

German Investors' Involvements in Japanese Real Estate and their Future Prospects

Yuko Tomizuka¹, LREA,MAI, MRICS, MBA

¹ Yuko Tomizuka
WIB Real Estate Finance Japan K.K, 37F Roppongi Hills MORI Tower, 6-10-1
Roppongi, Minato-ku, Tokyo, Japan, yuko.tomizuka@westimmo.com

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ABSTRACT

German investors have been active in the Japanese real estate market since late 2007, because of the favorable exchange rate, long-term stability in property value and cash flow, and debt availability. This paper analyzes the future trends of exchange rates and their impact on existing investments in Japan. The analysis highlights why German investors seek long-term stability. Factors that impact real estate market stability are the political system, the legal structure, and long-term GDP growth. The paper also outlines the difference of funding structures between Japan and Germany. Special focus will be given to the German lending criteria and the "Pfandbrief" as a means of fund raising. All above mentioned factors will play a role in the German investors' activity in the Japanese real estate market.

1. INTRODUCTION

The global financial crisis reached Japan in late 2007. As a result, real estate transaction activity slowed down significantly. With the break-down of Lehman Brothers in 2008, the Japanese real estate market almost reached a stand-still. Despite the crisis, German investors have seized the opportunity to buy Japanese properties and have continuously invested even under bearish markets. Nowadays, one of the major concerns in the market is the financial restructuring of assets, which has become more and more difficult due to decreased market values, limited capital injections, limited debt financing, and uncertainty of the assets' exit values. Although German players' involvements have been appreciated in the market, the Japanese market overall still seems to be dominated by domestic investors. Due to the lack of information and analytical assessment of German players' future involvements, deal participants tend to be limited domestic investors or non-German foreign investors who have committed to the Japanese market. Therefore, the purpose of this paper is to outline the background of German investors' activities and provide analysis of their future growth to increase the opportunities of German investors' involvement and to promote restructuring supported by German debt providers.

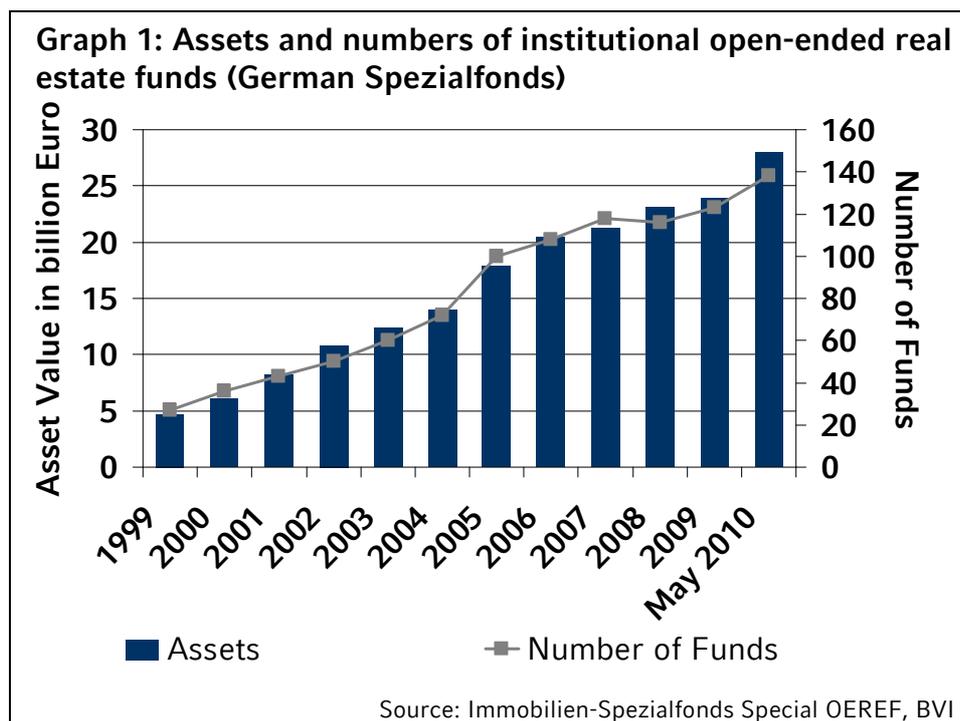
2. GERMAN INVESTORS' ACTIVITIES AND THEIR BACKGROUNDS

German public open-ended funds (GOEFs) as well as special open-ended funds have been actively investing in Japanese real estate. There are currently 46 public open-ended funds in Germany with a fund volume of about EUR 90 bn. The special open-ended funds are 138 in number with a fund volume of about EUR 28 bn as of May 2010. Both types of German funds seek diversification of their real estate portfolio, and both fund structures have increasing fund volumes due to steady inflow from pension funds and insurance companies. Even though

several public open-ended funds had to be closed for redemption due to concerns about liquidity reserves, the majority of open-ended public funds still register positive fund inflows. Public concern about Germany's economic future has led private investors to seek stable returns and safe investment options which are offered by the public open-ended real estate funds.

