

## Report on Discussion Results by the Working Group

### 1. Introduction

Since commencement in 2001, the Japanese market of listed real estate investment trusts (J-REITs) had grown steadily in terms of market size, number of acquired properties and number of listed issues. J-REITs had also made significant contributions to urban development and other aspects in Japan through acquiring properties with abundant funds as well as increasing the value of owned properties. However, triggered by the subprime loan problems that occurred in 2007, the entire J-REIT market turned to a downward trend. With the number of properties acquired by J-REITs quickly decreasing, the J-REIT system has entered an adjustment phase for the first time in the seven years since commencement. As a J-REIT went bankrupt for the first time in J-REIT history, and also due to appreciation of the Japanese yen, globally decreased stock prices, worsening economic indicators and other factors, the Tokyo Stock Exchange REIT Index momentarily marked an all-time low of 704 points. Though the REIT Index later rose again to the 800-point level, there is no telling how it will behave over time. Thus, we believe it a pressing task to enhance investor confidence in J-REITs.

The Working Group discussed reorganization of J-REITs through mergers and other measures, the necessity of reinforcing the governance of J-REITs and other issues, in line with the directives demonstrated at the Third Forum for Building Up the Real Estate Investment Market that is Trusted by Investors held on October 29, 2008, and made an ad interim report on February 10, 2009. The Working Group subsequently continued discussion on such issues as refinancing by J-REITs and promoting real estate investment by retail investors, pension funds and other investors, and hereby presents a report on its overall discussion results.

### 2. Necessity of Reorganizing J-REITs through Mergers and Other Measures

Among J-REITs, there exist many investment corporations that have a low price-to-book ratio (ratio of investment unit price to net assets per unit), providing a market environment favorable for buyers in the securities market. However, it has been pointed out that the entire J-REIT market is being damaged by the fact that there are few mergers and

acquisitions despite such a situation. Furthermore, there is a strong opinion claiming that it is more desirable for pension funds and other investors to invest in stable REITs with larger total assets. A merger between investment corporations is a measure that would allow the creation of a larger size investment corporation without spending a lot of money. This would also help meet the expectations of investors and further activate the J-REIT market.

The Working Group held discussions, as described below, concerning mergers and other forms of reorganization of investment corporations. Given that the relevant systems are being revised in a way that should contribute to promoting mergers, the Working Group expects the J-REIT market to make further developments through mergers between investment corporations and other measures using these systems.

- (1) The present formula used to determine whether conduit requirements are satisfied includes both income for taxation purposes and profits for accounting purposes in a mixed way. In order to resolve the unstable nature of the conduit determination, revisions have been sought so that the judgment should be based on profits for accounting purposes, not including income for taxation purposes. There has also been a concern that investment corporations might hesitate to merge with other investment corporations because the present conduit requirements could not necessarily be satisfied after the merger. We believe this concern has been appeased, as the fiscal 2009 tax reform revised the formula used to judge the conduit nature. The revisions included that a conduit shall distribute at least 90% of the distributable income (not the income for taxation purposes) for accounting purposes and that the negative goodwill generated upon a merger shall be deducted from the distributable income for accounting purposes in the fiscal year when the merger takes place. Moreover, the revisions to the formula allowed the surviving investment corporation to deduct the unrealized gains of the absorbed investment corporation (so-called “negative goodwill”), if any, from the distributable income in the fiscal year when the unrealized gains occur. We believe that this has also eased the concern that, when conducting mergers, investment corporations must pay cash dividends equivalent to the unrealized gains in order to keep satisfying the conduit requirements.
- (2) In the case of a merger between investment corporations, the surviving investment corporation is required to pay the so-called merger grants to the unitholders of the dissolved investment corporation in order to adjust the fractions of the merger ratio or to adjust dividend of profits when the settlement periods of the merging parties differ. However, there were doubts concerning the practical application of this rule because there

is no explicit provision in the Investment Trusts and Investment Corporations Law (hereinafter, the “Investment Trust Law”), and the concern was that this might discourage mergers between investment corporations. We believe this concern was eased as the Financial Services Agency revised the relevant Cabinet Office Ordinances (enforced on January 23, 2009) and its Inspection Guidelines (applied on January 30, 2009) in an effort to clarify the legitimacy of practical application.

- (3) When conducting an M&A, there may be fractions of investment units (less than one unit per unitholder) to be issued to the unitholders of the dissolved investment corporation. If that is the case, the Investment Trusts and Investment Corporations Law requires that the number of investment units equivalent to the sum of the fractions be sold at the stock exchange market and the proceeds from the sale be paid to the unitholders according to the fractions. This raised a concern that the investment unit price might drop significantly on the stock exchange market due to the sale. However, there were many in the Working Group pointing out that such a result could be avoided by, for example, trading on the ToSTNeT (Tokyo Stock Exchange Trading Network System) market.
- (4) As to the calculation method for a fair merger ratio upon merging, many members of the Working Group insisted that it is important to provide investors with sufficient explanation and disclosure concerning the thinking behind the calculation, the rationality of evaluations, etc.
- (5) The Working Group also discussed delisting and liquidation of J-REITs as a form of reorganization. Both ways are legally possible, but there are such issues of concern as how opposing unitholders should be protected, the contraction of the J-REIT market due to sales of investment properties, and the impact of their fire sale, etc. on the overall real estate market. Accordingly, many members claimed that investment corporations should endeavor to stay in the J-REIT market through such measures as mergers, changes in sponsors and switch of asset management companies.

