

Japan's Commercial Real Estate

Subjects: Business, Finance

Contributor: Martin Hoesli, Graeme Newell, Muhammad Marzuki, Lai Rose Neng

Japan commercial real estate investment market has, in general, seen a number of scholarly papers in the past, they are concentrated largely on its listed real estate investment segment. There is a significant knowledge gap concerning the non-listed value-add real estate funds' risk-adjusted performance and portfolio diversification benefits in an institutional investors' portfolio. This is particularly true in the case of specific countries e.g. in Japan.

Keywords: value-add real estate fund ; Japan ; risk-adjusted performance

1. Japan: General Profile

As the world's fourth largest country by gross domestic product (GDP) (second largest in Asia after China), with a USD 5.1 trillion economy ([World Bank 2019](#)), Japan is a highly advanced, free-market industrialised nation. Its predominantly service- and high-tech industry-oriented economic activities (accounting for 68% and 30% of total GDP, respectively) ([CIA 2022](#)) are the pillars of the country's high-income economy. Japan's economic performance has been positive by historical standards since the 2007–2009 global financial crisis (GFC), although it recorded a contraction in 2020 due to the global recession caused by the COVID-19 pandemic. The 2.8% domestic unemployment rate amongst its 125 million population is much lower than its OECD peers' average at 7.3%, indicating the importance of household spending and private consumption as the major drivers for its ongoing economic surplus in recent years ([CIA 2022](#); [IMF 2020](#)). Importantly, Japan has many economic and institutional qualities that are consistent with its advanced economy status. For example, Japan is the third most competitive economy amongst the Asian markets (global competitiveness ranking: #6), exceeded only by Singapore (#1) and Hong Kong (#3) ([WEF 2020](#)). Japan's strong economic stature is further supported by its strong institutional qualities; for example, it is considered as the fifth least corrupt Asia-Pacific country in the [Transparency International \(2020\)](#) Corruption Perception Index and ranked in 15th place in the [World Bank \(2020\)](#) Government Effectiveness Index. **Table 1** profiles the social, economic and real estate context of Japan.

Table 1. Profile of Japan: 2020.

Demographic:

Population: 125 million

Urban population: 91.9%

Major cities: Tokyo (37 M), Osaka (19 M), Nagoya (10 M), Yokohama (4 M), Sapporo (3 M)

Economic:

Real GDP growth: -4.7% (2020), 2.3% (2021F)

Inflation: -0.02%

Unemployment: 3.0%

Labour force: agriculture (2.9%), industry (26.2%), services (70.9%)

Stock market: Tokyo: #4 globally; USD 6.7 T

Global competitiveness: #6/141 countries

Corruption perception: #19 (least corrupt)/180 countries

Real estate:

Real estate transparency: #16 globally; #3 in Asia; transparent

Commercial real estate transactions: #4 globally; #1 in Asia; USD 38.0 B

Tokyo (commercial real estate transaction volume): #6 globally; #1 in Asia; USD 19.9 B

Commercial real estate market: #3 globally; USD 2.2 T

Listed real estate market: #2 globally; 3.7% of stock market

Sources: [CIA \(2022\)](#); [EPRA \(2021\)](#); [JLL \(2020\)](#); [RCA \(2021\)](#); [Transparency International \(2020\)](#); [WEF \(2020\)](#).