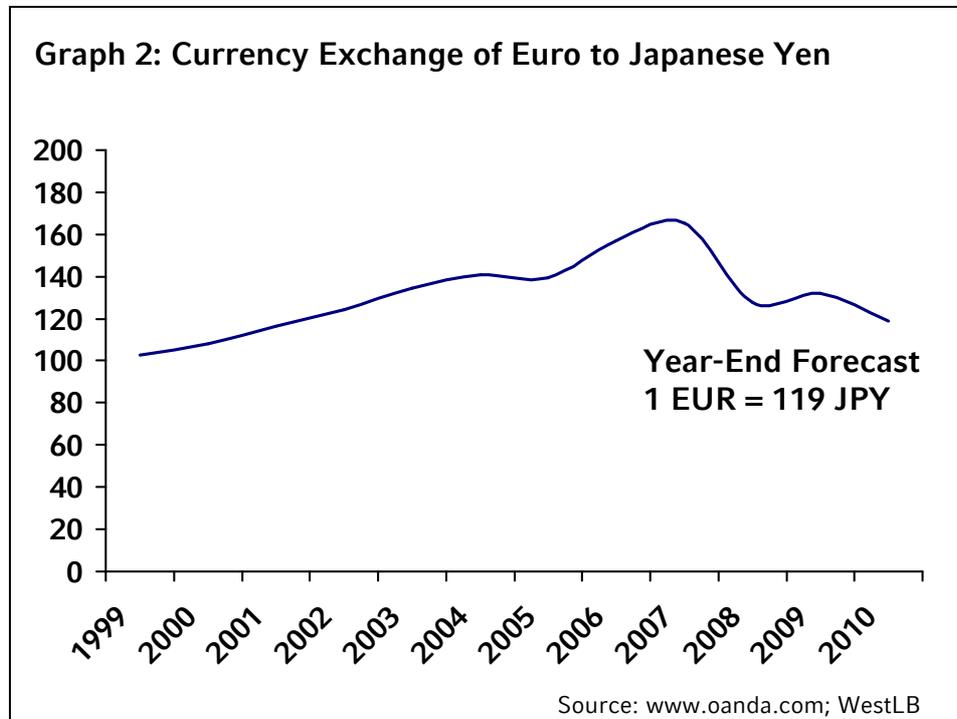
As the following graph shows, the asset value as well as the number of German open-ended funds has been increasing, and accordingly the investment to Japanese market has remained stable even after the market downturn in 2008. There are many factors which drove their investments: relatively high return brought by strong currency, low financing cost in Japan, transparency of social and legal regulations, less political risk in the Asia Pacific regions and less competitors in the market compared to the peak. The major reason for a strong investment appetite in Japan was the strong Euro, the long-term stability of Japan's business environment and the availability of debt.

GOEFs also followed a diversification strategy from 2005 onwards. Until 2005, GOEFS had not been active traders in the property market. Some funds had actually never sold any properties; it seemed they held on to their investments forever. The first major crisis of German Open-Ended Funds in 2003-2004 gave rise to new investment strategies and as a result, the funds sold lots of property in Germany and reinvested the money abroad. The diversification was intended to bring more stability into the funds. However, funds now had to learn that global real estate markets are nearly synchronized, and the global diversification actually did not help stabilize their portfolio.



3. ANALYSIS OF FOREIGN EXCHANGE RATE

Since the introduction of the Euro in 1999, the currency appreciated against the Japanese Yen and reached a peak in 2007 as shown in Graph 2.



