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INCENTIVE FOR GLOBALIZATION OF J-REITs

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ABSTRACT

This paper investigates the J-REITs' market performance and structure in order to suggest possible ways to overcome the J-REITs' major structural problems hindering further development. The JREITs market has been successfully grown; however, the growth has been mainly supported by Japanese domestic property market, which is currently sufficient to sustain the supply but will eventually face the issue of depletion. Thus, globalization is one of the most critical challenges which current domestic-dependent J-REITs urgently need to deal with. One way to promote globalization of J-REITs can be active overseas asset acquisition. Even though the necessary regulatory environment for overseas property acquisition has already been consolidated due to some legislative preparation by Japanese government, J-REITs themselves are also required to improve their governance structure. Because related-party transaction for overseas properties could be increased, the establishment of more solid governance structure would be necessary to maintain an upward trend for global transaction. Additionally, attracting offshore investors could be another way to generate further global expansion of J-REITs. Currently J-REITs could not successfully attract foreign investors because their current governance structure could not satisfy the needs of foreign investors. Particularly, the external management structure that all J-REITs adopt can be a main obstruct to draw interests of foreign investors. Together with the advanced governance systems and J-REITs supported from the reliable sponsor can play a significant role to encourage growth of the next stage of J-REITs. The application of the advanced governance systems and the synergetic relationship with the creditable sponsor can be short-time incentives for globalization of J-REITs.

Keywords: J-REIT, globalization, governance structure, sponsor

INTRODUCTION

Investing in Real Estate Investment Trust (REIT) is one of the most popular indirect real estate investment options for investors around the world. The FTSE EPRA/NAREIT Global Real Estate Index, which is one of competitive index series in the world and consists of data from 456 stocks of the listed real estate entities in 47 countries, shows that its market capitalization reaches U$1.2 trillion US dollar and approximately 78% of the capitalization are contributed by the REIT markets at the end of June 2014 (The National Association of Real Estate Investment Trust 2005). It could be true to say that REITs can be a major leading real estate investment vehicle all over the world and give investors an opportunity to expand asset selections for their portfolios. While the first REIT launched in the United States in 1960 (Brueggeman & Fisher 2011:685), the REIT markets have been successfully grown. Recently, the wave of active REIT markets has been shifting to Asia, showing rapid progress especially in Singapore, Japan, and Hong Kong (Asia Pacific Real Estate Association Limited (APREA) 2014a:7). Furthermore, some Asian countries such as China, India and Indonesia are now considering participating into the REIT markets (APREA, 2014a:7). REITs have been attracting increased attentions from many investors, as their superior performance and advantages are recognized step by step.

As a result, the current REIT markets have successfully achieved the third phase of growth in history (Nikkei Asian Review 2014). In these days, Japanese REITs (J-REITs) also contribute to the growth in the REIT

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markets. According to Nikkei Asian Review (2015), J-REITs recorded the third largest market capitalization among REITs all over the world after USA and Australia, reaching around 10.6 trillion yen (89.7 billion US dollar; USD 1= JPY117). The J-REIT market has been successfully growing within the country and now it could be necessary to seek ways to expand its portfolio globally as the next phase of its growth. However, in the J-REIT industry, some problems which obstruct further development of J-REITs as part of globalization have already been observed. This research will be conducted to foster greater understanding about J-REITs and their current market performance. Also, it could analyse the problems that J-REITs are confronting and evaluate viable solutions to incentivize J-REITs to develop the globally-esteemed J-REIT market. The paper is composed with the following six sections; (i) introduction, (ii) research aim and objective, (iii) literature review, (iv) case study, (v) discussion, and (vi) conclusion.

RESEARCH AIM AND OBJECTIVE

This paper is conducted in order to identify the current J-REIT market performance, determine major structural problems hindering J-REITs' further development, and suggest possible ways to overcome the problems by investigating existing problems of the current J-REIT structure and reviewing other possible structures which might be able to apply to J-REITs. The principal objectives of the research are as follows;

- To demonstrate the current conditions of the J-REIT market where substantial domestic development has been achieved
- To identify major structural problems with further offshore expansion of the J-REIT market with a focus on challenges and opportunities toward globalization
- To explore possible incentives for J-REITs to promote an inflow of global capitals

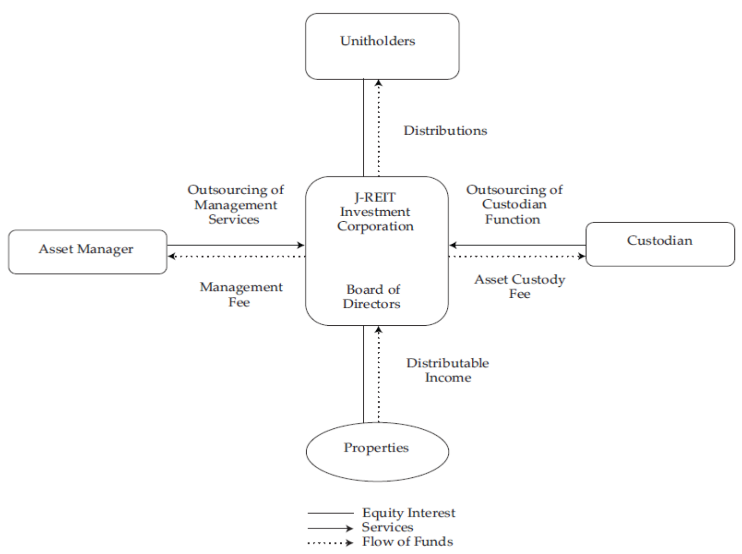
Throughout the research, these three objectives aim to indicate potential limitation of further growth of the J-REIT market with J-REIT's current structure, and introduce practical recommendation as an alternative option based on the review of other possible structures applied in other countries.

LITERATURE REVIEW

Overview of J-REIT

Two initial J-REITs, Nippon Building Fund Inc. and Japan Real Estate Investment Corporation, were launched on the Tokyo Stock Exchange (TSE) in 2001 (Association for Real Estate Securitization (ARES, 2007:1). This means that Japan opened the first REIT market in Asia and joined REIT members as the tenth countries in the world (APREA 2014a:7). Compared with US-REITs and Australian REITs (A-REITs), J-REITs have still been a newcomer legging few decades behind.

Figure 1. Typical Structure of Listed J-REIT (CFA Institute 2011)



As shown in the Figure 1 about the common structure of listed J-REITs, a REIT entity (called Investment Corporation) acts like a paper company since there is usually no employee but few broad members. Because of this condition, the Investment Corporation requires to outsource most of its main services to external third parties under the Investment Trust Law. For example, the Investment Corporation outsources its asset management and administration work to the asset management company, custodian work to the custodian, and accounting-related work to the trust banks.

To be qualified as a listed REIT in Japan for registration, tax, public listing purposes, J-REITs need to follow a number of requirements based on related laws and rules such as the Investment Trust Law, Special Taxation Measure Law, Financial Instruments and Exchange Law, and Tokyo Stock Exchange Listing Standards (Kanda et.al. 2014). According to Kanda et.al. (2014:3-6), key requirements to be recognized as a listed J-REIT are as follows;

Registration Requirement: An Investment Corporation, an entity of a J-REIT, needs to outsource its asset management services to an asset management company registered with Financial Service Agency (FSA).The Investment Corporation itself needs to be registered with FSA and earn both the Building Lots and Building Transactions Agent License and Discretionary Transaction Agent License from the Ministry of Land, Infrastructure, Transport and Tourism (MLIT). Under the supervision of various authorizations such as FAS, MLIT, and TSE, the J-REIT system has been practical and the J-REIT market has been maintaining healthy conditions.

Operation Requirement: An Investment Corporation, as “an asset holding vehicle,” is not permitted to have any employees. It is only able to assist its asset management business which is limited within works such as acquisition and disposal works and leasing. However, such as broker business and development activities are excluded from the asset management business which a J-REIT can implicate by itself. A J-REIT is required to outsource main asset management, custody, and general administrative businesses to independent companies. In addition, a J-REIT needs to maintain a finical period within one year.