2. Japan's Real Estate Profile

Japan's sophisticated USD 2.2 trillion commercial real estate market is the third largest in the world, after the US and China, accounting for 22% and 7% of the Asia-Pacific and the global real estate markets, respectively ([EPRA 2021](#)). Its commercial real estate market is also regarded as "transparent", ranked by [JLL \(2020\)](#) as the 16th most transparent real estate market in the world. Importantly, Japan has a vibrant USD 277 billion listed real estate investment space (comprising both REOCs and J-REITs), being the second largest in the world and constituting 13% of the size of its commercial real estate market. These listed real estate investment vehicles contribute approximately 4% of the Tokyo Stock Exchange's (TSE) USD 6.8 trillion market capitalisation ([EPRA 2021](#)). There was a total of sixty-four active Japanese REITs trading on the TSE market platform in 2020, with the Japan REIT market first established in September 2001. The J-REIT market is the second largest REIT market globally, only exceeded by the US REIT market. Leading J-REITs include the Nippon Building Fund, Nippon ProLogis, Japan REIT and GLP J-REIT. This is in addition to the Real Estate Operating Companies (REOCs) in Japan, which often act as sponsors for these J-REITs; these leading REOCs include Mitsubishi Estate, Mitsui Fudosan, Sumitomo Realty & Development, and Tokyo Land.

At USD 192 billion, transaction volumes in the Japanese commercial real estate market over the five-year period to 2020 have been significant, comparing favourably against the other global real estate markets such as the US (total transaction volumes: USD 2 trillion), Germany (USD 366 billion), UK (USD 313 billion) and France (USD 211 billion). Tokyo, Osaka and Yokohama have become the popular destinations for these investment activities, with the five major cities in Japan cumulatively absorbing over USD 153 billion in volume. Whilst domestic capital flows remain the centrepiece of real estate investment activity in Japan, there has been a rising trend in interest from overseas investors, as cross-border capital deployment accounted for about a third of this five-year transaction volume. The sources of these inbound capital flows were diverse and included real estate investors from regional countries such as Hong Kong, Singapore and China, as well as real estate investors from major countries such as the United States and France. Capital inflows to Japan's commercial real estate transactions over this period were originated from a full range of real estate investors, but were predominantly private equity funds, REITs and REOCs, with prominent global players such as Blackstone, GIC, LaSalle, M&G, Invesco, Morgan Stanley, AXA, Mapletree and CapitaLand actively involved. The traditional real estate sectors continued to dominate the real estate acquisition investment activities in Japan over 2016–2020, with the office sector (49% of total transaction volume) and retail sector (15%) accounting for the larger shares of all transactions over this five-year period ([RCA 2021](#)). **Table 2** presents the five-year commercial real estate transaction statistics for Japan.

Table 2. Japan commercial real estate transactions: 2016–2020.

<i>Panel A: Real estate sectors</i>		Volume (USD million)	Number of assets
1	Office	95,091	1870
2	Retail	27,382	611
3	Apartment	26,179	3233
4	Industrial	23,621	533
5	Hotel	17,480	381
<i>Panel B: Sources of cross-border capital</i>		Volume (USD million)	Number of assets
1	United States	25,120	2034
2	Hong Kong	6077	66
3	Singapore	5367	89
4	China	4825	283
5	France	2621	21

<i>Panel C: Real estate investors</i>		Volume (USD million)	Number of assets
1	Hulic	11,763	111
2	Blackstone	8592	373
3	Gaw Capital	4484	30
4	Mizuho	3939	30
5	Fuyo General	3843	51
<i>Panel D: Major cities</i>		Volume (USD million)	Number of assets
1	Tokyo	110,097	2734
2	Osaka	21,395	598
3	Yokohama	11,982	185
4	Nagoya	5158	201
5	Saitama	4779	131

Source: The analysis/compilation from [RCA \(2021\)](#).

Whilst Japan has seen a stagnant economy for many years and has unfavourable demographics due to its aging population, there are key reasons for investing in commercial real estate in Japan. These include being relatively attractive due to the yield gap, highly stable income returns from high-quality tenants, being politically and economically stable, large size and sophistication of the Japan real estate market, and being an important real estate market for investors as part of a global portfolio ([Sumitomo Mitsui Trust Research Institute 2020](#)).