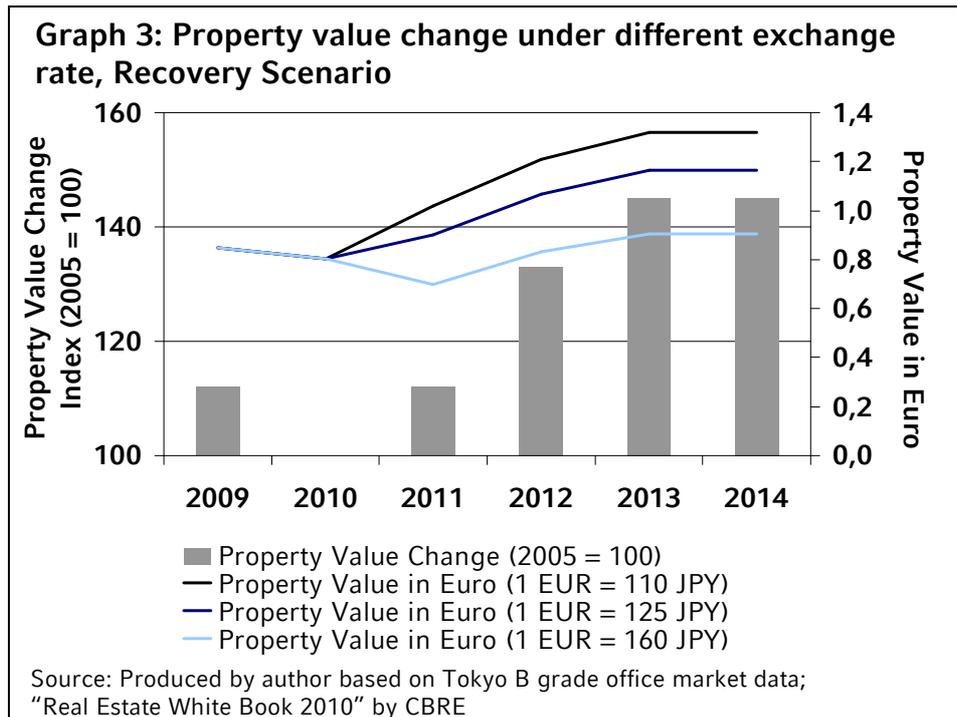
Therefore, in 2007 and following 2008, many German investors who bought property in Japan benefited from the favourable exchange rate to purchase real estate. To assess the currency impact on existing investments of German investors, a sensitivity analysis based on three currency scenarios will be applied. Namely, under three basic market scenarios of future market change, it will be analyzed how different currency rates would create loss or gain for Euro-zone investors. The assumptions for this analysis are as follows.

- Market scenario: analyzed future market trends are economic recovery, stabilization, and recession.
- Investment targets: B location, B grade office buildings² in central Tokyo.
- Value change: applying the income approach, the future value change transition is forecasted considering the past trends of rent and cap rate for the above investment targets.
- Timing of investment and exit point: purchasing in 2010 and selling the asset in 2014.
- Forecast exchange rate: simulations are made that 1 euro remains 125 yen**, appreciated to 110 yen³ and devaluated to 160 yen,
- The value change in Euro is measured as an index when the value at purchasing is 1.

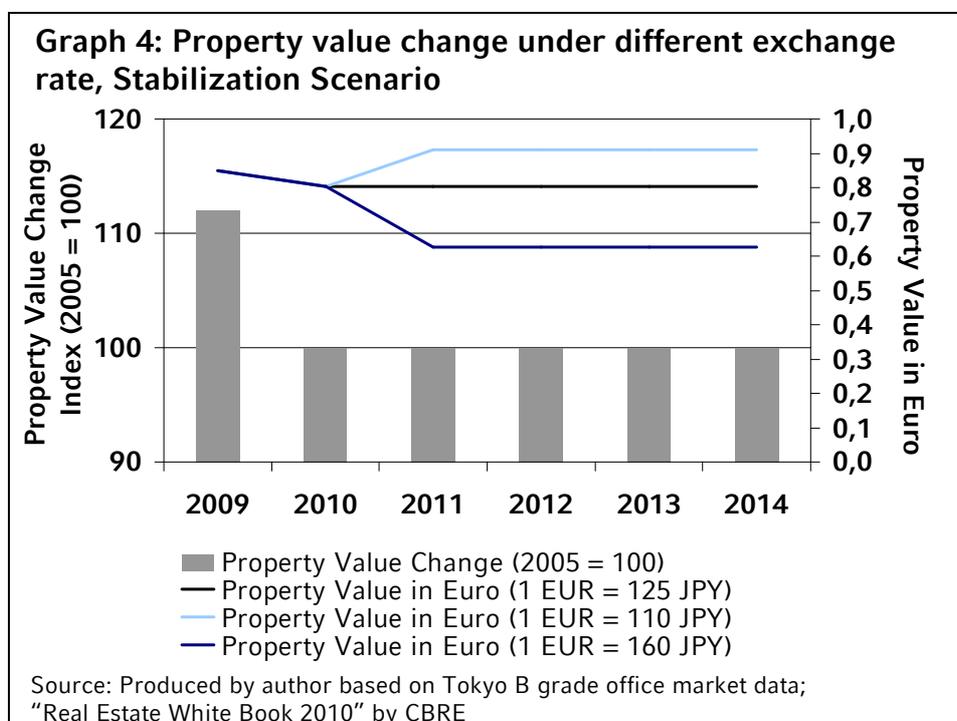
Based on the above assumptions, under the recovery scenario, if the exchange rate stays at EUR/JPY 125 or appreciates to EUR/JPY 110, the investor could record considerable gain. Even if the Japanese Yen (JPY) devaluated to 160 yen against euro, he can still record a small gain for the asset purchased in 2010 (see the Graph3).

