

# Mizuho Economic Outlook & Analysis

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## **Recent trends in Japan's real estate market: signs of shifting sands**

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## 1. Summary

Real estate prices, which were rising most notably in central Tokyo, are starting to fall. Behind the downtrend are the global financial turmoil, which is undermining investor confidence, and high property prices that are discouraging purchases of real estate.

Looking forward, the ongoing market adjustment should persist since the stabilization of the global financial market is unlikely anytime soon.

## 2. Recent trends in Japan's real estate market

### (1) The real estate market in central Tokyo

According to the Ministry of Land, Infrastructure, Transport and Tourism's *Chika LOOK Report (LOOK report on land prices)*, the number of locations that posted a 3% increase in real estate prices fell to zero in the Tokyo area in the second quarter of 2008, while the number of locations where real estate prices remained flat or declined went up. Among the 43 locations surveyed, the number of locations where land prices are declining has increased from three in the first quarter of 2008 to 14 in the second quarter of 2008 (**Chart 1**).

**Chart 1: Rate of change of land prices (by no. of locations)**

		Rate of change of land prices						Total
		6% ~	3% ~ 6%	0% ~ 3%	0%	-3% ~ 0%	~ -3%	
Tokyo area	4Q 2007	2	24	14	3	0	0	43
	1Q 2008	0	5	15	20	1	2	43
	2Q 2008	0	0	4	25	10	4	43

Note: Tokyo area

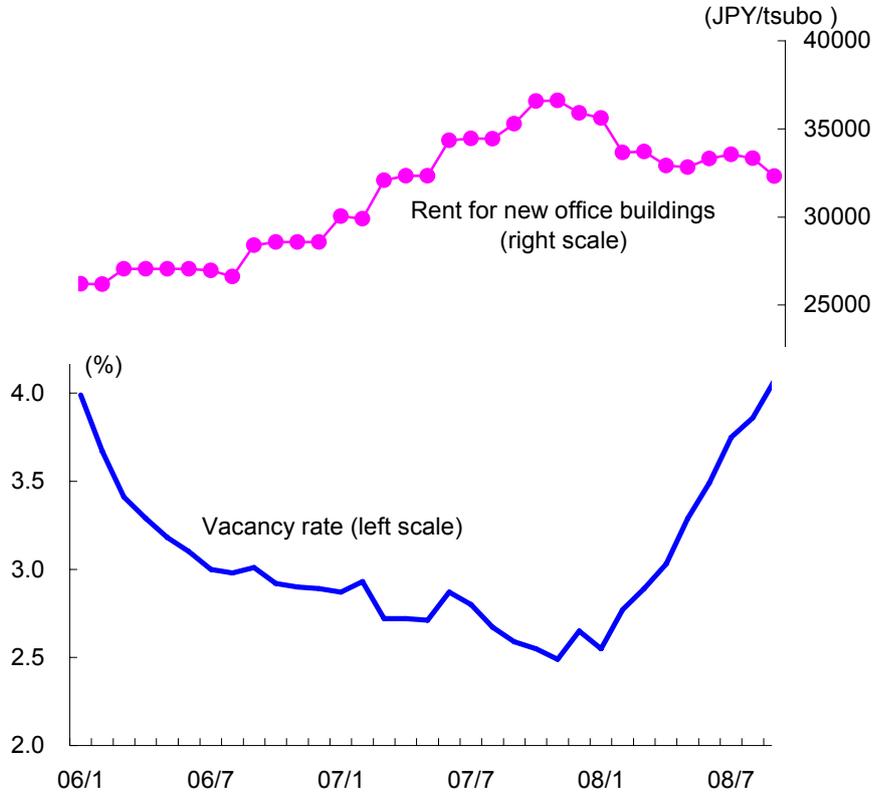
Source: Ministry of Land, Infrastructure, Transport and Tourism, *Chika LOOK Report (LOOK report on land prices)*.

Specific segments of the market such as the offices and condominiums are also deteriorating.

In the office market in central Tokyo, initial rents for new buildings have started to fall after reaching a peak, and vacancy rates have also started to rise (**Chart 2**). Meanwhile, the supply of condominiums in the Tokyo metropolitan district is falling sharply while

inventories are increasing.

