Chambers

GLOBAL PRACTICE GUIDES

Definitive global law guides offering comparative analysis from top-ranked lawyers

Real Estate

Japan
Trends and Developments
Hiroshi Niinomi, Koki Hara,
Naoto Yamamoto and Takanobu Yamamoto
Nishimura & Asahi

2021

practiceguides.chambers.com

Trends and Developments

Contributed by:
Hiroshi Niinomi, Koki Hara, Naoto Yamamoto and Takanobu Yamamoto
Nishimura & Asahi** ****see p.10

COVID-19's Impact on the Market

The COVID-19 outbreak had a significant impact on the real estate market, as it did on many other business sectors. However, its impact varied significantly depending on the real estate asset type.

Logistics

There has been a trend of increasing investment in the logistics area in recent years. The outbreak seems to be significantly accelerating this trend due to the expansion of e-commerce as a result of the widespread adoption of work-from-home arrangements and the quarantine measures imposed during the state of emergency. More investors and real estate funds have focused on logistics, especially those fitted to the rapidly updated technology of digital transformation (DX) from an e-commerce viewpoint.

There have been a number of logistics deals this year, including an investment by a foreign fund in a portfolio of newly built logistic facilities (over USD550 million) developed by a well-known Japanese developer, and the establishment of several private J-REITs focused on logistics properties. This trend seems likely to continue after the outbreak has passed.

Office and residential properties

Despite the pandemic, investment in office and residential properties in Japan seems to be steady, due to a combination of several factors including the quantitative easing policy, a relatively less severe number of infections compared to other markets and the relative difficulty for tenants to reduce rent under Japanese law (see **Building Lease** below). Specifically, the vacancy rate in high-quality assets in the Tokyo area has not risen as much as initially expected. One reason for this may be that the average rent rates for those high-class assets has been increasing in recent years and the rent prices of lease agreements ending in this year (which, in many cases, had been agreed upon in the aftermath of the financial crisis) still often look relatively low, so lessees are unwilling to terminate those contracts at this point.

There have been several impressively sized inbound transactions: a US-based fund invested more than USD1 billion in office and commercial properties and more than USD2.8 billion in a residential portfolio, and a Switzerland-based global insurance company invested more than USD1.2 billion in a residential portfolio (consisting of approximately 80 properties) in its first investment in Japan. In addition to these private funds, there is an established J-REIT market with a steady appetite for office and residential properties.

Hotels and accommodations

The pandemic has clearly had a negative effect on the hotel and accommodation market, including some J-REITs mainly focused on hotel assets. In contrast to office and residential properties, the cash flow of hotel properties is easily affected as a result of a drastic decrease in tourism. Although the Japanese government did support the travel market by providing a subsidy for domestic travel (the so-called "Go to campaign", under which customers received a certain percentage of tour costs from the Japanese government), this support did not make up for the negative effect of the outbreak on the cash flow of these assets. Consequently, asset prices seem to be decreasing, with investments in this sector shrinking this year.

Some mezzanine financing deals have taken place under these circumstances. From an owner's viewpoint, bridge financing may be an inevitable way to make up such damaged cash flows. On the other hand, financing providers may expect that the financing would lead to a potential opportunity to take over the assets after the COVID-19 situation is resolved. Accordingly, there may be an increase in the acquisition of hotels and accommodations, and in the restructuring of financing for such properties.

Building Lease

A lessee's rights are basically protected under the Act on Land and Building Leases (Act No 90 of 1991 – the Lease Act). As a general rule, upon the lapse of the term of a normal lease, the building lease contract will be renewed under the same terms and conditions as an existing contract. A lessor may not terminate a normal lease unless it has justifiable grounds for giving a termination notice to a lessee. Please note, however, that these rules are not applicable to "fixed term" leases.

