After a slow start, J-REITs rose to stardom through rapid acquisitions and climbing stock prices. The rescuers of the previous real estate plunge were flying high, before almost crashing as a whole in the latest financial crisis. After struggling for over a year, however, they have arguably started to show signs of recovery through their own efforts and a panicking government. Will the recovery be real, and are they bound to soar again?

The Rise and Fall of J-REITs

The J-REIT market was launched in September 2001 with the listing of the first two REITs, and the number of listed J-REITs grew to 40 by the end of 2006 when the market capitalization reached approximately 5 trillion yen. Investment unit prices of J-REITs started to soar in December 2006 with foreign capital rushing to join the fray, rising by approximately 52% to peak in July 2007. The market at this time was characterized by overheated competition to acquire properties among J-REITs and private funds.

However, the J-REIT market quickly decelerated, with only two J-REITs listing in 2007 and no J-REITs listing since. Investment unit prices fell sharply in the latter half of 2007 and continued to drop well into 2008. Given the price drop, some J-REITs issued new investment units unsuccessfully, while others suspended their planned public offerings. A few players even abandoned planned IPOs altogether.

Unit prices further dove in August 2008. Unlike the past pattern, the fluctuation of unit prices began to show a positive correlation to that of the stock market, despite the differences in their characteristics, indicating a strong macroeconomic impact on both classes of securities. Then came the “Lehman Shock,” a near fatal blow to J-REITs. An event that characterized the dire situation was the fall of New City Residence Investment Corporation with its bankruptcy in October 2008, the first bankruptcy among J-REITs. The REIT was delisted in November 2008. (We will return to this saga later.)
Whose Fault Is It?

J-REITs rose out of the ashes of the post-bubble malaise as a life preserver for struggling real estate firms and a proven overseas investment format that enabled Japanese retail investors to invest in real estate via a new investment vehicle with a middle-risk, middle-return profile and strong resistance to recessions. As the “last buyer of properties,” J-REITs provided “exits” to real estate developers and other property suppliers seeking means to move real estate assets off their balance sheets.

Among the first preys of the global recession induced by the credit crunch, which was triggered by first subprime and then the Lehman Shock, were real estate companies. Facing a fast receding market and lack of liquidity, a string of independent real estate firms went bankrupt – including sponsors of some J-REITs. This generated concerns among investors and financial institutions with regard to the credit of J-REITs, despite the fact that their fundamentals remained unchanged or less damaged. In other words, the credibility of sponsors became a primary factor in evaluating J-REITs.

The credit concerns for such real estate companies also drove financial institutions to take an increasingly stringent attitude toward providing loans to real estate-related projects and, as an extension, to J-REITs. As a result, many J-REITs with less name brand sponsors came to face a big problem refinancing as there was seemingly no money in the market. The absence of any money for borrowings globally also exacerbated this trend, while downward revisions of J-REIT ratings by ratings agencies based on somewhat dubious logic further accelerated this trend.

Banks Keep Tight Hold on Funds

Systematically, J-REITs require a huge amount of money to invest in income-generating properties to build their portfolio. To do so, they have issued new investment units to increase their capital, issued investment corporation bonds as long-term debt, and borrowed loans from banks and other financial institutions. The reality is that the J-REIT system was born of government planning and banks with abundant investment money that eagerly loaned funds to J-REITs in their earlier days of growth, and this tailwind led to the issuance of bonds by J-REITs. All of these factors, combined with securities firms, institutional investors and J-REITs eager to join in led to repeated public offerings and property acquisitions.

However, the Bank of Japan and the Japanese government began hinting at excessive real estate loans, subprime occurred and Lehman shocked the market. As a result, the stock market fell and J-REITs were no longer able to raise funds through equity financing, precisely when they were also facing growing difficulty in raising debt financing. The loan periods became shorter and loan conditions (interest rates, etc.) increased in severity for those in greater desperation.

This led to increased financing costs for many J-REITs (those with lesser name brands) and, in turn, decreased net income, despite the fact that their net operating income from the real estate rental business remained fairly strong. Worse still, some J-REITs had to sell properties to raise capital for the partial or full repayment of loans so other refinancing could be secured, generating losses from sales that had to be made in a stagnant real estate market where few transactions took place at sellers’ prices. Many J-REITs also had to cancel forward commitment purchase agreements.
because of financing challenges, paying penalty charges of up to 20%, which bit into their profits and dividends.