Overall, the Japanese real estate market provides sophisticated investment opportunities for institutional investors due to its scale, maturity, openness and transparency. Its investment stature is marked by strong real estate investor activities and the availability of multiple investment routes to tap into its substantial commercial real estate markets. However, a key investment issue is that many of the high-quality core real estate assets in Tokyo (e.g., in Marunouchi) are tightly held by the leading REOCs in Japan, resulting in very limited transactions in the core real estate space. As such, value-add real estate takes on increased importance in Japan as a commercial real estate investment opportunity for institutional investors seeking exposure to the Japanese real estate markets.

3. Non-Listed Value-Add Real Estate Funds

Non-listed real estate funds possess different investment styles across the broad investment risk–return spectrum, either prioritising a defensive investment strategy at the lower end of the spectrum (i.e., core) or pursuing an aggressive high growth strategy at the higher end of the risk–return scale (i.e., opportunity). The choice of investment strategy allows non-listed real estate funds to populate their portfolios with real estate assets at various stages in their life cycles, employ various value enhancement strategies, and implement different leverage levels to enhance the overall fund's investment mandate and performance ([INREV 2012](#)). This, in return, defines the investment style of non-listed real estate funds. Typically, investors are able to choose between three main styles—core, value-add and opportunity—based on their risk–return preference and fund mandate. The details and characteristics of each investment style of non-listed real funds are described below:

- Core (including core-plus)

Core real estate is considered the least risky investment, with strategies including the acquisition of income-producing high quality commercial real estate assets with high quality tenants, high occupancy rates, limited exposure to speculative real estate assets (less than 5% of GAV) and low leverage levels (less than 40% of GAV). The core-plus style shares the same features as the core style, but with more emphasis on certain enhancements in rental income than the latter. Traditionally, core real estate was the main component of institutional investors' real estate portfolios.

- Value-add

Value-add real estate aims to provide investors with enhanced total returns using a balanced income (income-producing assets = 50–70% of GAV) and capital appreciation approach (speculative assets accounting for less than 25% of GAV) with moderate use of leverage (40–60% of GAV). The typical life of a value-add real estate fund is up to 7 years, with

target returns of up to 20%. A number of real estate asset enhancement strategies, such as active risk management, refurbishment, repositioning and some redevelopment activities, are carried out to add value to the real estate portfolio. Poorly managed assets which are not fully leased or are leased at below market rent are also part of the value-add real estate space. Increasing the real estate asset cash-flow by renovation is also an effective value-add strategy.

- Opportunity

Opportunity real estate involves the acquisition of non-traditional real estate that requires extensive development or redevelopment, as well as intensive expert management to enhance its value. Being the riskiest real estate style, the total return is contributed mostly by capital appreciation (speculative assets = 60%+ of GAV), with much less focus on the income stream. This investment style also uses moderate to high financial leverage (60%+ of GAV).

As described above, compared to the core investment strategy, the value-add strategy allows for a more ambitious risk–return expectation and therefore a higher contribution of the portfolio's capital appreciation component in the fund's total return delivery. This is made possible as assets are not at their highest and best use (i.e., functional obsolescence); thus, they are likely to be able to be acquired at discounted prices, to which various value-enhancement strategies are then employed to increase the value of these assets. This reflects the need for a higher level of leverage to cover these capital expenses.

The emergence of real estate investment vehicles providing exclusive exposure to this value-add investment style is a key milestone in facilitating a greater variety in real estate investment opportunities, especially in the current context of a low interest environment and strong competition in the core real estate investment space. Investing in these non-listed value-add real estate funds is expected to deliver the performance of the underlying real estate assets, coupled with the value-enhancing skills and strategies of the investment managers. This has resulted in the creation of many Japan-focussed non-listed value-added real estate funds by major real estate investment players. **Table 3** lists some of these Japan-focussed non-listed real estate funds, including core, value-add and opportunity fund-style strategies by leading international real estate investment managers (e.g., LaSalle), leading regional players (e.g., Mapletree, GLP, PAG, ESR) and local Japan real estate investment managers (e.g., Fortress, Aetos).

