

Recommendations Towards the Revitalization of J-REITs and Japanese Real Estate Investment Market

- The Final Report of the Forum for Building Up the Real Estate Investment Market that is Trusted by Investors -

(Summary)

1. Introduction

Since its commencement in 2001, Japanese REITs (J-REITs) had grown steadily and also made significant contributions to urban development and other aspects in Japan through acquiring properties as well as increasing the value of owned properties. However, triggered by the subprime loan problems, J-REITs turned to a downward trend. With the number of properties acquired by J-REITs quickly decreasing, they have entered an adjustment phase for the first time. The J-REIT market is the basic foundation of the real estate investment market in Japan. It is required to enhance investor trust in J-REITs, to reactivate them as early as possible, and to reconstruct a good circulation of funds around real estate. By doing so, the rehabilitation of cities and local communities must be promoted.

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

With regard to the J-REIT market, it has been pointed out that the entire market is being damaged by the fact that there are few mergers and acquisitions, despite a market environment favorable for buyers as exemplified by the existence of many investment corporations that have a low PBR (price-to-book ratio). There is also a strong opinion claiming that it is more desirable for pension funds and other investors to invest in investment corporations with larger total assets. Mergers serve as a measure that would allow them to expand their asset size without spending a lot of money. It would also help meet the expectations of investors and further activate the J-REIT market. The Forum held discussions, as described below, concerning the reorganization of J-REITs. Given that the relevant systems have been revised to date in a way that should contribute to promoting mergers, the Forum 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.
- (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 make other adjustments. However, there is no explicit provision in 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 and its Inspection Guidelines in an effort to clarify the legitimacy of practical application.
- (3) As for the delisting and liquidation of investment corporations, which are legally possible, 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 on the overall real estate market. Accordingly, the Forum believes that investment corporations should endeavor to stay in the J-REIT market through such measures as mergers, changes in sponsors and switches of asset management companies.

3. Corporate Governance of J-REITs

Recently, administrative penalties were imposed on multiple asset managers for such activities as those that constituted conflicts of interest with the investment

corporations, and it has been pointed out that corporate governance of asset managers should be reinforced. Given this situation, the Forum held the below outlined discussions concerning specific measures to reinforce their governance capabilities while making comparisons to systems of various countries.

(1) The world's REIT systems are divided into externally-managed REITs (such as Japan) and internally-managed REITs, or a combination of externally- and internally-managed types (such as the U.S.). Both types have their respective advantages, and no general valuation can be made concerning which is more beneficial for investors. However, 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) Such schemes as internally-managed REITs and the stapled securities system 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, including the avoidance of taxation before paying dividends and discernment as to how the system would be positioned in relation to relevant laws and regulations. While it is important to continue examination among related parties on these ideas, it is essential for each J-REIT to voluntarily work on measures that should further enhance the trust of investors. Efforts to reinforce investor trust in J-REITs would include the following measures.

(a) Strengthen monitoring by investment corporations of 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 are fulfilling their fiduciary duties, duties of diligence of a good custodian and other duties towards the investment corporations. For this purpose, investment corporations would need to secure personnel and budgets that are required to conduct such monitoring, so as to allow the executive directors to sufficiently and proactively achieve their missions.

(b) Appoint outside directors for asset managers

From the viewpoint of reinforcing corporate governance of asset managers, etc.,

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.

4. Financing by J-REITs

Under the global credit crunch, strengthening the financial standing of individual J-REITs is a critical issue. In this regard, the Forum conducted discussions, as presented below, concerning a wide variety of options that could be introduced to Japan, on the condition that it is necessary to fully discern whether such options are suitable in terms of investor protection and systems in Japan.

