



# Creating Real Estate Investment Value in Japan

by Makoto Arai and Pip White  
May 2010

It is easy to understand why some global investors are not bullish on the prospects for the Japanese economy. The demographics are not positive, politics continue to interfere with an economic reform program and the fiscal situation seems dire, at least on the surface. In the face of all this, can investment value be found in Japanese real estate? We believe it can, but it is achieved by creating value in the property rather than by relying on a market recovery.



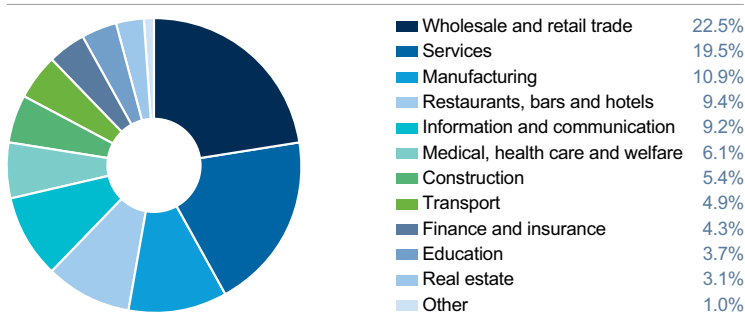
For a variety of reasons, ranging from historic land ownership issues, to the diversity of tenant demand, real estate investing in Japan, particularly Tokyo, is as much about finding value through active management as it is about growth. This paper explores some of these reasons in more detail and illustrates why macro-economic trends may not restrict an investor's ability to make profits in Japanese real estate.

### Tokyo is 'fundamentally' different from Japan

While real estate may be an attractive option in the current environment it is all driven by fundamentals going forward, therein lies the challenge. A common concern among investors is that they do not see any real growth prospects in the Japanese economy. So, what will drive rent and income growth for real estate? Couple that with the level of government debt approaching 190% of GDP, and failure to implement robust fiscal reform over the past two decades weak national demographics, and it is difficult to envisage a strong economic trajectory for Japan.

However, as a first step it is important to understand that Tokyo has fundamental differences to Japan as a whole. For example, while the overall population in Japan is shrinking, and forecast to lose 1.2 million people over the next five years, Tokyo is growing and is forecast to add 800,000 people over the same period. In addition, whilst the Japanese economy as a whole is only forecast to grow at a rate of 1.1%<sup>1</sup> annually over the next 15 years, the Tokyo economy is forecast to grow at a respectable 1.7% annually. So, despite the negative perception of Japan overall, Tokyo presents a very different, more positive set of macro-economic fundamentals that underpin the ability to add value to real estate in the Tokyo market.

### Employees by Industry (2006)



Source: Tokyo Metropolitan Government (August 2009)

<sup>1</sup> IHS Global Insight

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As the world's largest city with over 35 million people, Tokyo has many of the characteristics and attributes of a medium sized country. Among those is a strong diversification of its economic base in a variety of sectors, with no single sector dominating. Furthermore, well over half the businesses in Tokyo would be classified as SMEs with nearly 80% having fewer than 300 employees<sup>2</sup>. These characteristics help reduce the volatility in the market as, even in a downturn, some sectors will grow and expand. In addition they provide opportunities in the office sector as there is always occupier activity and people requiring different accommodation whatever the macro-economic conditions.

Therefore, we believe that a strategy focused on Tokyo office has the potential to benefit from the economic drivers of Tokyo largely de-coupled from the broader demographic and economic malaise affecting the rest of Japan.

### **Real estate offers value creation opportunities**

The anaemic performance of the Japanese economy over the past 20 years is well documented. A range of indicators support the conclusion of two lost decades: average GDP growth of 1.1%<sup>3</sup>, more years of deflation than inflation, an inability to enact meaningful fiscal reform legislation, etc. However, during this time there has been an increasingly active real estate market and some investors have successfully made money in real estate.

In 2001 MGPA purchased the Arasho building, a vacant office building in central Tokyo. With the bursting of the dotcom bubble, GDP growth was a meagre 0.2%, the Nikkei was hovering around 10,000 on its way to a record low in 2003, the Topix real estate index was also headed to an all time low and the 1.7 million sqm of new office space coming out of the ground was expected to swamp the market in 2003. Despite the gloomy outlook, the property was refurbished and Seiko leased the whole building as they consolidated employees from a number of different locations. The building was sold within 18 months achieving an IRR of 112% and an equity multiple of 1.7x.

