Trends and Developments

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Cross-border Transactions

Outbound investments

Japanese investors are continuously expanding their outbound investments in foreign real estate markets, searching for opportunities to take advantage of good domestic economic strength mixed with relatively limited investment opportunities within Japan. Over the past few years, a number of Japanese real estate developers have announced that they are or will be investing in real estate and real estate development businesses outside of Japan. In line with this trend, Japanese funds and investors are seeking outbound investments through J-REITs (Japanese real estate investment trusts) in addition to purchasing limited partnership (LP) interests, REITs or other types of securities whose underlying assets are foreign real estate. It is potentially beneficial for J-REITs to diversify their portfolios across various locations in order to mitigate risks associated with the Japanese real estate market, to some extent.

J-REITs are allowed to acquire property overseas. Although J-REITs were previously generally prohibited from holding more than 50% of the shares of a real estate holding company, the Financial Services Agency has issued a statement which confirmed that J-REITs are able to hold up to 100% of the equity of foreign real estate companies in certain foreign countries, including the USA, India, Indonesia, China, Vietnam and Malaysia.

Following the publication of this statement, Aeon Reit Investment Corporation (a J-REIT) invested in a commercial property in Malaysia by acquiring 100% of the equity of a Malaysian SPC, and Invincible Investment Corporation invested in hotels in the Cayman Islands in 2018. In 2019, a private J-REIT sponsored by Daiwa House invested in 100% of the equity of a Limited Liability Company that co-owns real estate in the USA.

Inbound investments

There have also been continuous increases of inbound investments into Japanese real estate. According to a Tokyo Stock Exchange survey in 2019, foreign investors held approximately 26% of J-REIT shares, and approximately 50% of the trading of J-REIT shares was executed by foreign investors. In addition, about JPY70 billion (approximately USD640 million) flowed into the J-REIT market in 2019.

Foreign investors have long played a key role in the Japanese real estate market. There has been a fairly large volume of transactions where SPCs sponsored by foreign investors have purchased Japanese real estate using financing with securitisation structures. In fact, foreign investors invested in seven of the top ten real estate sale and purchase transactions (by deal size) in 2019, according to Nikkei's real estate market information. Foreign investors were previously focused mainly on office and residential properties, but are shifting their attention to various other types of properties, including logistics, hotels and accommodations.

As the population of Japan declines, it will be important to continue to develop a sophisticated real estate market to attract inbound investment in order to sustain the growth of the national economy. The Japanese government expects that inbound investments will play a key role in real estate development in the country. This is also in line with the recent enactment of a new statute to allow Integrated Resorts (IRs) and Meeting, Incentive Travel & Event/Exhibition (MICE) properties to attract visitors from foreign countries.

Tourism Industry – Hotels, MICE and Casinos

The Japanese government has recently put its energy and focus into the Japanese tourism industry. The number of visitors coming to Japan has been soaring in the past six or seven years, with more than 30 million people visiting in 2019.

With the increase of foreign visitors, a number of construction projects for building hotels and other types of accommodations have been initiated, and some are under way, especially in mega cities and areas near international airports. As the number of repeat visitors to Japan increases, regional cities are also pulling in foreign guests with their unique attractions, such as ski destinations in Niseko, Hokkaido for example. It has been said that there are fewer five-star hotels in Japan than other parts of Asia seeking to attract tourists. However, an increasing number of luxury hotels have been developed, with more being planned, as wealthy visitors are coming to Japan more than before.

One of the Japanese government's policies in relation to the tourism industry is to promote the development of MICE projects. The expansion of MICE projects is intended to have an important effect not just on the tourism industry but also on the wider economy, because MICE can facilitate business innovation between top-tier companies as their core members gather to meet from around the globe. MICE projects are intended to provide an opportunity to improve the international competitiveness of Japanese industry by drawing on the exchange of information and other resources at MICE gatherings. On top of these effects, MICE projects are thought to cause an economic boost in local business activities, since the length of stay for visitors attending MICE events is generally longer than that for tourist visitors. The overall economic impact brought by MICE developments in 2016 was estimated to be approximately JPY1 trillion (USD9 billion), according to a government survey. Twelve cities, including Tokyo, Yokohama, Osaka and Kyoto, have been selected to be global MICE cities by the Japanese government. Government support for further MICE development in these cities is being implemented.