Also, generally, rent will not be revised for a normal lease unless there is a provision for automatic rent adjustments or if changes are separately agreed upon between a lessor and lessee. The Lease Act grants both lessor and lessee a statutory right to claim increases or decreases to rent under a normal lease where the rent becomes unreasonable due to a change in taxes or other factors relating to the lands and buildings, or due to fluctuations of economic circumstances (including a rise or fall in property prices), or in comparison with rents in other similar leases. It is not clear, however, whether COVID-19 constitutes grounds for a lessee to assert this statutory right to claim decreased rent, considering that overall property prices have not seen a material drop in Japan. Please note that this statutory right does not apply to a fixed term building lease if both parties have agreed otherwise.

In general, building rents have not fallen significantly, despite the turbulence caused by COVID-19, although certain tenants have requested that lessors voluntarily decrease rent for a certain period of time as a form of rent relief, to help lessees manage decreased business income. In relation to such trends, the Ministry of Land, Infrastructure, Transport and Tourism (the MLIT) delivered a notice in March 2020 asking real estate-related organisations to take flexible measures, such as rent reduction, by giving due care to tenants who were struggling due to COVID-19. However, such notice does not provide tenants with any legal rights to a rent reduction.

Digital Transformation

DX technology in the real estate market in Japan has been actively developed in this decade, and increasing demands corresponding to the COVID-19 outbreak are further accelerating the development.

Logistics

Logistics properties adopting cutting-edge DX technology are attracting investments from many domestic and foreign investors and real estate funds. Existing logistics facilities are facing problems in handling logistics operations corresponding to the expansion of e-commerce during the COVID-19 pandemic, and DX technology is expected to help with issues such as efficient operations of facilities and supply chains.

Mobility as a Service (MaaS) is a potential field that would utilise traffic data to efficiently operate logistics. While there is no integrated legislation for MaaS, other than a government guideline regarding MaaS-related data collaboration published in March 2020, the Japanese government is actively working on demonstration projects for "Distribution MaaS" with some private companies, which were announced in July 2020. The trend of private companies updating their logistics facilities with DX technology also seems to be continuing.

Smart City

Smart City measures are being implemented in several cities to address urban issues in Japan, such as aging and depopulation, de-carbonisation, traffic jams, rush hours and security improvements.

Aizuwakamatsu City in western Fukushima Prefecture is promoting Smart City measures with private companies, including Accenture Japan Ltd, which established its innovation centre there shortly after the Great Tohoku Earthquake in 2011. The city is expanding and advancing public services through utilising ICT, such as operating a public portal site for regional information. The city is one of 52 designated areas for government demonstration projects as part of the "Smart Mobility Challenge", and is the host of a MaaS in Smart City demonstration project.

In addition, a public-private consortium is promoting Smart City developments in an area of Otemachi, Marunouchi and Yurakucho, located between Tokyo station and the Imperial Palace. The project includes DX of the area management through gathering and utilising real-time data by providing several public services such as apps relating to mobility, emergency and health.

The Japanese government is formulating guidelines and other legislation to promote Smart City measures and the industrialisation of urban operating systems. An amendment to the National Strategy Special Regional Law came into force in September 2020 (the so-called Super City Act), to accelerate developments of the Smart City projects. Under this amendment, certain companies can gather regional data collated by government agencies and use a sandbox system for regulations in specific regions to conduct certain demonstrations, such as automatic driving. The investments and developments in this field are expected to progress steadily over the next few decades.

Electronic contracts

Due to the COVID-19 outbreak, demands to execute contracts in electronic form (an Electronic Contract) have increased. Another reason for this is that stamp duty is not required for agreements that are electronically delivered, which motivates transaction parties to use Electronic Contracts. Although the majority of real estate transactions in Japan still use written agreements, some companies engaged in real estate transactions – such as Nomura Real Estate Development Co., Ltd. – are introducing Electronic Contract services provided by DocuSign, CloudSign and other service providers.

In response to such increased demands, in 2020 the Japanese government announced that certain signatures signed electronically by an Electronic Contract platform provider under instructions from users through a strict certification process are considered to be electronic signatures signed by the users and presumed to be established authentically under the Electronic Signature Law (Act No 102 of 2000). In addition, a proposed Act on the Development of Related Laws for the Formation of a Digital Society was submitted to the Japanese National Diet in February 2021. This proposal includes several amendments of regulations so that seals and the delivery of certain written documents for real estate transactions may be omitted, such as certain documents explaining important matters under the Real Estate Brokerage Act (Act No 176 of 1952) and fixed term land/building lease agreements. These government announcements and amendments will further help real estate transactions in particular to be conducted electronically during the current COVID-19 situation.