Asset & Equity Requirement: A J-REIT should invest at least 70 % of its total assets in real estate and real estate-related assets. It is regulated to hold “qualified assets “as defined in the Investment Trust Law. A J-REIT should not hold its subsidiary company, which means it does not allow owning more than 50% of the equity of other business entities. A J-REIT must maintain capitalization of 100 million yen (800,000 US dollar) or more.

Borrowing Requirement: There is no LTV requirement for a J-REIT; however, most of J-REITs set voluntary own LTV limitation rule on their article, which is generally up to between 55% and 60%. All loans should be borrowed from “qualified institutional investors” such as banks, securities companies, insurance companies, and pension funds.

Distribution Requirement: A J-REIT must pay more than 90% of its distributable income as dividends at each financial term to obtain the tax benefit of the dividend payment deduction.

Stock & Ownership Requirement: At initial public offering of a J-REIT, it must issue its units priced 100 million yen (800,000 US dollar) or more. Or, as another option, a J-REIT must have more than 50 investors at the end of the relevant fiscal period or its all units must be hold by qualified institutional investors. Portion of domestically issued units must be more than a half of total units while reminding units can allow to be issued internationally. A J-REIT has no more than 50% of its shares value held by three or fewer individuals.

Table 1 lists summary of the current regulatory structure and features of J-REITs (Newell & Peng, 2012).

Table 1: Summary of Regulatory Structure and Characteristics of J-REITs

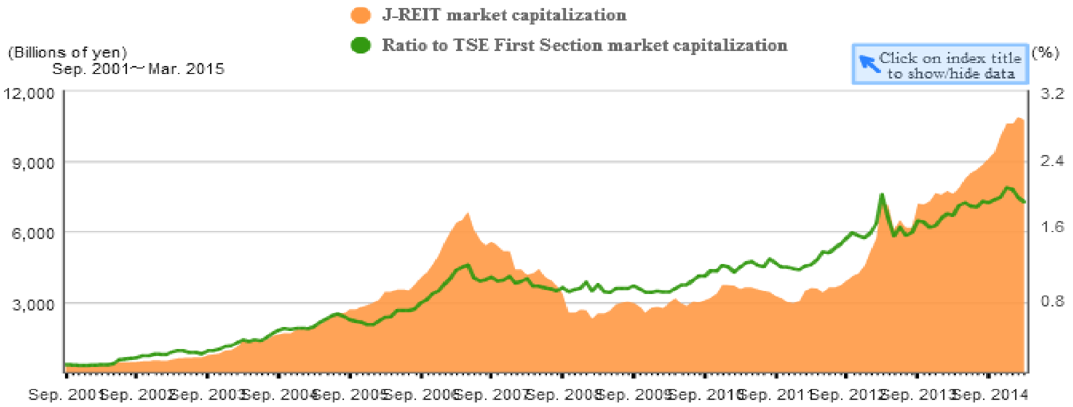
• Only external managers are allowed • Property to comprise at least 75% of asset • No geographic restrictions; but no overseas acquisitions have been made as the requirements on the valuation of overseas properties are ambiguous • Property development is restricted; at least 50% of total asses must be income-producing and unlikely to be sold within one year • No restrictions on gearing • At least 90% income distribution is required • Tax transparent • Legislation; Investment Trust and Investment Company Act

Market Fundamental OF J-REIT

MARKET SIZE

The J-REIT market has expanded to the third largest REITS market in the world after US and Australia (ARES, 2015b). This strong growth has been continued while J-REITs' equity market capitalization (10.7 trillion yen; 86 billion US dollar) is accounted for nearly 2.0% of TSE First Section market capitalization as of March 2015 (See Figure 2).

Figure 2. Ratio of J-REIT Market Capitalization to TSE First Section Market Capitalization (ARES 2015a)



DIVERSIFICATION

Sector Diversification: Starting with two J-REITs in 2001, the number of listed J-REITs increased to 51 J-REITs as of March 2015 (ARES 2015a). Currently, J-REITs are classified into either specialized or non-specialized REITs in terms of property type. As of today, 34 out of 51 listed J-REITs are classified into specialized REITs. Among them, 12 J-REITs are specialized in office, 9 J-REITs are specialized in residential, 4 J-REITs are specialized in retail, 4 J-REITs are specialized in industrial, 2 J-REITs are specialized in hotel, and 2 J-REITs are specialized in healthcare (IBRC Inc. & Japan REIT Inc. 2015). While majority of J-REITs are the specialized J-REITs, 16 diversified REITs investing in more than two property types and 2 combined REITs investing in two types of real estate also exist as non-specialized REITs (IBRC Inc. & Japan REIT Inc. 2015). A number of diversified REITs have been increased by supporting a recent movement to make J-REITs more diversified. Furthermore, REITs investing in non-traditional property types such as hotel and healthcare have been emerged in the recent J-REIT market although office sector has still been actively led the J-REIT market (ARES 2015). Even though the J-REIT market is still office-dominated, accounting for 46% of the total acquired assets, J-REITs have been actively acquiring various types of property than before (See Figure 3). Sector diversification of J-REITs has recently become enriched. Table 2 shows the market capitalisation of the top five leading J-REITs as of Dec 2015 (ARES 2015b).

Geographical Diversification: While J-REITs have recently become diversified more and more in terms of property type, their portfolios have been geographically relatively less diversified. As of March 2015, nearly 75% of assets held by J-REITs (based on asset value) are located in the Tokyo Metropolitan Area which consists of 5 Central Wards of Tokyo, 23 Wards of Tokyo, and Kanto Area. Especially, office sector has a strong preference to the Tokyo Metropolitan Area while nearly 85% of office assets acquired by J-REITs are located in the Tokyo Metropolitan Area (ARES 2015a). Thus, the J-REIT market is likely to be vulnerable to a change in market conditions of the Tokyo Metropolitan Area. Moreover, compared with REITs in other countries, J-REITs limit their portfolio distribution within a nation. Since J-REITs had experienced difficulties acquiring overseas properties due to regulation and tax system in Japan, there had been no internationally diversified J-REITs until relatively recently (Mori 2011:69). However, on June 2014, the first and only overseas asset in J-REIT history was acquired by AEON REIT Investment Corporation (AEON REIT) listed on TSE on October 2013 (AEON REIT & AEON REIT Management Co., Ltd. (ARM 2014a). J-REITs have now recognized an importance of geographical diversification and taken an initial step to be part of global REITs. Further geographical diversification both domestically and globally could be required for the J-REIT market to achieve the next growth in the modern era of globalization.

Figure 3. Fluctuation in Number of J-REITs listed and in Value of Assets owned by J-REITs by Property Type (ARES 2015a)

