



## **J-REIT (Japanese Real Estate Investment Trusts) and Brazilian real estate market**

### **J-REIT (Real Estate Investment Trusts do Japão) e o mercado de real estate brasileiro**

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#### **ABSTRACT**

In Japan, Real Estate Investment Trust (REIT) scheme is legally created in 2000 and it is commonly called J-REIT. Hence then, J-REIT market has been growing and the total market capitalization of J-REIT issues has reached in 4,362 billion yen (Closing price as of May, 31, 2008; approximately 42 billion USD, calculated as of 1 USD=104.14yen). It's less than 1.5 % of the total market capitalization of the Tokyo Stock Exchange listed securities. Thus a further expansion of J-REIT market is expected. In May 2008, an inclusion of overseas real estate to the portfolio of J-REIT funds is liberated by law; that means Japanese capital is legally permitted to invest in overseas by real estate securitization scheme. Considering its opportunity, this paper presents J-REIT history, current market and its perspectives and later, discusses a business environment between Japan and Brazil. As a final consideration, a first step to attract Japanese capital to Brazilian market is proposed; that is "to provide information of good quality on real time".

#### **RESUMO**

A securitização de real estate foi implantada legalmente em 2000 no Japão e chama-se J-REIT. Desde sua criação, J-REIT tem sido crescido e sua capitalização bursátil total é 4,362 bilhões de yen (valor final do dia 31 de maio de 2008; aproximadamente 42 bilhões de dólares, calculado com a cotação 1USD=104.14yen). Esse valor é menos de 1,5 % da capitalização bursátil total da Bolsa de Valores de Tokyo. Portanto, a expansão do mercado do J-REIT é esperada. Em Maio de 2008, foi liberada a inclusão de imóveis estrangeiros nos portfólios dos J-REIT. Isso significa que, agora, os capitais japoneses podem ser investidos em imóveis estrangeiros legalmente através de sistemas de securitização de real estate. Nesta oportunidade, este trabalho apresenta a evolução do J-REIT e o mercado atual e suas perspectivas. Como considerações finais, o primeiro passo para atrair capitais japoneses ao mercado imobiliário brasileiro é proposto.

## INTRODUCTION

A legal framework of real estate securitization is established in 2000 in Japan when the Investment Trust & Investment Corporation Law admitted an inclusion of real estates to compose funds for investment trusts. This Japanese real estate securitization scheme that utilizes investment trusts is commonly called J-REIT. The Tokyo Stock Exchange (TSE) created a listing system of J-REIT in March 2001 and since then, its market has kept growing. However, the number of listed issues is merely 43<sup>1</sup> and their total market capitalization is 4,362 billions yen, equivalent to 1.4% of total value of Tokyo Stock Price Index (TOPIX) according to the data published by TSE (Closing price as of May, 31, 2008; approximately 42 billion USD, calculated as of 1 USD=104.14yen). Therefore, further development of J-REIT is expected.

However, the composition of real estate of J-REIT has been limited to the ones that locate in Japan, so that the concerned parties have earnestly desired an admission for inclusion of overseas real estates to their portfolio. On the other hand, foreign capitals have been investing considerably on Japanese real estate, especially in Tokyo, in order to seek a higher return and also because of their risk allocation strategy. In May 2008, the TSE has amended their listing regulations and now investments in overseas real estates by J-REIT are lifted of the ban.

Thus, the objective of this paper is to provide information about J-REIT and propose a necessary measure to attract Japanese capital to the Brazilian real estate market. To do so, initially, this paper presents J-REIT history and then the current market and its provision. A business environment between Japan and Brazil is discussed and as a final consideration, a proposal will be done to attract Japanese capital to Brazilian real estate market.

## 1. J-REIT HISTORY

### 1.1. Creation of J-REIT

Securitization of real estate has started in 1987 in Japan, with "the small lot real estate investment product", which divided real estate into small ownership units. This product has changed the traditional real estate investment system - direct, large investment size- and made it possible for the retail investors to participate big projects. However, lack of investors' protection measures required an establishment of another real estate securitization scheme.

In 1990's, a financial system reform was undergone in Japan, including asset monetization and securitization. In 1998, the Financial System Reform Laws were enacted and one of the laws called the Law on Securitization of Specific Assets, know as the former SPC law, made it possible to securitize assets. Still, the procedure was complex and the real estate securitization was not promoted so that the law was revised and the new law called the Assets Monetization Law was enacted in November 2000 that remains in force today.