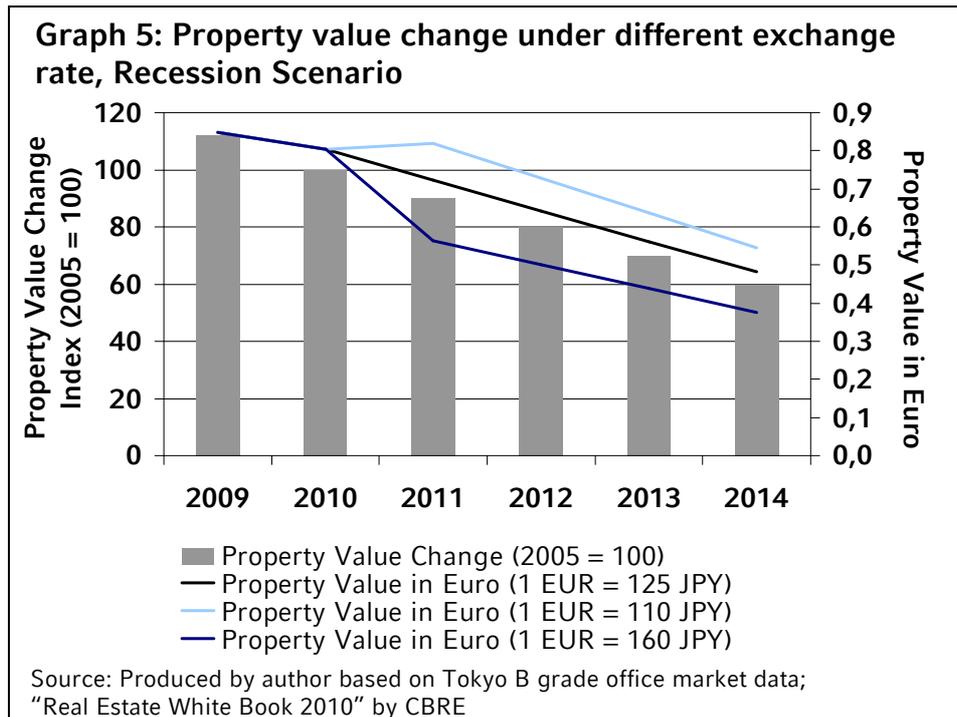
² Analyzing the location and quality of the assets purchased by German funds in the past

³ Forecasts made by Federal Reserve, West LB, and Commerzbank AG



On the other hand, under the stabilization scenario, the investor should accept a loss when the currency exchange moves to 160 Yen whereas a small gain is expected when the exchange rate moves to 110 Yen (Graph 4). Furthermore, as Graph 5 shows, if the current market is not at the bottom and it experiences prolonged recession, the investor would suffer loss from the value change. The loss would be especially large if the euro started appreciating again to the level of 2007 (160 Yen).





In conclusion, property appreciation in combination with a strong Yen may bring a large gain to investor as shown in Figure 1. Following the same reasoning, a value decrease in both property and local currency may cause unexpected loss.

Figure 1: Investment Results based on different EX Ratio & Market Trend

| EX Ratio/Market Trend | Purchase in 2010 | | | Purchase in 2011 | | |
|-----------------------|------------------|--------------|------------|------------------|--------------|-----------|
| | Recovery | Stablization | Recession | Recovery | Stablization | Recession |
| Euro = 110 yen | GAIN | GAIN | SMALL GAIN | GAIN | NEUTRAL | LOSS |
| Euro = 125 yen | SMALL GAIN | NEUTRAL | SMALL LOSS | GAIN | NEUTRAL | LOSS |
| Euro = 160 yen | LOSS | LOSS | LARGE LOSS | GAIN | NEUTRAL | LOSS |

The above simulation was made assuming acquisition of property in 2010. In order to analyze future investment trends, we assume acquisition in 2011 and show the results in columns 4-6 of Figure 1. This shows that the investor achieves a positive gain or moderate return unless the market goes further into recession. Now the market is close to the bottom and currency started to appreciate against the Euro. Currency exchange may motivate German investors to expand their portfolios in Japan.

