

## The Growth of J-REITs in the Japanese Real Estate Market and Real Estate Investment Structures: An Overview

This article provides an overview of the rapid rise of the J-REIT (Japanese Real Estate Investment Trust) as an investment vehicle in the Japanese real estate market over the last five years and also touches upon other more traditional Japanese real estate investment structures.

### I. The Growth of J-REITs in the Japanese Real Estate Market

#### 1. The growth of the real estate securitization market in Japan

One of the biggest trends in the Japanese real estate investment market over the last five years has been the growth of the real estate securitization market. As the accompanying chart (Figure 1) demonstrates, the Japanese real estate securitization market, which amounted to around 2.0 trillion yen in the year 2000, experienced over 300% growth in the next four years, with about 7.5 trillion in real estate secured assets in 2004. (Source: *Survey on Real Estate Securitization*, Ministry of Land, Infrastructure and Transportation, June 2005.) One of the biggest factors has been the explosive growth of the J-REIT market.

Figure 1 Volume of real estate securitization market



## **2. The Introduction of the J-REIT vehicle**

A J-REIT is a type of Japanese real estate securitization vehicle that is allowed to take a tax deduction for dividends paid provided that it meets certain statutory requirements, including that it must annually dividend out more than 90% of its taxable income. Introduced in the year 2000, the J-REIT market has rapidly grown, with a total value of listed J-REIT shares of approximately 2.6 trillion yen as of September 2005. Currently, there are 26 listed J-REITs, with 10 more J-REITs expected to be listed within the next year.

## **3. Attractiveness of J-REITs**

In a very short timespan, J-REITs have gained broad acceptance among both foreign and Japanese individual and institutional investors as a viable investment vehicle.

Its attractiveness seems largely due to: 1) the credibility of their sponsors, 2) high yields comparing with bond interest, 3) credibility due to strict regulation, 4) return stability, and 5) opportunity to invest in diversified Japanese real estate market.

## **4. Major investors to J-REITs**

To date, the largest investors into J-REITs have been local banks, individual investors, and foreign investors. Due to the differing objectives and concerns among J-REIT investors, two J-REIT derivatives – the “Fund of Funds” vehicle (an investment trust that invests into J-REITs) and the Global REIT Fund vehicle (a REIT that invests in REITs in various countries) – have starting gaining market presence.

## **5. Underlying assets of J-REITs**

In the beginning, J-REITs mainly invested in office buildings. Currently, however, a variety of J-REIT types have gone public, including residential J-REITs, commercial J-REITs, and logistics J-REITs (investing in warehousing and similar assets), to name a few.

## **6. Global REITs**

The rising J-REIT joins a global REIT market (Figure 2). The US REIT market, which adopted the REIT structure in 1960, is the largest market (approximately 30 trillion yen in value), with the second largest being the Australian REIT market (approximately 6.5 trillion yen in value). The J-REIT’s approximately 2.0 trillion yen value in 2004 places it third in the global REIT market.

Figure 2 Global REITs

	Year when REIT was introduced	Asset value (unit: trillion yen)
USA (REIT)	1960	Approx. 30
Australia (LPT)	1971	Approx. 6.5
Japan (J-REIT)	2000	Approx. 2.0
Netherlands (FBI)	1969	Approx. 1.7
Canada (C-REIT)	1993	Approx. 1.5

(The Association for Real Estate Securitization, "Real Estate Securitization Handbook 2005")

### 7. Growth in J-REIT stock price

Using three major public J-REITs, this section highlights some different financial metrics. With initial public offerings beginning in 2001, in three years these J-REITs' have doubled their share price (NBF: Nippon Building Fund; JRE: Japan Real Estate; and JRF: Japan Retail Fund) (Figure 3). During this period, J-REIT dividend streams have remained relatively constant, with the result that dividend yields have decreased by 50% (Figure 4).