**Chart 2: The central Tokyo office building market**

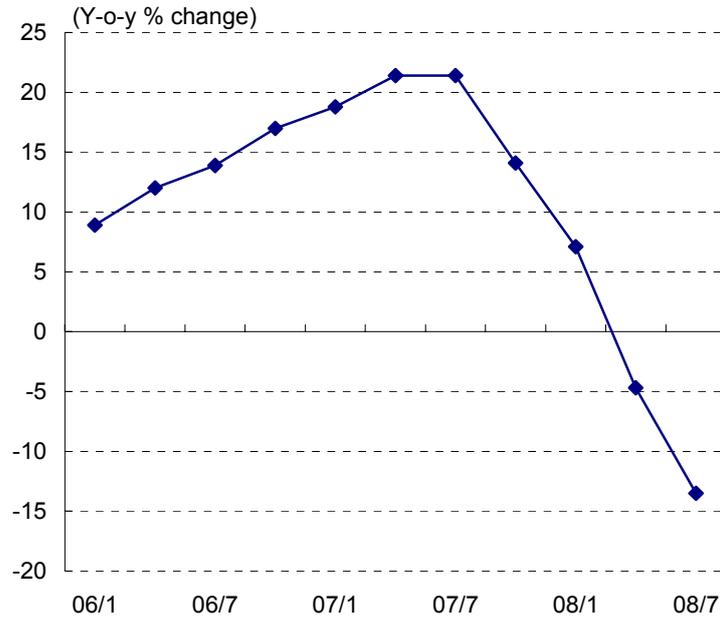


Note: 1tsubo = 3.3 sq. m

Source: Miki Shoji Company, *Latest Trend of the Office Building Market in Central Tokyo (in the Five Central Wards)*.

A survey by Nomura Real Estate Urban Net Co., Ltd. shows that actual housing prices in normal transactions in the 23 wards of Tokyo dropped substantially by 13.5% from the previous year as of July 2008 (**Chart 3**).

**Chart 3: Price of residential land in the 23 wards of Tokyo**



Source: Nomura Real Estate Urban Net Co., Ltd.

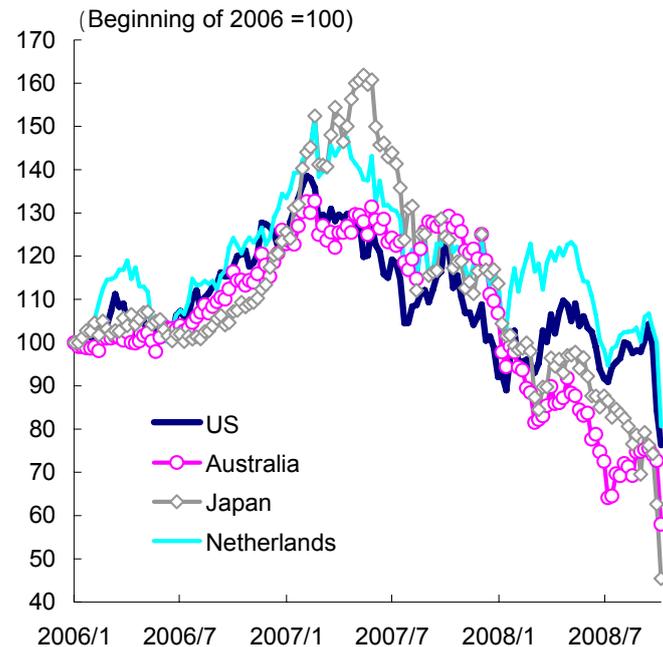
**(2) Global REIT market trends**

Similar shifts are also evident in the global real estate markets.

Turning to the housing market, the market downturn in the United State has occupied the center stage of attention. However, even in countries such as the United Kingdom, Spain, and Ireland that have enjoyed housing booms since the 1990s, the growth of residential prices is slowing or dipping into negative territory.

Furthermore, REIT indexes of major countries are starting to fall subsequent to the boom which lasted up to around 2007. Note the sharp decline from the peak, falling about 50% in Australia and about 40% in the United States (**Chart 4**).