### 3. Corporate Governance of J-REITs

Recently, administrative penalties were imposed on multiple asset managers, to which investment corporations entrust management of their assets, for activities that constituted conflicts of interest with the investment corporations or for their inadequate internal control systems. Given these incidents, it has been pointed out that corporate governance of asset

managers should be reinforced partly as a means of strengthening the trust of investors. Against this background, the Working Group held the below outlined discussions while making comparisons to systems of various countries.

- (1) The world's REIT systems are largely divided into externally-managed REITs (Japan, Australia and Singapore) and internally-managed REITs or a combination of externally- and internally-managed types (such as the U.S. and European countries). Both the externally-managed and the internally-managed types have their respective advantages, and no general valuation can be made concerning which is more beneficial for investors. However, as exemplified by the stapled securities system in Australia, there have been attempts to align interests of asset managers and investors by listing the shares of asset managers and investment units of the managed REITs together for trading while basically maintaining the externally-managed system to avoid taxation on the REITs before distributing dividends. As such, we believe there is a common global endeavor to enhance the trust of investors by aligning the interests of asset managers and investors as much as possible.
  
- (2) In the J-REIT system, the Investment Trust Law and the Financial Instruments and Exchange Law oblige asset managers to provide asset management services with fiduciary duties (loyalty to the trustors' interests) and care of a good custodian on behalf of the investment corporations, which are trustors. Along with these duties, it is important for asset managers to make efforts to further align their interests with the interests of investment corporations, which are an assembly of investors, so as to enhance the trust of investors. In this regard, such schemes as internally-managed REITs and stapled securities system implemented in other countries can be informative. However, if we are to attempt to introduce similar systems in Japan, there are still many issues that need to be examined. As far as the internally-managed REIT, for example, an investment corporation would have to be a format that is more similar to a corporation under the Company Law as it manages assets by itself and, also from the perspective of a comparison with other legal systems, it would not be able to avoid taxation before paying dividends. With regard to the stapled securities system, there also appear to be many issues to be examined, as Japan has had no cases of trading shares of multiple companies as a single unit and there would be a need to discern how the system would be positioned in relation to the Financial Instruments and Exchange Law as well as other relevant laws and regulations. Many members of the Working Group insisted that, while it is important to continue examination among related parties on such ideas as

internally-managed REITs and the stapled securities system in pursuing the ideal J-REIT system that secures the trust of investors, it is essential for each REIT to voluntarily work on measures that should further enhance the trust of investors. That would be a quicker way to reinforce investor trust as soon as possible. Such efforts would include the following measures.

(a) Strengthen monitoring by investment corporations on the fiduciary duties and other responsibilities being performed by their asset managers

Executive directors of investment corporations have an important mission to conduct monitoring, as representatives of investors, whether the asset managers that manage assets based on entrustment agreements with investment corporations are fulfilling their fiduciary duties, duties of diligence of a good custodian and other duties towards the investment corporations.

In order to reinforce their monitoring functions, investment corporations would need to secure personnel and budgets (such as increasing the number of directors and outsourcing some of the monitoring functions as needed) that are required to monitor how their asset managers are doing their fiduciary duties, duties of diligence of a good custodian and other duties, so as to allow the executive directors of the investment corporations sufficiently and proactively achieve their missions.

(b) Appoint outside directors for asset managers

From the viewpoint of reinforcing corporate governance of asset managers and enhancing the trust of investors, asset managers would appoint outside directors who are highly independent and can be expected to monitor the asset managers' business executions with a perspective of securing the interests of investors.

(c) Further elaborate the compensation systems of asset managers

Further elaboration would be made to the compensation systems of asset managers in a way that should contribute to the alignment of interests between asset managers and investment corporations.

Furthermore, in an attempt to align the interests between asset managers and investment corporations, investment corporations would own shares of asset managers in order to be able to have a certain influence on the asset managers. However, this would require prudent examination from the viewpoint of protecting investors, etc. as it would also cause

investment corporations to bear the business risks of asset managers.

#### 4. Financing by J-REITs

J-REITs are real estate investment trusts and, when acquiring real estate in accordance with the investment judgment of asset managers, encourage retail investors to invest their money while procuring part of the funds required for the acquisitions by borrowing loans from financial institutions, issuing investment corporation bonds or through other measures. Covering part of the procured funds with low-cost borrowings should enable J-REITs to acquire properties dynamically and pay high dividends to investors, among other things. As such, procuring funds in combination with equity financing (investment by investors) and debt financing (loans, etc.) is a procurement method commonly employed worldwide. However, the global credit crunch has made it difficult to increase capital through additional equity financing. On the other hand, REITs around the world with particularly high dependence on debt financing are found to have difficulty in securing refinancing of their borrowings, and the U. S. has seen the bankruptcy of a REIT (the Chapter 11 bankruptcy case). In Japan, it has also become a major management issue for J-REITs to avoid default caused by violating the LTV provisions (pledges on borrowing ratios), which are financial covenants in loan contracts, and there is a concern that a growing number of J-REITs may be forced to sell their properties at disadvantageous prices in order to repay loans.