4. ANALYSIS OF MARKET STABILIZATION

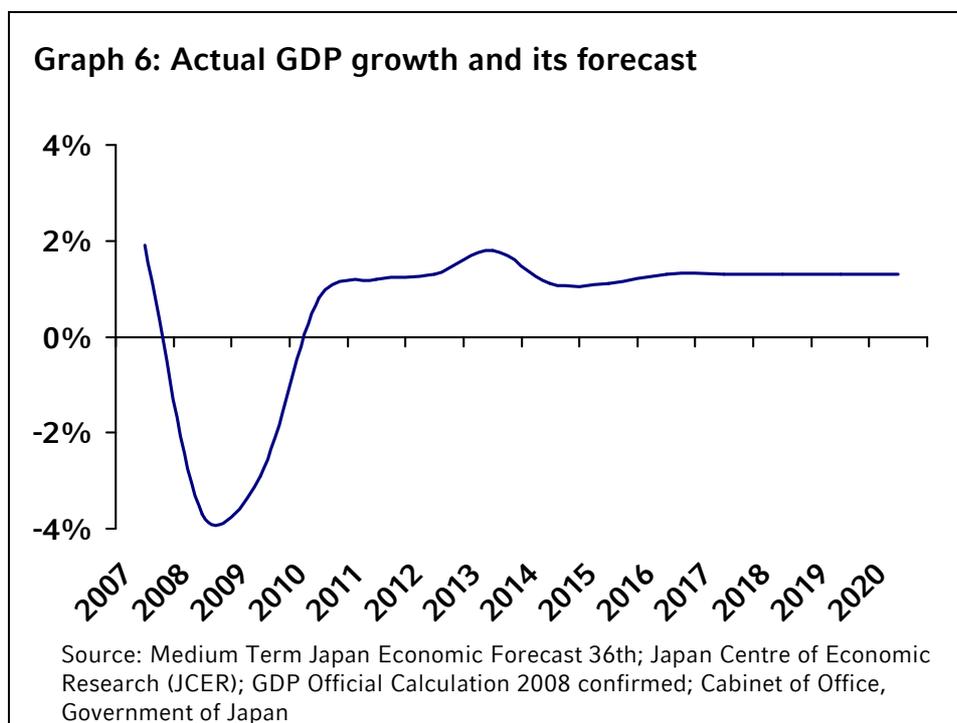
Long term stability is also considered to be the key for German investors. Table 1 shows the analysis of how the GOEFs improve portfolio returns and how the long-term investment affects the overall performance. The benchmark portfolio is assumed to consist of one third equities, one third bonds, and one third money-market investments. Increasing the allocation to property (equity; GOEFs) and decreasing the allocation of other assets results in decrease of the risk of the portfolio. On the other hand, higher return is secured when the GOEFs holds the assets longer period. In other words, to manage the risk of portfolios efficiently, it is necessary to increase allocation to GOEF. Considering the long-term characteristic of real estate markets, GOEF's performance should be discussed in long-term time horizon. Therefore, the stability of the market over the asset holding period has also been considered to be an important investment criterion for those property funds.

Table 1: Average Minimum Returns (AMR) for Various Holding Periods

| allocation to GOEFs | Investmetn years | | | | | | | | | |
|------------------------|------------------|---------|---------|---------|--------|--------|--------|-------|--------|--------|
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
| 0% GOEFs | -12.98% | -13.48% | -10.24% | -10.41% | -9.06% | -7.97% | -5.99% | 0.08% | 4.36% | 5.71% |
| 5% GOEFs | -12.04% | -12.27% | -8.99% | -8.84% | -7.50% | -6.33% | -4.27% | 1.75% | 6.01% | 7.50% |
| 10% GOEFs | -11.10% | -11.08% | -7.75% | -7.29% | -5.97% | -4.72% | -2.57% | 3.39% | 7.63% | 9.27% |
| 15% GOEFs | -10.18% | -9.90% | -6.53% | -5.76% | -4.46% | -3.14% | -0.91% | 5.00% | 9.23% | 11.00% |
| 20% GOEFs | -9.26% | -8.73% | -5.32% | -4.26% | -2.97% | -1.58% | 0.73% | 6.59% | 10.80% | 12.70% |
| 25% GOEFs | -8.35% | -7.58% | -4.12% | -2.78% | -1.51% | -0.04% | 2.34% | 8.15% | 12.35% | 14.37% |