Figure 3 NBF, JRE, JRF stock price

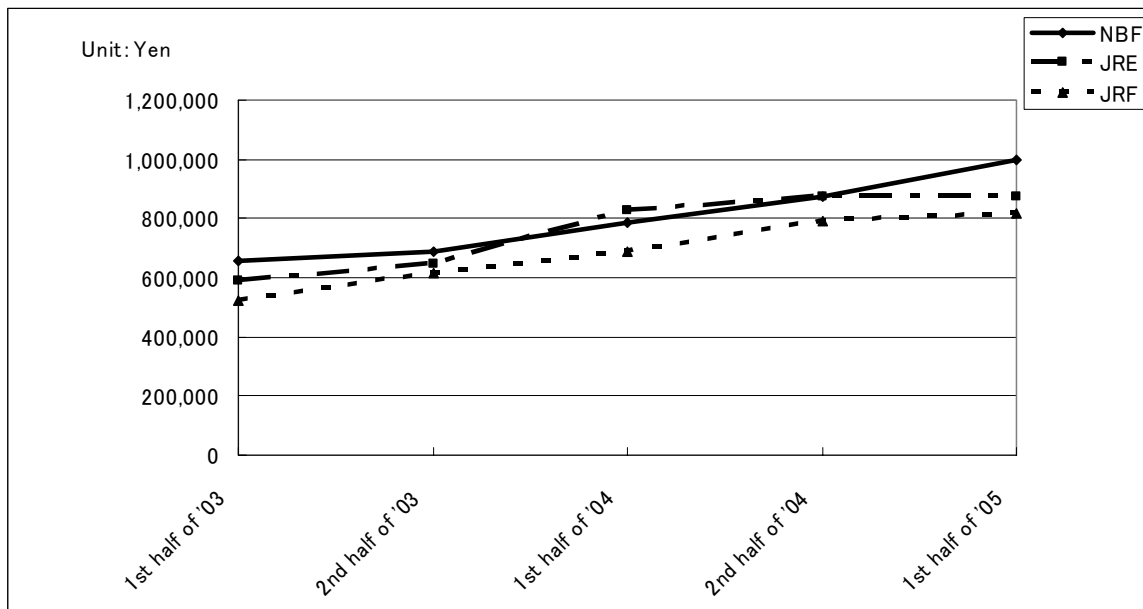
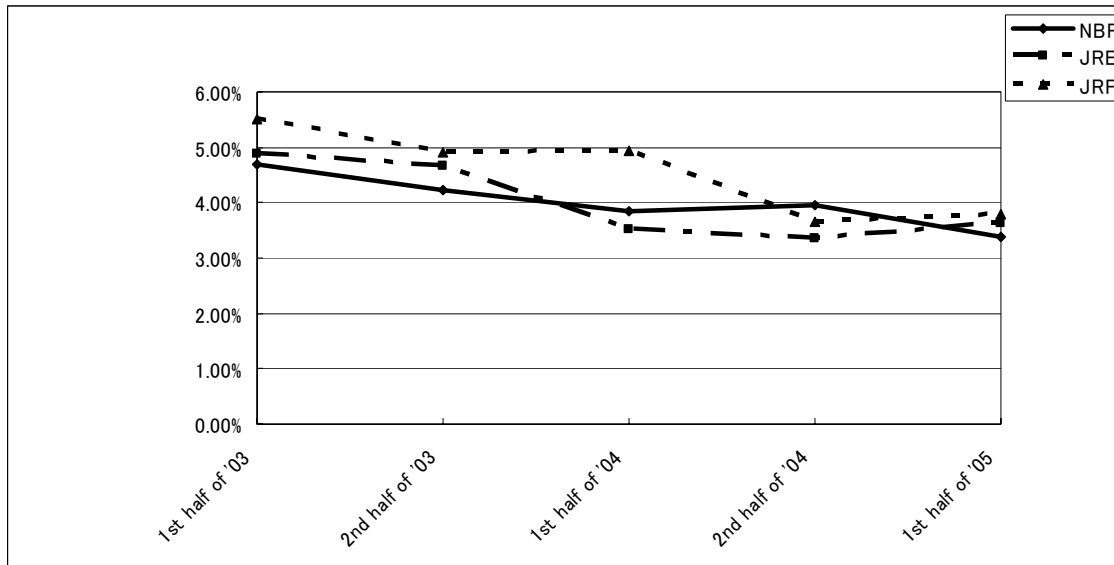


Figure 4 Return on Equity (NBF, JRE, JRF)



**8. Market based balance sheet of J-REITs**

The following is a marked to market based average of the balance sheets of NBF (as of June 2005), JRE (as of March 2005), and JRF (as of February 2005) (Figure 5).

Figure 5 Average of the balance sheets and market cap of NBF, JRE and JRF

	Real estate 320 billion yen	Loan 180 billion yen
	Cash and cash equivalent 27 billion yen	Market cap 257 billion yen
Unrealized gain and liquidity premium →	Premium 90 billion yen	

(Real estate is valued based on appraisal values disclosed in the financial report. Market cap is aggregated market value as of the first half of 2005. Other assets and liabilities are valued based on book value.)

From the above balance sheet, one can see that the J-REITs' liquidity premium is around 90 billion yen. Under the main viewpoint, this premium is assumed to come mostly from reduction

of risk due to diversified investments and liquidity premiums. There is another view that the unrealized gain in the assets held is already taken into account in the premium.

### 9. Weighted average of cost of capital of J-REIT

If one were to analyze purchasing power of J-REITs, one would analyze the J-REIT's weighted average of cost of capital (WACC). Taking an illustrative balance sheet (Figure 6) into account, such a process of analysis is explained more below.