### The Government Steps In with Financing Initiatives to Revive J-REITs

As many J-REITs struggled in the storm, attempting to figure out why LTVs generally around 50% or less of acquisition prices were the new high-risk level, the global market began to sort out the distrust and welcome various financial stimulus measures. At the same time, the Japanese government made it clear following a survey of all J-REITs that they should be proactively provided with funds for refinancing. The Association for Real Estate Securitization and other bodies began a widespread effort to revitalize the J-REIT market, laying much of the blame on an inadequate understanding of the essential characteristics of REITs and an overvaluation of their risks.

In tune with this, the Japanese government has clearly emerged to support the revival of J-REITs by announcing and conducting initiatives and measures for financial support (attempting to evade the turmoil that would have ensued if a financial product it supported had collapsed within ten years of its launch). Perhaps the most important step is the planned establishment of a Fund through a joint effort between the government and the private sector to provide funds to J-REITs, which was announced by the government in the “Countermeasures to Address the Economic Crisis” in April 2009. The Fund, temporarily called the Real Estate Market Stabilization Fund, should play a major role as J-REITs are expected to require around 65 billion yen in total to refinance their loans coming due in September 2009 and after, and it appears that a few of the REITs will be unable to obtain funds from the private sector.

#### “Kanmin Fund” Plan

In April 2009, the Ministry of Land, Infrastructure, Transport and Tourism (MLIT) announced that it will “provide funds to J-REITs through a Fund to be jointly established by the government and the private sector.” The Fund (colloquially called the “Kanmin Fund,” or “government – private sector fund,”) is planned to be set up in the fall of 2009 to provide funds to J-REITs that are struggling with capital procurement despite their stable cash flows and profits. The measure aims to have J-REITs recover their function as buyers of properties by providing funds needed for refinancing their investment corporation bonds or for merging. MLIT is in detailed discussions with the real estate industry, financial institutions and other related parties, and as of printing has agreed that the Fund will be operated by the Development Bank of Japan and Nomura Securities.

Other governmental efforts to support J-REITs include the emergency measures for activating the housing and real estate markets initiated by MLIT in December 2008, in which loans are provided to residence/real estate operators and others, including J-REITs, that conduct sound operations but are facing temporary troubles with financing. The government has also been conducting systemic reforms to facilitate mergers between J-REITs.

### Positive Moves, Positive Signs

At the same time, J-REITs and their sponsors have taken proactive measures to sustain themselves, sending a positive message to the market.

In April, New City Residence Investment Corporation (NCRI) entered into a Sponsor Agreement with the Lone Star Real Estate Fund group and prepared its rehabilitation plan, in which Lone Star will acquire NCRI at approximately 120 billion yen (including succession of liabilities) in an aim to relist NCRI in five years. The market warmly accepted this move as the arrangement assured 100% repayment of rehabilitation liabilities as well as offering a TOB to existing unitholders. (The effort is presently caught in a quagmire though as creditors’ rejected the proposal and Daiwa House has led an effort to sponsor NCRI instead of Lone Star. Another vote is scheduled for early September, at which time matters will become clearer.)

In June, Joint REIT stated that it will continue to be listed on the stock exchange and will look for a new sponsor, although its existing sponsor, Joint Corporation, went bankrupt in May. In the same month, DA Office Investment Corporation announced that its asset manager, K.K. daVinci Select, will become a subsidiary of the Daiwa Securities Group, one of Japan’s largest securities groups, in an effort to enhance its credit and trust. This again is a sign of conservative, established Japan making a vote of confidence in real estate and J-REITs.

And in the latest development before going to print, Advance Residence Investment Corporation (ADR), sponsored by Itochu Corporation, and Nippon
Residential Investment Corporation announced on August 6 that they have basically agreed to merge, planning to conclude the formal agreement in September 2009. This represents the first merger for J-REITs. ADR will be the surviving corporation and will become the largest residential REIT in Japan. Their respective asset managers will also merge.