Security token offerings

Amendments to the Financial Instruments and Exchange Act (Act No 25 of 1948 – FIEA) and the Payment Service Act (Act No 59 of 2008) were enforced on 1 May 2020 in response to the diverse range of financial instruments and investment schemes that are emerging as DX technology develops. These amendments established regulations for Security Token Offerings (STOs), including continuous disclosure obligations addressing information asymmetry between issuers and investors. The applicable regulations depend on whether or not the offered security token falls under "Electronically Recorded Transfer Claims", a new concept established under this amendment; if it does, it becomes more necessary for the issuers to consider the security token's legal characteristics.

In addition to the FIEA, the Japan Security Token Offering Association as a self-regulatory organisation has published several self regulations for STOs, which must also be followed. Under the amendments, the regulations relating to STOs have become more clear and investors are able to receive more information regarding the security token, so real estate transactions using security tokens under the FIEA are likely to increase gradually.

Outbound Investments

Despite the COVID-19 pandemic, outbound investments have not been withdrawn. Over the past few years, Japanese investors have continuously expanded their outbound investments into foreign real estate markets, searching for opportunities to take advantage of good domestic economic strength mixed with relatively limited investment opportunities within Japan. 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. This trend seems to have slowed down to some extent as a result of COVID-19's negative impact on real estate market overseas, but most Japanese funds and investors are not yet withdrawing outbound investments.

Having said that, no new transactions where a J-REIT has acquired property overseas have yet been announced this year, although it has been 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. There have been three outbound investments by J-REITs to date:

- AEON REIT Investment Corporation's investment in a commercial property in Malaysia by acquiring 100% of the equity of a Malaysian SPC;
- Invincible Investment Corporation's investment in hotels in the Cayman Islands in 2018; and
- the investment by a private J-REIT sponsored by Daiwa House in 100% of the equity of a Limited Liability Company that co-owns real estate in the USA.

REITs

In the Japanese capital markets, REITs have generally showed a strong and steady performance, although some hotel and commercial REITs seem to be struggling with the downturn in guest/consumer demand. The REIT index plummeted in March 2020 due to uncertainty caused by COVID-19, but has recovered quickly. The total value of real estate held by REITs including private REITs has reached approximately JPY24 trillion (on the basis of acquisition price), and the aggregate market capitalisation of listed

REITs was about JPY14 trillion (approximately USD127.8 billion) at the end of 2020.

The growth of private REITs has played a certain role in the Japanese REIT market, with private REITs owning properties valued at about JPY4 trillion (on the basis of acquisition price) in December 2020. There are 36 REITs, ranging from comprehensive REITs (those diversifying their portfolio in multiple asset types) to sector-specific REITs, such as residential, hotel and logistic properties. Sponsors from various business fields have initiated private REITs. Financial institutions (including insurance companies and banks) and other industry are also engaging in, or interested in, the management of REITs.

One of the current key events in the REIT market is hostile takeovers of J-REITs. There were some M&A transactions between J-REITs before 2019, but all of them were 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 affiliated sponsors in an effort to increase their assets under management (AUM), expand the types of their assets, and/or streamline their business.

The first hostile REIT M&A transaction was completed in 2020. A minor shareholder called a shareholders' meeting of a target REIT with the financial bureau's permission, at which both the selection of a new officer on the minor shareholder side and the execution of a management agreement with a new sponsor and the termination of an existing management agreement were resolved. After the meeting, a merger was conducted between the REIT managed by the new sponsor and the target REIT.

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 only be replaced by a company that is 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 replaced the target REIT's asset management company with the asset management company of the acquiring REIT and then entered 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 the shareholders of both REITs, so it will not be easy for other REITs to follow the same strategy. 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 a shareholders' meeting to 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 who are mainly hunting for high returns so are less concerned about attending shareholders' meetings or 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 those 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.

