Trends & Developments

Contributed by Nishimura & Asahi

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Diversification of Asset Type – Development of J-REIT

The Japanese real estate market has been recovering and growing since 2012, and the variety of real estate assets available to investors has expanded due to developments and revisions to the rules and regulations governing J-REITs. A J-REIT was listed on the Tokyo Stock Exchange for the first time in 2001. The asset portfolios held in those early days consisted mainly of offices and residential properties, but investors can now find J-REITs that hold diversified assets such as healthcare facilities, hotels and logistic facilities. Recently, these new types of assets have drawn especially close attention from people involved in the market, based on the expectation of high demand for these types of real estate.

Healthcare Facilities

The Japanese population is ageing at an unprecedented pace, leading policymakers to encourage private investment into areas that enhance social security, including the care and treatment of the elderly. Such policies include encouraging investment into healthcare facilities through J-REITs. In 2014, the Ministry of Land, Infrastructure, Transport and Tourism ("MLIT") published its guidelines for J-REITs investing in healthcare facilities ("Healthcare REIT").

The guidelines set forth criteria that an asset manager of a Healthcare REIT must meet before submitting an application for regulatory approval to MLIT (eg, to employ officers with certain experience levels, and to obtain certain outside professional advice). The guidelines also detail the recommended manner for dealing with particular issues in connection with healthcare facility transactions, such as the collection and disclosure of relevant information, and maintaining relationships with the operators and users of the facilities. In addition to these guidelines, the Tokyo Stock Exchange has revised its rules to add disclosure items with respect to Healthcare REITs, in order to facilitate their use. A self-governing organisation that supervises REIT asset managers has made revisions to its rules as well. The purpose of these regulatory revisions was not necessarily to tighten regulations, but instead to promote Healthcare REITs by improving their reliability and transparency.

Following these reforms, three Healthcare REITs were listed on the Tokyo Stock Exchange in 2014 and 2015.

Hospitals

Compared to other types of real estate assets (offices, residential property, etc), the volume of transactions regarding hospitals has not been substantial, based on public information, with no J-REIT investing in hospitals at the time of writing. Likewise, private funds using a securitisation structure where a small number of investors make equity contributions to an SPC (such as a TMK) have historically targeted properties with stable income rather than operational assets, such as hotels and hospitals. However, this overall trend is gradually shifting.

An ageing population creates market demand for hospitals as well as healthcare facilities. A relatively large number of hospitals are facing substantial restoration and reconstruction needs since their initial construction decades ago. Owners of hospitals are beginning to recognise the value of using securitisation structures to monetise their real property, overcoming a traditional mindset of medical professionals to hesitate to relinquish ownership of hospitals. Under these circumstances, there have been growing discussions about using J-REITs to invest in hospitals, with the Japanese government announcing guidelines for J-REIT investment in hospitals (the "Hospital Guideline") in 2015. The Hospital Guideline sets forth factors used to evaluate governance of asset managers, similar to the guideline for Healthcare REITs. Asset managers are required under the Hospital Guideline to hire a hospital operations expert who is familiar with the characteristics of hospital business as an employee or committee member, or to receive advice from such an expert, in order to establish internal systems capable of handling hospital transactions.

Hospital transactions present inherent practical issues. For example, the Medical Care Act requires a hospital to be a non-profit organisation, which prohibits a medical operator from entering into a lease with rent that fluctuates based upon income from hospital operations. In addition, when a J-REIT invests in a hospital, required disclosure under exchange rules is also a challenge that must be addressed properly. Also, there may be practical difficulties in evaluating hospital operations.

Despite the issues associated with hospital transactions, it appears that banks, financial institutions and investors are looking forward to these new investment opportunities. The scale of each hospital asset is generally larger than a healthcare facility, so there may be a greater impact on the real estate market if hospital-backed transactions increase through securitisation (including J-REIT).

Hotels and Accommodation

The number of visitors coming to Japan has been increasing, rising to 19.74 million people in 2015, which is double the amount from 2013, and triple the amount from 2011, according to an announcement from MLIT. The Japanese government's target to increase inbound visitors to 20 million by 2020 was almost met last year, with the number of hotel guests expanding more dramatically than expected.

Japan will host the Tokyo Olympics in 2020, which has boosted the market for hotels and other accommodations around the Tokyo area. For instance, developers recently announced new hotel construction plans around the Tokyo Disney Resort, and there are some large-scale hotel transactions underway, such as the reconstruction of Hotel Okura Tokyo. One of the current trends in the hotel market is to rebrand property following refurbishment and restoration to accommodate more guests, including foreign visitors. There are five J-REITs listed on the Tokyo Stock Exchange that are focused on investing in hotels, and a new J-REIT is also expected to be listed this year. More than 200 hotel (and accommodation) properties in Japan are held by J-REITs, offering diverse investment opportunities to investors.

Logistics Facilities

Logistics facilities is another asset class that is attracting attention in the Japanese real estate market. The market for electronic commerce is increasingly developed; the amount of business-to-consumer transactions regarding electronic commerce reached JPY13,774.6 billion in 2015, up from JPY7,788 billion in 2010, according to a report issued by the Ministry of Economy, Trade and Industry. With this growth, logistics companies are seeking facilities in proper locations to accommodate their increased inventory. Furthermore, it is anticipated that international transactions will continue to grow following the implementation of the TPP and related policies, which will further increase demand for logistics facilities.

Six J-REITs investing in this space are listed on the Tokyo Stock Exchange, the newest of which was listed in 2016.

