JAPANESE INVESTMENT IN U.S. REAL ESTATE

Barring a major disruption in oil prices or world trade, the Japanese will be investing in U.S. real estate for some time to come.

by Bowen H. McCoy, CRE

The history of dealing with Japanese investment in U.S. real estate can be characterized by two axioms: one only learns how to deal with another when things go wrong; renegotiating a transaction and restructuring a financing are the real tests of a long-term relationship.

One project that had to be renegotiated with the Japanese involved the Westin Bonaventure Hotel in downtown Los Angeles. The project was financed with equity from Mitsubishi International Corporation and a long-term fixed rate mortgage from Equitable Life Assurance. Although the hotel was completed on time and at projected cost, room rates and occupancy levels did not meet *pro forma* projections; the hotel consequently had operating deficits equal to about 20 percent of initial project cost.

To protect their initial investment and prevent others from reaping the benefits of stabilized returns, the Japanese equity investors had to be convinced to provide additional funds to cover the hotel's operating deficits. At the same time, the advisory firm arranged a refinancing program which diluted the developer partner, brought in a tax shelter equity investment group, extended loans from banks and established a first mortgage accrual program.

Almost 10 years later, a project involving the Pac West office building had to be renegotiated. The building was completed on time and within budget, but the leasing period became extended, and a leasing deficit of 20 percent of the project's cost had to be funded. The renegotiations with Mitsubishi Estate Corporation and Meiji Mutual Life Insurance Company took 15 months to accomplish and required four trips to Tokyo to obtain the additional funds and to reallocate partnership losses.

Bowen H. McCoy, *CRE, is managing director of Morgan Stanley and Company, Inc., Los Angeles, California. With this firm since 1962, he previously was responsible for its real estate operations. More recently his responsibilities widened to include all western operations with a focus on real estate.*

Perception Versus Reality

There are a number of misconceptions commonly associated with Japanese investment in U.S. property.

Overpayment

In almost all cases when Japanese institutions paid the highest price for a property in this country, a prospective U.S. purchaser was right behind. Recently, evidence indicates that the initial return requirement for Japanese purchases is increasing.

Huge Investment Totals

Japanese investment, while large in recent years, accounts for only 8 percent of the total foreign investment in U.S. property.

Limited Investment Preference

Japanese investment never has been limited to existing high-rise urban office buildings. Beginning in the early 1970s, Japanese capital has been invested in residential land deals, development hotels and office buildings, and Japanese investors have purchased shopping centers and extensive industrial property.

Low Cost Tokyo Takeout

Interest rates in Japan have been significantly lower than they have been in the United States. For a time, Japanese banks were willing to lend on the unrealized appreciation on property owned in Japan. Such loans obviously entailed exchange risk if they were utilized to purchase U.S. property. More recently, this type of speculative lending has been discouraged. Although U.S. affiliates of Japanese banks have lent dollars to Japanese borrowers, they have done so only at prevailing U.S. interest rates.

Why Do They Do It?

Institutional equity investment by the Japanese in U.S. property totaled $5 billion during 1984-1986 with $3.3 billion in 1986. Investment increased to $7 billion in 1987, and an increase to $10 billion is predicted for 1988. Japanese investment in U.S. real estate is prompted by several factors.

Lower Returns on Real Estate in Japan

Returns on real estate in Japan typically are 1 percent to 2 percent, making the 7 percent to 8 percent return on U.S. real estate appear uncommonly attractive.

High Land Cost in Japan

Land cost for an urban office tower is about 20 percent of the total project cost in the United States but 90 percent of the project cost in Japan. Land may cost as much as $3,000 or even $5,000 per square foot in Tokyo. At a floor-area ratio of 10:1, the land cost per rentable foot is $300 or higher, requiring a rent of as much as $45 per foot annually to achieve a true equity return by U.S. standards. This makes almost any office building purchase in the United States appear attractive at $300 per foot, including the fee interest.

