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Real Estate

Japan: Trends & Developments
Nishimura & Asahi

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Trends and Developments

Contributed by Nishimura & Asahi

Nishimura & Asahi has substantial experience in a wide array of real estate securitisation in both domestic and cross-border transactions. The firm's real estate finance team has a proven track record of 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, REIT transactions. Nishimura & Asahi advise 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. Furthermore, the firm specialise in environmental law, providing risk analysis and settling disputes on soil pollution, asbestos, and other environmental law issues that arise regarding real estate; capabilities extend to environmental law related issues to be complied with by business entities and Corporate Social Responsibility (CSR).

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Cross-border Transactions

Outbound investments

Japanese investors are continuously expanding their outbound investments in foreign real estate markets, searching for opportunities to take advantage of good domestic economic strength mixed with relatively limited investment opportunities within Japan. Over the past few years, 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. In line with this trend, Japanese funds and investors are seeking outbound investments through J-REITs (Japanese real estate investment trusts) in addition to purchasing limited partner (LP) interests, REITs or other types of securities whose underlying assets are foreign real properties. It seems potentially beneficial for J-REITs to diversify their portfolio among various locations in order to mitigate risks associated with the Japanese real estate market to some extent.

J-REITs were not permitted to invest in real estate outside of Japan until 2008 when Tokyo Stock Exchange rules were revised to permit J-REITs to acquire property overseas. However, despite these revisions, J-REITs were prohibited from holding more than 50% of the shares of a real estate holding company. This restriction resulted in obstacles to outbound investments by J-REITs into countries that have adopted rules under which foreign investments may not directly hold ownership interests in real estate. Although the general rule regarding a restriction on owning shares still remains in effect, the regulations were amended in 2013 (effective in 2014) to allow J-REITs to hold equity in real estate companies in overseas countries if (i) the foreign country's law does not permit J-REITs to acquire real estate directly and (ii) the business purpose of the real estate company is solely real estate. The Financial Services Agency has issued a statement which confirmed 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 USA, 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% of the equity of a Malaysian SPC. In addition, in 2018 it was announced that Invincible Investment Corporation invested in hotels in the Cayman Islands by way of a *t okumei kumiai*

(TK) investment into a Cayman SPC. In the coming days, J-REITs are expected to move to diversify their portfolios by acquiring more foreign entities holding foreign real estate.

Inbound investments

There have also been continuous increases of inbound investments into Japanese real estate. A Tokyo Stock Exchange survey in 2018 revealed that foreign investors held approximately 25% of J-REIT shares, and that approximately 45% of trades of J-REIT shares were executed by foreign investors. In addition, over JPY300 billion (approximately USD2.7 billion) flowed into the J-REIT market in 2018, according to the survey.

Foreign investors have long played a key role in the Japanese real estate market. There has been a fairly large volume of transactions where SPCs sponsored by foreign investors have purchased Japanese real estate using financing with securitisation structures. Foreign investors previously were focused mainly on office and residential properties but seem to be shifting their attention to various other types of properties, including hotels and accommodations, in light of the significant expansions of the tourism industry in Japan that is underway.

As the population of Japan declines, it will be important to continue to develop 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. This is also in line with the recent enactment of a new statue to allow Integrated Resorts (IRs) and Meeting, Incentive Travel, Convention, & Event/Exhibition (MICE) to attract visitors from foreign countries.

Tourism Industry – Hotels, MICE, and Casinos

The Japanese government has recently put its energy and focus into the Japanese tourism industry. The number of visitors coming to Japan has been soaring in the past six or seven years, rising to approximately 30 million people in 2018. The Japanese government aims to push it even further, to 40 million people in 2020, the year that Tokyo will host the Olympic Games.

With the increase of foreign visitors, a number of construction projects for building hotels and other types of accommodations are under way, especially in areas near international airports. The 2019 Osaka G20 Summit is to be held in Osaka near the Kansai and Itami airports, encouraging the construction of high-end hotels in Osaka. In addition, regional cities are also pulling in foreign guests with their unique attractions, such as ski destinations in Hokkaido.

One of the Japanese government's policies in relation to the tourism industry is to promote the development of MICE. The expansion of MICE is intended to have an important effect not just on the tourism industry but also the wider economy, because MICE can facilitate business innovation between top-tier companies as their core members gather to meet from around the globe. MICE are intended to provide an opportunity to improve the international competitiveness of Japanese industry as a result of drawing on the exchange of information and other resources at MICE gatherings. On top of these effects, MICE are thought to cause an economic boost in local business activities since the length of stay for visitors attending MICE events is generally longer than that for tourist visitors. The overall economic impact brought by MICE in 2016 is estimated to be approximately JPY1 trillion (USD9 billion) according to a government survey. Twelve cities, including Tokyo, Yokohama, Osaka, and Kyoto, have been selected to be global MICE cities by the Japanese government. Government support for further MICE development in these cities is being implemented.

