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Real estate investment's growing appeal as a financial product

Nomura Research Institute, Ltd.

Japanese real estate investment's risk/return profile is starting to change. Recent high returns from capital gains are likely unsustainable, but we see favorable prospects for solid income returns and improvement in liquidity. We expect real estate's appeal as a financial product to increase.

Real estate's risk/return characteristics as a financial product

Real estate has several favorable characteristics that differentiate it from equities and bonds and make it an attractive investment vehicle. First, real estate has a low correlation with equities and most other asset classes, making it an effective portfolio diversifier. Second, it has a high empirical probability of price appreciation in excess of the inflation rate, making it a strong inflation hedge. Third, it has the potential to generate a stable, long-term income stream. Moreover, like equities, real estate also offers the potential for capital gains through price appreciation. Methods of investing in real estate have been diversifying in recent years. Investors can now invest in real estate through J-REITs and private funds in addition to direct ownership of individual properties.

On the flipside of such positive attributes are several risks intrinsic to real estate investment. For institutional investors, the biggest risk is illiquidity. Real estate also varies widely from one property or investment product to the next, putting investors at risk of making investment decisions without adequate information. Other notable risks include property defects and property damage from natural disasters.

Below we discuss the Japanese real estate market's recent history and future outlook in light of such risk and return characteristics.

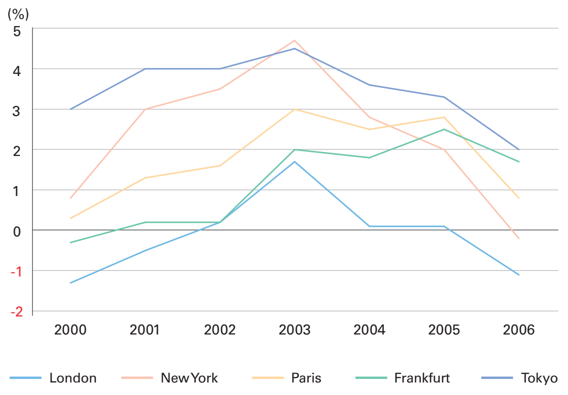
Japanese real estate's performance in recent years

Since around 2000, domestic real estate investments have delivered impressive returns. For example, total returns from J-REITs, the most liquid real estate investment vehicle, have averaged 15% annualized over the past three years, split roughly 80:20 (ie, 12ppt vs. 3ppt) between capital gains and property income.

The biggest factor behind capital gains' predominant share of total returns was acquisitions of properties at depressed prices. With many Japanese companies restructuring their balance sheets (monetizing their real estate holdings) in the early 2000s, investment properties could be purchased at a steep discount to asset value. Properties sold by ordinary companies typically had substantial upside potential, making it easy for purchasers to reap capital gains. Amid such an environment, the most common method of real estate investment until around 2005 was investment in private opportunity funds with a 3–5 year horizon for holding properties.

Income returns from real estate also have been healthy. The spread between J-REITs' dividend yield and the 10-year JGB yield was as wide as 350–400 basis points

Exhibit 1. Yield gaps in major cities worldwide



Source: Jones Lang LaSalle, Bloomberg

(bp) in 2003. Although it has since narrowed, it still remains in the 200–250bp range (in October 2007, the J-REIT dividend yield and 10-year JGB yield were 4.4% and 1.7%, respectively). Income returns from Japanese real estate are attractive even from a global standpoint. Exhibit 1 plots spreads (yield gaps) between income yields on office building investments in major cities and the swap rate. Tokyo is the market with the widest yield gap among the world's major cities, meaning that investors can earn high returns from leveraged real estate investments funded with low-interest borrowings. The yield gap has been narrowing, but with rents on the rise, chiefly in the office market, it is likely to resume widening eventually.

Real estate investment's appeal is likely to grow further

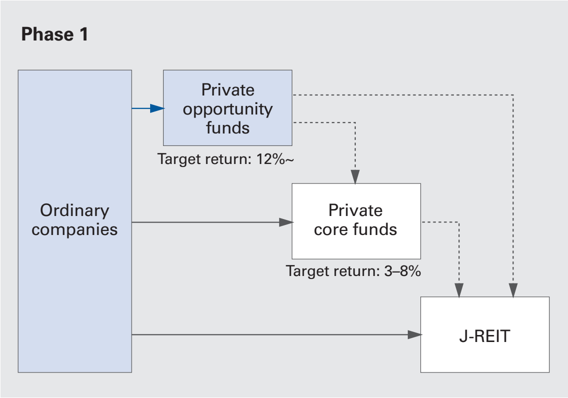
The environment that has hitherto fostered Japan's thriving real estate market is changing. We see the market transitioning to a new phase.

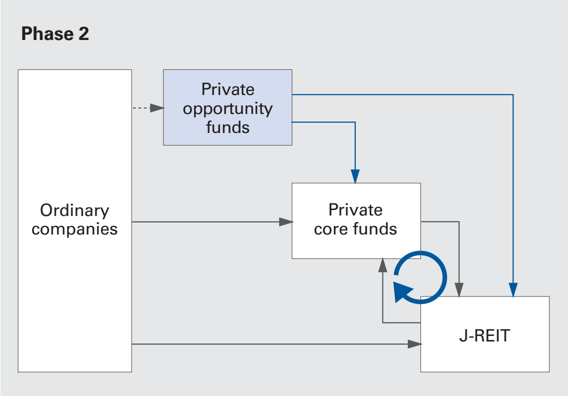
One change is that real estate transactions increasingly involve real estate funds as the buyer and/or seller. Real estate funds always have an exit strategy. Many of them dissolve after operating for 3–8 years. We expect property sales between funds to increase, leading to the emergence of a relatively liquid secondary market for real estate. Meanwhile, as holding periods become more clearly defined, institutional investors' propensity to invest in real estate should increase.[1)]

Another change is that with real estate prices now rising, opportunities to purchase properties with substantial upside potential will decrease relative to the recent past. New sales of properties by ordinary companies will likewise slow to a trickle. We accordingly expect opportunity funds that pursue capital gains to be hard-pressed to maintain high returns in the Japanese market. Private core funds that realize stable target returns of 3–4% will likely increase in prevalence.

In sum, we see the real estate market transitioning to a second phase in the development of a liquid secondary market. Specifically, we expect many existing opportunity funds to dissolve and the properties that they divest to be acquired by newly formed core funds (Exhibit 2).

Exhibit 2. Development of a real estate market in Japan





To sum up our outlook for real estate as a financial product, returns from capital gains are unlikely to be as high as in recent years, but we expect real estate to nonetheless be a relatively attractive financial product by virtue of both income returns and better liquidity relative to the past.

Japanese institutional investors lag behind their US and European counterparts in terms of real estate investment. We look for real estate in the form of directly owned properties and/or private fund investments to emerge as an important asset class in Japanese institutional portfolios.

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Note

1) Uncertain prospects for exiting real estate investments have largely precluded institutional investors from owning interests in real estate. The growth of real estate funds (private funds) will alleviate this risk of "stranded investments".

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