Renewable Energy

Even after the global COVID-19 pandemic exerted considerable pressure on economic activity in Japan, domestic and foreign investors have actively and consistently invested in Japanese renewable energy businesses. Such trends have continued since the Japanese Feed-in-Tariff regime (the FIT Regime) came into effect in July 2012. Under the FIT Regime, a relatively high fixed purchase price (eg, JPY40/kWh (plus consumption tax) for solar projects that meet certain requirements by the end of March 2013) for a fixed period of 20 years is determined at the outset of a project. After the FIT Regime began, the proportion of renewable energy in Japan's power generation mix increased from approximately 9% to 18%.

A major amendment to the Japanese Renewable Energy Act (Act No 108 of 2011) was promulgated into law in June 2020 and will come into force in April 2022, and includes an expiration of certificate system where the certification of a renewable energy project will expire if a renewable energy generator fails to commence operation of its project by an applicable deadline, but this trend has still continued.

In addition to the ordinary renewable energy businesses (ie, solar, onshore wind and biomass), developments of offshore wind projects have greatly accelerated in recent years, in line with global trends. The major developers in this field are domestic energy businesses, including trading companies (shosha), major construction contractors and Japanese utilities.

The Offshore Renewable Energy Act (Act No 89 of 2018) came into force in April 2019, to promote the development of offshore wind projects in Japan. The Act governs offshore wind projects being developed in "open waters" – ie, projects that are not within port limits and are not subject to the Port and Harbour Act (Act No 218 of 1950). Under the Offshore Renewable Energy Act, the Japanese government designates specific zones for the development of offshore wind projects (Promotion Zones), which are sites available for tender and the award of occupancy permits with a maximum term of 30 years. In 2020, four tender processes commenced under the Offshore Renewable Energy Act for five Promotion Zones in Nagasaki Prefecture, Chiba Prefecture and Akita Prefecture. Additional Promotion Zones are expected to be designated within a few years, according to an announcement of the Japanese government indicating that ten sea areas have progressed to a certain level of preparation for starting projects.

Under its Green Growth Strategy towards 2050 Carbon Neutrality published in December 2020, the Japanese government plans to achieve around 50% to 60% of total power generation through renewable energy by 2050, with offshore wind power considered a high growth potential sector. In response to the legislation anticipated under this strategy, investments and developments in the renewable energy section will be continuously stimulated over the next few decades.

ESG

Environmental, social and governance (ESG) factors have gained 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 sustainable development goals (SDGs), 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, with the participation rate of Listed J-REITs in the Assessment 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 on 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 the government's strategy to improve environmental performance in the real estate sector, which 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.

Contributed by: *Hiroshi Niinomi, Koki Hara, Naoto Yamamoto and Takanobu Yamamoto,* ***Nishimura & Asahi***

Nishimura & Asahi has substantial experience in a wide array of real estate securitisations 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).

AUTHORS

Hiroshi Niinomi is a partner at Nishimura & Asahi. His practice covers capital markets, banking, finance regulations/compliance, asset management/funds, REITs/real estate finance, structured finance/securitisation, project finance, securities litigation/disputes related to financial products, real estate, environmental law, and the medical field/healthcare.

Koki Hara is a partner at Nishimura & Asahi. His key practice areas are REITs/real estate finance, structured finance/securitisation, banking, finance regulation/compliance, asset management/funds, project finance, acquisition finance and real estate.

Naoto Yamamoto is a senior associate at the firm. His key practice areas are real estate transactions, asset management/funds, REITs/real estate finance, structured finance/securitisation, project finance, banking, and finance regulation.

Takanobu Yamamoto is an associate at the firm. His key practice areas are real estate finance, structured finance/securitisation, project finance for renewable energy, and finance regulation.

Nishimura & Asahi

Otemon Tower
1-1-2 Otemachi, Chiyoda-ku
Tokyo 100-8124
Japan

Tel: +81 3 6250 6200
Fax: +81 3 6250 7200
Email: info@jurists.co.jp
Web: www.jurists.co.jp