Amid this movement, a new statute related to MICE (the Act on Development of Specified Integrated Resort Area – the IR Act) was enacted in 2018. Among other things, the statute governs the development of complex tourist facilities (including MICE and casinos), as well as the management and regulation of these facilities. One of the most remarkable aspects of the IR Act is that it legalises casinos for the first time in Japan. Gambling is generally treated as criminal activity in Japan, with some exceptions, such as horse racing. The IR Act expressly permits casinos – based on an examination of their overall positive contribution to the public interest – by advancing an internationally competitive tourism industry, boosting regional economies, and providing tax revenue. The casinos will only be permitted as a part of integrated resorts, which will be developed in accordance with authorised area development plans under the IR Act. Casinos will not be independently operated outside of IRs, and the size of each casino will be limited to 3% of the total floor space of each integrated resort facility.

One thing to be noted about the IR Act is that the initial authorisation to open an IR facility is only valid for ten years. The authorisation may be extended, but this limited period is likely to be a significant risk factor for financing providers, potentially challenging the funding of the construction and management of the IR facilities.

With the rules of the Japan Casino Regulatory Commission and other regulations still to be published, the legal structure for IR developments is likely to be revealed more in the near future. Since the IR Act limits the number of IR areas in Japan to three, several cities are competing for them, including Osaka.

Logistics, Data Centres and other Industrial Facilities
Logistics facilities is another asset class that is attracting attention in the Japanese real estate market. Nikkei's report shows that four of the top ten real estate sale and purchase transactions (by deal size) in 2019 were logistics properties. The market for electronic commerce is increasingly developed, with the amount of consumer transactions using electronic commerce reaching USD160 billion in 2018, up from USD126 billion in 2015, according to a report issued by the Ministry of Economy, Trade and Industry. With this growth, logistics companies are seeking facilities in proper locations to accommodate their increasing inventory. There are ten J-REITs listed on the Tokyo Stock Exchange specifically investing in this space, and four of them have been newly listed since 2017.

In addition to logistics, data centres are a rather new type of asset. Data centres generally house servers in racks with ample electricity, controlled temperature and tight security, and provide IT network services and facilities, including cloud services. Leases for data centres have some unique aspects compared with other types of property leases, since data centres are primarily designed to accommodate IT facilities, such as servers. Also, these leases often include important terms relating to the provision of additional services incidental to the lease (eg, the supply of electricity, technical support, etc). Consequently, unique legal issues may need to be addressed when reviewing data centre transactions (eg, whether the Act on Land and Building Lease (Act No 90 of 1991) applies to a data centre's lease contract).

REITs
In the Japanese capital markets, REITs showed a strong and steady performance in 2019. The aggregate market value of REITs reached about JPY16 trillion (approximately USD145 billion) at the end of 2019, which exceeded the aggregate market value of the real estate sector companies listed on the First Section of the Tokyo Stock Exchange for the first time.

One of the key events of interest in 2019 was the first hostile takeover of a J-REIT. There have been some M&A transactions between J-REITs during the past ten years, but all of them have been friendly mergers under previous agreements between all relevant parties (including the sponsors). In addition, many of them were carried out between the J-REITs under the same sponsors or friendly sponsors in an effort to increase their assets under management (AUM), expand the types of their assets and/or streamline their business.

The types of REIT M&A transactions are generally as follows:

- mergers between two REITs (via a consolidation-type merger or an absorption-type merger);
- the acquisition of an asset management company's shares; and
- the acquisition of all portfolio assets held by one REIT by the acquiring REIT.

As a general rule, a shareholders' meeting will need to be held to approve a merger between two REITs.