Characteristically, REITs are supposed to be backed by assets under management that are expected to produce stable income gains. In reality, the prices of their investment units have decreased significantly due to such factors as yen appreciation, globally stagnant stock prices and worsening economic indices. Furthermore, increases in the number of properties sold as a measure to secure refinancing would cause a shrink of assets under management and a drop in dividends. Moreover, selling properties at cheap prices might cause a negative spiral as it places downward pressure on prices in the real estate market, which is in a recession, followed by lowered appraisal values of owned properties. On the other hand, the first peak of redemption deadlines arriving for investment corporation bonds will come around September 2009 and after. This has made it necessary for J-REITs to secure cash on hand without selling their owned properties in a forced manner, lower borrowing rates, and prepare for conducting refinances. Outside Japan, there are cases in which REITs endeavor to reinforce their financial standing; some U.S. REITs work to prevent the outflow of cash on hand by partially paying dividends in treasury stocks instead of cash. In the British Commonwealth countries, REITs try to procure funds through rights issue at issue prices far

below market in spite of the market conditions in which general capital increases are hard to carry out; issue convertible bonds that can be exchanged into stocks when the stock prices recover; and conduct self-help efforts to sustain their stock prices by purchasing treasury stocks.

Strengthening financial standing of individual REITs is also a critical issue in Japan. In this regard, the Working Group conducted discussions, as presented below, concerning what can be devised to tackle this issue.

(1) Diversification of Financing Methods by J-REITs

As real estate investment trusts, REITs are by nature a collective investment scheme and represent a system that is based on investments by investors (equity), and loans and other debts should be a complementary measure. In order for REITs to construct a stable financial foundation that allows them to avoid over-dependence on borrowings, they may either sell their properties to repay borrowings and reduce asset size, or dynamically collect investment funds to lower borrowing ratios. Excessive sale of properties provokes concerns for negative impacts that include: REITs losing their basic characteristics of being a stable income-gain product; decreases in dividends per unit; the shrinking J-REIT market; and the real estate prices triggered to drop. As to capital increases, on the other hand, the Investment Trust Law in Japan allows J-REITs to issue nothing but ordinary investment units (an equivalent of common stocks in stock-related vocabulary). As such, the only practical way to improve LTV ratios within the market environment where capital increases through public offering are difficult due to stagnant stock prices, is to implement capital increases through issuing investment units by way of third-party allocation. In fact, there have actually been many cases using the third-party allocation method to increase capital. However, if capital increases are conducted by way of third-party allocation within a situation where investment unit prices are falling, the per-unit price for the allocated units will be significantly below per-unit investment funds. This is why investors have not necessarily welcomed the arrangement in all occasions.

Given such situations, the Working Group has made the following studies as to how financing methods can be diversified in Japan, referring to cases in foreign countries where financing methods for REITs have been as diversified as those for general operating companies. Changes toward more diversified fund procurement have also already been seen in Japan, as a J-REIT issued subordinated investment corporation bonds – the first

among J-REITs – in February 2009 and an interpretation was indicated that rights issue at fair values are not banned under the Investment Trust Law. In order to allow respective REITs to implement the most effective financial policies for investors, we believe it necessary to investigate appropriate control methods, while prudently conducting examinations on introducing a wide variety of options, fully discerning if they have any disadvantages that harm investors' interests or if they fit the Japanese REIT system that embraces an externally-managed scheme. In doing so, references should also be made to the Company Law and the trends in overseas markets. This is also important for re-recognizing the essential nature of REITs that they are stable and income-gain-oriented financial products backed by real estate rental revenues.

#### 1) Rights Issue

Rights issue is used by foreign REITs particularly as a means to procure funds in times of recession. The amounts to be paid in these cases are usually set at a price significantly discounted compared with the market price, so that all shareholders are given opportunities to acquire the rights. In Japan, the Investment Trust Law does not specifically ban rights issue. Nevertheless, Japan has seen no case of rights issue by J-REITs because of such reasons as: the Investment Trust Law does not have provisions concerning rights issue while the Company Law has such provisions or applies to similar provisions; and Article 82-6 of the Investment Trust Law designates that “the paid amount for offered investment units must be a fair value in light of the content of assets owned by the investment corporation.” Meanwhile, there are issues to be examined from the viewpoint of protecting investors. Such issues include: investors who do not or cannot agree to additional investment will lose their rights and cannot enjoy benefits, possibly resulting in decreases in per-unit investor equity or dividend, or they may hate dilution and choose to sell their investment units, and; the amount of procured funds can vary in accordance with the proportion of investors losing their rights, so that care must be taken of how the funds are used. Therefore, related parties should prudently examine the preparation of systems that will make it possible to appropriately conduct rights issue, while grasping the needs of individual REITs and investors.