(1) Diversification of Financing Methods by J-REITs

In order for individual J-REITs to construct a stable financial foundation that allows them to avoid over-dependence on loans, etc., they may dynamically collect investment funds to lower borrowing ratios or take other measures. Within the market environment where capital increases through public offering are difficult due to stagnant stock prices, the only practical way is to increase capital by way of third-party allocation, since the Investment Trust Law allows J-REITs to issue nothing but ordinary investment units (an equivalent of common stocks in stock-related vocabulary). However, if capital increases are conducted through third-party allocation within a situation where investment unit prices are falling, investors may not necessarily come to welcome them. Given such situations, the Forum has conducted the following studies concerning the diversification of financing, referring to cases in foreign countries where financing methods for REITs have been as diversified as those for general operating companies.

a) Rights Issue (capital increase through unitholder allocation)

Rights Issue is used by foreign REITs particularly as a means to procure funds in times of recession. Japan has seen no case of use of this method, although the

Investment Trust Law does not specifically ban it. 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. Therefore, related parties should prudently examine the preparation of systems that will make it possible to appropriately conduct capital increases through unitholder allocation.

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

Although it is recognized that the issuance of convertible bonds by J-REITs is difficult under the Investment Trust Law, many countries including the U.S. allow the issuance of such bonds. If convertible bonds were issued at a time when investment unit prices remained stagnant, it would allow such expectations as reduced borrowing ratios as conversion rights are executed through the process in which investment unit prices should recover to the level of the NAVs. On the other hand, there is also a concern 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. Therefore, prudent investigations should be made on such issues as fully securing governance and the need for system design for investor protection, while considering the possibility of their introduction in Japan.

c) Classified stocks (classified investment units)

Issuance of classified investment units would be difficult under the Investment Trust Law, but they are generally used in the U. S. In Japan, approving the issuance of classified investment units so as to meet various types of investors' needs is expected to help investment corporations improve their financial standing and increase investor trust. However, the issuance of preferred investment units might also bring about a negative impact, as it would make all outstanding investment units subordinate to them and have a major impact on existing investors. Because of this, prudent investigations should be made on this issue while considering the possibility of their introduction in Japan as well as focusing on fully securing governance and protecting investors.

d) Acquisition of treasury stocks (acquisition of treasury investment units)

As a rule, the Investment Trust Law prohibits investment corporations from acquiring treasury investment units. Meanwhile, the acquisition of treasury stocks by REITs is permitted in such countries as the U.S., and is utilized for their capital and dividend policies, etc. Now that investment units are listed, pricing measures on investment units by investment corporations are important in order to enhance investor trust. On the other hand, depending on the source of funds to acquire treasury investment units, care must be taken with regard to the relationship with existing creditors and to fair and equal handling of all unitholders. Accordingly, prudent investigations should be made as to how systems should be to take into account investor protection, while considering the possibility of approving the acquisition of treasury investment units in Japan.

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

Given the credit crunch currently prevailing, it has become important for individual J-REITs to reinforce their finance strategies and to improve their financial standing. Because of this, it is important for individual J-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.

Some investment corporations have been pointed out to have problems in redeeming the investment corporation bonds they issued. Investment corporations with upcoming maturity dates of these bonds must work to secure funds for redemption well in advance, through such measures as new borrowings from financial institutions and selling properties at appropriate prices.

(3) Necessity of Loans Provided Appropriately by Financial Institutions

J-REITs' main business is owning properties over the long term and leasing them for rent; they are not involved in risky business like that of real estate development. In spite of this, if financial institutions should refuse refinancing deals, it may force the unreasonable sale of properties in the real estate market that is said to have no buyers, and the drops in real estate prices might have a significant impact on the financial system and real economy. Due to this concern, we expect financial institutions to appropriately respond to refinancing requests

from J-REITs after fully reviewing their assets under management and other factors.

Moreover, although J-REITs have enhanced their presence as major buyers of income-generating properties, they are now adding to the “no buyer” situation in the real estate market, as the recent circumstances of stagnant stock prices and the credit crunch have made it difficult for them to newly procure funds and their property acquisition amounts have dropped rapidly. 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 investment corporations with high credit to buy blue-chip properties and stabilizing management by expanding their size through mergers, etc. For these issues, financial institutions should agree to requests for new loans as much as possible and contribute to the vitalization of the Japanese economy through supporting real estate buyers.