**Chart 4: Trends in REIT indexes (US, Australia, Japan, Netherlands)**



Note: S&P Citigroup Index. Local currency-basis.  
Source: DATASTREAM.

### 3. The background factors leading to the real estate market downturn

#### (1) Impact of the global financial turmoil

The primary reason for these shifts in the real estate markets is the global financial meltdown triggered by the subprime loan crisis in the United States.

Global investment in the real estate expanded rapidly from around 2005, reaching USD759 billion in 2007 (**Chart 5**). However, real estate investment fell from USD385 billion in the first half of 2007 to USD374 billion in the second half. In terms of regions, the second-half falls in the United States and the United Kingdom were particularly significant. Why? The soaring real estate prices were already creating a cautious mood in the global market, and the US housing problems then triggered the financial market crisis. As a result, 1) investors are becoming more and more risk-averse, and 2) securitization markets are becoming less and less functional, making financing activities difficult for some investors.

**Chart 5: Global trends in real estate investment**

(USD billion)

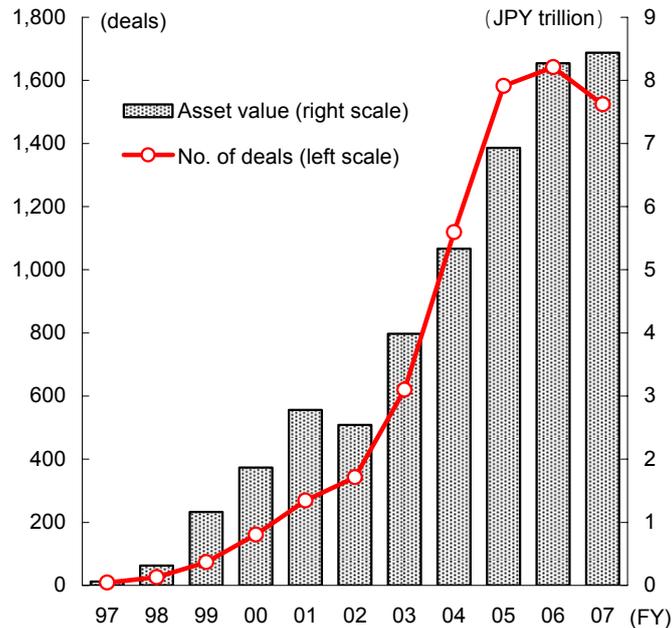
	2005	2006	2007	2007	
				1H	2H
Global	495	700	759	398	<b>361</b>
US continent	216	283	304	172	<b>132</b>
US	205	271	282	163	<b>119</b>
Europe	212	322	333	171	<b>162</b>
UK	103	115	96	54	<b>42</b>
Germany	25	62	72	36	<b>36</b>
France	18	30	41	21	<b>20</b>
Asia Pacific	67	95	121	54	<b>67</b>
Japan	23	52	60	30	<b>30</b>
Australia	11	12	18	6	<b>12</b>
China	—	9	9	6	<b>3</b>

Note: Part of the data regarding the 1H and 2H of 2007 was calculated by Mizuho Research Institute Ltd. (MHRI) based upon the following material.

Source: Jones Lang LaSalle, *Global Real Estate Capital Report*.

Japan's real estate market has also contracted. In recent years, real estate funds by means of securitization, such as J-REIT or private funds, boosted acquisition of properties. The real estate securitization business grew rapidly after FY2002, and in FY2006, the asset value of this business reached JPY8.2 trillion, or more than three-fold since 2002. The value of securitizations stood at JPY8.4 trillion in FY2007, slightly up from the previous year, but revealing a drop in the number of deals (**Chart 6**).

**Chart 6: Trends in real estate securitization**



Source: Ministry of Land, Infrastructure, Transport and Tourism, *Survey on Real Estate Securitization*.

The sluggish growth of Japan's securitization market also stems from the global financial turmoil. Along with plummeting global REIT prices, prices of J-REIT investment units have dropped substantially. As a result, it has become difficult to raise funds for J-REITs by means of capital increase.<sup>1</sup> Regarding private funds, borrowing on the premise of liquidation by financial institutions has declined due to the impaired function of the global securitization market.