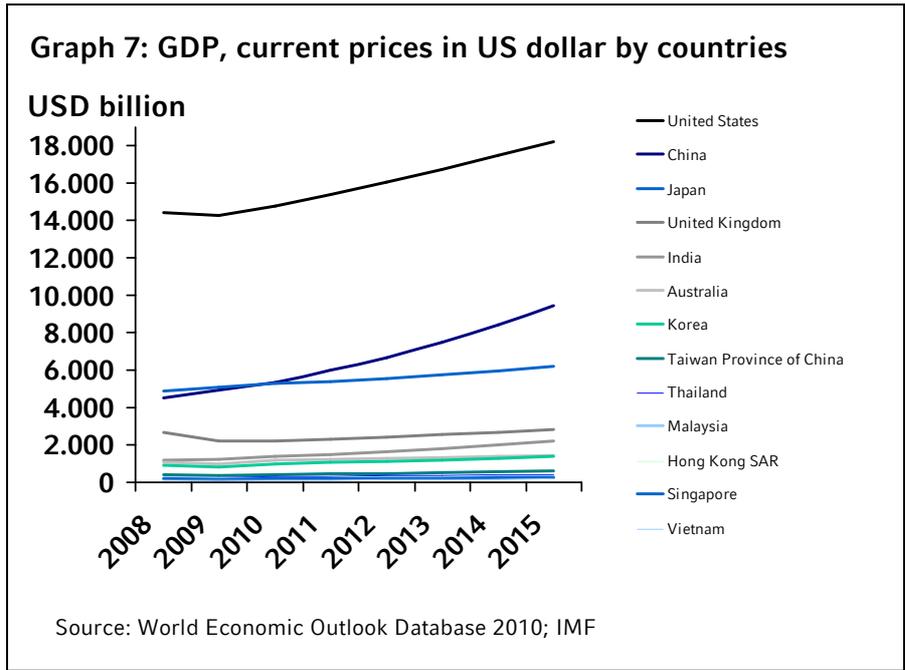
Open-ended Property Funds as an Essential Building Block in a Successful Asset Allocation Oct 2008;BVI

To assess the market stability, there are many indicators which seem to be useful to be analyzed. Political system and reliable regular and legal structure are factors that influence social stability. Among many factors, looking at its consistency and comparability, GDP growth will be analyzed as the comprehensive stability indicator.



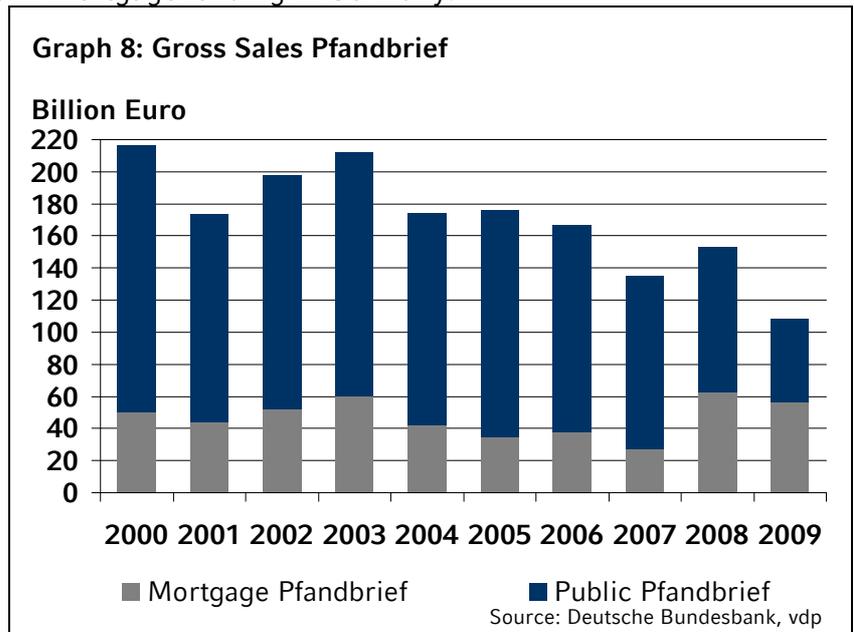
Graph 6 reflects the view released by JCER, concluding that, due to a slow-down in export growth and uncertainty of the government economic policies, the average GDP growth for the next decade is 1.2% p.a. Investments in IT, sustainable technologies, telecoms or in the medical-social security system might drive an early economic recovery. However, overall growth of the Japanese economy looks moderate.

Nevertheless, comparing Japan with other Asian countries, Japan's position as an investment destination with solid economic output is expected to persist over the medium term (see Graph 7). Considering the political stability, market transparency, and efficiency of real estate management processes (holding, leasing, and disposing), Japan will remain an attractive market for German investors as long as the country stays on a positive growth path.