(4) Roles of the Government and Other Institutions

The financial operations of J-REITs must be conducted appropriately with the initiative of the private sector. However, if some investment corporations should go bankrupt, not only would investors lose confidence, but J-REITs would likely cause a crash in the real estate market by dumping properties and other actions. To prevent such from happening, the Japanese government took such measures as providing financial support under its “Emergency measures for activating housing and real estate markets” and conducted system reforms to facilitate mergers in the previous fiscal year. In addition, the government announced the “Countermeasures to Address the Economic Crisis” in April 2009 and stated 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.” 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 J-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 such moral hazards, it is expected that J-REITs must make further management efforts as conditions for obtaining support from the Fund.

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

J-REITs are backed by stable rental income, and their dividends and investment unit prices should also be 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 the like, who are inclined to sell investment units to meet immediate needs for money or for other purposes. Considering the original characteristics of investment units, investors are supposed to be retail investors and pension funds, etc. who intend to own investment units for a long time. Still, we can hardly say that investment units have sufficiently reached such investors. Accordingly, the Forum held the following discussions concerning how to encourage the holding of investment units by them.

(1) Promoting Diffusion to Retail Investors

Since the recognition rate by retail investors of J-REITs remains at around one-third that of stocks, we expect that operators, related groups and other players will cooperate and endeavor to conduct promotion and other activities, and that securities companies and banks will make efforts such as proactive sales promotions as sales channels.

(2) Promoting Diffusion to Pension Funds

Pension funds abroad invest a great deal of funds in real estate, but many of Japan's public pensions make no investment in real estate. Since the entire real estate market in Japan is huge at approximately 2,300 trillion yen and has the potential to produce significant added value, we expect pension funds to proactively investigate investment in this class. On the other hand, developing products that satisfy the needs of pension funds is also important. To encourage them to invest, it is also important to investigate the use of advisory and other services by real estate investment advisors, and to study the necessity of organizations for investment education and enlightenment such as the Pension Real Estate Association (PREA) in the U.S.

6. Investigations on Real Estate Appraisals

Appraisals play a major role as a useful referential index for justifying the reasonability of trade prices, and the appraisal system has been revised as necessary in line with the expanded use of appraisals and other factors. However, it is pointed out that, when calculating using the discount cash flow (DCF) method, it is important in appraisals currently employed for properties subject to securitization, the appraisal values vary in accordance with variations in the discount rate and other yield factors even though rental income is stable. Since J-REITs disclose appraisal values and they have a major impact on the investment behavior of investors, real estate appraisers are expected to fully examine the grounds of the yields they appraised, such as the discount rates, and to describe the grounds in the appraisal statements in an easy to understand way, while J-REITs are expected to enhance their disclosure. Moreover, further investigations are required concerning the continuous appraisal of properties on the assumption of continuous ownership such as J-REITs.

7. Information Disclosure by J-REITs

(1) Information Disclosure by J-REITs

Individual J-REITs are endeavoring to provide information through timely disclosure, but it is pointed out that more unified disclosure is called for because the content of disclosure is not consistent among the respective corporations. Although providing information is accompanied with such problems as related costs, etc., it is desirable that individual J-REITs will discuss with market-related parties in efforts to make improvements in their endeavors to provide information useful for investment judgment.

(2) Housing Price Indices

Some people point out that, in Japan, the lack of such indices as the S&P/Case-Shiller Home Price Indices in the U.S. 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 selling prices and to make them widely available.

8. Other Issues for Activating the Real Estate Investment Market

(1) Development of Diversified Business Methods

The Forum 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.

(2) Privately-Placed Real Estate Funds, Etc.

Privately-placed funds account for a large proportion in the real estate investment market. Presently, the credit crunch makes it difficult for many of them to be newly formed, and they are faced with the problem of redeeming their CMBSs (commercial mortgage backed securities). While the trends of privately-placed funds have a major impact on the real estate market, it may be possible to expect them to serve as new buyers of properties. Therefore, it is necessary for parties involved in the market to unite and study how to activate the real estate investment market in areas other than J-REITs, as well.