The difficulty to finance real estate funds is cooling down the overheated real estate market through the decline in number of property acquisitions.

## (2) The impact of high real estate prices

The second reason for the decline in real estate prices is that high office rents and condominium prices are serving to hamper demand.

### a. The Office Building Market

In the office market, real estate prices have been rising on the back of strong expectations toward the rise of office rents in the future. However, aggressive price strategies, in particular those of new buildings, are failing to attract tenants and office vacancy rates are rising. This indicates a rapid downturn of expectations toward the future rise of

<sup>1</sup> Details are provided later.

rents .

**Chart 7** shows the anticipated rents in five years, compared with a base score of 100, as of the implementation of the survey. In the Marunouch/Otemachi area, the anticipated rent index is 105 in April 2008, down from 110 when the previous survey was conducted in October 2007. Rents have been revised downward for all survey locations where they were expected to rise in the previous survey in October 2007.

Furthermore, the soft demand for offices due to the sluggish local economy appears to be compounding the negative impact on expected rents, further pushing down real estate prices.

**Chart 7: Level of rents in 5 years  
(level of rent at the time of survey = 100)**

Level of rents in 5 years compared with a base score of 100 as of the implementation of the survey							
Implementation of survey	Oct-2003	Oct-2004	Oct-2005	Oct-2006	Apr-2007	Oct-2007	<b>Apr-2008</b>
Marunouchi/Otemachi	100	101	105	107	110	110	<b>105</b>
Nihonbashi	98	100	100	105	105	105	<b>103</b>
Toranomon	98	100	100	105	105	105	<b>103</b>
Nishi-Shinjuku	97	100	100	105	104	104	<b>102</b>
Shibuya	98	100	100	105	105	105	<b>102</b>
Roppongi	98	100	101	105	105	105	<b>102</b>
Ueno	95	97	98	101	101	102	<b>100</b>
Shinagawa	100	100	100	105	105	105	<b>102</b>
Shiodome	100	100	100	105	105	105	<b>102</b>
Main street in front of Sapporo Station	95	95	98	100	100	100	<b>100</b>
Area in front of Nagoya Station	95	100	101	103	104	103	<b>100</b>
Osaka Midosuji	95	98	100	103	103	103	<b>101</b>
Fukuoka Tenjin	95	98	100	102	102	102	<b>100</b>

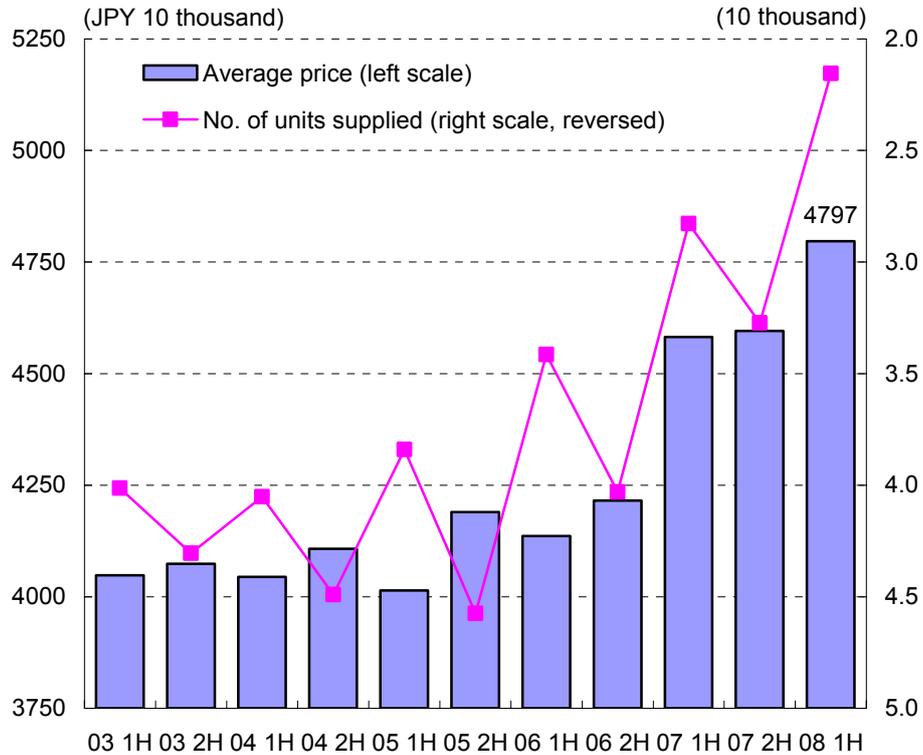
Source: Japan Real Estate Institute, *Fudosan toshika chosa (Survey on real estate investors)*.