Amid this movement, a new statute related to MICE (the Act on Development of Specified Integrated Resort Area – the IR Act) was enacted in 2018. The statute governs, among other things, the development of complex tourist facilities (including MICE and casinos), as well as the management and regulation of these facilities. One of the most remarkable aspects of the IR Act is that it legalises casinos for the first time in Japan. Gambling is generally treated as criminal activity in Japan, with some exceptions such as horse racing. The IR Act expressly permits casinos – based on an examination of their overall positive contribution to the public interest – by advancing an internationally competitive tourism industry, boosting regional economies, and providing tax revenue. The casinos will only be permitted as a part of integrated resorts which will be developed in accordance with authorised area development plans under the IR Act. Casinos will not be independently operated outside of IRs.

The size of each casino will be limited to a certain portion of the total floor space of each integrated resort facility.

Considering the general principle that gambling is banned under the criminal code, there will be heavy restrictions imposed on casinos at IRs. For example, each casino business operator will be required to obtain a licence from a public committee specially set up before commencing its business. The IR Act requires each casino to be operated in a regulated manner, meaning that the type of gambling at each casino will be required to be limited to certain categories to be specified in regulations, and each casino may only be operated with equipment and facilities that have been reviewed and approved by the committee. Besides, to control excessive gambling, the number of admission to casino facilities will be restricted to certain times, and certain categories of players (such as people aged less than 20 years old and people affiliated with organised crime) will be prohibited from entering casino facilities. Also, casino operators will be subject to reporting requirements.

One thing to be noted about the IR Act is that the initial authorisation to open an IR facility is only valid for ten years. The authorisation may be extended, but clearly this limited period is likely to be a significant risk factor for finance providers, potentially challenging the funding of construction and management of the IR facilities.

A cabinet order regarding the IR Act is expected to be promulgated in the first half of 2019. With the cabinet order and other regulations to be published, the legal structure for IR developments is likely to be revealed in the near future. As the IR Act limits the number of IR areas to three, several cities – such as Osaka – are competing for them.

Concession Rights

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 waste-water facilities. The amendment is intended to encourage private investment and expertise to construct and operate public facilities. For instance, in April 2016, the rights to operate two popular international airports in Japan – the Kansai and Itami airports – were awarded to a private consortium under the concession system under the Act. Some regional airports, such as Sendai airport, have also been operated by private companies with concession rights, and other regional airports are in the process of reviewing the implementation of a concession. The Japanese government announced a target of JPY7 trillion of projects under the concession system by 2022. Several types of public facilities are targeted as key areas for concessions, including airports, toll roads, and water and waste-water facilities. Local governments that have been facing difficulties to maintain and improve their facilities and infrastructure are currently considering utilising the concession system to harness and co-operate with private sector operators.

The Water Supply Act was amended in 2018 to facilitate the use of the concession system for water facilities. The amendment authorises private companies to operate water supply businesses with proper local government's oversight if a concession right is awarded. Although concessions had been possible in water facilities prior to the amendment, there were no concessions operating water supply businesses, partly due to concerns about water quality, safety and price after privatisation of facilities. Under the amendment, in order to mitigate concerns and risks, local governments are able to maintain water supply licences to regulate properly the private company who operated a water supply business with concession rights.

Accordingly, the market for concession projects including airports and water facilities is expected to grow.

Data Centres and other Industrial Facilities

Information and communication technology has been advancing at an accelerated pace, with people becoming more and more reliant on information processing over the internet. Due to mounting concerns over IT security, preserving safe access to data is 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 growing number of data centres may be required in Japan.

Leases for data centres have some unique aspects compared with other types of property leases, since data centres are primarily designed to accommodate IT facilities, such as servers. 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 online retail commerce is increasingly expanding. With this growth, logistics companies and fulfilment centre operators 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.

Healthcare and Hospital Properties

While the population in developed countries is ageing in general, population ageing rate in Japan is the highest in the world. By 2036, Japanese adults over 65 years old are expected to account for approximately 33.3% of Japan's population. The Japanese government is planning to increase healthcare facilities for the elderly to accommodate these rapidly growing needs, implementing policies to encourage investment into healthcare facilities and hospitals through J-REITs. In 2014, the Japanese government published 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 involving healthcare facilities and hospitals has not been substantial, in comparison to other types of real estate assets, such as offices and residential property. The proportion of investment by J-REITs into healthcare facilities and hospitals as an asset class is less than 1% (roughly JPY14 billion) of all J-REIT investments. Investment exposure to healthcare facilities and hospitals by private real estate funds is also limited to some extent. In particular, investments into healthcare facilities are difficult to manage as investment assets. It is generally not feasible for an investor to replace the operator of a healthcare facility because of the peculiarity of Japanese regulation of the healthcare business sector.

