Chambers

GLOBAL PRACTICE GUIDES

Definitive global law guides offering
comparative analysis from top ranked lawyers

Real Estate

Japan– Trends and Developments
Nishimura & Asahi

chambersandpartners.com

2018

JAPAN

The 'Trends & Developments' sections give an overview of current trends and developments in local legal markets. Leading lawyers analyse particular trends or provide a broader discussion of key developments in the jurisdiction.

Trends and Developments

Contributed by Nishimura & Asahi

Nishimura & Asahi is one of Japan's premier full-service law firms, covering all aspects of domestic and international business and corporate activity. We have substantial experience in a wide array of real estate securitisation in both domestic and cross-border transactions. Our real estate finance team has a proven track record of advising both lenders and borrowers in finance transactions throughout the real estate industry. Clients can rely on us at all stages of their real estate transactions, from the term sheet and structuring stage, to closing, tranching, syndication and securitisation, administration, servicing and, if required, restructuring. We are the one of the pre-eminent law firms in the REIT and real estate securities industry. Since the early 2000s, our 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, REIT transactions, complex acquisition and financing transactions, and M&A transactions.

Authors

Hiroshi Niinomi is a partner, specialising in capital markets, banking, finance regulations/compliance, sset management/funds, REIT/real estate finance, structured finance/securitisation, project finance, securities litigation/disputes related to financial products, real estate, environmental law, and medical field/healthcare.

Naoto Yamamoto is a senior associate, specialising in real estate transactions, asset management/funds, REIT/real estate finance, structured finance/securitisation, project finance, banking, and finance regulation.

Koki Hara is a senior associate, specialising in real estate transactions, REIT, structured finance/securitisation, banking, and finance regulation.

Satoshi Tanabe is an associate, specialising in structured finance/securitisation, real estate finance, project finance, acquisition finance, and corporate and commercial transactions.

REIT M&A

The Japanese REIT market has been growing steadily, with a total asset value of JPY18.9 trillion at the end of 2017. The Japanese government has announced that it aims to encourage the REIT market, to reach a total asset value of JPY30 trillion by 2020. In the meantime, 82 REITs (including 23 private REITs) had started their asset management by the end of 2017, and many real estate properties in Japan have already been acquired by REITs.

Under these circumstances, M&A transactions involving REITs have attracted attention as a strategy for growth. The purposes of recent REIT M&A transactions have included expansion of the size of assets under management, diversification of investment portfolios (eg, expanding sector-specific REITs to diversified REITs), and improving investment yields by reduced book values of acquired properties. Since there are advantages to being a private REIT (such as lower volatility due to the lack of direct influence from stock exchange), a listed REIT ("J-REIT") may go private via a merger with a private REIT. This current trend is different from the REIT M&A transactions that took place during the recession following the Lehman Brothers bankruptcy in 2008, where M&A transactions were mainly executed to minimise refinancing risks and stabilise finances in a passive market.

The types of REIT M&A transaction are, in general: (i) merger between two REITs (via a consolidation-type merger, or an absorption-type merger), (ii) acquisition of an asset management company's shares, and (iii) acquisition of all portfolio assets held by one REIT by the acquiring REIT. As a general rule, a shareholders' meeting will need to be held to approve a merger between two REITs.

These three methods can be carried out if all relevant parties (including the sponsors) agree with the merger. If not, it is not easy to implement an unfriendly or hostile takeover of a J-REIT. Although shares of a J-REIT may be purchased in the stock exchange, the requirements of avoiding double taxation (deduction of the amount of distribution from taxable income) cannot be met if more than 50% of a J-REIT's shares are purchased and owned by a specific investor group. Also, it is not enough to acquire shares of a J-REIT: it is necessary to take control of or replace an asset management company of such J-REIT, as an asset management company has the authority to dispose of real estate owned by the J-REIT. This complicates any effort to acquire sufficient shares to win approval of an unfriendly or hostile merger proposal at a shareholders' meeting of the defensive target J-REIT. With respect to the acquisition of an asset management company's shares, an asset manager is usually an subsidiary of its unlisted sponsor, and thus a majority of the asset manager's shares are typically not available for sale without acceptance from the existing shareholders. Likewise, if a target J-REIT is not willing to sell its portfolio in an attempted acquisition of all portfolio assets held by one REIT by the acquiring REIT, the transfer of the whole portfolio held by the J-REIT may not be achieved.

However, M&A transactions are a useful technique to increase the value of REIT shares. Accordingly, REIT M&A transaction are expected to continue to occur, through negotiations between the relevant parties.