#### 2) Convertible bonds (investment corporation bonds with subscription rights to new investment units)

The Investment Trust Law neither has provisions equivalent to those in the Company

Law concerning subscription rights to new stocks or corporate bonds with subscription rights to new stocks, nor applies to such provisions. As such, it is recognized that issuance of convertible bonds by J-REITs is difficult under the current Investment Corporation Law. By contrast, many countries including the U.S. and Australia allow REITs – not only company type but also trust type REITs – to issue such bonds. Indeed, there would be cases where investor trust could be improved if convertible bonds were issued as a means to procure funds at a time when investment unit prices remain stagnant, as it would help REITs implement policies including refinancing at low interests and improving capital structures. For example, REITs would be able to reduce LTVs if conversion rights were executed through the process in which investment unit prices underestimated in the securities market due to refinancing risks should recover to the level of their NAVs, net asset values of the properties they own. Moreover, capital sources such as strategic investors might be more inclined to buy convertible bonds in anticipation of the advantages that they could execute conversion rights in a process of rising investment unit prices; such capital sources would help decelerate the speed of dilution, caused by the conversion into investment units, throughout the lives of the convertible bonds. In fact, GPT Group, an Australian REIT, has combined rights issue and issuance of perpetual subordinated bonds with conversion rights to common stocks, in an effort to reconstruct its financial structure, and has successfully improved its LTV by obtaining support from the Government of Singapore Investment Corporation.

However, there is also a possibility that, depending on how the conversion prices of the convertible bonds are set, a significant level of dilution would be caused through their conversion into a huge amount of investment units. Dilution might be further accelerated if the conversion prices were subject to some unlimited moving strike clauses. Moreover, downward pressure on investment unit prices may arise, if trade practices are employed in which investment units are sold in the securities market while at the same time conversion rights are executed. On the other hand, no financial improvement – such as improvements in LTVs – anticipated initially might be achieved if investment unit prices would not rise after issuance and the convertible bonds were not converted into common stocks (investment units) despite the arrival of conversion deadlines. Therefore, we believe that prudent investigations should be made as to the product characteristics of convertible bonds and other factors, such as fully securing governance and the need for system design for investor protection, while considering the possibility of their introduction in Japan.

### 3) Classified stocks (classified investment units)

Issuance of classified investment units would be difficult as the Investment Trust Law neither has provisions equivalent to those in the Company Law concerning classified stocks, nor applies to such provisions. However, preferred stocks with conversion rights are generally used in the U. S. as a means to satisfy needs to procure funds over the long term. In the U.K. also, a revision bill was announced in April 2009 that should allow REITs to issue preferred stocks with conversion rights. In Japan, approving issuance of classified investment units so as to meet various types of investors' needs is expected to help REITs improve their financial standing and increase investor trust. However, issuing preferred investment units, for example, might also bring about a negative impact, as they would make all outstanding investment units subordinate to them and have a major impact on existing investors. Redemption of such preferred investment units would also become a big problem. Furthermore, there is a possibility that, if investors of investment units become relatively subordinated, such a situation would not fit the simple product characteristics of REITs that they are financial products oriented to stable income gains. Because of this, we believe that prudent investigations should be made concerning such factors as to how classified investment units by REITs should be, while considering the possibility of their introduction in Japan as well as focusing on fully securing governance and protecting investors.

### 4) Acquisition of treasury investment units

As a rule, the Investment Trust Law prohibits REITs from acquiring their treasury investment units, except for such cases as succeeding them from investment corporations that cease to exist through mergers. The Law also does not have provisions corresponding to those in the Company Law concerning acquisition of treasury stocks by joint stock companies. Therefore, it should be difficult for investment corporations to acquire their treasury investment units based on their own judgment. Meanwhile, acquisition of treasury investment units by REITs is permitted in such foreign markets as the U.S., Australia, Hong Kong and Canada, and is utilized for their capital and dividend policies as a means to counter stagnant stock prices or to improve dilution that occurs after capital increases. It is also expected to possibly help improve investor trust. Nevertheless, care must be taken with regard to the relationship with existing creditors when using capital of the REITs as funds to acquire treasury investment units, and to fair and equal handling of all shareholders when using distributable profits to shareholders.

Moreover, we believe it necessary to examine introducing regulations on insider trading, from the viewpoints of investor protection and securing fairness in securities trading including prevention of market maneuvering. Now that investment units are listed, pricing measures on investment units by REITs are important in order to enhance investor trust. In this regard, we believe that prudent investigations should be made as to how systems should be to take into account investor protection, while considering the possibility of approving acquisition of treasury investment units in Japan.

#### 5) Distributing treasury stocks as dividends (stock dividends)

Given the global credit crunch, it has become important for individual REITs to increase cash on hand to an adequate level. In the U.S., for example, a measure was enforced in December 2008, in relation to the dividend requirement of distributing 90% or more of taxable income as a conduit requirement, in which REITs were permitted to distribute stock dividends according to investors' choices (although at least 10% of dividends must be done in cash and the measure shall be applied to dividends paid in the limited time frame of January 1, 2008 through December 31, 2009). It is pointed out that this measure has helped to control the outflow of cash on hand and reduce refinancing risks without violating the conduit requirements. In contrast, the Investment Trust Law of Japan is understood to prohibit REITs from using investment units as dividends in place of cash. In addition, the Special Taxation Measures Law stipulates in its provisions on recording paid dividends as losses that "distribution of monies paid by investment corporations" can be recorded as losses; dividends in forms other than money cannot be recorded as losses, and are subject to taxation. These show that issuing investment units in place of money for dividends is difficult. Investors may also have disadvantages when they want to liquidate stock dividends, since the market prices are low and selling them in the market will further lower the stock prices. Accordingly, we believe it necessary to continue prudent examination concerning distribution of treasury stocks as dividends.

