwind for the Greater Tokyo (which encompasses Chiba, Saitama, and Kanagawa Prefectures in addition to the Tokyo Metropolis) real estate market is population growth from brisk in-migration. Greater Tokyo benefits from a net in-migration trend dating back almost two decades (Exhibit 1). Although Tokyo lost population to its three neighboring prefectures in the early post-Bubble years, the Greater Tokyo area continued to absorb population from throughout Japan almost uninterruptedly, even while Tokyo itself was experiencing net out-migration.

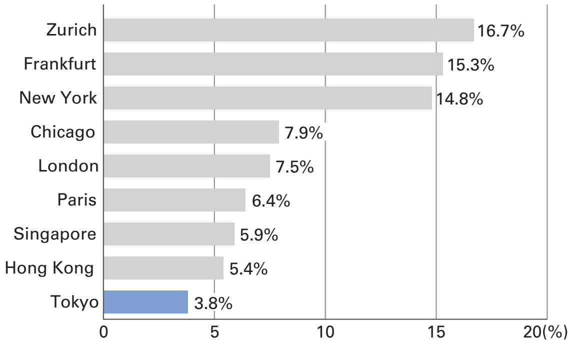
In recent years, Greater Tokyo's population growth has accelerated as young adults that relocate to Greater Tokyo upon graduation from high school or college have increasingly tended to settle permanently in Greater Tokyo[1]. According to current population forecasts, inter-

Exhibit 1. Net in-migration to Greater Tokyo



Source: NRI, based on Report on Internal Migration Derived from Basic Resident Registers

Exhibit 2. Financial sector employees' labor-force share in the world's major cities



Source: NRI, based on data from The Economist

prefectural migration is generally projected to decrease in the future[2], but with in-migration to Greater Tokyo actually accelerating, Greater Tokyo's population growth could exceed current forecasts.

What are such trends' implications for the real estate investment market? In terms of housing, for example, Greater Tokyo gained some 90,000 new households in 2007. This household formation rate requires the equivalent of 900 new 100-unit apartment or condo complexes to be supplied annually to meet housing demand. Given that new condo prices have recently been rising sharply, rental apartments' occupancy rates are likely to remain high and investment returns from such properties are likely to increase.

Aside from demographics, the Tokyo real estate market is also distinguished by a diverse local economy. More specifically, Tokyo is the world's largest nonfinancial commercial center, a distinction that adds to its appeal as a real estate investment market. In many of the world's major cities, most notably New York and London, financial sector employees account for a disproportionately large share of the resident labor force (Exhibit 2). Such cities' office markets are consequently largely dependent on financial sector tenants. Tokyo's office market, by contrast, has no such structural dependence

By virtue of such, the Tokyo office market is unlikely to suffer any major repercussions in the event of financial market turmoil like the ongoing subprime crisis. For investors, the Tokyo office market is a very effective risk diversifier for real estate portfolios.

Forward-thinking investors are steadily acquiring global real estate

Forward-thinking foreign institutional investors have taken a growing interest in real estate in Japan and other Asian markets in recognition of these markets' structural attributes and supply deficits stemming from demographic changes such as the migration trends discussed above. From the standpoint of market fundamentals, such investors are confident that they are highly likely to earn adequate long-term returns irrespective of intervening short-term volatility.

A notable case in point is CalPERS (California Public Employees' Retirement System), which raised its target asset-allocation for real estate in October 2007 and unveiled a plan to increase its real estate investment in Asian and other emerging economies in August 2008.

Asset managers that manage portfolios for institutional investors also have announced plans to ramp up investment in Japan. Macquarie announced that it intends to invest some ¥500 billion over the next three years. Others that have likewise announced plans to expand their Japanese real estate holdings include GE Real Estate, LaSalle Investment Management, ProLogis, and AMB Properties.

Making the decision to invest in or extend financing to a market in the midst of a downturn is not easy. Uncertainties abound in such markets, making it difficult to gauge the timing of investments. Nonetheless, some foreign investors continue to proactively invest, confident of earning adequate returns based on in-depth analysis, as noted above.

In Japan, we hope that domestic investors regain a modicum of composure and look at the market from a long-term perspective. Such a shift should lead to abatement of real estate investment market's current turmoil. It would be a shame if the turmoil were to continue unabated with no lessons learned.

Note

1) For example, over the five years through 1990, Greater Tokyo saw a net outflux of over 110,000 residents aged 30-34, but out-migration in this age brackets subsequently decreased yearly, turning into a net in-migration of 3,000 residents in the five years through 2005. Similar trends are evident across all age brackets. For a more detailed discussion of this analysis (in Japanese), see http://www.nli-research.co.jp/report/misc/2008/fudo080610.pdf.

2) For example, the National Institute of Population and Social Security Research's population estimates assume that inter-prefectural migration will decline to 70% of its historical level in the future. Additionally, the Tokyo Metropolitan Government's population estimates assume no inter-prefectural migration.

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