

# Past, Present and Future

## A Perspective on Japanese Real Estate from the Debt Side

When one summarizes Japanese real estate, one cannot do so without touching upon the long decline of real estate values from the peak of the Japanese bubble that occurred in the early 1990s. A summary of the long-term history of Japanese real estate returns indicates that, with the exception of 2004 to 2007, Japanese real estate lost value during the past two decades. The obvious question then becomes whether such a period was the only period when investors in Japanese real estate made money. The answer is clearly: “No.” Investors were making money even with losses in real estate value.

### AFTER THE BUBBLE BURST

From 1997 to the early 2000s, significantly high returns, well north of 20 percent IRR, were made for investors both from Japanese loan assets, many of which were collateralized by real estate. The “Japanese Real Estate Returns” graph on page 14 shows the breakdown of income and capital returns from Japanese real estate, and we can see that it provides counterintuitive data. Until competition for non-performing loans (NPLs) collateralized by real estate became extremely fierce, the value of real estate continued to decline. Even with the decline, most investors made substantial money from their NPL investments.

This conflicting phenomenon can be explained by a variety of factors. First, we have to understand that real estate hard assets are different from NPLs. For example, discounted pay-offs accounted for the largest share among various methodologies of NPL resolutions. However, this methodology was applied often in conjunction with or as a condition for

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***The implications of the current real estate debt marketplace in comparison with the past, including changes in lending practices, are manifold.***

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voluntary disposition of collateral real estate. Second, the universe of real estate included in the graph on page 14 and that for NPL collateral might have been extremely different. As an NPL seller, adviser and buyer, I saw a huge amount of collateral real estate, which was almost useless or abandoned from use. However, the bulk of assets were income-producing assets or houses that could be sold. That is, with the exception of minor portions of NPL collateral, the value of such real estate assets is believed to have moved in the same direction as that of more decent and institutional-quality assets.

Were the significantly high returns due to “predatory” pricing by vulture funds? People often say that everybody was able to make money in that period due to the timing, and that it must have been so easy. But that was not the case.

Many loan sales were, in fact, transacted on a competitive bidding basis. In my view, the huge amount of profits earned by NPL investors is attributable to the structural/regulatory situation and to the Japanese pursuit for improving the system.

It is important to note that structured nonrecourse loans virtually did not exist back then. Loans were offered to Japanese

developers, real estate owners and non-real estate businesses with their real estate and other assets as collateral. Furthermore, up to that point domestic loans not abiding by Banking Transaction Terms and Conditions (ginko torihiki yakujo-sho), under which the obligors were required to provide whatever collateral the bank requested to their satisfaction, were scarce to none. Given this, the prevailing framework’s precise techniques to enable lenders to take action on cash flows from the collateral properties or to avoid other liens to be imposed on such properties had not been developed. As such, although it varied from case to case, revenue from such real estate assets were not generally placed for “custody” of the lenders. Mortgages were set up by various lenders over many properties with different priorities, some on a joint-collateral basis and some on a standalone basis. This resulted in having to create a messy mortgage ladder chart to figure out which lender can receive how much when a certain event occurs. Further, in many cases lenders found it extremely difficult to seize rent revenues due to the complex mix of rights of numerous lenders. Therefore, outside of any voluntary resolutions, lenders virtually had to pursue court-administered foreclosure proceedings for any payment.

For foreclosure sales, Japanese courts were required to set a minimum sales price (MSP). MSPs were generally set above market to protect the interest of the obligor. When an initial foreclosure sale was not successful at the initial MSP, the MSP was reset only at the next foreclosure sale. Foreclosure sale was an extremely gradual process because a failed foreclosure case was put to the far end of the

foreclosure queue, creating a very tedious process for Japanese lenders to achieve repayment. In addition, Japanese tax rules were rigorous on accepting losses as long as borrowers still held some potential for repayment. This caused significant incentives for Japanese banks to realize tax deductions from actual losses from selling loans early. Among other things these were the fundamental reasons why Japanese banks rushed to sell their NPLs and buyers of NPLs were able to enjoy handsome returns.

