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Real Estate 2022

Japan: Trends & Developments
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Trends and Developments

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Inbound Investment

Inbound investment in Japanese real estate has been increasing continuously. According to a 2021 survey by the Tokyo Stock Exchange, approximately 53% of trades in J-REIT shares were executed by foreign investors, and about JPY260 billion (approximately USD2.14 billion) flowed into the J-REIT market from foreign investors.

Foreign investors have long played a key role in the Japanese real estate market. In a fairly large volume of transactions, SPCs sponsored by foreign investors have purchased Japanese real estate using financing with securitisation structures. In fact, despite the ongoing COVID-19 pandemic, foreign investors actively invested in five of the top ten largest real estate sale and purchase transactions (by deal size) in Japan in 2021, according to Nikkei's real estate market information.

As the population of Japan declines, it will be increasingly important to continue the development of a sophisticated real estate market to attract inbound investment, in order to sustain the growth of the national economy. The Japanese government expects that inbound investments will play a key role in real estate development in the country moving forward. This is also in line with the recent amendment to the Financial Instruments and Exchange Act, concerning Special Permitted Business for Overseas Investors, effective from 22 November 2021, which allows certain funds whose main investors are overseas corporations or foreign resident individuals holding certain assets to operate in Japan by notification, without limiting the number of investors or requiring investments by an investor that has filed to be a Qualified Institutional Investor under the Act.

COVID-19's Impact on the Market

The COVID-19 outbreak had a significant impact on the real estate market, as it did on many other business sectors. However, its impact varied significantly depending on real estate asset type.

Logistics

As in 2020, the outbreak seems to be causing significant acceleration in investment in logistics assets, due to the expansion of e-commerce resulting from the widespread adoption of work-from-home arrangements and quarantine measures imposed during the state(s) of emergency in Japan and elsewhere. More investors and real estate funds have focused on logistics, especially those assets that are related to supporting e-commerce and other digital transformation (DX) trends.

Office and residential properties

Despite the pandemic, investment in Japanese office properties seems to be steady. Specifically, the vacancy rate in high-quality assets in the Tokyo area has not risen as much as initially expected. 2021 saw increased investment in residential properties, specifically those located in core regional cities like Osaka, Nagoya and similar locations. A fund targeting a portfolio of detached single-family houses, which is unfamiliar and may be the first fund of this type in Japan, also began in 2021, although it was previously considered difficult to originate this type of fund. It appears that investors have started to focus on portfolios of detached houses, as such properties are relatively spacious but far from city centres, and these characteristics seem to be in line with the widespread adoption of work-from-home arrangements, which require additional room in residential properties and allow workers to live relatively far away from their offices.

Hotel and accommodation assets

The pandemic has clearly had a negative effect on the hotel and accommodation market, including some J-REITs that focused primarily on hotel assets. In contrast to office and residential properties, the cash flow of hotel properties can be affected easily by a drastic decrease in tourism. With the exception of some hotels that have succeeded in generating domestic demand, conditions continue to be difficult, and some restructuring deals for hotel properties have taken place.

Many private funds and J-REITs with hotel assets continue to face financial covenant breaches (from the latter half of 2020 to the present), but have avoided default by making additional capital injections or by providing additional cash reserves. However, there might be limits to these measures, and it remains to be seen how lenders will respond in 2022.

REITs

In the Japanese capital markets, REITs have generally showed a strong and steady performance, although some hotel and commercial REITs seem to be struggling with the downturn in guest/consumer demand. The REIT index plummeted in March 2020 due to uncertainty caused by COVID-19, but it has recovered quickly. The total value of real estate held by REITs, including private REITs, has reached approximately JPY25.5 trillion (on the basis of acquisition price), and the aggregate market capitalisation of listed REITs was about JPY16.5 trillion (approximately USD140 billion) at the end of 2021.