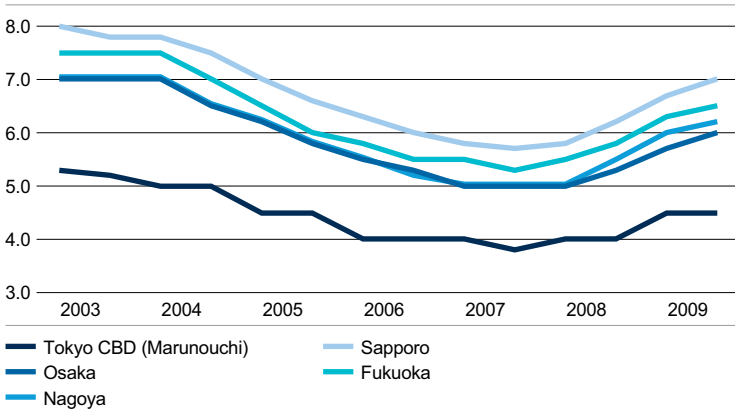
The size of the Tokyo market (the world's second largest and Asia's largest office market) creates a dynamic where there is an ongoing supply of buildings that require some form of refurbishment. The office stock in Tokyo is relatively old and of poor quality, partly due to restrictive planning and approvals processes and the difficulty of consolidating smaller parcels of land to facilitate re-development. The 2009 JREI survey reports that 45% of Tokyo's office stock is

<sup>2</sup> Tokyo Metropolitan Government August, 2009

<sup>3</sup> IHS Global Insight

over 20 years old and 27% over 30 years old – providing ample opportunity for refurbishments and upgrades across the city. The age of Tokyo's offices also means a substantial number are demolished each year providing new development opportunities. Further, as a result of the economic environment, there are an increasing number of unnatural owners of real estate who no longer have the means or desire to actively manage their assets. As a result there are plentiful opportunities to enhance property income through efficiencies and active tenant management.

### JREI survey – Cap rate for top quality office in 5 major cities (%)



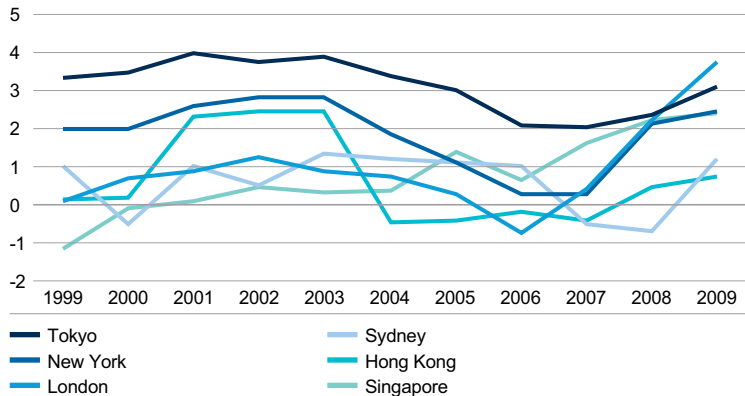
Source: JREI

These properties are now priced significantly below replacement cost and present an opportunity to create value, even without a market recovery. The upside potential presented through active management of these types of investments exists, whether or not the market is at or near the bottom of the cycle, as it appears to be at the time of writing this.

Cap rates in the central wards in Tokyo appear to have stabilised according to the most recent JREI survey. The rates have risen nearly 1% from their low in late 2007, but have not yet reached the previous peak in 2003. The JREI survey also shows that the cap rate spread between grade A and grade B buildings has moved in a range of 100 to 180 basis points. This spread demonstrates the ability to create value by moving grade B buildings to grade A through active asset management. Risk premiums for real estate in Tokyo are among the highest in the world and when deposit rates are next to nothing real

estate becomes a more attractive option as part of an investment portfolio, generating underlying demand from domestic buyers for stabilised quality investments.