Figure 6 Balance sheet of J-REIT

2001		2005	
Real estate 4%	Loan 2%	Real estate 4% →2.5%	Loan 2%
	Equity 6%		Equity 6%→3%

(The above assumes that (1) the debt equity ratio is 1:1; (2) the average interest rate on the loan balance was 2% in 2001 and remained constant at that rate through 2005; and (3) the dividend yield was 6% in 2001 and 3% in 2005. Under those assumptions, the WACC would have been 4% in 2001 and 2.5% in 2005.)

### 10. Impact of the WACC lowering on J-REITs

Provided that the example J-REIT adopts its WACC as its target discount rate for acquisition when acquiring real estate, a decrease in the WACC from 4% to 2.5% as shown below significantly increases the J-REIT's ability to acquire additional assets.

Example: Typical office building case

- Total floor space: 3,000 tsubo (one tsubo is approximately 3.3 square meters)
- Monthly net income on investment: 20,000 yen / tsubo
- Annual net income on investment: 20,000 yen×3,000 tsubo×12 months=720,000,000 yen
- Capitalized value with a discount rate of 4%: 720,000,000 yen / 4%=18,000,000,000 yen
- Capitalized value with a discount rate of 2.5%: 720,000,000 yen / 2.5% = 28,800,000,000 yen

As demonstrated above, a 1.5% decrease in the discount rate (from 4% to 2.5%) increases the capitalized value of the real estate by a factor of 1.6. It is likely that such an increase in the J-REIT's share value would trigger the J-REIT to become a more aggressive buyer.

## II. Real Estate Investment Structures for Foreign Corporate Investors

In addition to J-REITs, Japanese real estate investment structures include direct investment, *Tokumei Kumiai* (TK) structures, and *Tokutei Mokuteki Kaisha* (TMK) structures. The Japanese tax implications of these structures are briefly touched upon on a high level basis below, although such should be taken for informational purposes only and is not to be relied upon as tax advice in any form. We assume that the foreign investor does not have a permanent establishment in Japan :

### 1. Direct investment

This is the simplest structure and involves the foreign investor directly acquiring and holding the real estate asset. However, any rental income and capital gain from disposal of the property will be taxable in Japan, with the foreign investor required to file a tax return and pay tax at a 30% rate, assuming no permanent establishment (the effective tax rate becomes approximately 42% if a permanent establishment exists).

### 2. Tokumei Kumiai (TK) structure

The TK structure is a type of partnership where the limited partner (*tokumei kumiai-in* or TK investor) invests in a unrelated special purpose vehicle (structured to be bankruptcy remote) holding the real estate asset (generally called the TK operator). The TK operator operates the property, with the TK investor receiving an annual percentage allocation of any profit. Subject to meeting certain requirements, the TK allocations are deductible for Japanese tax purposes at the TK operator level.

TK structures have been very popular with the foreign investment community for a few reasons: 1) relatively easy to set up, 2) low setup costs, and 3) ease of the TK structure once established to acquire additional assets. The TK structure is also relatively tax efficient, with the foreign investor being subject to Japanese tax on its TK allocation (withholding tax) at a rate of 20%, unless reducible by tax treaty. However, full attention should be paid to setting a TK structure up, as certain tax risks do exist.

### 3. Tokutei Mokuteki Kaisha (TMK) structure

The TMK structure is a special purpose securitization vehicle (the TMK vehicle) that issues to its investors either corporate bonds (TMK bonds) or equity (in the form of preferred shares). The TMK vehicle then acquires the real estate asset in question. The TMK outsources the operation of the real estate to an asset manager and distributes any profit realized in the form of bond interest on the TMK bonds or dividends on the preferred shares. Provided that certain requirements are met, such distributions are tax deductible for the TMK vehicle, resulting in a low Japanese tax rate. Foreign investors are generally subject to 20% withholding tax on the preferred share dividends, unless reducible by tax treaty. With the application of a tax treaty, the withholding tax rate could be reduced to as low as 0%. As a real estate acquisition structure, the TMK vehicle is very stable legally, enjoys good Japanese tax results, and is popular for those reasons.

However, the TMK vehicle also is subject to significant regulatory restrictions and involves a longer establishment period and greater costs. In addition, the TMK structure is a per-asset structure; additional asset acquisitions require additional TMKs to be established.

### 4. Investment in J-REITs

In general, for a foreign investor the J-REIT structure is also attractive vis-à-vis the above structures from a Japanese tax viewpoint. Under current rules, foreign investors are generally subject to 7% withholding tax on J-REIT dividends (until March 2008). Any capital gain arising from the sales of J-REIT shares is exempted from tax under domestic tax laws, provided that the foreign investor owns 5% of the listed J-REIT or less. If the foreign investor owns more than 5% of the listed J-REIT, any capital gain on the investor's shareholding will be subject to Japanese tax at the rate of 30% for corporate investors, unless such rates are reducible via a tax treaty.

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