The growth of private REITs has played a role in the Japanese REIT market, with private REITs holding properties valued at about JPY4 trillion (on the basis of acquisition price) in December 2021. There are 39 private REITs, ranging from comprehensive REITs (those diversifying their portfolio in multiple asset types) to sector-specific REITs, such as residential, hotel and logistic properties. Sponsors from various business fields have initiated private REITs. Railroad companies, electric power and gas companies, financial institutions (including insurance companies and banks) and other industry are also engaging in the management of REITs, or are interested in doing so.

One of the current key trends in the REIT market has been hostile takeovers of J-REITs. There were some M&A transactions between J-REITs before 2019, but they were all friendly mergers under agreements between all relevant parties (including the sponsors), and many were carried out between J-REITs under the same sponsors or affiliated sponsors in an effort to increase their assets under management (AUM), expand the types of their assets, and/or streamline their business.

The first hostile REIT M&A transaction was completed in 2020. A minor shareholder called a shareholders' meeting of a target REIT with the financial bureau's permission, at which both the selection of a new officer nominated by the minor shareholder and the execution of a management agreement with a new sponsor were resolved, as well as the termination of an existing management agreement. After the meeting, a merger was conducted between the REIT managed by the new sponsor and the target REIT.

Another contemplated hostile transaction case is a hostile takeover bid against a listed office J-REIT in 2021 to try to take over the REIT's shares, which resulted in the delisting of the

REIT through a counter-bid and squeeze-out of minority shareholders by its sponsor. In comparison with a company incorporated under the Companies Act, a REIT has more limited defensive measures against a hostile takeover bid (eg, poison pills and specially designed shares are not recognised under the Act on Investment Trusts and Investment Corporations, which regulates REITs).

The types of REIT M&A transactions are generally as follows:

- mergers between two REITs (via a consolidation-type merger or an absorption-type merger);
- the acquisition of J-REIT shares and the replacement of an asset management company; and
- the acquisition of all portfolio assets held by one REIT by the acquiring REIT.

These types of transactions are subject to approval by the shareholders of the REIT, so there are hurdles to implementing hostile REIT M&A transactions. Even so, REIT asset management companies cannot overlook the possibility of such transactions, considering that a shareholder holding 3% or more of the issued shares for the preceding six-month period can request a shareholders' meeting to be held regarding such transactions. Under these circumstances, it is becoming more important for REIT asset management companies to regularly provide sufficient reporting to shareholders and to obtain their understanding of the advantages of having them manage REIT assets as well as their investment policies and investment records.

Furthermore, under the Act on Investment Trusts and Investment Corporations, a J-REIT may provide in its certificate of incorporation that shareholders who do not attend a shareholders' meeting or exercise their voting rights will be deemed to agree to the proposal(s) submitted to that meeting (the Deemed Votes in Favour Provision). Shareholders of J-REITs include many individual or corporate investors who are mainly hunting for high returns so are less concerned about attending shareholders' meetings or exercising their voting rights. Therefore, most J-REIT asset management companies provide Deemed Votes in Favour Provisions in REIT certificates of incorporation in order to constitute a quorum and pass necessary resolutions at shareholders' meetings. However, as a general rule, a Deemed Votes in Favour Provision can also apply to important proposals such as those for the replacement of management companies or the hostile takeover mentioned above, and can therefore make such transactions easier.

Security Token Offerings

Amendments to the Financial Instruments and Exchange Act (Act No 25 of 1948 – FIEA) and the Payment Service Act (Act No 59 of 2008) were enforced on 1 May 2020 in response to the diverse range of financial instruments and investment schemes emerging as DX technology develops. These amendments established regulations for Security Token Offerings (STOs), which included continuous disclosure obligations to address the information asymmetry between issuers and investors.

One of the leading methods for structuring STOs backed by real estate is to use a Trust with Certificates of Beneficial Interest. Unlike other types of equity instruments, such as equity investments in TK partnerships, which generally require written documents with a certified date to be transferred and perfected, a beneficial interest in a trust can be transferred and perfected by agreement between the parties without a document with a certified date. This is because the transfer of a beneficial trust interest can be perfected by an entry or record in the beneficial interest register if the trust deed indicates that no beneficiary certificate is issued. Therefore, this beneficial interest registry may be directly linked with a blockchain, and nothing other than the registration would be required to complete a transfer (including perfection).