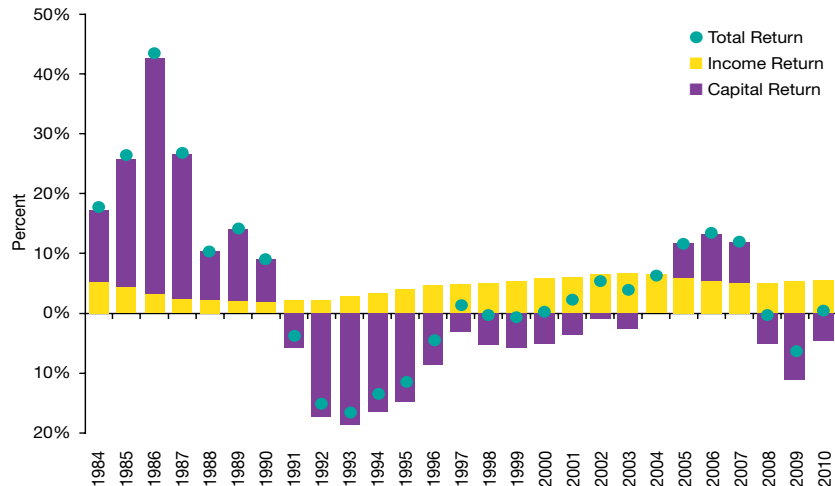
Furthermore, in those days banks were required to obtain approval from their regulator, the Ministry of Finance, for write-offs by compiling huge amounts of documents to support their write-off request. For Japanese banks suffering from a huge amount of NPLs, this became an enormous headache as well as an operational burden. Because a sale of the loan confirms the result, it enabled the bank to reduce tax burden much sooner than continuing to work out its NPLs. This tax aspect, in my view, served as one of the most important factors that presented pricing opportunities for the buyer.

This antiquated foreclosure process eventually was made much more streamlined. The streamlining shortened the time required for the NPL investors to reach the foreclosure result. This trend also accounted for acceleration of discounted pay-off discussion between the NPL investor/creditor and the borrower. In my view, tremendous efforts made by the Japanese government also helped NPL investors at the time to make more money than they originally had dreamed.

### WHERE ARE WE NOW IN 2011?

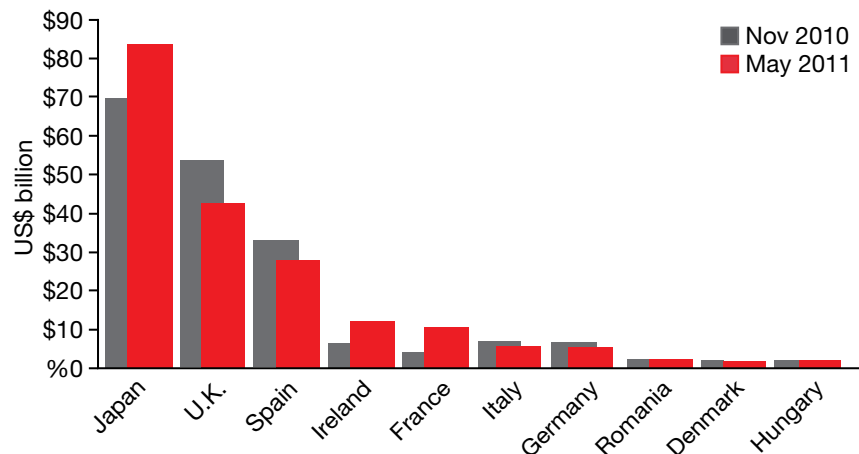
After the hike of property prices in 2007 and 2008, Japan experienced a precipitous decline in real estate values. At this time in 2011, among global real estate investment and management professionals, Tokyo is painfully tainted as one of the only large cities of the world that has failed to recover from the

### Japanese Real Estate Returns, 1984–2010



Source: IPD

### Debt Funding Gap by Country, 2011–2013



Note: The graph shows the approximate debt-funding gap for 2011–2013 based on research from November 2010 and May 2011.

Source: DTZ Research

global financial crisis. The failure to recover has been burdened with concerns of the possibility of radioactive contamination due to the accident at the Fukushima Daiichi nuclear power plant and the possible further slowdown of the economy caused by or in connection with power shortage constraints.

However, the Great Tohoku Earthquake also has uncovered the fact that the world economy relies heavily on Japan. Why were domestic sales of U.S. car manufacturers severely affected by the damage caused to Japanese auto parts suppliers located in the region devastated by the earthquake? The rest of the world also has witnessed similar

damages to its supply chain in many places in reaction to the earthquake. It is important to realize that the Japanese economy is an integral part of the global economy, and there are not many countries in the world that are integrated into the system of indispensable interdependence. As a country's real estate is a subset of its economy so deeply enmeshed with other factors, it is safe to say that Japanese real estate market conditions (opportunities and threats therein included) cannot stay immune from those of the rest of the world. It can move either in a similar direction or in the opposite direction at one point in time. Even if the latter is the

case, it will not move entirely in the opposite direction but rather at a different phase of a cycle.

### REAL ESTATE LOANS NOW

I am aware that investors in Japanese loan portfolios sold by certain foreign lenders have been enjoying handsome returns for the past couple of years. Is this an obvious harbinger of massive loan sales by Japanese lenders as it happened a decade ago? Not at this time.