#### 6) Establishment of provisions concerning capital decreases

If a J-REIT has its capital (unitholders' equity) decreased considerably due to impairment of the assets it owns, it may find it difficult to distribute profits as dividends over the long term. In this regard, there was an opinion among the Working Group that such a REIT would be able to resume dividends as early as possible if provisions corresponding to capital decreases approved under the Company Law were introduced to the Investment

Trust Law to allow it to cover losses due to capital decreases, and such an arrangement would also be effective in view of financing measures. Since the present system allows investment corporations to distribute dividends in excess of profits, we believe it necessary to clarify the position of such provisions on the system, and conduct an investigation on this issue while taking into account investor protection and other viewpoints.

## (2) Necessity for Individual REITs to Reinforce their Financial Strategy Functions

It is common practice globally for REITs to manage their assets by conducting a certain level of borrowing. Given the credit crunch currently prevailing, however, investors and lenders have started to pay attention to finance strategies of REITs, including LTVs, lengths of loan periods, levels of loan interest and the status of collateral, as information directly relating to the management of the REITs. In Japan as well, it is pointed out that REITs noted to have dependence on securitization lenders and short-term debts, high LTVs, etc. must improve their financial standing as a critical issue. As these show, what is important for heightening investor trust is not only on the asset side, where the key is the assets under management and how they are administrated, but also on the liability side, where appropriate financial strategies – taking loans and issuing investment corporation bonds on what conditions and to what degree, etc. – are essential. For example, such financial strategies would include diversifying repayment dates of respective loans so as to avoid duplication of maturity periods through a balanced combination of long-term and short-term debts – borrowing low-interest short-term loans as working capital over the short term, while securing stable long-term loans within a scope of rational judgment. Thus, we believe it important for individual REITs to work to reinforce their financial strategy functions by such measures as securing staff that are highly capable in financial matters, in an effort to heighten investor trust.

The Investment Trust Law allows REITs to issue investment corporation bonds as a means to procure funds over the long term, and there have been many such bonds issued to date. Under the present credit crunch, however, it is understood that no REITs other than those with considerably high ratings can issue them. Nevertheless, there were events in February 2009 when subordinated investment corporation bonds were issued for the first time in J-REIT history and the Bank of Japan newly included investment corporation bonds with a certain level of ratings in its list of eligible collaterals. As these events suggest, it is hoped that the environment for issuing investment corporation bonds

will recover as quickly as possible. In addition, with regard to short-term investment corporation bonds, investigations on the recovery of their issuance environment and the necessity to moderate issuance conditions are desirable, as they represent a means to procure short-term funds speedily from sources other than financial institutions.

In relation to investment corporation bonds, some REITs have been pointed out to have problems in redeeming the investment corporation bonds they issued. In the case of borrowings from financial institutions, for example, REITs can ask the same financial institutions to refinance the loans again upon the arrival of maturity dates. In contrast, investment corporation bonds owned by institutional investors and other investors must be redeemed by the stipulated maturity dates. Because of this, REITs with upcoming maturity dates of investment corporation bonds must work to secure funds for redemption well in advance, through such measures as new borrowings from financial institutions, selling properties at appropriate prices, merging with other REITs or having sponsors with high credit participate in their operational management.

### (3) Necessity of Loans Provided Appropriately by Financial Institutions

In acquiring and managing real estate properties, J-REITs use borrowed money to partly fund the acquisitions. However, some financial institutions have found themselves unable to accept refinancing deals, as they have had difficulty in issuing loan obligation securitization products since the occurrence of subprime loan problems. For other financial institutions, it is pointed out that, given the current credit crunch, they have made their refinance conditions too rigorous, such as shorter loan periods and higher interest rates and loan fees. However, J-REITs are a scheme in which they own high-occupancy, income-generating properties over the long term while enhancing the property values and return the rent income to investors: they are not involved in risky business like that of real estate development. If financial institutions should refuse refinancing deals in spite of these characteristics of J-REITs, it may force the unreasonable sale of properties in the current real estate market that is said to have no buyers and, if properties cannot be sold in time for repayment dates, there might be bankruptcies and liquidations among J-REITs in worst case scenarios. The concern is, as a result, that the current drops in real estate prices will be accelerated and, through decreases in collateral values, there would be significant impact on the financial system and real economy. Due to this concern, we expect financial institutions to be self-conscious that they are major players supporting the REIT market, and to

appropriately respond to refinancing requests from REITs after fully reviewing their owned properties and how they are managed.

Moreover, since establishment in 2001, J-REITs have enhanced their presence as major buyers of income-generating properties. In fiscal 2007, J-REITs acquired properties equivalent to approximately 1.5 trillion yen against approximately 3.3 trillion yen – the value of properties sold by listed real estate companies. Despite this, stagnant stock prices and the recent credit crunch have made it difficult for J-REITs to procure funds for newly acquiring income-generating properties. The reduction in property acquisitions by J-REITs, which sharply dropped to the level of 600 billion yen in fiscal 2008, is adding to the “no buyer” situation in the real estate market. In order to stabilize Japan’s real estate market and the entire economy, it is important to revive the function of J-REITs as property buyers, such as encouraging REITs with high credit to buy blue-chip properties featuring high yields and stabilizing management by expanding their size through mergers between REITs, etc. For these issues, we believe that financial institutions should agree to requests for new loans as much as possible by employing co-finance operations, etc. and contribute to the vitalization of the Japanese economy through supporting real estate buyers.