Favorable Yen/Dollar Exchange Rates

During the period when returns on real estate in the United States were falling, the Japanese still made more than acceptable returns on their U.S. investments because of the difference in value between the dollar and the yen.

Liquidity of U.S. Real Estate

An active trading market in U.S. real estate among principals as well as an active market in real estate mediated by brokers provide Japanese investors with a perceived way out of U.S. investments which has not existed within their own marketplace.

Cheap Financing

Japanese real estate has appreciated significantly in recent years, and a large portion of the unrealized gain is being utilized as collateral to support borrowings from the Japanese banking system to acquire U.S. property. The Japanese banking system has been highly liquid and aggressively establishing a position in the U.S. real estate market.

Tax Incentives

U.S. depreciation schedules, tax rates, provisions for interest deductibility, etc., are much more liberal than Japanese tax breaks on real estate.

Where Do They Go From Here?

A close look at the Japanese and the U.S. economies provides the basis for predicting future investment in U.S. real estate by the Japanese. Strong appreciation since 1985 pushed the yen to historic heights. Despite some retreat (10%) from the highs against the dollar this year, the yen remains one of the strongest currencies in the world. Thus, the yen will remain an attractive currency with which to purchase U.S. assets. Yen appreciation has, however, reduced Japan's export volume and encouraged imports. The drop in export volume is beginning to have a positive impact on the U.S. trade deficit; the deficit is narrowing faster in the physical volume of goods than in dollars because of the yen's appreciation.

The Japanese domestic economy has experienced a dramatic shift from export-driven growth to internal, consumer-driven growth. Domestic consumption has grown so extensively, it has made up for the drop in exports. The Japanese economy also has experienced growth in housing and in major construction. Behind the strength in domestic demand are strong gains in real disposal income. Inflation is less than 1 percent per annum and is driven down by cheap imports. A high personal savings rate of over 15 percent (compared to a U.S. savings rate of less than 4 percent) suggests that domestic consumer spending will continue to expand.

Japanese exports to the United States are continuing at high levels, even though the Japanese are absorbing large foreign exchange losses because they are being paid in weak dollars. Japanese export profits have been cut severely as they have held onto market share. Meanwhile, at current exchange rates, Japanese labor costs have risen over the past four years from 50 percent of U.S. labor costs to close to parity. Because of foreign exchange losses and rising labor costs, it has been estimated that, before long, the Japanese will produce more than 1.5 million automobiles a year in the United States.

Large U.S. trade deficits will continue for several years and require capital inflows. In recent years, the foreign private sector has not been willing to make the required investment, and foreign central banks have had to take up the slack. When the dollar was weakening, foreign investors were discouraged from buying U.S. financial assets (U.S. Treasury securities, corporate bonds and corporate equities), because of repeated currency losses. But now that the dollar is close to its low ebb, long term direct foreign investment in manufacturing and real estate assets is extremely attractive. Multinational corporations worldwide have 15 percent of their plant and equipment located offshore; the Japanese only have 3 percent of their manufacturing capacity offshore.

U.S. economists say the dollar will fall another 1 percent to 15 percent against the yen before trade patterns reverse

and reflect the changes in consumer spending patterns that have occurred in the United States. Such a decline in the dollar carries with it higher interest rates and a heightened risk of recession. Even if the dollar falls, however, it will take at least four years to nullify the trade deficit. Thus, for the next three to five years we may expect to see continuing reinvestment of excess liquidity by the Japanese in the U.S. marketplace. The Japanese will shift their portfolios among the debt markets, the stock market, direct manufacturing investments and real estate as their perception of markets change.

Conclusion

The Japanese have established a highly visible position in U.S. real estate, and they no doubt will add to this position in the near future. In certain markets, such as downtown Los Angeles, they actually may be able to excercise a degree of market control within the next few years.

However, the Japanese come from a landlord's marketplace in which annual rents can equal $120 per square foot and landlords require a three year rental deposit upfront. It is difficult to shift mentally from such a landlord's market to a tenant market. The Japanese, therefore, must become educated to provide tenant service, and they must develop first-rate property management and leasing capabilities.