Japanese lending practices to income properties have almost completely changed from a decade ago. The Japanese lending community has developed what can be deemed as one of the most lender-friendly loan servicing structures (see graph below). Although specific structures vary slightly from one to another, whether a GK/TK structure with a trust or TMKs either with or without a trust, each structure is designed so that the relevant lender is able to seize cash flows from the relevant collateral properties quite easily with certain loan covenant violations.

The implications of the current real estate debt marketplace in comparison with the past, including changes in lending

practices, are manifold. First, this new lending practice relieves lenders from the previous problems of not being able to secure property cash flow. Second, sponsors of investments through SPVs for which structured non-recourse loans are made are under no obligations to provide additional collaterals or to find any other repayment sources. Though this may be bad news for lenders, lenders can now easily deduct tax from losses as proof of no further recovery. Third, in today's Japanese market, the significant difference on views of real estate value that previously existed has declined substantially over the years. Fourth, much of the previous foreclosure court obstacles have been eliminated. Fifth, other mechanisms of collateral dispositions have been made feasible. These factors have made it especially difficult for investors who want to make a spread between loan acquisition value and collateral real estate disposition proceeds.

### JAPANESE REAL ESTATE INVESTMENT STRATEGIES

At present, Japan is cited as the country having the largest loan gap in the world as a result of

the aforementioned precipitous drop of real estate value (see "Debt Funding Gap by Country," page 14). In order to address the severe loan gap, most foreign lenders that were active in Japanese markets have opted to sell their loan portfolios at low prices for their strategic exits from such business in Japan.

As for Japanese lenders, they are reluctant to sell collateral real estate properties. If they choose not to sell collateral properties but cannot find capital source to bring down their LTVs to a more desirable level, what will they do? I do not expect lenders to sell real estate loans going forward. For Japanese lenders, real estate loans are an indispensable part of their homeland business, and they will not find any strategic reasons to offload real estate loans as long as the maximum amount of recovery is expected from seizing cash flows from the properties. I believe certain potential profit opportunities may be presented to those investors who can carefully deploy capital to help shrink the loan gap faster for lenders.

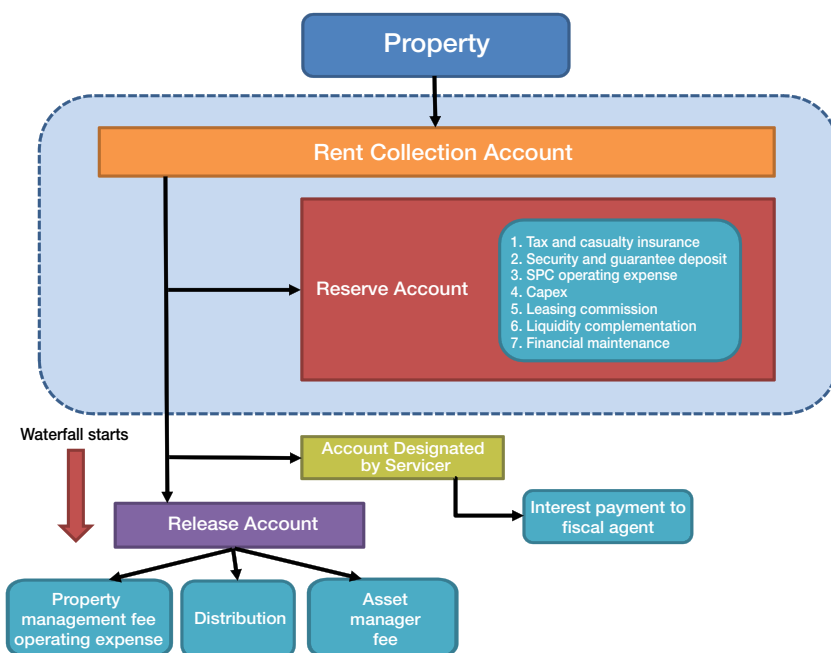
### FINAL REMARKS

I hope this analysis provided certain reference points upon which astute investors are beginning to build their investment strategies from Japanese real estate in the coming several years.

You will remember that from late 1997 to the early 2000s, when property values were declining, investors in Japanese NPLs earned enormous returns, and from 2003 to 2007, when property prices were rising, global investors who invested in Japanese real estate hard assets equally achieved handsome returns. It is important to note that decent returns have been earned and shall continue to be earned by investors in Japanese real estate irrespective of the directions of Japanese real estate prices by carefully selecting and implementing the right strategies based on accurate understanding of Japanese systems and market participants' behavior. ❖

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### Illustration of Cash Waterfall Mechanism of a Structured Real Estate Loan in Japan



Source: Atlas Partners Japan

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