#### (4) Roles of the Government and Other Institutions

As stated above, it is needless to say that financial operations of J-REITs must be conducted appropriately with the initiative of the private sector, while continuing to disclose the content to investors in an appropriate manner. However, if some REITs should fail in securing funds and go bankrupt, not only would investors lose their confidence in the entire J-REIT market, but REITs would likely cause a crash in the real estate market by dumping properties, contrary to their expected role as major buyers of properties. To prevent such from happening, the Japanese government announced the “Emergency measures for activating housing and real estate markets” at the end of last year. The government has been providing financial support to residence/real estate operators and others (including J-REITs) that conduct sound operations by utilizing operations of smoothly responding to crises through the Japan Finance Corporation, and has immediately conducted system reforms to facilitate mergers between J-REITs. These measures clarify the government’s stance of supporting the J-REIT market, and are positively evaluated. In addition to these, the government stated in the “Countermeasures to Address the Economic Crisis” announced in April 2009

that it will implement the “provision of funds to J-REITs through a Fund to be jointly established by the government and the private sector, etc.”

This measure aims to stabilize the real estate market and prevent asset deflation by newly providing funds to J-REITs that are having trouble with fund procurement despite their stable cash flows and secured profits; forming a Fund in cooperation between the government and the private sector in order to recover the function of J-REITs as buyers; and working to recover the price formation functions in the market through the activities of J-REITs. The desire is that the measure will be implemented without delay. However, loans and other support by the Fund are nothing but a safety net. Individual REITs must not feel too secure to neglect voluntary efforts in improving their financial standing, reinforcing their governance, and so on. The measure should also not set back reorganization in the market.

In designing detailed systems for preventing moral hazards by the said Fund, it is expected that, if the Fund enables REITs to avoid bankruptcy, they must make further management efforts, including sponsor changes and mergers with other REITs, as conditions for obtaining support by the Fund.

## 5. Promoting Real Estate Investment by Retail Investors, Pension Funds and Other Investors

Given their primary characteristics, J-REITs should be able to produce stable dividends as they are backed by stable rental income, and their investment unit prices should also be fairly stable. Recently, however, it has been pointed out that their investment unit prices are strongly linked to stock prices and that, as the background of this linkage, owners of investment units are mostly foreign investors and financial institutions, who are inclined to sell investment units to meet immediate needs for money or sell them at particular prices to avoid further losses. Considering the original characteristics of investment units, investors investing in REITs are supposed to be those who intend to own investment units for a long time – specifically, retail investors and pension funds, etc. Still, we can hardly say that investment units have sufficiently reached such investors. Accordingly, the Working Group held the following discussions concerning how to encourage the holding of investment units by retail investors, who have a strong inclination for saving, and pension funds that expect stable income over the long term.

### (1) Promoting Diffusion to Retail Investors

According to the survey conducted by The Association For Real Estate Securitization (ARES) in December 2008, the recognition rate by retail investors of J-REITs remains at around one third that of stocks, and there were opinions that product characteristics of J-REITs are not well understood. Although the industry held the “J-REIT Fair 2009 for Retail Investors” (sponsored by ARES) in March 2009 – the first such event – to facilitate recognition of J-REIT product characteristics, it is important that operators, related groups and other players first cooperate and endeavor to conduct promotion activities and investor education for retail investors.

Moreover, it is necessary for securities companies to further strengthen their sales activities, as they are the sole direct contact for selling investment units. We expect that they will take the initiative and make efforts to construct an environment that should facilitate investment by retail investors – such as raising the priority of J-REITs in their marketing strategies and enhancing recognition of their sales staff on J-REITs, and such.

Next, banks are expected to play certain roles, as they have strengthened their sales activities for life insurance and investment trusts (mutual funds) in recent years. At present, banks sell investment trusts that cover J-REITs. They are an extremely important sales channel for expanding the retail investor base, and banks are expected to further reinforce their sales frameworks. J-REITs are an important part of investment products based on laws, and represent a major public interest as their investment funds lead to urban development through acquisition of income-generating properties and increasing the value of such properties. Banks are also expected to share this perspective and implement proactive measures to promote sales.

## (2) Promoting Diffusion to Pension Funds

Pension funds abroad invest more funds in real estate compared to pension funds in Japan, motivated by the diversification of management subjects, pursuing high cash returns, securing inflation hedge effects, and other benefits. In contrast, only a limited number of pension funds conduct real estate investment, and many public pensions make no investment in real estate.

As far as the J-REIT market is concerned, there are opinions that the market is still too small for pension funds to invest. In this regard, we believe that reorganization and further growth of the market is needed through such measures as mergers between REITs. Meanwhile, the entire real estate market in Japan is huge at approximately 2,300 trillion yen and has the potential to produce significant added value. As such, we expect pension funds, which conduct stable investment over the long term, to more proactively investigate the effectiveness of real estate investment.

On the other hand, pension funds have expressed their expectations over years for large-sized privately-placed funds with low LTVs that are specialized in managing stable assets, in line for their demand for stable investment subjects over the long term. However, we cannot say that there has been a sufficient supply of products that respond to this requirement. Developing products that satisfy the needs of pension funds is also important from the viewpoint of executing social missions to meet the national challenge of managing pension funds in the aging society.