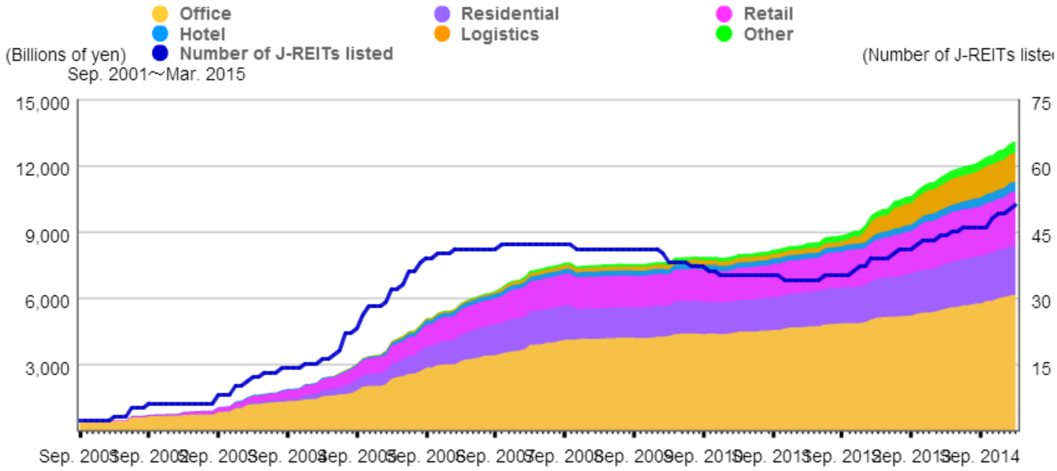
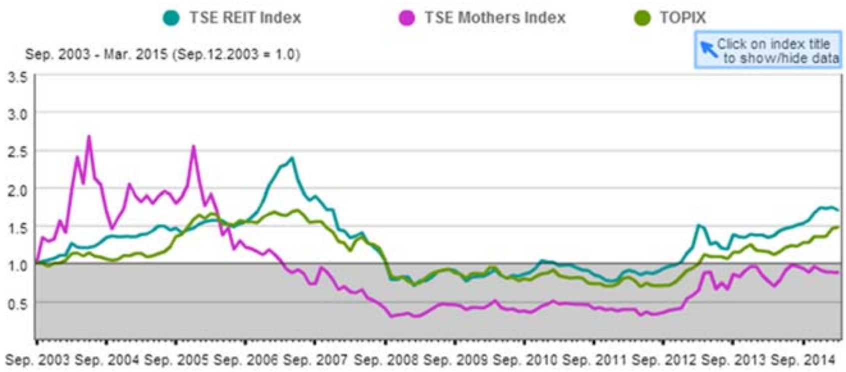


Table 2: the Leading J-REITs (ARES 2015b)

J-REIT	Market Cap Value (1U$ = ¥117)		Portfolio Sector
Nippon Building Fund	¥814.7 bn	U$6.96 bn	Office
Japan Real Estate	¥768.5 bn	U$6.57 bn	Office
Japan Retail Fund	¥592.6 bn	U$5.07 bn	Retail
Nomura Real Estate Master Fund	¥556.0 bn	U$4.75 bn	Office/Retail etc
United Urban	¥451.2 bn	U$3.86 bn	Office/Retail etc

MARKET PERFORMANCE & ACTIVITY

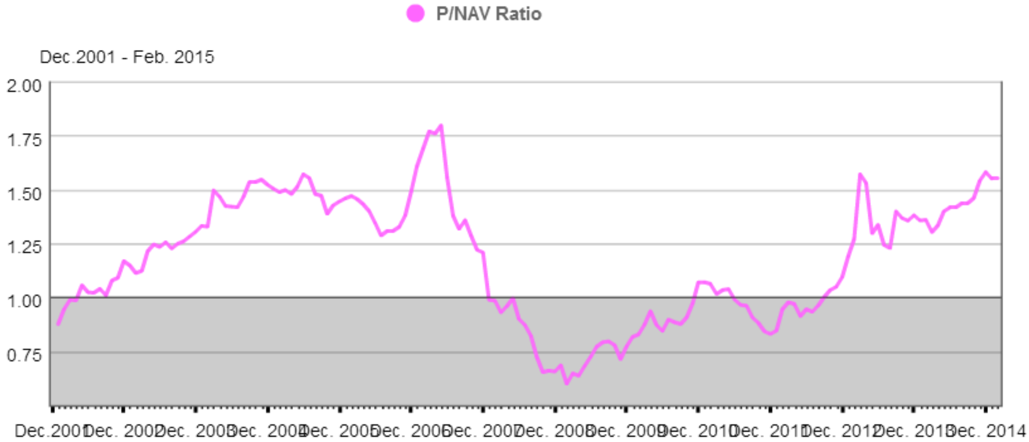
Figure 4. Fluctuation of TSE REIT Index, TOPIX, & TSE Mother Index (ARES 2015)



Overall, the TSE REIT Index has continuously risen in recent years although it has shown sluggish performance for the last few months (See Figure 4). This favourable condition toward J-REIT market could be generated from various reasons such as extremely low interest rate in Japan, the announcement by the Bank of Japan to purchase consecutively units in J-REITs, and improvement of Tokyo office market, according to Torii (2015:26). He indicates that stable growth of the J-REITs market will be continuously recognized in 2015 due to the easy monetary policy of Japanese governments and recovering office market in Tokyo (Torii 2015:31). J-REITs could develop mainly by supporting from such external factors for the next couple of years.

Torii also points out that current higher Net Asset Value (NAV) ratio could also be contributed to the stable market performance of J-REITs. Since market unit price of J-REITs has been increased, the price to NAV ratio has been also increased. The average NAV ratio at the end of February 2015 was 1.55 times which is relatively high considering in historical record (See Figure 5). Torii (2015:31) explains that higher NAV-driven premium public offering (public offering at a premium) would improve dividends per unit and NAV, which can attract investors and achieve the active J-REIT market. Following an increase in NAV ratio, the average LTV of J-REITs decreased progressively. Since higher NAV ratio could generate a comfortable equity finance environment, J-REITs have been actively raising their capitals from the equity market (Torii 2015:28). In fact, a number of both initial and regular public offerings have been carried out since 2013 (Obu *et al.* 2015:9). As a result, LTV recorded over 50% during 2011 were improved and declined to 45.57% on December 2014.

Figure 5. P/NAV Ratio in the J-REIT Market (ARES 2015)



The recent trend of active public offerings by J-REITs could result from demands of minimizing leverage risks and increasing acquisition opportunities in the growing property market in Japan. Obu *et al.* (2015:9) state that transaction by J-REITs has been active since 2013 and the preliminary volume of acquisition by J-REITs is recorded as 2.4 trillion yen (19 billion US dollar) in the six months to March 2015.

Noticeably, new asset types such as healthcare and foreign assets have recently begun to be acquired into J-REITs' portfolios (Obu *et al.* 2015:9). With more various asset options and a recovery of property markets in Japan, property transaction by J-REITs can be expected to be active more and more. Besides, acquisition activities are essential for J-REITs. J-REITs could mainly grow by acquiring new assets because development activities by J-REITs are not currently allowed due to registration and structural matters (APREA 2014b:17). Thus, active property transaction by J-REITs could a key factor to lead to further expansion of J-REITs.

Challenge for Globalization of J-REIT

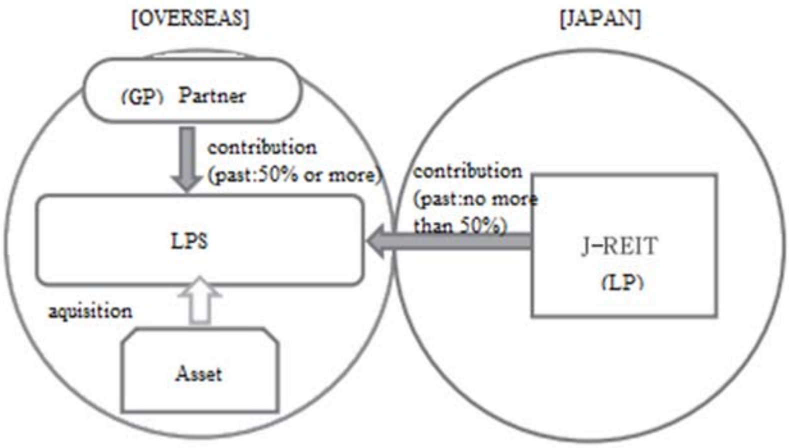
Although the current J-REIT market has rapidly grown, the growth has mainly delivered within the domestic market. While a dramatic domestic expansion of the J-REIT market has been seen in recent years, J-REITs have lagged their overseas expansion. This condition where only J-REITs have been left by the global movement of overseas REITs can manifest the need of globalization of J-REITs. There could be two main challenges for obtaining global capitals as J-REITs' globalization: acquisition of overseas properties and enticement of foreign investors.