Healthcare and Hospital Properties

While the population in developed countries is aging in general, the rate that Japan's population is ageing is the highest in the world. Japanese adults over 65 years old are expected to account for approximately 33.3% of Japan's population by 2036. The Japanese government is planning to increase healthcare facilities for the elderly to accommodate these rapidly growing needs, characterised by policies to encourage investment into healthcare facilities and hospitals through J-REITs. In 2014, the Ministry of Land, Infrastructure, Transport and Tourism published its guidelines for J-REIT investment in healthcare facilities and hospitals in order to facilitate such investments. Among other items, the guidelines set forth certain criteria (eg, to employ experts with required experience and to obtain certain external professional advice) that a REIT's asset manager must meet before submitting an application to the ministry for regulatory approval.

Despite a favourable environment for investments, the volume of transactions regarding healthcare facilities and hospitals has not been substantial in comparison to other types of real estate assets, such as offices and residential properties. The proportion of healthcare facilities and hospitals as overall asset classes invested by J-REITs is less than 1% (roughly JPY122 billion). Private funds' investment exposure in healthcare facilities and hospitals is limited to some extent. In particular, investments in healthcare facilities are difficult to manage as investment assets; it is generally not feasible to replace an operator because of the peculiarity of the Japanese healthcare business.

However, Japan's ageing society is creating an increasing market demand for healthcare and hospitals, and J-REITs have been established specifically to invest in these assets. Several healthcare facilities have been liquidated through securitisation by both private real estate funds and J-REITs, after working through practical issues associated with investments in healthcare and hospitals (including those mentioned above). Furthermore, a J-REIT acquired a hospital in Japan for the first time in November 2017, which may serve as a precedent for future investments in hospitals.

Hotels and Accommodation

The number of visitors coming to Japan has been soaring, rising to 24.04 million people in 2016, according to a government announcement, meaning that the Japanese government's target to increase inbound visitors to 20 million by 2020 has been met much earlier than expected. The market for hotels and other accommodations has seen dramatic growth not only in Kyoto and Tokyo, where Japan will host the Tokyo Olympics in 2020, but also in other areas, such as Osaka, Fukuoka, Nagoya, Hokkaido, etc.

To respond to such strong demand, there seems to be a new trend in the property market of converting and utilising other types of property, such as offices and private houses. This trend supplements the current trends of rebranding hotel properties after refurbishment and restoration projects, in order to accommodate more guests (including foreign visitors). In this respect, accommodation regulations have been modified. Previously, the Inns and Hotels Act generally prohibited the utilisation of private houses to charge accommodation fees (*Minpaku*), unless permission was obtained under the Inns and Hotels Act (Act No 138 of 1948), but a new act governing the residential accommodation business will come into force in June 2018. It is intended to allow the efficient use of private houses to charge accommodation fees without special permission, subject to some conditions, such as not operating as an accommodation facility for more than 180 days in a year.

There are five J-REITs listed on the Tokyo Stock Exchange that are focused on investing in hotels, including a new J-REIT that was listed in 2017. Many hotel (and accommodation) properties in Japan are held by J-REITs, offering diverse investment opportunities to investors.

Diversification of Asset Type - Data Centres and Other Industrial Facilities
ICT technology has been advancing at an accelerated pace, with people becoming more and more reliant on information processing over the internet. With mounting concerns over IT security, preserving safe access to data is seen to be crucial to many businesses. Also, as the volume of data that must be processed keeps expanding, many consumers opt for – or are at least considering – cloud services instead of establishing their own IT systems.

Accordingly, data centres are becoming more prevalent. Data centres generally house clients' servers in racks with ample electricity, controlled temperature and tight security, and provide IT network services and facilities, including cloud services. It is often beneficial for Japanese companies to use data centres located in Japan, partly because shorter distances result in faster data exchange speeds. Thus, a certain number of data centres may be required in Japan.

Leases for data centres have different aspects from other types of property leases, as data centres are primarily designed to accommodate IT facilities, such as servers, rather than people. Also, these leases often include important terms relating to the provision of additional services incidental to the lease (eg, supply of electricity, technical support, etc). Consequently, unique legal issues may need to be addressed when reviewing data centre transactions (eg, whether the Act on Land and Building Lease (Act No 90 of 1991) applies to a data centre's lease contract).

In addition to data centres, other industrial facilities are promising target assets for investment, with logistics facilities attracting attention in the Japanese real estate market as an asset class. The size of the market for electronic commerce is increasingly expanding. With this growth, logistics companies are seeking facilities in efficient locations to stock their increased inventory. A number of REITs include logistics facilities as one of the target asset classes in which they may invest.