To encourage pension funds to invest in real estate, it is also important to investigate use of advisory and other services by real estate investment advisors with abundant knowledge and experience in real estate investment, and to study the necessity of organizations for investment education and enlightenment such as the Pension Real Estate Association (PREA) in the U.S., which was established in 1979 for providing communication opportunities for investors (including public pension), management institutions and real estate service operators and provides opportunities for cross-industry dialogue specifically for real estate investment).

Furthermore, major institutional investors in the West have prepared Principles for Responsible Investment, which are the principles for socially responsible investment (SRI), under the guidance of the United Nations, and are proactively conducting socially responsible investments. Stable real estate investment by such pension funds and other investors may be more readily introduced into Japan if Japanese real estate operators are encouraged to further endeavor to develop and manage blue-chip properties that could be the subject of socially responsible investment.

## 6. Investigations on Real Estate Appraisals

Appraisals play a major role in real estate securitization, as the Investment Trust Law requires that price surveys be conducted based on appraisals by real estate appraisers, and the importance of appraisals is growing throughout the real estate securitization business. This is primarily because the appraisal system is recognized as a useful referential index for justifying the reasonability of trade prices of individual real estate transactions to investors. The background of this recognition is that real estate in general is an asset with high particularity, where prices are determined in negotiated contracts, and there is no price formed in a permanent and open transaction market – in contrast to general products traded in markets.

The real estate appraisal system has been revised in line with the expanded use of appraisals and other factors. The appraisal standards were amended in April 2007 to include items concerning appraisal of properties subject to securitization, and the report announced in April 2001 by the Real Estate Appraisal Subcommittee of the Land Policy Division at the National Land Council indicated directions that included reinforcing internal control systems in order to enhance the credibility of appraisals.

Under the appraisals currently employed for properties subject to securitization, focus is put on the income capitalization approach that applies the discount cash flow (DCF) method as a rule. When calculated with the method, the appraisal values vary in accordance with variations in the discount rate and other yield factors. As such, it is pointed out that appraisal values vary significantly as a result of changes in yields in accordance with economic trends, although J-REITs usually intend to own assets for a long time instead of trading them, and enjoy stable rental income over the long term. Appraisal values of J-REITs are disclosed at the end of each fiscal term and, through comparisons with their book values and other measures, have a major impact on the investment behavior of investors.

Because of this, real estate appraisers are expected to fully examine the grounds of the appraisal values and the discount rates and other yield factors they employ in appraising, and to describe the grounds in the appraisal statements in an easy-to-understand way. In addition, it is desirable that investment corporations disclose the essential parts of appraisal statements to investors in a more enhanced way to provide explanations to investors as to the appraisal values and the yields used in the appraisals. Such disclosures are also expected to bring about such effects as improved appraisal quality and shared views on appraisal values

and yields. Thus, it is desirable to conduct investigations concerning how to disclose the content of appraisal statements in a way that is easy to understand for investors.

Moreover, such arrangements would also be effective for continuous evaluation of properties owned by J-REITs, such as handling of negotiable securities for an accounting purpose that is treated differently according to the purposes of “owning them through maturity” and “owning for trade,” and such. On the other hand, however, there may also be many issues to tackle, including consistency with international accounting standards and other rules, as well as whether or not it constitutes a problem from the viewpoint of investor protection that continuous appraisal values are highly likely to differ significantly from appraisal values or actual trade values upon acquisition or sale of properties. For this reason, further investigations are required concerning continuous appraisal of properties and their disclosure on the assumption of continuous ownership such as J-REITs, with consideration given to opinions of investors, operators, financial institutions, real estate appraisers, certified public accountant, etc.

## 7. Information Disclosure by J-REITs

As products listed and traded on stock exchanges, J-REITs have contributed to the improvement in transparency of the real estate market through timely disclosure by stock exchanges. The emergence of J-REITs has greatly enhanced transparency of the real estate market in Japan. On the other hand, there were opinions that further improvement is required from the viewpoint of investors, and the Working Group held the following discussions concerning disclosure by J-REITs and other products.

### (1) Information Disclosure by J-REITs

Individual J-REITs are endeavoring to provide information through timely disclosure at stock exchanges and on their respective websites, but it is pointed out that the content of disclosure is not consistent among J-REITs. In particular, there were opinions that call for more unified disclosure among J-REITs including information in English for overseas investors, which hold approximately half of the share in investment unit trades, or disclosure of such items as NOI (net operating income) and cap rates under direct capitalization method that work as assumptions for conducting appraisals, and repair and maintenance costs over the long time calculated upon acquisition of properties. Of course, providing information is accompanied with such

problems as related costs and the duty of confidentiality. However, in order to activate the market, constant efforts to provide information useful for investment judgment in a way that is easy to understand for investors are indispensable. Thus, it is desirable that each REIT will continue to discuss with market-related parties including stock exchanges in efforts to make improvements.

## (2) Housing Price Indices

In the U.S., housing indices based on actual sell prices are publicly available to make it possible to grasp housing price trends over a wide range of areas, and serve as important information for investors and other parties. Among such indices is the S&P/Case-Shiller Home Price Indices. There is no counterpart to these indices in Japan, and some people point out that the lack is one reason why the housing values perceived in the market are lower than what they are supposed to be. Therefore, we believe it is necessary for Japan to develop housing price indices based on actual sell prices and make them widely available.