Table 3. Japan non-listed real estate funds: examples.

- Mapletree Japan Office Fund
- LaSalle Japan Property Fund
- GLP Japan Development Partners III
- Goodman Japan Core Fund
- Ostara Japan Fund 3
- Greater Tokyo Office Fund
- Fortress Japan Opportunity Fund IV
- ESR Redwood Japan Logistics Fund 2
- Odyssey Japan Boutique Hospitality Fund
- Japan Value Fund II
- Secured Capital Real Estate Partners V
- Angelo Gordon Asia Realty Fund IV
- Fudo Capital III
- Aetos Capital Asia
- APLUS Japan Real Estate Investments I

4. Institutional Investor Intentions for Real Estate Investment in Japan

Globally, there has been increased interest in recent years in value-add real estate over core real estate for each year of 2015–2020, although this slowed in 2021 due to the impact of COVID-19, when investors sought lower risk profiles (INREV 2021). Specifically, for Japan, there has been less impact from COVID-19 than in the US and Europe, but this still saw a significant reduction in economic activity to control for the impact of COVID-19 (L¹ 2021b). There was still strong institutional investor support for Japanese real estate in 2019–21, as well as local investors seeing an appetite for new real estate funds and acquiring new properties (CBRE 2021a; Sumitomo Mitsui Trust Research Institute 2020). In 2022, value-add real estate was the preferred style ahead of core real estate amongst Asia-Pacific investors. Similarly, Tokyo was the preferred investment destination, ahead of Shanghai, Singapore and Sydney (CBRE 2022). This sets a strong context for the ongoing importance of value-add real estate in Japan.

References

1. World Bank. 2019. World Bank Open Data. Available online: <https://data.worldbank.org/> (accessed on 15 January 2022).
2. CIA. 2022. The World Factbook. Available online: <https://www.cia.gov/the-world-factbook/countries/japan/> (accessed on 15 January 2022).
3. IMF. 2020. World Economic Outlook. Available online: <https://www.imf.org/en/Publications/WEO> (accessed on 15 January 2022).
4. WEF. 2020. Global Competitiveness Report. Available online: <https://www.weforum.org/reports/the-global-competitiveness-report-2020> (accessed on 15 January 2022).
5. Transparency International. 2020. Corruption Perception Index. Available online: <https://www.transparency.org/en/cpi/2020> (accessed on 15 January 2022).
6. World Bank. 2020. World Bank Open Data. Available online: <https://info.worldbank.org/governance/wgi/> (accessed on 15 January 2022).
7. EPRA. 2021. Global Real Estate Total Markets Table. Available online: https://prodapp.epra.com/media/EPRA_Total_Markets_Table_-_Q2-2021_1626682317868.pdf (accessed on 15 January 2022).
8. JLL. 2020. Global Real Estate Transparency Index. Available online: <https://www.jll.com.au/en/trends-and-insights/research/2020-global-real-estate-transparency-index> (accessed on 15 January 2022).
9. RCA. 2021. Capital Trends: Asia. New York: RCA.
10. Sumitomo Mitsui Trust Research Institute. 2020. Survey of Private Real Estate Funds in Japan: January 2019. Tokyo: Sumitomo Mitsui Trust Research Institute.
11. INREV. 2012. INREV Style Classification. Available online: https://www.inrev.org/system/files/2016-12/INREV_Fund_Style_Classification_Report.pdf (accessed on 15 January 2022).
12. INREV. 2021. Investment Intentions Survey 2021. Amsterdam: INREV.
13. CBRE. 2021a. Japan Investor Intentions Survey 2021. Hong Kong: CBRE.
14. CBRE. 2021b. Asia-Pacific Real Estate Market Outlook: Japan. Hong Kong: CBRE.
15. CBRE. 2022. Asia-Pacific Investor Intentions Survey 2022. Hong Kong: CBRE.