In addition, many individual J-REITs that were faced with refinancing issues in the past several months have overcome their challenges, helping to ease concerns over their financial credibility. A unique method was taken by Industrial & Infrastructure Fund Investment Corporation, which issued 8 billion yen in subordinated corporate bonds in February 2009 to partially fund its refinancing efforts. Not permitted earlier, this was the first subordinated corporate bond issued by any J-REIT. Financial institutions have also started to take a somewhat milder attitude toward lending to J-REITs.

A most recent sign of the positive turn of J-REITs is the fact that their investment unit prices are again showing a lower correlation with Japanese stock prices, after roughly half a year of strong positive correlations. This is thought to reflect the market’s appreciation for the moves mentioned above, including expectations for the establishment of the Kanmin Fund. J-REITs may once again be establishing themselves as an alternative investment product.

For the moment, the rental market for offices and residential properties remains tough and occupancy rates are declining, though still very mildly compared to the West. There is a concern that this will decrease rental revenues for many J-REITs, causing them to reduce dividends. Nevertheless, figures suggest that the Japanese economy is on the road to recovery. Building on the positive moves and faint signs of recovery, it is expected that J-REITs will make a resurgence in accordance with the general upturn of the economy. There is no telling when, but the turn could be close, though it will be impacted somewhat by the elections scheduled for the end of August.

J-REITs have strong advantages in terms of transparency and compliance over other investment products and real estate listings. Most notably, J-REITs have allowed retail investors to participate in the real estate market. If their essential characteristic of generating stable income over the long term is better understood, they should be able to serve retail investors again.

In closing, it must be noted that despite all of the grief mentioned here, the vast majority of J-REITs (75% - 80%) are operated solidly, both financially and in real estate terms. Most of these REITs have strong sponsors and portfolios of 1 billion USD or more based on acquisition prices. The troubles have essentially been limited to REITs sponsored by relatively young independent firms with no legacy bank relationships, and many of their troubles have not been caused by the REITs themselves but rather concern the failures of the sponsors, which in many cases has proven to be a serious issue. Of note now, trading companies are emerging as strong players in the industry and securities firms are also taking a large stake. As a result of this new interest by those with very deep pockets, the easing of money through government initiatives, the settling of real estate prices and what appears to be at least a bottoming out of the real economy, the stars appear to be realigning for at least institutional investment, if not retail investment, in J-REITs.

### Comparison of REIT market size between Japan, the U.S. and Australia

<table>
<thead>
<tr>
<th>REIT market size (USD bil.)</th>
<th>Japan (J-REIT)</th>
<th>US (US-REIT)</th>
<th>Australia (A-REIT)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share of stock market capitalization</td>
<td>0.9%</td>
<td>1.7%</td>
<td>5.5%</td>
</tr>
</tbody>
</table>

**Notes:**
- “REIT market size” refers to the market capitalization of all listed REIT issues.
- “Stock market capitalization for each country” refers to the following:
  - In Japan, market capitalization of Tokyo, Osaka, Nagoya, Fukuoka, Sapporo and NASDAQ exchanges (data source: Bloomberg, STB Research Institute)
  - In the U.S., market capitalization of NYSE, AMEX, NASDAQ, BSE, CHX, NSX, PCX, PHILX and SDFSE exchanges (data source: Bloomberg, STB Research Institute)
  - In Australia, market capitalization of the ASX exchange (data source: ASX, Bloomberg, STB Research Institute)

### Comparison of REIT total returns between Japan, the U.S. and Australia

#### Data as of June 30, 2009

<table>
<thead>
<tr>
<th>REIT market</th>
<th>JAPAN (J-REIT)</th>
<th>US (US-REIT)</th>
<th>Australia (A-REIT)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total return over most recent year*</td>
<td>-24.5%</td>
<td>-43.3%</td>
<td>-42.1%</td>
</tr>
<tr>
<td>Total return since listing of J-REITs (converted to annual rates)**</td>
<td>4.7%</td>
<td>3.9%</td>
<td>-0.6%</td>
</tr>
</tbody>
</table>

**Notes:**
- *Japan (J-REIT) figures were calculated using the STBRI Composite J-REIT Total Return Index.
- **U.S. (US-REIT) figures were calculated using the FTSE NAREIT Equity REITs Total Return Index.
- *Australia (A-REIT) figures were calculated using the S&P/ASX 300 A-REIT Accumulation Index. (data source: Bloomberg, STB Research Institute)