In parallel, in November of 2000, the legislative body of Japan revised the Investment Trust & Investment Corporation Law, commonly known as the Investment Trust Law. Until then, capital use of Japanese investment trusts was limited to securities but these amendments expanded them to include real estate, thereby made it possible to compose funds on real estate. This Japanese real estate securitization scheme is the present J-REIT. In March 2001, TSE created a listing system for REITs to be traded on its market, and the first two REITs, Nippon Building Funds

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<sup>1</sup> The total number of listed J-REIT of TOPIX. There is one more listed J-REIT issue, not at TSE REIT market but in JASDAQ.

Inc. (securities code: 8951/TSE) and Japan Real Estate (securities code: 8952/TSE) were listed on September 10, 2001.

## 1.2. Legal framework of J-REIT

The Investment and Trust Law created two different legal systems for REIT. The difference is the form of vehicle, or what is defined as Special Purpose Entity (SPE) in the law. The first system is to found an investment corporation as SPE and the other is to conclude trust contract. Consequently, investment and equity monetization formats are different. Presently, all the listed J-REIT issues are based on the Investment Corporation System. The following Figure 1 shows the basic legal frameworks of two J-REIT systems.

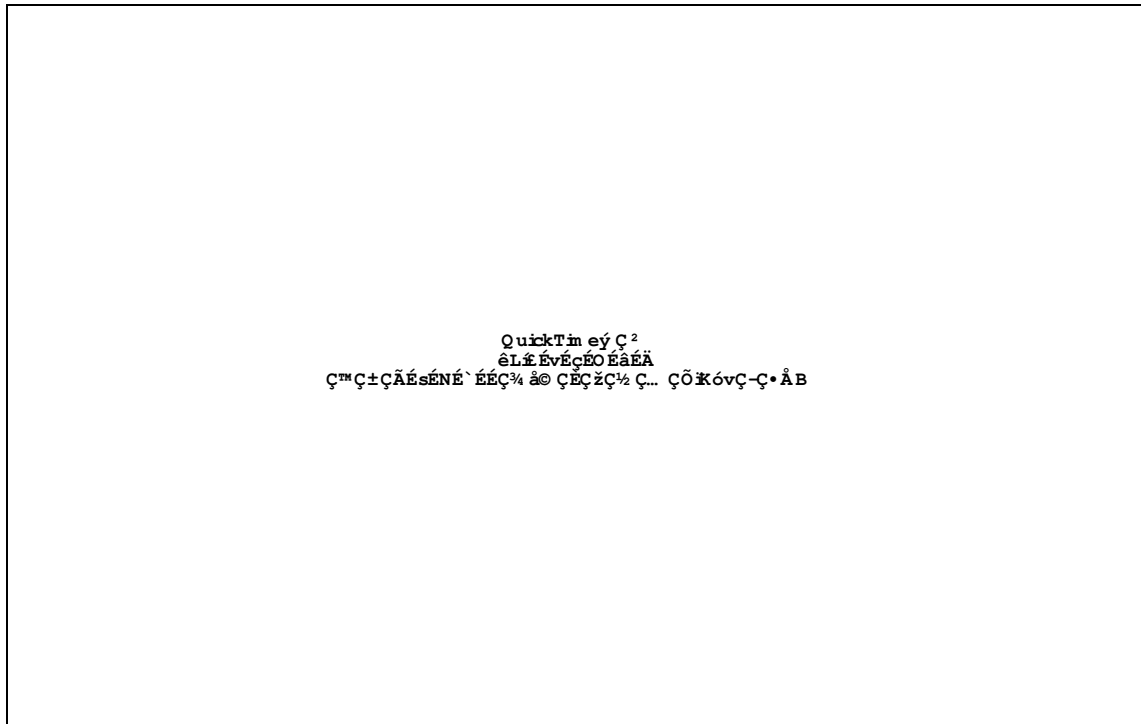
*Table 1: Outline of Two J-REIT Systems Regulated by the Investment and Trust Law*

		Investment Corporation System	Investment Trust System
<b>Vehicle (SPE: Special Purpose Entity)</b>		Investment Corporation	Investment Trust
<b>Foundation of SPE</b>		Foundation of Company	Contract
<b>Investment format of investors</b>	<b>Equity form</b>	Investment Securities	Investment in beneficiary trust certificates
	<b>Debt Form</b>	Investment Corporation Debt	Investment in beneficiary trust certificates
<b>Equity monetization</b>	<b>Designation as negotiable securities under the Securities and Exchange law</b>	Negotiable securities	Negotiable securities
	<b>Presence of distribution market</b>	Listing market exists	Presently no listed issue

*Based on a table made by ARES -Association of Real Estate Securitization-.*

The following Figure 1 represents a brief legal framework of Investment Corporation System of J-REIT. The characteristic of J-REIT is that the SPE are obliged to contract with trustees for general administration, property maintenance and asset management, because the Investment Trust Law prohibits direct management of assets by SPEs.