## 8. Other Issues for Activating the Real Estate Investment Market

### (1) Development of Diversified Business Methods

The Working Group discussed that investigations should be made into development of new business methods to allow the realization of a variety of businesses that meet market demands. Such methods might include those for joint entities solely comprising developers and real estate investment professionals to receive nonrecourse loans and conduct development-type real estate investment businesses.

### (2) Privately-placed Real Estate Funds, Etc.

In comparison to the asset size of J-REITs totaling approximately 8 trillion yen, the asset size of privately-placed funds is approximately 3 trillion yen. Privately-placed funds also account for a large proportion in the real estate investment market. Generally, privately-placed funds are formed by such professional investors as institutional investors, and tend to have higher LTVs compared to J-REITs. There are a variety of funds with different characteristics that have an extensive scope of assets under management, ranging from development-type assets to small-sized rental condominiums.

Presently, the credit crunch makes it difficult for new privately-placed funds to be formed, and many privately-placed funds are faced with the problem of redeeming their CMBSs (commercial mortgage backed securities) due to the drop in property prices. If the “no buyer” situation in the market does not improve, privately-placed funds may be forced to put their properties on the market. As these show, the trends of privately-placed funds have a major impact on the real estate market. On the other hand, there have been cases in which new privately-placed funds are formed with an aim to acquire income-generating properties that are currently priced lower than their value. It may be possible to expect them to serve as new buyers of properties.

While the trends and other events in privately-placed funds must be watched carefully, it is necessary for operators, experts, government agencies and other parties involved in the real estate investment market to unite and study how to activate the real estate investment market in areas other than J-REITs, as well.

(Reference 1)

Forum for Building Up the Real Estate Investment Market  
that is Trusted by Investors:  
List of Members of the Working Group

As of May 25, 2009  
(Honorifics omitted)

Chairman: Shohei Harada, Certified Public Accountant (CPA), Partner, Financial Services Department, Ernst & Young ShinNihon LLC

[Experts on laws, accounting and tax system]

- Shunpei Tanaka, Attorney at Law, Nagashima Ohno & Tsunematsu
- Shohei Harada, CPA, Senior Partner, Ernst & Young ShinNihon LLC
- Yukie Kuwahara, Partner, Ernst & Young Shinnihon Tax

[Operating companies]

- Yuichi Nakata, Project Manager, Operating Administration Department, Real Estate Securitization Planning Group, Mitsui Fudosan Co., Ltd.
- Hirokazu Aoyagi, Deputy General Manager, Commercial Property Development and Investment Planning Department, Mitsubishi Estate Co., Ltd.
- Riichi Morihiro, Chief Operating Officer, Nippon Building Fund Management Ltd.
- Takashi Kataoka, Head of Financial & Control Group, Office Management Division, Nomura Real Estate Asset Management Co., Ltd.
- Hiroyuki Ota, Advisor, STB Real Estate Investment Management Co., Ltd. and General Manager, The Sumitomo Trust & Banking Co., Ltd.
- Masaru Itagaki, Managing Director, Asset Finance Department, Nomura Securities Co., Ltd.

[Related organization]

- Hideaki Hirose, Manager, Listed Company Services, Listing Department, Tokyo Stock Exchange, Inc.

[Related government agencies]

- Takashi Kanda, Deputy Director, Securities Business Division, Supervisory Bureau,

Financial Services Agency

- Takuya Ishikawa, Director, Real Estate Investment Market Office, Real Estate Industry Division, Policy Bureau, Ministry of Land, Infrastructure, Transport and Tourism
- Yoshifumi Takafuji, Deputy Director, Real Estate Investment Market Office, Real Estate Industry Division, Policy Bureau, Ministry of Land, Infrastructure, Transport and Tourism

[Members for specific subjects]

REIT systems in other countries:

- Hitoshi Sumiya, Attorney at Law, Baker & McKenzie GJBJ, Tokyo Aoyama Aoki Koma Law Office (Gaikokuho Joint Enterprise)
- Koji Shikama, USCPA, Director, Financial Solutions Group, Financial Services Department, Ernst & Young ShinNihon LLC

Tax system:

- Akemi Kito, CPA, Tax Partner, Financial Services Department, Zeirishi-Hojin PricewaterhouseCoopers

(Reference 2)

Forum for Building Up the Real Estate Investment Market  
that is Trusted by Investors:  
Meetings of the Working Group Held to Date

2008

November 11      First meeting of the Working Group  
Subject: Reorganizing J-REITs through Mergers and Other Measures (1)

November 26      Second meeting of the Working Group  
Subject: Reorganizing J-REITs through Mergers and Other Measures (2)

December 9        Third meeting of the Working Group  
Subjects: Reorganizing J-REITs through Mergers and Other Measures (3)  
Corporate Governance of J-REITs (1)

December 24      Fourth meeting of the Working Group  
Subjects: Corporate Governance of J-REITs (2)  
Financing by J-REITs (1)

2009

January 30        Fifth meeting of the Working Group  
Subject: Financing by J-REITs (2)

March 4            Sixth meeting of the Working Group  
Subject: Financing by J-REITs (3)

March 31          Seventh meeting of the Working Group  
Subject: Promoting real estate investment by retail investors, pension funds  
and other investors

April 20            Eighth meeting of the Working Group  
Subject: Real estate appraisal, information disclosure and housing price

indexes

May 25

Ninth meeting of the Working Group

Subject: Other challenges concerning the real estate investment market