ACQUISITION OF OVERSEAS PROPERTY

Fiorilla *et al.* (2012:4) estimate that Japan's institutional real estate size ranked the second place (335 trillion yen; 2,678 billion US dollar) following to the United States (884 trillion yen; 6,753 billion dollar). Even though such an enormous number of underlying properties are available in Japanese real estate market, both historical and forecast real estate growth in Japan are estimated considerably low (Fiorilla *et al.* 2012:11). For the next decade, J-REITs would possibly develop by supporting by a huge pool of domestic assets; however, J-REITs would likely to face a potential threat of running out supply of domestic properties over the long run. Thus, it would be vital for J-REITs to take an initial step to establish the non-domestic-dependent market by actively acquiring overseas properties into their portfolios.

Acquiring overseas properties could be advantageous for J-REITs. According to Hashimoto (2013:77-78), there are four benefits for REITs to invest in offshore assets. Firstly, REITs can improve their dividend yield by acquiring overseas properties which can generate higher yield in general. Secondly, REITs can mitigate risks by achieving well-geographical diversification. Thirdly, they can give an opportunity for their investors to access to offshore property investment. Lastly, REITs can also provide an opportunity for public listing with their domestic and international sponsors who own their asset portfolios both domestically and internationally. J-REITs, whose dividend yield is relatively lower than other leading REITs such as US-REITs and A-REITs, could generate higher dividend yield by investing in overseas assets. In terms of geographical diversification, J-REITs' portfolio allocation is diversified within the country but not internationally since there is only one overseas asset in the J-REIT market today. It could be necessary for J-REITs to promote active overseas property investment in order to reduce risks of investing in heavily one country market. It is also true to say that there are a number of investors who are interested in investing in offshore assets. In fact, there has been an active movement toward funds-of-funds investment by domestic investors in order to invest in overseas properties (Suzuki 2014). The current J-REITs might be losing a number of such potential investors because of their poor geographical diversification across the world. J-REITs need to promote their overseas property investment to attract potential investors and retain existing investors. Additionally, J-REITs could support their sponsors engaging in sponsors' businesses globally by allowing using their overseas properties.

Figure 6. Traditional Overseas Asset Acquisition Structure through Limited Partnerships before the amendment in 2013 (Mori 2011)



Despite elimination of the restriction for overseas property acquisition in 2008, there had been no J-REITs undertaking overseas property investment until 2014. Although Japanese regulatory system already allowed J-REITs to invest in overseas assets, there had been still technical and structural difficulties to carry out acquisition of non-Japanese properties. Mori (2011:64-66) mentions that there are three ways J-REITs to invest in overseas properties: direct investment, indirect investment through Limited Partnerships (LPS) and indirect investment through overseas REITs. He points out direct investment could not be practical since corporation taxation on rental income and capital gain are imposed under the current tax regulation applied to J-REITs. Considering such tax disadvantages and risks, he indicates indirect investment through either LPS or overseas REITs could be reasonable options (See Figure 6). Moreover, since overseas REITs would be a competitor, indirect investment through LPS, which is corporation tax-free vehicle as a conduit, could be the most appropriate investment steam (However, J-REIT itself as a member of LPS could be eventually subject to corporation tax) (Mori 2011:65). However, because of the restriction that J-REITs had prohibited owning more than 50% of the voting shares of other corporations, J-REITs had to seek local partners who could take more than 50% of contribution to the LPS. J-REITs had faced this challenge for a long time. However, in 2013, some of J-REIT-related laws, rules, and tax system amended to promote overseas property investment of J-REITs (Suzuki 2014). As part of the amendments, now J-REITs allow indirect investment by owning more than 50% of the voting shares through special purpose vehicle such as LPS for the sole purpose of acquiring overseas assets under the Investment Trust Law (Suzuki 2014). As a result, the first J-REIT, AEON REIT, which acquired an overseas property on June 2014, emerged successfully in the J-REIT market (AEON REIT & ARM 2014a). At the head of AEON REIT, other J-REITs would be now expected to plan to start acquiring overseas assets.

Although the contribution restriction was abolished, in practical, there is still no J-REIT investing in offshore assets by themselves with 100% own contribution. In fact, AEON REIT acquired only 18% of trust beneficially interests of the total value of the oversea retail shopping center by sharing with its group company, AEON CO. (M) BHD (AEON REIT & ARM 2014a). J-REITs that can commonly acquire offshore properties through LPS scheme could now control the LPS by acquiring 50% or more stakes. However, J-REITs as a Limited Partner must require one or some General Partners to establish and operate the LPS together. The risk to find qualified and creditable partners could still exist. Moreover, such partners would be most likely to be formed by related parties such as REIT's sponsor. According to Suzuki (2014), elimination of the contribution restriction for overseas properties acquisition was introduced by highly expectation toward rejuvenation of Japanese companies in the global market. He points out that J-REITs' active offshore property investment could allow Japanese companies to own their commercial buildings abroad and promote improvement of the environment for their overseas business development. Moreover, he indicates that Japanese developers can also promote their global development businesses with securities that J-REITs can accept post-developed properties by Japanese developers. While these trends can be beneficial for many Japanese industries, they could constitute a considerable threat to J-REITs' investors in terms of the conflicts of interest.

ENTICEMENT OF FOREIGN INVESTOR

As real estate markets have gone globally, there have been observed increased cross-border transactions of real estate by using REIT system across the world. While a large number of investors are looking opportunities to invest in globally diversified REITs, J-REITs, which have been left behind in the wave of globalization, might be losing opportunities to gain such valuable international investors. As of August 2014, 22% are hold by foreigners based on market value while domestic trust banks are a main player investing in J-REITs. The J-REIT market has been strongly supported by domestic players. At the same time, it has been demanded to be friendlier to offshore investors to obtain global money.

To attract potential offshore investors to the J-REIT market, it is important to understand their needs. APREA (2014b) carried out the survey on structures, regulation, and taxation of REITs in Asia Pacific. The data were collected from 195 international senior institutional investors and fund managers in real estate and REIT business to understand demands and trends of the current global REIT investors. Firstly, nearly 95% of all the investors in the survey show favourable attitude toward REIT's acquisition of overseas properties. While majority of investors have huge preferences to REITs acquiring overseas assets, the current J-REITs portfolio allocation which consists of only one overseas asset might lead to decline in investors' motivation to invest in J-REITs. Thus, the recent amendment of regulations and tax system to realize practical J-REIT's overseas property investment could result in positive effects on active participation of foreign investors in the J-REIT market.

Under the APREA survey, they found that 94.1% of 195 survey participants strongly support REITs to adopt internal management rather than external management in terms of governance structure. As mentioned before, all J-REITs are currently externally managed REITs. The current governance structure of J-REITs could also reduce investors' willingness to invest in J-REITs. Additionally, majority (94.7%) are positive REITs to take development risks. Even though nearly two third of them are prefer to have small portions, less than 10 to 20% of assets under management (AUM), of development risks, 15.8% of the investors manage to have development activities up to 30% of AUM and another 15.8% of them do not set any AUM portion limitation for development. However, J-REITs do not permit to take any development activities at present (APREA 2014b:17) because the current external management structure is generally focused on passive investment rather than active investment (Brueggeman & Fisher 2011:685-686). Introducing a structure which J-REITs can take active investment could be another ways to obtain favourable reactions from many international investors.

The survey shows that A-REITs have highest level of confidence and integrity in the light of related-party transaction while J-REITs are assessed their level as noticeably low among major Asia REITs. This result could imply that J-REITs need to improve the existing systems or structures expeditiously in order to ensure the confidence and integrity since related-party transition would be expected to increase following their rapid market expansion.

Considering all above survey results, a huge gap between investors' expectation and the current conditions of J-REITs can be seen. Especially, it could be necessary J-REITs to reinforce their governance structure to be effectively interfaced with demands of their investors.

CASE STUDY

Activia Properties INC.