**Figure 1: Legal Framework of Investment Corporation System of J-REIT**



*Based on a figure made by ARES (2006).*

### 1.3. J-REIT market development

The number of J-REIT listed issue has been growing gradually since its creation and there are 43 on TSE e 1 in JASDAQ as of 1st of July of 2008. The Graph 1 shows the growth of the number of listed issues on TSE (please note that the database of this paper is based on J-REITs on TSE only and the JASDAQ issue is not included).

**Graph 1: Growth of J-REIT (Number of listed issues on TSE)**

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*Based on data disclosed by TSE.*

The total market capitalization of J-REIT at the end of May of 2008 is 4,362,025 millions yen, approximately 41,886 million USD, calculated as of 1 USD=104.14yen. According to the data published by TSE, this value is equivalent to 1.4% of total market capitalization of issues that compose TOPIX. The Graph 2 represents the growth of total J-REIT market capitalization.

*Graph 2: Growth of Total J-REIT Market Capitalization*

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*Based on a graph made by ARES*

More than 50 % of the properties owned by J-REIT are office buildings. About 20% are invested on commercial properties, such as shopping centers, and the residential properties occupy about 19%. Other types include mainly hotels and logistic centers. The Graph 3 shows types of property owned by J-REIT in 2005 and 2006.

*Graph 3: Types of Property Owned by J-REIT*

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*Based on a graph made by ARES*

The average occupancy of commercial properties have kept almost 100% since their listing. The office buildings suffered a decrease of their occupancy in 2002 and 2003; the recovery of office market started in 2004 and has reached 98% in 2005. Since then, the market keeps its level. On the other hand, the average occupancy of residential property is relatively low compared to other two types. Still, it is around 95% in 2007. The Graph 4 shows the fluctuation in average occupancy of J-REIT by property type.

*Graph 4: Fluctuation in Average Occupancy of J-REIT*

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*Based on a graph made by ARES*

#### 1.4. J-REIT Property Index

The Association of Real Estate Securitization (ARES) publishes "ARES J-REIT Property Index" on its website. To calculate investment return rate, ARES employs formulas of NCREIF<sup>2</sup> Index as their base, but applies modified formulas in order to reflect Japanese market<sup>3</sup>. The data about return rate which is disclosed on Index have 3 types; Income return, Capital return and Total return. Each rate is obtained by the following expressions.

$$\text{Income return} = \frac{NOI}{BMV + 0.5CI - 0.5PS - 0.417NOI} \quad (1)$$

$$\text{Capital return} = \frac{(EMV - BMV) + PS - CI}{BMV + 0.5CI - 0.5PS - 0.417NOI} \quad (2)$$

$$\text{Total return} = \text{Income Return} + \text{Capital Return} \quad (3)$$

<sup>2</sup> National Council of Real Estate Investment Fiduciaries: a north American non-profit organization which offers Real Estate Investment Index since 1985.

<sup>3</sup> For further information about the formulas, see ARES website:  
 <[http://www.ares.or.jp/jreit\\_pdb\\_e/jreit\\_pd001.html](http://www.ares.or.jp/jreit_pdb_e/jreit_pd001.html)>.

Where  
 NOI: Net Operating Income  
 EMV: Ending Market Value  
 BMW: Beginning Market Value  
 PS: Partial Sales  
 CI: Capital Improvement or Expenditures

The Graphs 5 to 7 show the fluctuation of each return rate of J-REIT, classified by property types (return rate are annual).

