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Why Japan, Why Japanese Real Estate, and Why Now?

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I. Introduction

With the focus of the investment world on equity markets, commodity prices and BRICS (Brazil, Russia, India, China, and South Africa), many people question whether Japan remains a good place for investing in real estate. However, there are several good reasons why investors should not lose sight of the Japanese property market.

Japan is known all over the world for its state-of-the-art infrastructure, well-educated population, and stable political system. Nevertheless, you may not know that the Tokyo metropolitan area has the largest office property investment market in the world, and that it is home to 49 of the world's Fortune Global 500 firms (Fortune, July 25, 2011). The Tokyo metropolis is also the largest in the world with a *growing* population of over 30 million. This last point is sometimes shocking to people versed in the tale of a deflationary and aging Japan, but from January 1, 2011 to September 1, 2011, the population increased by 24,129 to a total of 13,187,461 residents in the 23 wards of Tokyo proper (Tokyo Metropolitan General Affairs Bureau). This is expected to continue going forward: there is a projected net inflow of migration from the countryside to Japanese cities over at least the next ten years (*Nikkei Shimbun*, August 9, 2011).

II. Kyushu is Sweden

The scale of the Japanese economy is not comparable to that of any other country in the world of similar land area. The gross domestic product of the Kanto region (comprised of Tokyo city and the prefectures of Ibaraki, Tochigi, Gunma, Saitama, Chiba and Kanagawa) alone is over 10% larger than that of Russia or Brazil, and the size of the economy of Kyushu is comparable to that of Sweden (IMF World Economic Outlook Database April 2011, in 2008 USD). In sum, Japan has a large and highly developed market with significant demand for the foreseeable future.

A lot is made of the fact that the Japanese government is highly indebted, with a total debt to GDP ratio of close to 200%, but it is important first to realize that about half of the debt consists of debts Japanese government agencies owe each other. (Forbes, "Japan's Debt Conundrum", July 18, 2010) Another significant part of the debt is made up of surpluses in the government's social security accounts. (Ibid) Even more importantly, the Japanese private sector's massive asset balance is far bigger than the government's debt, and Japan's net international investment position, that is, the total of all external (non-Japan) public and private financial assets less all public and private external debt, is one of the biggest in the world (Bank of Japan Report, May 2010). In other words, because of its extraordinarily credit-rich private sector and on-going current account surpluses, Japan remains and is expected to remain one of the richest countries in the world.

III. The Influence of Changes in Japanese Society

From a macroeconomic perspective, it is likely that demand for high quality real estate assets will continue to grow in Japanese cities over the next two decades. One reason for this is the long-term transition of Japanese families from multi-generational households to nuclear families. Another reason is the unabated migration of young people from the countryside to the cities, especially to Tokyo. These two background forces, coupled with the slow evolution of the Japanese economy from a purely manufacturing economy to a more service-oriented economy, should continue to provide a future positive impetus to office and residential real estate values in major Japanese cities (*Nihon Fudousan Kyuufujou Ga Hajimaru*, Ootani Youji, 2011).

IV. Evolution of the Legal Environment

One of the watershed events in Japanese real estate law occurred with the advent of the 'fixed term lease' agreement in 2000. Prior to the law, all Japanese real estate leases gave tenants the right to continue leasing property indefinitely (even after the contract term) until the landlord had a ‘justifiable reason’ to terminate the tenancy. The problem was that facts demonstrating a ‘justifiable reason’ were narrowly construed by Japanese courts. This also meant in practice that lease agreements with terms for less than one year were not possible (under Japanese law such leases were deemed to be for ‘an indefinite period’). Further, tenants had a non-waivable right to demand a decrease in rent level during the term of the lease based on, among others, changes in real estate market prices and average rent levels in the relevant area. In event of dispute, the issue was settled by a third-party panel of real estate arbitrators, and usually not very favorably for landlords.

On March 1st 2000, the Fixed Term Lease Law was enacted, giving landlords the right to end a tenancy conclusively at the end of the contracted term (provided certain conditions are fulfilled by the landlord), and the right to receive an enforceable waiver of the tenant’s right to demand a decrease in rent level during the term of the lease (provided the landlord gives an assurance not to raise rent during the term). In addition, fixed term leases for less than one year became fully enforceable. Although traditional lease agreements remain valid and exist in parallel in Japan, fixed term leases are becoming more and more common in commercial deals, thereby enhancing the stability and security of real estate securitizations and other commercial investments in Japanese real estate.

An important factor when assessing an investment in Japanese real estate is the security and safety of the asset itself, especially in the wake of the March 11th earthquake. The National Building Standards Law was amended in June 2007 with the aim of preventing damage from earthquakes by more strictly regulating architects and the building inspection process. Despite the fact that the Tohoku region was subject to a M9 earthquake in March, the fourth largest in recorded history, generally Japanese real estate assets were not significantly affected by the disaster in any lasting way. It is also interesting to note that even after the disaster, London and Hong Kong both have higher average levels of radioactivity than Tokyo (Bloomberg, April 1, 2011).

V. Investing in Japanese Real Estate Now

The worst is likely behind the Japanese real estate market. Most real estate professionals think of real estate prices as cyclical, and there are many reasons why the cycle could begin to point up in Japan prior to other regions in Asia (which in general are just now beginning to point down). Indeed, when considering the extraordinarily long-term decline of Japanese real estate prices starting from the early 1990s, downside risk has been overwhelmingly reduced. As a general rule, buying at cyclically low prices lowers potential investment risk and builds in room for values to grow through asset renovation and repositioning. In Japan there are quality real estate assets which became overleveraged due to the global financial crisis, yet net operating incomes have not changed much in many cases. An additional benefit to investing in Japanese real estate is that Japan's deep domestic markets lessen the exit risk for investors when compared to, for example, the Asian tigers.

Japanese interest rates are very low, and the positive yield when making a real estate investment with debt financing is attractive. Rising interest rates closely correlate to rising real estate values, so interest rate risk is limited. In Japan, business trends tend to develop slowly, followed by a rush once a critical mass of Japanese companies decides to act. If this were to play out in Japanese real estate, prices could rebound very quickly.

Although it is assumed high capital returns are harder to realize in Japan, few would argue with Japanese real estate's record of creating stable cash flows, and quite a few investors view Japanese assets as the 'senior' portion in a pan-Asian portfolio. One reason for this is that Tokyo has never experienced double digit office vacancy rates (like some major cities in Europe and the US). With the world seemingly trending to a slower or even negative growth environment, the opportunity to receive a steady, positive cash flow from Japanese assets should be considered in a new light. Finally, as stock markets fall and liquidity begins to dry up, lenders all over the world may be forced to make the hard decisions they have been putting off over the last few years, resulting in the possibility of new and favorable investment opportunities in Japan in the near future.