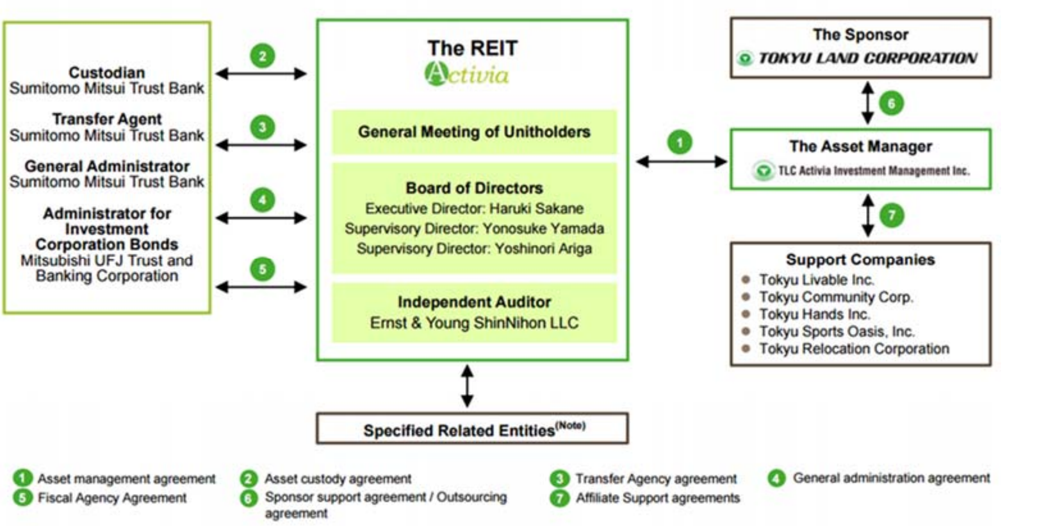
BIRTH OF SECOND GENERATION J-REIT

Activia Properties Inc (ACTIVIA) launched on TSE on June 2012, which invests in diversified assets, mainly office in urban area and retail. ACTIVIA's initial public offering was renowned as birth of one of the second generation of J-REITs (SG J-REITs). Before ACTIVIA's initial public offering (IPO), the J-REIT market had still been struggling with the aftereffects from the global financial crisis. In fact, Obu *et al.* (2014:8) note that the J-REIT index had not been improved since 2009 unlike US-REITs and S-REITs although slightly a recovery sign of J-REITs was recognized in the short period in 2012 by outperforming Nikkei 225 index. Besides, equity finance activities in the J-REIT market were significantly fewer between 2009 and 2011. There was no IPO in the J-REIT market in almost last four and half years until IPOs of ACTIVIA and Kenedix Residential Investment Corporation in 2012 and even only few public offerings were recognized between 2009 and 2011.

However, after ACTIVIA's IPO, the J-REIT market had rapidly recovered. From 2013, market capitalization of J-REITs had significantly increased (ARES 2015). Additionally, 16 IPOs were recorded after ACTIVIA's IPO and now the total number of J-REITs becomes 51 as of March 2015 (ARES 2015). A main feature of these Second Generation (SG) J-REITs listed after 2009 could be identified a strong supportive relationship with their sponsor and sponsor group. All of SG J-REITs have one major strong sponsor and particularly almost all of their sponsors undertake property development and asset management business (IBRC Inc. & Japan REIT Inc. 2015). Since transactions with the sponsor would be expected to be frequently carried out, the current governance structure of J-REITs needs to be put on the review. Thus, ACTIVIA as one of leading SG J-REITs would be an appropriate case study to understand the current trend of governance structure of J-REITs and verify how to deal with the potential agency issue.

STRONG SPONSOR GROUP RELATIONSHIP

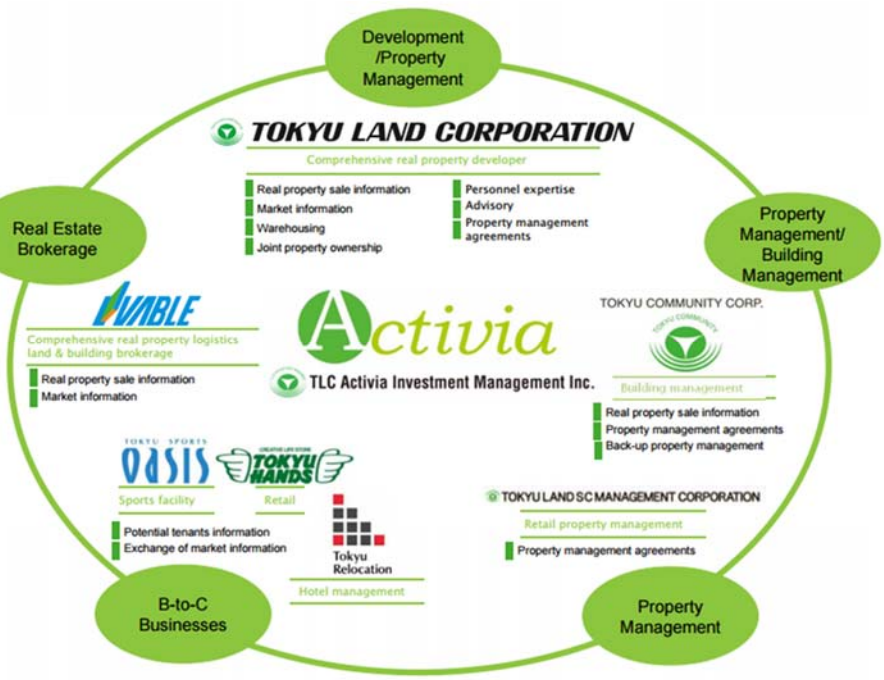
Figure 7. ACTIVIA's Organizational Structure Overview (ACTIVIA & TAIM 2015)



ACTIVIA was established by its asset management company, TLC Activia Investment Management Inc. (TAIM) who is fully owned by ACTIVIA's sponsor, Tokyo Land Corporation (TLC) (Activia Properties Inc. & TLC Activia Investment Management Inc. 2015:62) (See Figure 7). Because TAIM is a 100% subsidiary company of TLC, a major leading property developer in Japan, it could be assumed that a possibility to emerge the agency issue between ACTIVIA's investors and TAIM can be high. Besides, TAIM could assign some of major services for ACTIVIA such as property management and facility management to some of their affiliate companies such as Tokyu Livable Inc and Tokyu Community Corp that are TLC's group companies as well (See Figure 7). Besides, other TLC group companies such as Tokyu Hands Inc operating deportment stores and Tokyu Sport Oasis, Inc. operating sports facilities can be potential tenants for ACTIVIA's investment properties. Thus, the conflicts of interest in leasing activities might also occur.

Despite of anxiety of the agency issue, ACTIVIA explains an advantage of Tokyu Group synergies to their investors as "Tokyu Fudosan Holdings Group's Value Chain" (See Figure 8). They explain that the closer relationship with TLC and TLC's affiliate group companies could be beneficial to ACTIVIA's investors because of their robust backup to ACTIVIA. For example, TLC can support ACTIVIA's external growth by offering a main supply pipeline of new assets which TLC develops. In fact, more than 90 % of ACTIVIA's assets were acquired from related parties, mainly TLC as of January 2015 (ACTIVIA & TAIM 2015:2).

Figure 8. Tokyu Fudosan Holdings Group's Value Chain (ACTIVIA & TAIM 2015)



GOVERNANCE STRUCTURE OF ACTIVIA

Some of unique governance structures can be highlighted in order to mitigate the conflicts of interest. Firstly, any related-party transactions need to take six steps to be approved and two of them, approval steps in investment committee and compliance committee, involve judgement of third parties' experts for the execution of the transactions. Additionally, since two of three directors of ACTIVIA are appointed from outside the TLC group, a fair investment decision for related-party transaction can be made (ACTIVIA & TAIM 2015:61). Secondly, both ACTIVIA and TLC tend to have the same interest by adopting a co-ownership structure in some properties. ACTIVIA's flagship properties such as Tokyu Plaza Omotesando Harajuku and Tokyu Plaza Akasaka are co-owned by both ACTIVIA and TLC (ACTIVIA & TAIM 2015:61). Also, TLC owns approximately 10% of ACTIVIA's units. Being a major investor of ACTIVIA, TLC could have the same investment aim and reduce the conflicts with the investors (ACTIVIA & TAIM 2015:61).