5. ANALYSIS OF DEBT AVAILABILITY

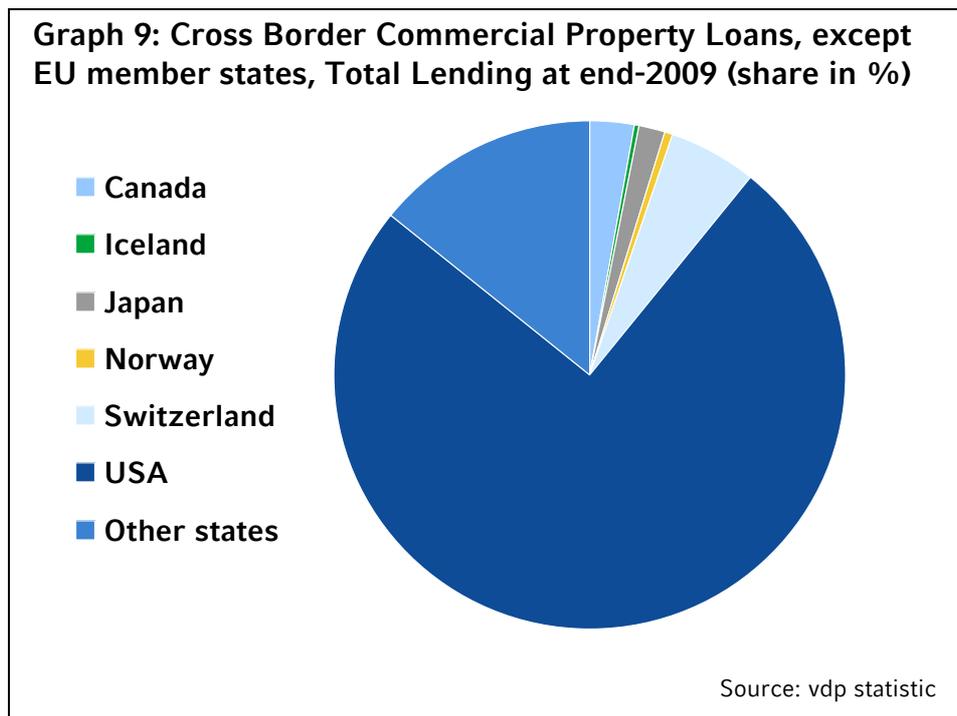
Looking at the debt in asset financing, since early 2000, when the securitization of real estate grew rapidly in Japan, the mainstream of real estate financing is a non-recourse loan, which is provided to the borrower Special Purpose Company (SPC) specifically relying on the ability of an individual asset to generate cash flow. In Japan major non-recourse loan providers are financial institutions of large financial groups whose funding sources are savings and funds from the central bank. On the other hand, in Germany, dominating banks in commercial property finance are Pfandbrief-issuing banks which have been successful in raising funding through the Pfandbrief scheme⁴ (See Graph8). Therefore, reflecting the features of Pfandbrief, quality of the asset, high level of security and long-term stability have been considered as primary criteria in mortgage lending in Germany.



⁴ VERBAND DEUTSCHER PFANDBRIEF BANKEN "Annual Report 2009" Verband deutscher Pfandbriefbanken e.V Berlin 2010, 33p

A Pfandbrief is a type of bond issued by German mortgage banks that is collateralized by long-term assets⁵. The features of this scheme are safety on legal basis, quality assured by underlying-mortgages, simplicity (no subordination), transparency, covered pool liquidity, standardization, and continued quality control⁶. Looking at Mortgage Pfandbriefe⁷, which are used for the funding of property loans and which must be secured by real estate, to secure this scheme, similar to non-recourse loans in Japan, detailed due diligence and thorough analysis of property values have to be conducted. Specifically, the assessment of the property value on a conservative basis is comprehensively regulated under the The Pfandbrief Act⁸.

Graph 9 shows where the collateralized assets of the Pfandbrief structure are located. Great Britain, France and Poland are important foreign markets. The USA is dominating cross-boarder lending, and Japan so far accounts for less than 2%.



One of the difficulties for Pfandbrief lending to penetrate into countries outside Germany is the local legal structure. For this scheme to be efficient, the preferential right of creditors of the German Pfandbrief should be secured in the event of insolvency of a Pfandbrief bank. In real estate financing in Japan, the generally preferred scheme is the Tokutei Mokuteki Kaisha (TMK) structure⁹ under which TMK bonds are issued with the General Security. However, as the legal status of the General Security is only a statutory preferential right, it has always been questioned whether TMK is eligible for the covered pool of Pfandbrief. Namely the General Security can not be perfected under Japanese law and therefore it will subordinated against

⁵ definition by www.investopedia.com

⁶ Tolckmitt Jens "Further refining Pfandbrief framework-legal and rating issues-" VERBAND DEUTSCHER PFANDBRIEFBANKEN Tokyo 2010 3p

⁷ one of the four Pfandbriefe business Pfandbriefe Act Section §1 (1) 1

⁸ Regulation on the Determination of the Mortgage Lending Values of Properties in accordance with Section §16 pars. 1 and 2 of the Pfandbriefe Act

⁹ Tokutei Mokuteki Kaisha-Special Purpose Company, the representative type of vehicle defined under Asset Monetization Law ("Act on Securitization of Asset" revised and implemented in 2000)

any registered collateral such as mortgage or pledge over TBI. Therefore General Security per se can not establish the secured position required under the Pfandbrief scheme.