Furthermore, under the Industrial Competitiveness Enhancement Act, which was amended and enforced on 16 June 2021, a transfer may be perfected against the debtor and third parties if a notice or consent to the transfer has been conducted through a certified business operator that uses information systems (with certain features).

Outbound Investments

Despite the COVID-19 pandemic, outbound investments trends have continued. Over the past few years, Japanese investors have continuously expanded their outbound investments into foreign real estate markets, seeking to take advantage of good domestic economic strength mixed with relatively limited investment opportunities within Japan. A number of Japanese real estate developers have announced that they are or will be investing in real estate and real estate development businesses outside of Japan. Although this trend seems to have slowed down to some extent as a result of COVID-19's negative impact on real estate markets overseas, most Japanese funds and investors are not yet withdrawing their outbound investments. Having said that, no new transactions where a J-REIT has acquired property overseas have yet been announced in 2022, although it has been confirmed that J-REITs are able to hold up to 100% of the equity of foreign real estate companies in certain foreign countries, including the USA, India, Indonesia, China, Vietnam and Malaysia. There have been three outbound investments by J-REITs to date:

- AEON REIT Investment Corporation's investment in a commercial property in Malaysia by acquiring 100% of the equity of a Malaysian SPC;
- Invincible Investment Corporation's investment in hotels in the Cayman Islands in 2018; and
- the investment by a private J-REIT sponsored by Daiwa House in 100% of the equity of a limited liability company that co-owns real estate in the USA.

Renewable Energy

Even after the global COVID-19 pandemic exerted considerable pressure on economic activity in Japan, domestic and foreign investors have actively and consistently invested in Japanese renewable energy businesses.

After the Japanese Feed-in-Tariff regime (the FIT Regime) came into effect in July 2012, the proportion of renewable energy in Japan's power generation mix increased from approximately 9% to 18%.

As the next step, for the independence of renewable energy, a major amendment to the Japanese Renewable Energy Act (Act No 108 of 2011) was promulgated into law in June 2020 and will come into force in April 2022, and the Japanese Feed-in-Premium regime (the FIP Regime) will be introduced, shifting away from the FIT Regime.

In addition to the ordinary renewable energy businesses (ie, solar, onshore wind and biomass), developments of offshore wind projects have greatly accelerated in recent years. The major developers in this field are domestic energy businesses, including trading companies (*shosha*), major construction contractors and Japanese utilities.

The Offshore Renewable Energy Act (Act No 89 of 2018) came into force in April 2019, to promote the development of offshore wind projects in Japan. Under the Offshore Renewable

Energy Act, the Japanese government designates specific zones for the development of offshore wind projects (Promotion Zones), which are sites available for tender and the award of occupancy permits with a maximum term of 30 years. From 2019 to 2021, five tender processes commenced under the Offshore Renewable Energy Act for six Promotion Zones in Nagasaki Prefecture, Chiba Prefecture and Akita Prefecture. More Promotion Zones are expected to be designated within a few years, according to a government announcement indicating that ten sea areas have progressed to a certain level of preparation for starting projects.

Under its Green Growth Strategy towards 2050 Carbon Neutrality, published in December 2020, the Japanese government plans to achieve around 50% to 60% of total power generation through renewable energy by 2050, with offshore wind power considered a high growth potential sector. In response to the legislation anticipated under this strategy, investments and developments in the renewable energy section will be continuously stimulated over the next few decades.

ESG

ESG factors have gained attention in the real estate market, in line with other investment sectors.

To create a sustainable environment, it is generally understood that real estate, as a basic component of society, should follow global policy, such as contributing to Sustainable Development Goals (SDGs). The real estate industry is thought to have significant potential to play an important role in meeting SDGs, especially with respect to the environment. There have been developments of buildings that achieve high environmental performance to reduce energy consumption. Buildings with environmental performance certificates appear to attract more investments than those without such certificates.