*Graph5: Fluctuation in Income Return of J-REIT (annual)*

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*Based on a graph made by ARES*

*Graph 6: Fluctuation in Capital Return of J-REIT (annual)*

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*Based on a graph made by ARES*

*Graph 7: Fluctuation in Total Return of J-REIT (annual)*

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*Based on a graph made by ARES*

## 2. CURRENT J-REIT MARKET AND ITS PROVISION

The J-REIT market is in transition at this moment. After the long depression that Japan has suffered in 90's, its economy hit the bottom in January of 2002 and started to recover. J-REIT market enjoyed this Japanese economic expansion and had developed with such favorable background since its creation. The Graph 8 shows a fluctuation of TOPIX and TSE J-REIT Index<sup>4</sup>. As the Graph demonstrates, J-REIT issues have marked a higher raise on their price than TOPIX. In a physical real estate market, numbers of real estate transactions had increased and their value started to rise in Tokyo and some other major cities in Japan. Not only Japanese capitals but also foreign capitals has invested actively in commercial real estate (properties for retails and office) and supported this uptrend.

*Graph 8: Fluctuation of TOPIX and TSE J-REIT Index*

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*Based on a graph offered by TSE*

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<sup>4</sup> TOPIX uses January 4th of 1968 as base date (index =100). TSE J-REIT Index uses March 31st of 2003 as base date (index=1000).



Although, unit price of every J-REIT issue has marked a keen decline since the subprime crisis occurred. Banks that have suffered losses of their operating assets because of the subprime matters has started to limit real estate related finance. Consequently, real estate market in Japan is confronting a transition phase. The economic recession affected directly in physical real estate market and J-REIT market.

The global economic recession outset by subprime issue brought uncertainty to Japanese real estate market and J-REIT market. Although, foreign institutional investors consider that the decline of real estate value is the opportunity to acquire assets in Japan. On the other hand, J-REIT investment corporations are severely required to establish countermeasures for their risk allocation. One of the risk allocation measures is an inclusion of overseas real estate in their portfolio because overseas real estate cycles are different from that of Japan. Therefore, the liberation over investment in foreign assets has been a matter of concern. The ARES had negotiated its liberation to the government and the Ministry of Land, Infrastructure and Transportation (MLIT) established “The Guideline for Real Estate Investment in Foreign Countries” in January of 2008. An establishment of this guideline urged TSE to modify its listing rule over J-REIT to admit an inclusion of foreign assets in their portfolio.

The Graph 9 shows a comparison of value of assets under management of J-REIT (public funds) and Private Funds (non-listed issues). It demonstrates that assets under private funds almost double that of J-REIT. With economic recession, environments around equity for private funds are in transition. This is also a reason to expect a further development of J-REIT.

*Graph 9: Assets Under Management of J-REIT (public funds) and Private Funds*

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*Based on a graph made by ARES*

### **3. PROPOSAL FOR ATTRACT JAPANESE CAPITALS TO BRAZILIAN REAL ESTATE MARKET**

Japan and Brazil locate the other side of the world for each other. This physical distance had been an obstacle for information exchange between two countries. Brazil is still an unfamiliar country for Japanese. The physical distance, 25 hours on airplane, makes it difficult for Japanese to visit Brazil. Only a small number of businessmen of major firms have been treating business between two countries. The major interest of Japanese business has been forwarded into U.S.A,

Europe and especially in Asia in recent years. Therefore, not only business information about Brazil but also general information that can be obtained in Japan has been quite limited.

However, the global economic map is changing and the business interest of Japanese is also has been in transition. The contributions of emerging countries, especially the countries so called BRICs to the global economic growth have been increasing and as a natural result, the business and political information related to Brazil is notably gaining its space in Japanese media. The security market has already started to sell financial products related to BRICs, such as Indian stock price index funds, Brazilian Real-denominated funds, Brazilian bonds, etc. Certainly, Brazil is obtaining its space among the interests of Japanese business.

Further more, 2008 is a memorial year for two countries: Japanese Immigration Centenary. Since the beginning of this year, economic and cultural exchange between two countries has been active. Frequent news about such events and a series of special TV programme about Brazil improved national consensus of unfamiliarity over Brazil.

With these observation done above, it can be said that the business environments is set up. Then, what is necessary now to attract Japanese capitals to invest in Brazilian real estate market?

The answer is "the information". To provide information on real time with good quality about the Brazilian real estate market might be the best and most important measure at this moment. Japanese doesn't know that the Brazilian real estate market cycle nor real estate investments return rates. Even though, it is permitted "fund of funds" in Japan where Japanese capital can legally invest in *fundos imobiliários*, most of them don't know the existence of real estate securitisation market in Brazil. When such information were offered, a window of business opportunities might open.

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