### **b. The Condominium Market**

In the condominium market, the annual supply of condominiums in the Tokyo metropolitan district was approximately 80,000 units per year, or about 40,000 units in six months, until 2006. However, after the first half of 2007, prices surged because of rising land prices and construction costs, which in turn led to the sharp decline in of supply (**Chart 8**). According to the latest data for the first half of 2008, the average

price of condominiums was JPY47.97 million, and the number on offer had decreased to 21,000 units.

**Chart 8: Condominium prices and the number of units supplied in the Tokyo metropolitan district**



Source: Real Estate Economic Institute Co. Ltd., *Shutoken manshon shijo doko (Trends in the condominium market in the Tokyo Metropolitan District)*.

Slow wage growth and higher condominium prices are inevitably affecting sales, serving as negative pressures upon the supply of new condominiums.

Assuming that purchasers of condominiums finance 75% of the price of the condominium by mortgage loans, the annual amount of repayment would be as follows: if the condominium price is JPY40 million, 75% of the price is JPY30 million. On a payback period of 30 years and fixed interest rate of 3.5%, the annual repayment will be about JPY1.62 million. This accounts for 24% of the average household income, which is about JPY6.72 million<sup>2</sup>, and the percentage is lower than the repayment standard ratio, 25%. However, if the property price is JPY48 million, the estimate will be 29%. In other words, the higher property price from JPY40 million to JPY48 million means

<sup>2</sup> Average income of workers' households comprised of two or more persons in the Kanto area according to the *Family Income and Expenditure Survey*.

crossing the border of the standard repayment ratio. This price increase is thought to be the cause of the drop in demand.

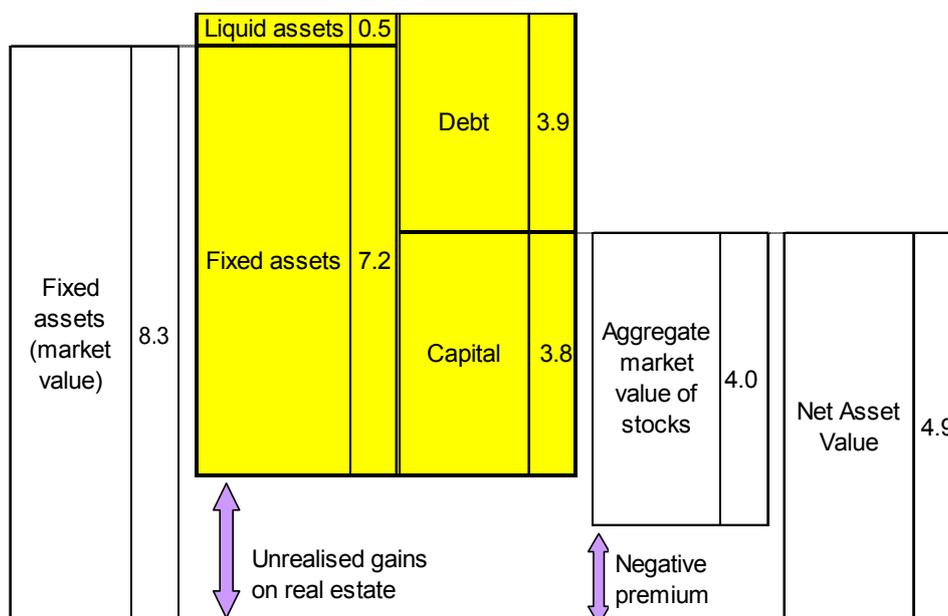
#### 4. J-REIT market trends

Even though the J-REIT market had been expanding steadily up to last year, it is facing a turning point.