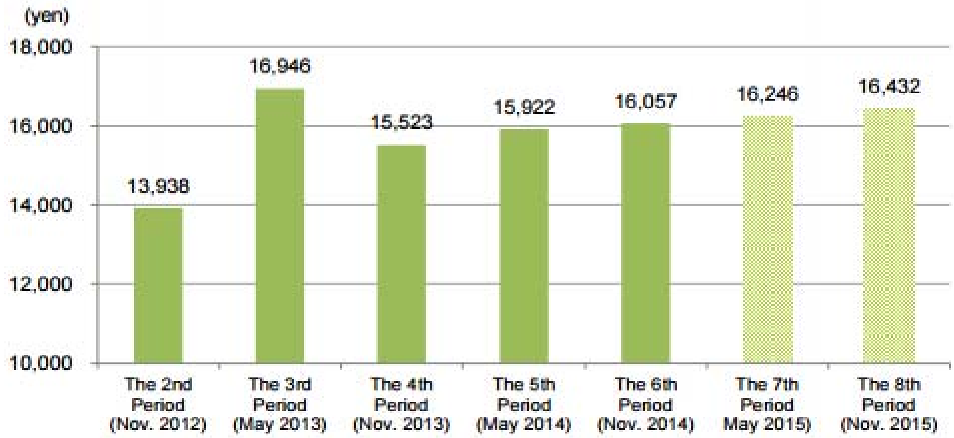
Lastly, ACTIVIA has an effective management fee structure to share the same interest with their investors. Distributions per Unit (DPU)-linked management fee system was introduced by ACTIVIA for the first time in J-REIT history (ACTIVIA & TAIM 2015:49). Since typical management fees paid for an asset management company of a REIT are calculated based on the total asset value of the REIT, there could have a huge fear to generate the agency issue as mentioned the previous section. However, by linking the management fees with DPU, the interests between ACTIVIA's unitholders and TAIM could match. Moreover, acquisition and disposition fees for any related-party transactions are set lower than fees for transactions with third parties.

Plus, there would be no disposition fees that TAIM can earn if any loss on sales of holding properties, in order to protect profits of the investors. ACTIVIA adopts countermeasures effective in the agency issue.

CURRENT PERFORMANCE OF ACTIVIA

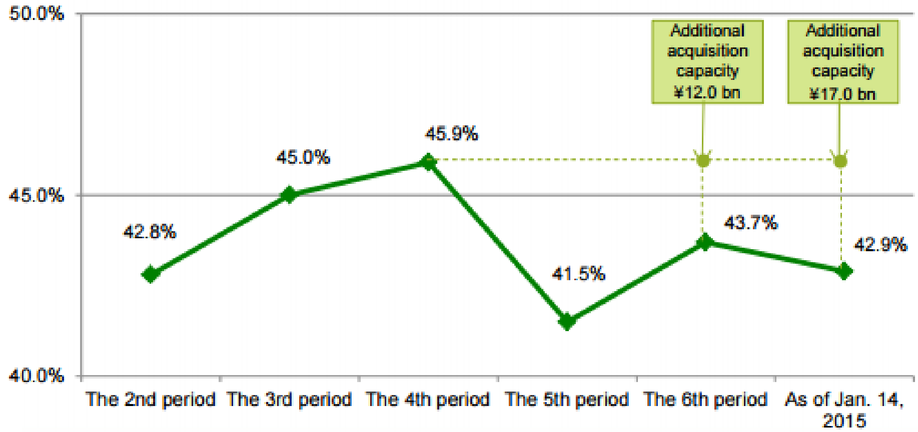
ACTIVIA has been successfully grown by active acquisition from both their sponsor and third parties. Currently, the total asset size of ACTIVIA's portfolio, where there are 30 properties with higher occupancy rate, achieved at 282.6 billion yen (U$2,415 million) as of January 2015. Together with the growth of the asset size, ACTIVIA's unit price also becomes steady increasing, out-performing TSE REIT Index (ACTIVIA & TAIM 2015:28). They mention that as of January 2015, the highest price since IPO was recorded (1,062,000 yen; 9,076 US dollar with volume 251,062 units). DPU of ACTIVIA also maintains at the higher level (See Figure 9). ACTIVIA seems to return their profits to their investors sustainably.

Figure 9. DPU of ACTIVIA (ACTIVIA & TAIM 2015)



Although ACTIVIA actively carried out a number of property transactions, they successfully managed to keep their LTV at the reasonable level (See Figure 10). Due to well-organized equity and debt financing, they could gain extra acquisition capacity (17 billion yen; 145 million US dollar) as of January 2015 (ACTIVIA & TAIM 2015:16). This additional capacity could be possibly used for the purpose to increase in DPU if any conditions where ACTIVIA could not achieve the forecast DPU to guarantee stable returns of the investors. Overall, ACTIVIA would be one of well-operated and performed J-REITs which could attract investors. The "Tokyu Fudosan Holdings Group's Value Chain" has effectively supported ACTIVIA's performance and offers stable growth of their portfolio and returns to their investors without being a negative chain.

Figure 10. LTV Trend of ACTIVIA (ACTIVIA & TAIM 2015)

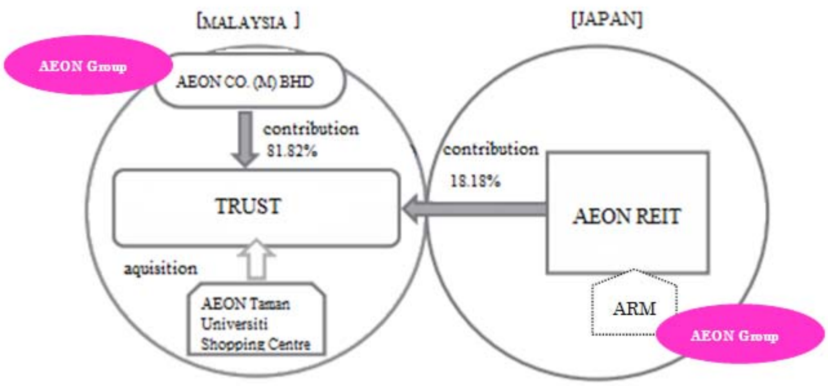


AEON RRIT Investment Corporation

FIRST & ONLY J-REIT HOLDING OVERSEAS ASSET

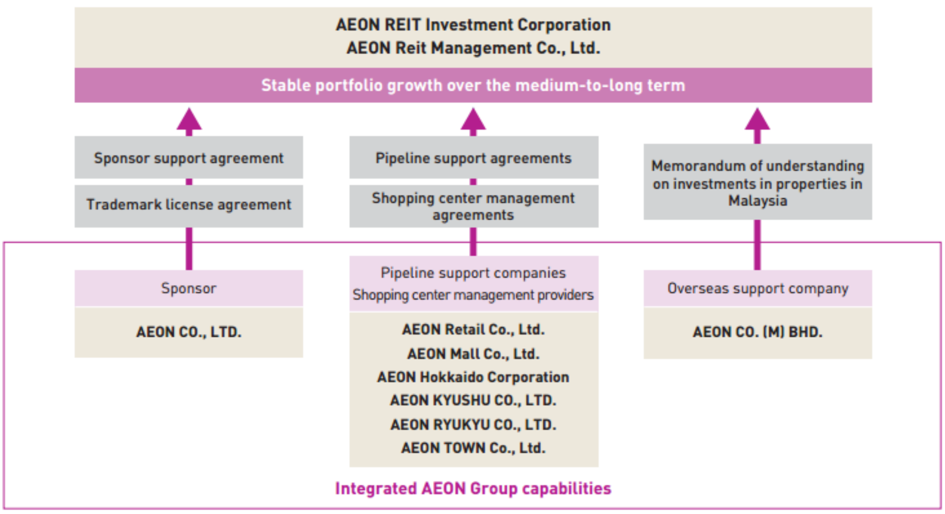
AEON REIT investing in retail properties recently joined as the tenth SG J-REIT, listing on TSE on November 2013 (AEON REIT & ARM 2013). Their distinguished feature is the external growth strategy with a strong support from their sponsor group (AEON Group) domestically and internationally (AEON REIT & ARM 2014b:7). They state that up to 15% of AEON REIT portfolio will plan to invest in assets in "ASEAN region, China and other countries / regions with good medium- to long-term economic growth prospects" (2014b:23). AEON REIT and ARM (2014b:6) announced that the first overseas asset among all J-REITs was acquired on June 2014 through the trust set up in Malaysia.