However, Japan's ageing society is creating increasing market demand for healthcare facilities and hospitals, and some J-REITs have been established specifically to invest in this asset class. There are examples of both private real estate funds and J-REITs successfully liquidating healthcare facilities, after working through the practical issues associated with healthcare and hospitals (including the regulatory issues 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.

REITs

In the Japanese capital markets, REITs showed strong and steadily performance in 2018, though the stock market showed relatively weak and unstable performance in the same period. With such market conditions, some financial institutions and developers are trying to launch new REITs. Although the REIT market is brisk in Japan, not all REITs are equally successful. Due to high real estate prices in the country, it tends to be difficult for REITs to acquire new properties unless they are affiliated with a sponsor that can supply adequate properties. In addition, the current share price of some REITs is lower than NAV (net asset value), which may limit their ability to raise new equity funds through share offerings and subsequently restrict funds available to expand their assets under management (AUM). Under these circumstances, there may be opportunities for stronger REITs to seek to acquire other REITs to expand their AUM. We have seen some M&A transactions between REITs in 2018. This may be an increasing trend in the Japanese REIT market.

The types of REIT M&A transaction are, in general: (i) mergers 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 difficult to implement a hostile takeover of a J-REIT. Although shares of a J-REIT may be purchased from the stock exchange, the requirements to qualify to avoid double taxation (ie, the deduction of dividends from a REIT's 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, acquiring shares of a J-REIT is not sufficient to take control of a REIT – it is also necessary to take control of or replace the target REIT's asset management company, since the asset management company has the authority to dispose of the 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. Typically, a J-REIT's asset manager is an unlisted subsidiary of its sponsor, so its shares are usually not available to be acquired by a hostile acquirer. Likewise, if a target J-REIT is not willing to sell its portfolio in an attempted acquisition of all portfolio assets held by one J-REIT by the acquiring J-REIT, the transfer of the whole portfolio held by the J-REIT may not be achieved.

In addition, some REITs have replaced their older properties with newer properties in order to decrease the average age of their portfolio properties. Moreover, some J-REITs have sold their properties to their sponsors for renovation or redevelopment.

Real Estate Tech/PropTech

In these days, new businesses in the real estate market – called Real Estate Tech or PropTech – are developing in Japan, taking advantage of information technology (IT).

Real Estate Tech refers to various types of businesses, such as: (i) crowdfunding for real estate investment; (ii) improving efficiency of real estate transactions with IT (eg, conversion of written legal documents into an electronic version); (iii) matching users and owners of properties; and (iv) the estimation of the value of, or appraisal of, real estates by using big data.

Real Estate Tech enables issuers to offer their financial instruments for mass investors. It means that issuers may design new types of financial instruments for individual investors. The recent amendment of the Real Estate Specified Joint Enterprise Act (Act No 77 of 1994, REJEA) in 2017 has helped this innovation by making it easier to arrange new investment schemes for small properties with less legal requirements and costs. With Real Estate Tech and the current REJEA, it has become easier to design new investment structures with more flexibility to invest in small properties with funds from small investors.

In the near future, financial instruments created by applying blockchain technology may be introduced in Japan. In such case, disclosure is one of the important points to focus on. The Japanese government appears to have concerns about whether there will be sufficient disclosure in connection with such new financial instruments. The study group on virtual currency exchangers organised by the Financial Services Agency prepared a report in December 2018. The report discusses several issues related to virtual currency including initial coin offerings and the manner of information disclosure. Based on the study group's discussion, new rules may be introduced in Japan in the near future.

ESG

ESG (Environmental, Social, and Governance) factors have received some attention in the real estate market. The Government Pension Investment Fund, a giant investor in Japan, has signed the Principles for Responsible Investment advocated by the United Nations in 2015, and has been taking ESG factors into consideration when investing in assets, including real estate. This development seems to be influencing others investors. To create a sustainable environment, it is generally understood that real estate, as a basic component of society, should follow global policy, such as SDGs (Sustainable Development Goals), and contribute thereto.

In line with the promotion of ESG, the number of Japanese participants in assessment of GRESB has been increasing. GRESB assess the disclosure of ESG elements, and gives rating results. Investors using GRESB as a benchmark of ESG investment has also increased. More and more listed J-REITs disclose ESG principles as to their real estate investment.

According to published news sources, one of the Japanese banks implemented a new service programme where funds raised by issuing green bonds from investors who prioritise ESG in their investment strategy are extended through loan facilities to J-REITs on a priority basis if they obtain from the bank verification of having met certain standards in terms of ESG. Also, the Japanese government appears to have started discussions to implement a policy to provide further information disclosure with respect to ESG in real estate investments in order to encourage investment in sustainable real estate and, in turn, to encourage the stable growth of the Japanese real estate market.

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