Concession
Concession rights are a relatively new type of asset class in Japan. The Act on Promotion of Private Finance Initiative (Act No 117 of 1999) was amended in 2011 to introduce the concession system, under which private operators may have rights to operate public facilities such as airports, water and wastewater facilities, etc. The amendment is intended to encourage private investment and expertise to construct and operate public facilities. For instance, rights to operate two of the popular international airports in Japan – the Kansai and Itami airports – were awarded to a private consortium under the concession system under the Act in April 2016. In June 2017, the government announced a target of JPY7 trillion (about USD63 billion) for projects under the concession system by 2022 in the "Future Investment Strategy 2017", in which several types of public facilities are targeted as key areas for concessions, including airports, toll roads, and water and wastewater facilities. Local governments that have been facing difficulties in maintenance and improvement of their facilities and infrastructure are currently considering utilising the concession system to harness efficient and effective co-operation with private sector operators.

The market for PFI projects with the concession system is, accordingly, expected to grow.

Real Estate Redevelopment and Revitalisation
A relatively large amount of Japanese real estate has become decrepit in certain areas, and needs to be restored or replaced. Additionally, earthquake risks must be taken into consideration when evaluating Japanese real estate, as some older buildings were not constructed with sufficient seismic capacity.

A statute related to securitisation – the Real Estate Specified Joint Enterprise Act (Act No 77 of 1994 - "REJEA") – was amended in 2013 in order to support a policy of real estate redevelopment and revitalisation.

Under the amended REJEA, a special purpose company ("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, retaining qualified business operators to manage certain aspects of the SPC's real estate transactions and its solicitations to enter into equity contracts, and limiting investors in a scheme to certain types of investors) and if the 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.

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 held in a trust in order to avoid a restriction imposed by the 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 that is required of a TMK.

Following the amendment in 2013, the REJEA was amended further in March 2017, which came into force on 1 December 2017, in order to make real estate transactions more convenient, incorporating new categories including the Real Estate Specified Joint Enterprise for small properties and the Specially Permitted Enterprise for Special Investors. Where a transaction falls under these new categories, less strict regulation will apply: registration in the case of the Real Estate Specified Joint Enterprise for small properties, and notification in the case of a Specially Permitted Enterprise for Special Investors. It is, therefore, desirable that a new scheme will be effectively promoted in the future and will facilitate an increased use of securitisation for the restoration of aging properties, including those with defects (such as the lack of seismic capacity), that are difficult or practically impossible to be placed into a trust (due to requirements by trust companies and trust banks).

Real Estate Tech

Investing in real properties via electronic systems such as cloud funding is becoming a new trend, and real estate tech has been discussed globally in recent years. Although Japan may not be the leader in this field at the moment, it appears that Japanese companies are interested in engaging in new real estate tech businesses, and there is space for growth in this field.

One of the schemes of cloud funding to invest in real properties is structured in the form of the real estate specified joint enterprise under REJEA. As mentioned above, investment in small properties under the REJEA may benefit from the deregulation, which might encourage cloud funding transactions. Cloud funding could be suitable for relatively small transactions as well, since investment units are not big in general.

There are also some amendments of laws and changes in interpretation, incorporating electronic methods in order to catch up with ICT technology such as video conferencing. Regarding the interpretation of the Real Estate Brokerage Act (Act No 176 of 1952) with respect to substitution or intermediary of lending, it was announced that brokers may be allowed to fulfil their obligation under the Act to explain important matters through the internet. Another example is that, due to the amendment in 2017, electronic methods can be selected for several documents that business operators shall be obliged to prepare under the REJEA, such as regular investment reports.

Through real estate tech, real estate investments may become more sophisticated and accessible.

Cross-Border Investments

Inbound Investments

Foreign investors have long played a key role in the Japanese real estate market. A Tokyo Stock Exchange survey in 2017 revealed that foreign investors held approximately 25% 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. Examples of such acquisitions in recent years include a well-known wedding complex building, a landmark tower, and large office buildings in Tokyo.

As the population of Japan declines, 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.

Outbound Investments

As discussed above, domestic transactions in some areas, such as hotels, have seen healthy growth but, due to long-term concerns about the expected decline of the Japanese population, Japanese developers are casting jealous eyes 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 the shares of a real estate holding company. This served as an obstacle to outbound investments by J-REITs, since some countries have adopted rules under which foreign investments may not directly hold ownership interests in real estate.

Although the general Tokyo Stock Exchange rule still remains, regulations were amended in 2013 (effective in 2014) to allow J-REITs to hold equity shares in real estate companies 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 real estate company is solely real estate.

Nishimura & Asahi
Otemon Tower
1-1-2 Otemachi
Chiyoda-ku
Tokyo 100-8124
Japan

Tel: +81 3 6250 6200
Fax: +81 3 6250 7200
Email: contacts@jurists.co.jp
Web: https://www.jurists.co.jp/en

NISHIMURA & ASAHI

The Financial Services Agency of Japan has confirmed in a statement that this 2013 amendment enables J-REITs to hold up to 100% of the equity of foreign real estate companies in certain foreign countries, including the United States, India, Indonesia, China, Vietnam and Malaysia.

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.