Figure 11. Overseas Asset Acquisition Structure used by AEON REIT (AEON REIT & ARM 2014b)



The asset, AEON Taman University Shopping Centre, located in Malaysia is co-owned by both AEON REIT (18.18% of the total) and one of AEON Group's members named AEON Co (M) BHD (See Figure 11). It could be highly evaluated that AEON REIT opened up new opportunities for overseas property acquisition by J-REITs. However, AEON REIT accomplished this first offshore asset acquisition with a related party, AEON Co (M) BHD, as AEON REIT declared that their overseas assets would be "in principle, retail properties that are leased in their entirety under master lease contracts to the Aeon Group, which manages and operates the properties" (2014b:23). Although any J-REITs including AEON REIT, allow holding any properties solely by law (Suzuki 2014), AEON REIT partially holds co-ownership beneficially interests of the trust (AEON REIT & ARM 2014b:6). Besides, the transaction has considerably a huge risk for the conflicts of interest since AEON Co LTD (AEON), the sponsor of AEON REIT, can have a closer relationship with the co-ownership partner, AEON Co (M) BHD and easily control ARM by owning ARM's 100% shares. This overseas asset acquisition would have not been acceptable for investors without sufficient governance structures against the conflicts of interest.

Figure 12. AEON REIT's organizational structure overview (AEON REIT & ARM 2014b)



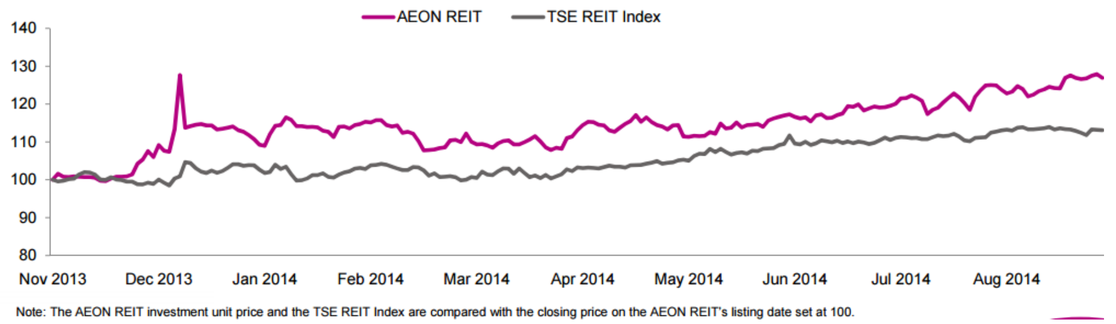
GOVERNANCE STRUCTURE OF AEON REIT

As one of common features of SG J-REITs, AEON REIT also insists on an advantage of robust supports from AEON Group (See Figure 12). While AEON REIT and ARM positively consider that supply of new assets and shopping centre management services from AEON Group can result in better performance of AEON REIT, they also carefully establish the safer governance structure to enhance unitholders' value. With similar transaction decision-making processes to ACTIVIA, AEON REIT needs to set an external expert in each investment committee and compliance committee (AEON REIT & ARM 2014b:25). Since AEON REIT would expect to carry out more related-party transactions than ACTIVIA, their transaction decision-making processes would be stricter by requiring approvals of all external experts for any transactions. As is the case with ACTIVIA, AEON owns approximately 19% of units in AEON REIT and there are three co-owned properties between AEON REIT and AEON (AEON REIT & ARM 2014b:25). In addition, ARM adopts the DPU linked management fee structure together with the traditional total-asset-value-based management fee system by reference to ACTIVIA's management fee systems. They also set special acquisition and disposition fees for related-party transaction in common with ACTIVIA. Furthermore, AEON REIT introduced more strengthened governance structure. AEON REIT has adopted "Cumulative Investment Unit Purchase Program" since May 2014, that directors and employees of AEON REIT and ARM can encourage purchasing units in AEON REIT to generate "greater financial motivation in line with the interests of the unitholders" (AEON REIT & ARM 2014b:25). This could also play an important role to mitigate the conflicts of interest.

PERFORMANCE OF AEON REIT AFTER OVERSEAS ASSET ACQUISITION

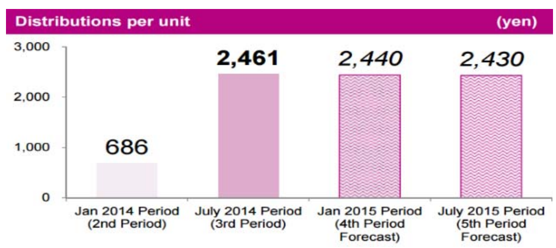
After AEON REIT announced the completion of the acquisition of one overseas asset, they hold 17 retail assets in the total asset value 169.9 billion yen (1.45 billion US dollar) as of July 2014 (AEON REIT & ARM 2014b:10-27). Their unit price continuously increased and kept to remain the higher level than TSE REIT Index after the transaction (See Figure 13).

Figure 13. AEON REIT's unit price and TSE REIT Index (AEON REIT & ARM 2014b)



The unit price of AEON REIT ranged between 122,400 and 138,900 yen (between 1,046 and 1,187 US dollar; USD1=JPY117) with volume 950,000 units for the third fiscal period ended July 31, 2014, according to AEON REIT and ARM (2014c:47). Compared to the unit price range for the second fiscal period (range between 113,200 and 145,000 yen: between 967 and 1,239 US dollar), they indicate that the unit price for the third period became relatively less volatized. In addition, AEON REIT and ARM (2014b:5) state that DPU reached 2,461yen (21.03 US dollar) as of July 2014 and is expected to contribute steadily for the next one year (See Figure 14).

Figure 14. DPU of AEON REIT (AEON REIT & ARM 2014b)



The unit ownership portion ratio of foreign corporation unitholders such as The Bank of New York, Non-Treaty JASDEC Account, slightly increased from 12.5% in the January 2014 period to 13.1% in the July 2014 period whereas the ratio of financial institutions investors who compose the major portion also increased from 42.6% to 48.1% (AEON REIT & ARM 2014b:30). This result could be interesting because an event of overseas asset acquisition could be possible to have a certain correlation with unitholder type. LTV (excluding leasehold deposits) of AEON REIT has been slightly improved from 43.4% to 41.4% for the second fiscal period (AEON REIT & ARM 2014b:16). Since the offshore asset acquisition in the second fiscal period was already planned since their IPO, AEON REIT could manage to acquire the asset without additional borrowings.

In the case of AEON REIT, the overseas asset acquisition did not adversely effect on AEON REIT's performance. Rather, it could be possible to be considered as a slightly positive event by maintaining to increase in their unit price and offering reasonable DPU to their unitholders. Although domestic investors, especially individual investors might have a negative view against the overseas asset acquisition, foreign investors could see the event positively. However, this transaction implemented outside of Japan was the first global deal in J-REIT history. Therefore, many investors who might have anxieties for the unparalleled transaction might take a wait-and-see attitude regardless of their demands. Because the transaction was executed by J-REITs at the first time and even still in the early periods from AEON REIT's IPO, it could be difficult to estimate actual effects of the overseas asset acquisition on REIT performance. In general, more various factors influencing on REITs' performance could be involved for the first case and for the first couple of operating years. Thus, it could be necessary to apply continual case studies for this matter.