The investment unit price of J-REITs has declined substantially, and the aggregate market value stood at JPY3.3 trillion as of the end of September 2008, down by 51% from its peak of JPY6.8 trillion in May 2007.

**Chart 9** shows the combined balance sheet of all J-REITs. Total assets reached JPY7.7 trillion: on the liabilities side, equity capital stood at JPY3.8 trillion, while the amount of fixed assets was JPY7.2 trillion. Fixed assets refers to real estate owned by J-REIT, and their appraisal value (market value) stood at JPY8.3 trillion, with JPY1.1 trillion of latent profit from real estate. While the net asset value stood at JPY4.9 trillion, the aggregate market value remained at 4.0 trillion yen as of the end of June. The aggregate market value is lower than the net asset value, a situation known as “negative premium.”

**Chart 9: J-REIT balance sheet**



Note: Unit = JPY trillion. As of the end of June 2008.  
 Prepared by MHRI on the basis of financial statements of investment corporations.  
 Source: Material disclosed by investment corporations.

Ever since their market listing, J-REITs continued to grow by purchasing properties based on increased capital. However, when capital is increased during a period of “negative premium,” the amount of financing is limited, and the decreased net asset value per unit and lower dividends may further reduce the investment unit prices.

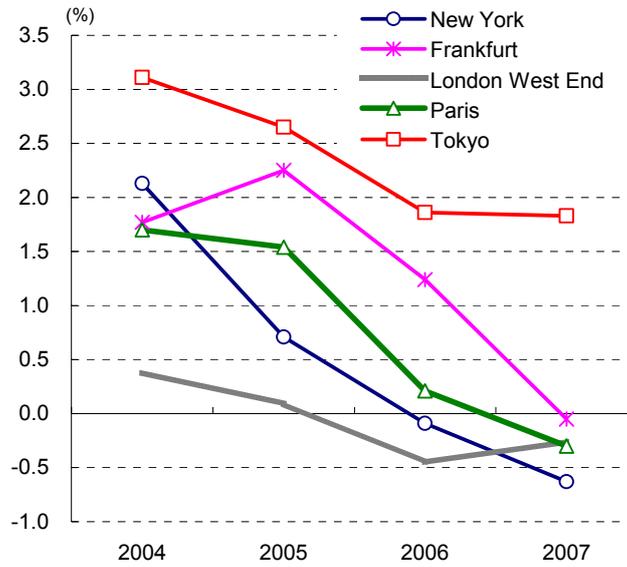
The decline of investment unit prices may be a reflection not only of the deterioration of the future real estate market but also of the global financial market crisis. Even so, most J-REITs are suffering from the “negative premium,” and it is difficult for them to grow by purchasing more properties in such severe conditions.

## **5. The future real estate market**

Looking forward, the current real estate market downturn should persist since the stabilization of the global financial market is unlikely anytime soon..

That said, investment trends in the Japanese real estate market are positive from a relative point of view despite the contraction of global real estate investment. This stems from the fact that Tokyo’s yield gap is the highest in the world – around the upper end of the 1%-level (the yield gap refers to yields of real estate investment minus government bond interest, and represents the profitability of investment) – in contrast to the negative yield gaps in most other major cities (**Chart 10**). Given the cool-down of the overheated market, pension funds and foreign government funds, which basically make long-term investments, are expanding their investment. Furthermore, since Japan’s real estate market did not experience an all-embracing bubble as in the US, we are inclined to believe that Japan’s real estate market adjustment will turn out to be relatively benign.

**Chart 10: Yield gaps of major cities of the world**



Note: Yield gap = cap rate minus government bond yield.  
Sources: COLLIERS INTERNATIONAL, *Global Office Real Estate Review*, OECD.

A worrisome phenomenon is that expectations regarding higher rents are spreading to properties surrounding prime buildings. Given the strong downward pressures upon property prices in these areas, investors involved in these areas will face grim conditions.

During the past few years, Japan's real estate market had been improving relatively uniformly under a macro-environment of declining real estate investment yields, . However, in the ensuing market downturn, we expect to see a further diversification of the real estate market stemming from the profitability of each and individual property.

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