In line with the promotion of ESG, the number of Japanese participants in GRESB Real Estate Assessment has been increasing, with the participation rate of Listed J-REITs in the Assessment reported to have been approximately 90% (on the basis of market capitalisation) in 2019. GRESB Real Estate Assessment is the global ESG benchmark capturing information on ESG performance and sustainability best practices for real estate, and gives rating results. It appears that more and more investors have referred to, or are considering, GRESB Real Estate Assessment for their investment decisions.

The Japanese government is also delivering positive signals regarding ESG/SDGs and publishing its policies related to this field, such as:

- SDGs Action Plan 2020;
- Financial Administration and SDGs;
- the interim report for the promotion of ESG investment in real estate;
- the interim report of the study group on real estate-specific joint ventures based on ESG investment; and
- Guidance for responding to “Proposals of Task Force on Climate Related Financial Information Disclosure” in the real estate field.

The idea of a green lease is part of the government’s strategy to improve environmental performance in the real estate sector, which the Japanese government is also suggesting through its Green Lease Guideline. In a green lease, the owner and tenant share the costs for environmental improvements of the leased building.

Also, public money, together with private funds, has been flowing into investments to redevelop aged buildings and remodel them to have improved seismic capacity and environmental efficiency. The green bonds market is also growing and collecting funds to be spent on eco-friendly businesses.

ESG is currently at an early stage of development in Japan; although certain examples are being created, it seems that ESG investment methods, disclosure models and the effects of ESG investments have not been established completely. Nevertheless, the global ESG trend will continue to grow in the Japanese real estate market, and attention needs to be paid to this development.

Recent Reforms

One of the latest reformations to Japanese real estate law is legislation related to land with unknown owners (including owners whose whereabouts are unknown), most of which will become effective in April 2023. The background of the legislation is that land with unknown owners, which is relatively common in Japan, has become a social issue, as it can complicate disaster reconstruction and other projects.

To facilitate transactions for land with unknown owners, the legislation establishes a new management system for such land, under which courts may appoint a manager for such land upon request by an interested party. A court-appointed manager is authorised to sell or otherwise manage such land (with or without the court's separate permission). Also, if multiple owners co-own a parcel of land, they all need to reach an agreement if they would like to proceed with a sale, but the legislation enables co-owners to proceed with a sale without the consent of an unknown co-owner, after obtaining court authorisation. This may increase the market liquidity of lands that are co-owned by groups that include unknown owners. The legislation also allows the exclusion of the voting rights of unknown owners in order to approve the alteration or management of co-owned property, with court approval. The legislation includes other rules, such as those enabling a land owner to set facilities for a lifeline (eg, electricity, gas and water) in neighbouring land or to use such facilities owned by a neighbour. These rules are intended to facilitate the easier management of land.

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Nishimura & Asahi has substantial experience in a wide array of real estate securitisations in both domestic and cross-border transactions. The firm's real estate finance team has a proven track record in advising both lenders and borrowers in finance transactions throughout the real estate industry, offering expert assistance to clients in all stages of their transactions, from the term sheet and structuring stage through closing, tranching, syndication and securitisation, administration, servicing and, if required, restructuring. Since the early 2000s, the firm's lawyers have played a significant role in advising publicly traded REITs, private REITs, and real estate operating and finance companies in all stages of their life cycles, from REIT formation, roll-up transactions and initial public offerings to secondary debt and equity offerings, and REIT transactions. Nishimura & Asahi advises on real estate sales and purchases, investment, lease and management in Japan and abroad; as the growth in real estate funds and private equity investment in real estate increases, the firm has been advising all of the key fund-related specialties. It also specialises in environmental law, providing risk analysis and settling disputes on soil pollution, asbestos and other environmental law issues that arise regarding real estate, with capabilities extending to environmental law-related issues to be complied with by business entities and corporate social responsibility (CSR).

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