It has generally been considered difficult to implement a hostile takeover of a J-REIT, mainly for the following reasons:

- the requirements to qualify to avoid double taxation (ie, the deduction of dividends from a REIT's taxable income) cannot be met if more than 50% of a J-REIT's shares are purchased and owned by a specific investor group; and
- acquiring the shares of a J-REIT is not sufficient to take control of a REIT – it is also necessary to take control of or replace the target REIT's asset management company, since the asset management company has the authority to dispose of the real estate owned by the J-REIT.

Regarding the second reason in particular, a J-REIT's asset manager is typically an unlisted subsidiary of its sponsor, so shares of such asset management company are usually not available to be acquired by a hostile acquirer. Furthermore, in terms of licensing, as a REIT's asset management company can be replaced only by a company already licensed as another REIT's asset management company, such replacement may give rise to a conflict of interest between two REITs.

To avoid these problems, the hostile takeover mentioned above adopted the following transactions: replacing the target REIT's asset management company with the asset management company of the acquiring REIT and then entering into a merger agreement between the two REITs, subject to the necessary approvals of the shareholders' meeting.

These types of transactions should be subject to merger approval by shareholders of both REITs, so it will not be easy for other REITs to follow the same strategies. Even so, REIT asset management companies cannot overlook the possibility of such transactions, considering that a shareholder holding not less than 3% of issued shares for the preceding six-month period can request that a shareholders' meeting be held regarding such transactions. Under these circumstances, it is becoming more important for REIT asset management companies to regularly provide a sufficient account to shareholders and to obtain their understanding of the advantages of having them manage REIT assets as well as their investment policies and investment records.

Furthermore, under the Act on Investment Trusts and Investment Corporations, a J-REIT may provide in its certificate of incorporation that shareholders who do not attend a shareholders' meeting or exercise their voting rights in the shareholders' meeting will be deemed to agree to the proposal(s) submitted to that meeting (the "Deemed Votes in Favour Provision"). Shareholders of J-REITs include many individual or corporate investors mainly hunting for high returns who are less concerned about attending shareholders' meetings and exercising their voting rights. Therefore, most J-REIT asset management companies provide Deemed Votes in Favour Provisions in REIT certificates of incorporation in order to constitute a quorum and pass necessary resolutions at shareholders' meetings. However, a Deemed Votes in Favour Provision can also apply to important proposals such as proposals for the replacement of management companies or the hostile takeover mentioned above, and consequently can make such transactions easier. Thus, Deemed Votes in Favour Provisions remain an issue for the future, from a legislative perspective as well.

Real Estate Tech/Proptech

These days, new businesses in the real estate market – called Real Estate Tech or proptech – are developing in Japan, taking advantage of information technology (IT). Real Estate Tech refers to various types of businesses, such as:

- crowdfunding for real estate investment;
- improving the efficiency of real estate transactions with IT (eg, the conversion of written legal documents into electronic versions);
- matching users and owners of properties; and
- estimation of the value of, or appraisal of, real estate by using big data.

Real Estate Tech enables issuers to offer their financial instruments to many investors. This means that issuers may design new types of financial instruments for individual investors. The recent amendment of the Real Estate Specified Joint Enterprise Act (Act No. 77 of 1994 – REJEA) in 2017 has helped this innovation by facilitating the arrangement of new investment schemes for small properties with fewer legal requirements and costs. With Real Estate Tech and the current REJEA, it has become easier to design new investment structures with more flexibility to invest in small properties with funds from small investors.

In response to such diversification of financial transactions accompanying the progress of information technology, the Financial Instruments and Exchange Act (Act No. 25 of 1948 – FIEA) and the Payment Services Act (Act No. 59 of 2008) were amended in March 2019, and will be enforced within a year; the drafts of the relevant cabinet order and ordinance have been published. In this amendment, certain types of financial instruments fall under securities under the FIEA, such as TK investments in which crypto-assets are invested. In addition, if such financial instruments are able to be transferred through an internet system including blockchain technology, the regulations applied to such instruments would be those for securities with high liquidity, which is different from the current regulation. These amendments aim to catch up with progress in information technology, so the tech players are paying more attention to the future trends and development of these types of securities based on the amendments.