Real Estate Redevelopment and Revitalisation

A relatively large amount of Japanese real estate has become decrepit in a certain area, and needs to be restored or replaced. Additionally, earthquakes must be taken into consideration when evaluating Japanese real estate, as some older buildings were not constructed with sufficient seismic capacity. For example, a 2015 survey published by the Ministry of Health, Labor and Welfare showed that only 69.4% of hospitals met Japanese earthquake-resistance standards.

A statute related to securitisation – the Real Estate Specified Joint Enterprise Act ("REJEA") – was amended in 2013 in order to support a policy of real estate redevelopment and revitalisation.

Under the amended REJEA, an SPC may acquire real property – and distribute proceeds to TK investors without entrusting the property to a trust company or trust bank – if all requirements set forth under the REJEA are met (eg, delegation to certain qualified business operators of SPC's business of real estate transactions and its business of solicitation for entering into equity contracts, and the limitation of investors involved in a scheme to certain types of person) and if an SPC follows the processes thereunder, such as giving notification to a relevant authority. Regarding registration and licence tax, and real estate acquisition tax, tax breaks are available for the reconstruction of old facilities under the amended REJEA.

The amended REJEA has some advantages over a traditional GK-TK structure and a TMK structure. A GK-TK structure generally requires property to be entrusted to avoid a restriction imposed by REJEA, but no such restriction applies to an SPC qualified under the amended REJEA. As opposed to the TMK structure, an SPC under the amended REJEA is not required to issue bonds in order to be free from double taxation; it is also not required to submit Asset Liquidation Plans and other documentation, etc.

A further amendment to REJEA is currently under discussion to make the execution of real estate transactions more convenient. Seeking to encourage investments in relatively small properties in regional cities as well, there has been some discussion about relaxing restrictions on real estate businesses covered by REJEA. Among other things, the types of investor with which an SPC is able to deal through a qualified business operator may become broader, capital requirements regarding a business operator to be qualified may be lowered, and an electromagnetic record may become available instead of hard copies when documents are delivered, depending upon discussion and amendment to REJEA in future.

Hopefully, the amendment(s) of REJEA will facilitate an increased use of securitisation and the restoration of ageing properties, including those with defects (such as the lack of seismic capacity) that are difficult or practically impossible to be entrusted to a trust company or trust bank.

Investments in Regional Cities, etc

It appears that the real estate market is active in certain areas outside of large metropolitan cities, although the size of this market is not comparable to the Tokyo area. Cities such as Sendai, Sapporo, Hiroshima and Fukuoka are attracting real estate investments. Properties acquired in regional cities by J-REITs have accounted for about 20% of J-REIT acquisitions over the past few years, according to government data. Logistics properties and commercial properties seem to be the favoured asset class in these areas.

J-REITs specialising in specific areas have emerged. Fukuoka REIT has elected to manage properties located in the Kyushu area, including Fukuoka, as well as Yamaguchi and Okinawa, which are appealing to local investors.

Japan's feed-in tariff ("FIT") to support renewable energy development became effective in 2012, whereby a qualifying renewable energy supplier may sell electricity from its facility to an electric utility at a subsidised fixed price for a 20-year period. Since then, investments in renewable energy power generation facilities have dramatically expanded, leading to an increase in real estate transactions in small cities and towns, and in countryside areas that are appropriate for the development of renewable power facilities.

Promoting regional revitalisation is one of the key themes adopted by the Japanese government to sustain national power and population overall. With this policy as a background, the aforementioned further amendment to REJEA has been considered.

Cross-Border Investments

Inbound Investments

Foreign investors have already played a key role in the Japanese real estate market. A Tokyo Stock Exchange survey in 2015 revealed that foreign investors held approximately 23% of J-REIT stocks, and that approximately 43% of J-REIT stock transactions were executed by foreign investors.

On top of this, there has been a fairly large volume of transactions where SPCs sponsored by foreign investors have purchased Japanese real estate using financing from banks with securitisation structures. Example acquisitions in recent years include a well-known wedding complex building, a landmark tower, and large office buildings in Tokyo.

As the population of Japanese society has declined, it will be important to continue to develop a sophisticated real estate market to attract inbound funds in order to sustain the growth of the Japanese economy. In line with this idea, in 2014 and 2015 the Japanese government published information briefs, in English, regarding real estate transactions and the real estate market.

Outbound Investments

As discussed above, there is activity in domestic transactions in some areas, such as hotels, but due to long-term concerns about the expected decline of the Japanese population, Japanese developers are casting a jealous eye on overseas real estate markets, especially in other parts of Asia.

J-REITs were not permitted to invest in real estate outside of Japan until 2008; following the revisions to the Tokyo Stock Exchange rules, they are now permitted to acquire overseas property, but are restricted from holding more than 50% of equity shares issued by a corporation that owns real estate. This served as an obstacle to outbound investments by J-REITs, since some countries have adopted rules under which foreign investments may not hold an ownership interest in real estate.

Although the general rule still remains, regulations were amended in 2013 (effective in 2014) to allow a J-REIT to hold equity shares in corporations in overseas countries without an upper limit if (i) the J-REIT is not permitted under the foreign country's law to carry out transactions of real estate directly, such as acquiring the ownership of property, and (ii) the business purpose of the corporation that issues the equity shares is solely real estate.

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This 2013 amendment enables J-REITs to hold up to 100% of the equity of foreign entities that invest in foreign real estate in certain foreign countries, including the United States, India, Indonesia, China, Vietnam and Malaysia, as declared by the Financial Services Agency of Japan.

Following the 2013 amendment, Aeon Reit Investment Corporation (a J-REIT) declared in 2016 that it would indirectly invest in a commercial property in Malaysia through 100% equity shares in a local SPC.

In the coming days, it is to be expected that J-REITs will move to diversify their investments by including more foreign entities holding foreign real estate in their portfolios holdings.