However, by implementing other schemes like Godo Kaisha-Tokumei Kumiai¹⁰ (GK-TK) in which lenders make loans with Trust Beneficially Interest (TBI) pledge or mortgage in stead of TMK bonds, lender's right is perfected and both mortgage and TBI pledge are considered equivalent to a mortgage in Germany. This will also apply for the TMK loan portion with a mortgage or TBI pledge under a hybrid structure where the TMK loan is made in combination with TMK bonds. This is because tax law in Japan will require TMK bonds to be issued prior to the fiscal year end of TMK, in order for TMK to benefit from tax pass through structure. Consequently, the TMK structure is dominant among foreign investors. In recent market practice in Japan, some progress has been made to develop a structure eligible to Pfandbrief namely in January 2010, WestImmo AG made a loan to a German real estate fund for purchasing a property located in Japan and this loan was qualified for Pfandbrief. Mitsubishi UFJ Trust & Banking Co., Ltd also issued a press release in January 2010 stating that they have arranged the trust contract for the creditor of Pfandbrief as trust beneficiary for another Pfandbrief bank for a loan originated in the past.

In 2009, the Pfandbrief association, vdp, took initiative to amend the Pfandbrief Act to improve the quality of Pfandbrief and for 2010 the efforts to monitor the improved Pfandbrief quality have been actively made by vdp. In addition to the actual implementation of Pfandbrief into the Japanese real estate market, improved quality and reinforced security of the Pfandbrief will activate the Pfandbrief market to encourage Pfandbrief lenders to increase financing in Japan. This will also lead to improvement of debt availability when German investors acquire properties in Japan.

6. DISCUSSION ON FUTURE PROSPECTS

The three major drivers of German investors' activities in the Japanese real estate market were analyzed. Further considerations and analysis should be carried out for each aspect.

First, the currency simulation showed that under the recovery and stabilization scenario, the German investors may be able to gain from the property investment in Japan unless foreign exchange rates rise up to 160 yen. This assessment is plausible; given that the future economic outlook issued by many research institutions implies that the real estate market in Japan is now at the bottom and will recover within the next years. The number of transactions has started increasing especially in 2010 and investment appetite from institutional investors is improving. Even though foreign exchange rates are difficult to forecast, it is unlikely that the exchange rate will return to the level of 2007 given the slow economic recovery of the Euro zone. Therefore, the currency may not hamper further investments of German investors to real estate in Japan.

Second, the analysis of the economic stability of Japan demonstrates that Japan's economic recovery is a tardy progress although it gives long-term stability. So far, the investment scheme sought by German funds has preferred long term stability rather than large profit driven by capital gain. Therefore, as long as Japan's economy records positive growth, Japan has to be a preferable investment destination for German investors. However, if China's economic growth slows down and keeps constant annual growth higher than that of Japan, for instance 3% of growth in China against 0.1% in Japan, the former might become a preferred destination in terms of long term stable growth. So far China has been regarded as an emerging country and the economic cycle is difficult to analyze based on past records. If the economy experiences several cycles and such data is accumulated, the pragmatic assessment

¹⁰ Godo-Kaisha+ Tokumei- Kumiai, the scheme which is exempt from Corporate Reorganization Act

of stability in relation with economic growth could be available. Under such circumstances, the investment shift may happen for seeking more stable and solid return.

Third, the debt availability analysis pointed out the positive environment to expand Pfandbrief financing in Japan despite of its structural difficulties. The legal framework had been the largest obstacle for Pfandbrief banks. However, now that the basic platforms have been developed and successfully implemented, the major concern is solved. There are still some issues to be discussed for future growth of Pfandbrief in foreign countries. For instance, it has to be discussed with higher priority how to insure against earthquake risks, which is one of the relevant risks in Japan, complying with the Pfandbrief Act.

In addition to the above three factors, the laws and regulations which significantly affect the German investors' decision, have also to be considered. For instance, the exposure or new investment might be restrained by the German Ministry of Finance. This may decrease future new investments of German investors. Due to security and diversification, those investors have to seek foreign market exposure to some extent. Taking into account the political stability and legal and social efficiency of Japan besides above three features, Japan is highly likely to remain one of the attractive investment destinations.

7. FINAL CONSIDERATION

The stability of Japan's economy might not be secured long-term compared with alternative markets; however, the currency exchange rate and debt availability may support German investors' decision to expand their exposure in Japan. Consequently, so long as these three drivers change positively and moderately, further investment demand from German investors can be expected.

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