### Real estate risk premium – Selected cities (Yield spread above risk free rate)



Source: PMA; Colliers International; CBRE

Neither vacancy nor rents show convincing signs of stability yet. However, the rates of increase in vacancy and decrease in rent are slowing; often an indicator that the cyclical bottom is close. The market currently has a much lower supply overhang than in the 2003 cycle when cap rates rose sharply. The excess supply was absorbed quicker than anticipated as tenants left older space for the newer accommodation, leaving behind a supply of older buildings with opportunities for refurbishment. The next development cycle will peak in 2012 although at a relatively modest level of supply of 1.5 million sqm of new space. In the broader context of Tokyo's total office market of 42 million sqm, this represents less than 3% of stock, before deducting demolitions and conversions of office to other uses. The overall continued under-supply of quality accommodation in Tokyo is expected to result in demand emerging for better quality existing assets and the space being absorbed faster than econometric models would suggest, as happened in 2003. Development land is in short supply in Tokyo and new development is largely dependent on the very time consuming process of assembling existing buildings on adjacent blocks. Furthermore, development activity is likely to be more restrained since the financial crisis due in part to the absence of development finance, therefore longer term supply is likely to be restricted.

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Hence, we believe that the period from late 2010 through 2011 will provide excellent investment opportunities as the market reaches its floor and starts to recover.

### **Value outweighs risk**

Japan has now had two lost decades with periods of deflation and anaemic economic growth. While steps have been taken to reform the economy, there is more work to be done in getting the fiscal house in order. Much has been made in the media of a potential looming debt crisis in Japan as the amount of public debt has gradually increased over the last decade to record levels. However, more astute commentators have pointed out that the situation in Japan is better than some other countries as the net value of Japan's public debt is about half the gross value and is more in line with many other developed countries. Secondly, conversely to most countries, more than 95% of Japanese government debt is Yen denominated and held by domestic capital, reducing the risk that government bond yields will be driven by fickle international investors. An ongoing issue for Japan is how to deal with its gradually shrinking population. Immigration is the most obvious solution, but Japan has a strong, largely homogeneous culture and the practicalities of opening up immigration will not be easy. Meanwhile, the key demographic trend is internal migration from the regions in to Tokyo in search of education, jobs and social services – a factor affecting both the nation's young and old.

The recent announcement by the Government of Japan that they believe the economy can achieve a sustainable annual growth rate of 2% may be a signal that they are finally ready to take a serious run at fiscal reform. This view is supported by unexpectedly high levels of consumer confidence. Further, the economy has shown a strong rebound in exports over recent months as global trade improves, assisted by the change in the export destinations for Japan which are increasingly orientated to Asia.

We have identified opportunities for real estate investment in Tokyo, particularly in its office sector, which exploit the economic advantages of the Tokyo region compared with overall Japan. Our belief that the market is at, or close, to the bottom of its cycle is reinforced by the evidence of credit conditions starting to thaw, bid-ask spreads coming in and investment transaction volumes starting to rise. Buying assets at cyclically low prices, often below replacement cost, lowers risk and therefore, in our view, highlights the value of the opportunity presented by an active management strategy.

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The best investments are often made by investors who are able to 'see through the cycle' and recognise that investing at or close to the cyclical low represents value, as opposed to extrapolating past negative trends in to the future. The supply of international capital coming to Japan is limited by the less informed foreign views of Japan, which is keeping cap rates at higher levels and representing opportunity for investors who are closer to the market and its potential. Buying below replacement cost is a key to managing downside risk in real estate investment. MGPA believes that, with real estate markets approaching a cyclical low point, the downside risk is limited and the upside potential very attractive.

### **Japan will survive but Tokyo will thrive**

The Japanese economy has been under pressure for over 20 years and without serious fiscal reform that pressure may remain for some time to come. However, despite the weak macro economic position there have been and, more importantly, will continue to be opportunities to make sound investments, as there are in all markets however challenging the economic environment. We have identified that in Japan, Tokyo presents a set of positive fundamentals for real estate that rival many other established markets around the world with solid GDP growth, a growing population and a well diversified economic base. These indicators will continue to drive the property cycle in the city and create opportunities to make positive returns on real estate investment. We believe that there are good opportunities to buy good quality, well-located small to medium sized office properties (generally below 5000sqm net lettable area) and create value by improving income through pro-active asset management and generating capital returns by selling the newly stabilised assets into the large and liquid domestic capital market. For these reasons we believe that despite the lost decades of Japan's macro-economy, a focused active investment strategy centred on Tokyo's office sector will yield results that outweigh the apparent risks of Japan as a whole.



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