DISCUSSION

Application of Synergetic Relationship with Sponsor

The current J-REITs with the external management structure have been rapidly growing domestically and expanding their asset size mainly by acquiring assets from the domestic market since they are not allowed operating any development activities. In general, there are only three means of fund-raising for property acquisition: increasing capital through a public offering, issuing investment corporation bonds, and getting into debt. Because J-REITs set their upper limit for LTV, normally below 50%, together with borrowings, public offerings would also be commonly required to carry out acquisition. Thus, it could be difficult for J-REITs to acquire their preferable assets promptly and they might lose an opportunity for the best deal due to the failure of adjustment of acquisition timing.

In the case of ACTIVIA, when the market was still in adverse condition where fewer capital raising and property transaction activities by J-REITs were recorded (Obu *et al.* 2015:9), they launched with 18 properties acquired only from their sponsor (ACTIVIA & TAIM 2015:2). Without the strong sponsor support, it would not have been achievable for ACTIVIA's IPO under such a harsh market condition. Many REITs listed in the worse market economy climate such as Kenedix Residential Investment Corporation, Daiwa House REIT, GLP J-REIT, and Comforia Residential REIT INC were also strong sponsor-backed J-REITs and acquired their assets mainly from their sponsors (IBRC INC & Japan REIT INC 2015). It could be true to say that the strong sponsor can be advantageous for J-REITs particularly when they face up to difficult time to acquire new assets.

The sponsor could be a great reassurance to J-REITs by offering sustainable supply pipeline with relatively flexible dealings schedule. Although Nagano (2015:5) concludes that J-REITs are used as an entity contributed to maximize the benefits of the sponsor, it also notes that the building a synergetic relationship with the sponsor, who can sincerely consider REIT's growth by proactively offering valuable assets, could commonly enhance returns for the unitholders. Besides, transaction price between the REIT and the sponsor could be set at reasonably discounted price since the sponsor might be able to offer lower selling price by taking account for other extra management services offered from the REIT. Additionally, J-REITs backed up by a large sponsor (and its group) could obtain coherent services which can be qualified total management services.

Therefore, in the J-REIT market, a synergistic relationship with the reliable sponsor could help to develop J-REITs. The relationship can also be an advantage for J-REITs to participate into the global market. Because the globalization era of J-REITs have just begun, reliable supporters will be necessary to take further stride. Also, at this beginning stage, many J-REITs would follow AEON REIT's overseas asset acquisition process. Accordingly, a robust relationship with the sponsor will be a driver to achieve further global expansion of J-

REITs. Further growth of J-REITs domestically and globally can eventually attract international as well as domestic investors.

Application of Advanced Governance System of Second Generation (SG) J-REIT

The closer relationship with the sponsor is set, the more risks could emerge especially as the agency issue. Chan *et al.* (2003:61) introduce a "Captive REIT" in their book as an example of the worst-case scenario of an externally managed REIT generating the agency issue. Major parts of the model case of a Captive REIT are alike the structure of sponsor-backed J-REITs such as ACTIVIA and AEON REIT. Together J-REITs' inadequate governance structure and the current trend of the closer sponsor-REIT relationship, the agency issue could remain as one of major concerns of investors as reviewed in the literature review section. Specially, many SG J-REITs, which encourage a synergic relationship with their sponsors (and its group) as their distinguished strength, have earnestly addressed the controversial agency issue and made an effort to reinforce their governance structure.
In the cases of ACTIVEA and AEON REIT, they adopt strengthened decision-making processes for transaction by the two-step interposition of independent experts. Additionally, their sponsors try to minimalize the separation of ownership by holding a certain percentages of units in their REITs and jointly owning some of REITs' flagship assets with their REITs. Their advanced fee structures have been improved in the light of the mitigation of the conflicts of interest. The DPU-linked asset management fee and discounted acquisition and disposition fee system in related-party transaction could be effective to protect their investors from the agency issue. Furthermore, through the Cumulative Investment Unit Purchase Program which AEON REIT applies, directors and employees of both of the REIT and the asset management company can share the same interest with their unitholders. These advanced governance systems mainly applied among SG J-REITs can be welcomed and highly evaluated by investors as a sign of a good-faith effort against the potential agency issue from the external management structure. Both international and domestic investors can positively accept the synergetic relationship with the sponsor (and its group) and have better understating toward related-party transaction with arms-lengths pricing.
Additionally, overseas asset transaction by J-REITs adopting the advanced governance systems could secure a better understating from the investors in the light of transparency. Even though oversea assets transaction is carried out by externally managed REITs primarily under strong influence of the sponsor, majority of factors caused the agency issue could be eliminated thanks to the advanced governance systems. As a result, overseas asset acquisition could be possibly more active because both REIT's sponsor and investors could become more confident about fair global property transaction.
Furthermore, by adopting the advanced governance systems, the investors can remove a negative idea against the external management structure and fully enjoy merits of externally managed J-REITs. J-REITs adopting the advanced governance systems can attract an inflow of capitals from the global as well as domestic market and gain positive supports for overseas asset acquisition. Thus, the advanced governance systems can be an incentive to lead to further development of J-REITs in the global market.

CONCLUSION

REITs have been a popular investment option because of their distinguished features attracting many investors around the world as seen in the part of an overview of REIT. Without exception, J-REITs also have been recognized their advantageous abilities to yield greater investment performance. Although it is not easy to meet strict requirements to be a qualified J-REIT, a number of J-REITs have been proactively joined into the J-REIT market by pursuing beneficial investment opportunities. Today, they achieved the largest market size with the largest number of J-REITs in the fourteen-year J-REIT history. The J-REIT market has been successfully grown; however, the growth has been mainly supported by Japanese domestic property market, which is currently sufficient to sustain the supply but will eventually face the issue of depletion. Thus, globalization is one of the most critical challenges which current domestic-dependent J-REITs urgently need to deal with.

One way to promote globalization of J-REITs can be active overseas asset acquisition. The J-REIT market is still at the infant stage in terms of global property transaction. The first offshore property in the J-REIT market was just acquired in the last year. Even though the necessary regulatory environment for overseas property acquisition has already been consolidated due to some legislative preparation by Japanese government, J-REITs themselves are also required to improve their governance structure. Because related-party transaction for overseas properties could be expected to be increased, the establishment of more solid governance structure would be necessary to maintain an upward trend for global transaction.

Additionally, attracting offshore investors could be another way to generate further global expansion of J-REITs. Offshore investors, who are the key driver to generate an inflow of global capitals, tend to hesitate to invest in externally managed REITs in general because of their insufficient governance structure toward the agency issue. Although replacing to the internal management structure through the stapled securities structure could be a complete and feasible way to solve the agency issue, there could be other ways to strengthen governance of J-REITs by continuously using the existing structure. The current external management structure of J-REITs could be reinforced by some advanced governance systems newly invented by SG-J-REITs. The introduction of the advanced governance systems can be effective to prevent the agency issue and offer the investors reassurance of investment in externally managed REITs. Thus, the application of the advanced governance systems currently adopted by many SG-REITs would be an incentive for global development of J-REITs. In addition, the robust relationship with the sponsor and its group, who make their best effort for their REIT, can also add an incentive to promote further growth both internationally and domestically. Together with the advanced governance systems, J-REITs supported from the reliable sponsor can play a significant role to encourage growth of the next stage of J-REITs.

The application of the advanced governance systems and the synergetic relationship with the creditable sponsor can be short-time incentives for globalization of J-REITs. These incentives could usher in a new era of globalization of J-REITs. Although it has to be admitted that the research is still far from being conclusive. Further research needs to be undertaken and other various measures should be additionally used to assure the effectiveness of the incentives for globalization of J-REITs.

(This version was revised based on the comments by referee for 2016 PRRES Conference.)

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