ESG

Environmental, Social and Governance (ESG) factors have gained some attention in the real estate market as well as other investment sectors. The Government Pension Investment Fund, a major investor in Japan, signed the Principles for Responsible Investment advocated by the United Nations in 2015, and has been taking ESG factors into consideration when investing in assets, including real estate. This development seems to be influencing other investors. To create a sustainable environment, it is generally understood that real estate, as a basic component of society, should follow global policy, such as SDGs (Sustainable Development Goals), and contribute thereto. The real estate industry is thought to have significant potential to play an important role in meeting SDGs, especially with respect to the environment. There have been developments of buildings that achieve high environmental performance to reduce energy consumption. Buildings with environmental performance certificates appear to attract investments more than those without such certificates.

In line with the promotion of ESG, the number of Japanese participants in GRESB Real Estate Assessment has been increasing. The participation rate of Listed J-REITs in the Assessment is reported to have been approximately 90% (on the basis of market capitalisation) in 2019. GRESB Real Estate Assessment is the global ESG benchmark capturing information as to ESG performance and sustainability best practices for real estate, and gives rating results. It appears that more and more investors have referred to GRESB Real Estate Assessment for their investment decisions, or are considering doing so.

The Japanese government is also delivering positive signals regarding ESG/SDGs and publishing its policies related to this field, such as SDGs Action Plan 2020, Financial Administration and SDGs, and the interim report for the promotion of ESG investment in real estate. The idea of a green lease is part of government strategies to improve property environmental performance that the Japanese government is also suggesting through its Green Lease Guideline. In a green lease, the owner and tenant share the costs for environmental improvements of the leased building.

Also, public money, together with private funds, has been flowing into investments to redevelop aged buildings and remodel them to have seismic or environmental capacity. The green bonds market is also growing and collecting funds to be spent on eco-friendly businesses.

ESG is currently early in its development in Japan, and it seems that ESG investment methods, disclosure models and ESG effects investment have not been established completely. Nevertheless, the global ESG trend will continue to grow in the Japanese real estate market, and attention needs to be paid to this development.

The Amendment of the General Civil Code

The law concerning contracts and obligations in the general Civil Code was amended in 2017, and the amendment became effective on 1 April 2020 (the "Effective Date"). The amendment includes changes to general rules relating to transfers of claims, guarantees and standard terms and conditions applied to similar transactions, etc. Although this amendment of the general Civil Code does not appear to have brought about any drastic changes to existing court rulings or other business operations related to real estate transactions between companies, the amendment is likely to require some changes (including terminological changes) in contract documents, so it is recommended to keep it in mind when conducting Japanese transactions following the Effective Date.

Nishimura & Asahi has substantial experience in a wide array of real estate securitisation in both domestic and cross-border transactions. The firm's real estate finance team has a proven track record in advising both lenders and borrowers in finance transactions throughout the real estate industry, offering expert assistance to clients in all stages of their transactions, from the term sheet and structuring stage through closing, tranching, syndication and securitisation, administration, servicing and, if required, restructuring. Since the early 2000s, the firm's lawyers have played a significant role in advising publicly traded REITs, private REITs, and real estate operating and finance companies in all stages of their life cycles, from REIT formation, roll-up transactions and initial public offerings to secondary debt and equity offerings, and REIT transactions. Nishimura & Asahi advises on real estate sales and purchases, investment, lease and management in Japan and abroad; as the growth in real estate funds and private equity investment in real estate increases, the firm has been advising all of the key fund-related specialties. Furthermore, the firm specialises in environmental law, providing risk analysis and settling disputes on soil pollution, asbestos and other environmental law issues that arise regarding real estate; capabilities extend to environmental law-related issues to be complied with by business entities and Corporate Social Responsibility (CSR).

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