Real Estate Securitization Gaining Favor in France & Japan

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"Those who cannot remember the past are condemned to repeat it."

George Santayana, 1863-1952, American philosopher & poet

Just a few short years ago, the United States real estate market was characterized as overbuilt, illiquid, and even under-demolished. Steadily increasing loan delinquency rates at traditional institutional lenders such as commercial banks and life insurance companies contributed to a liquidity crisis, making new mortgage financing difficult if not impossible. The Resolution Trust Corporation ("the RTC") was formed to step in and dispose of the unwanted real estate assets of failed lending institutions, many of which had to be bailed out by the federal government because of their excessive amount of under- or non-performing mortgages. In February 1992, the RTC concluded its first commercial property-backed securitized offering.

A few brave souls formed "vulture funds" to buy real estate and mortgages at depressed prices. Who can forget the infamous March 1993, Salomon Brothers report titled, "It's 50 Cents on the Dollar, Stupid"[1]? Mimicking the, "It's the Economy Stupid," it proved to be the undoing of re-election efforts for President George Bush. In the early 1990s, when a lack of transactions made real estate values largely conjectural, these contrarian investors made a fortune buying real estate assets at 50 percent of their previously reported value, later selling them at a substantial profit when the property markets and the national economy recovered a few short years later.

Now many domestic real estate markets are so strong that there is talk of renewed speculative construction ("although it will be different this time"), and from time to time, there are even isolated instances of purchases in excess of replacement costs. As a result, value-oriented investors are having a difficult time securing domestic properties at attractive prices. Fortunately, history has once again repeated itself, and there is now a golden opportunity for forward thinking investors who view the market globally: acquiring bulk real estate assets overseas in countries where

prices have declined significantly, but whose economies can be expected to recover, specifically France and Japan.

FRANCE

Since the mid-1980s, France's economic growth has been modest. In the 10-year period from 1983 to 1994, Gross Domestic Product (GDP) grew by an average of only 2 percent annually. Starting with unemployment of 8 percent in 1983, the unemployment rate increased in seven of the following 10 years, exceeding 12 percent by the end of 1993. France had succumbed to the worldwide recession of the early 1990s.

A weakened economy, coupled with a series of internal corruption scandals, skyrocketing unemployment, and a budget deficit were the principal causes of the Socialist's downfall in 1993. A new political regime led by former Paris Mayor Jacques Chirac took office, one of whose first priorities was to create jobs and stimulate the economy. A loosening of monetary policy in 1995 has finally begun to reverberate throughout the French economy. Although unemployment remains high, currently approaching 13 percent, annual inflation is under 2 percent, and interest rates remain low. While anticipated GDP growth remains in the 2 percent to 2.5 percent range, consumer confidence is increasing. The reason that unemployment remains high is because of a strong increase in the French workforce, rather than a lack of jobs. Furthermore, President Chirac pledged to reduce the budget deficit from 4.2 percent of GDP in 1996 to 2 percent, a move that would allow the government to gradually reduce taxes.

If the French economy was sluggish during the last dozen years, the office market was on a roller coaster ride characterized by booms and busts. Until the 1970s, office facilities in France were largely constructed (and owned) by industrial companies for their own use. Service companies in need of accommodations sufficed by converting centrally-located residential apartment buildings into suites by altering their interiors.

During the 1970s, strong tenant demand for office space, coupled with the onset of a speculative construction market fueled by foreign investors, led to the construction of the first generation of buildings designed specifically for office use. The 1980s witnessed an explosion of office development including buildings with varying levels of quality, ranging from superficial conversions of residential properties to new construction of top quality buildings.

Fortunately, history has once again repeated itself, and there is now a golden opportunity for forward thinking investors who view the market globally: acquiring bulk real estate assets overseas in countries where prices have declined significantly, but whose economies can be expected to recover, specifically France and Japan.

The Paris office market enjoyed a spectacular boom during the latter half of the decade, with property prices and office rentals often doubling in value. Developers responded vigorously to the run-up in prices and rents, and new office construction surged to record levels. The office market peaked at the end of 1990, following a decade during which office rents soared in the face of little availability. This lack of suitable accommodations forced many space users to the suburbs, furthering a building boom in the suburban areas as well.

By late 1990/early 1991, the booming office market began to sputter, a result of over-building and a weakened global economy, and both rental and capital values began to decline precipitously. Rentals for the best, most modern accommodations in Paris peaked at about 4,500 FF/m^2 or U.S.$84 PSF (and occasionally higher), compared to about 3,000 FF/m^2 (U.S.$56 PSF) in 1995. Similarly, some buildings that were sold to overseas investors at capital values as high as 125,000 FF/m^2 (U.S.$2,300 PSF), declined to maximum attainable prices of 50,000 to 75,000 FF/m^2 (about U.S.$1,150 PSF) by 1995. Like those in the U.S., French banks and insurance companies found themselves awash in bad loans secured by real estate that had greatly declined in value.

Similar to the United States years earlier, the combination of a gradually recovering economy and depressed real estate prices presented an opportunity for astute real estate investors. This opening became apparent to forward thinking United States investors and investment bankers during 1995, as the French wrote down the value of their assets to market levels, permitting bulk sales of assets. Although this occurred almost two years ago, it has recently received an increasing amount of press coverage in the United States.

In a watershed event akin to the first RTC portfolio sale, in late 1994 Comptoir des Entrepreneurs

securitized U.S.$1.8 billion of non-performing loans, one of the first securitizations in Europe. Sensing that French institutions were motivated sellers (Credit Lyonnais announced in 1995 that it would dispose of 10 percent of its U.S.$8.6 billion problem real estate portfolio), overseas investors rushed to France, led by investors, investment bankers, and consultants from the United States. Gerald Hines entered into negotiations to acquire U.S.$1 billion of shopping centers in France, Italy, and Spain from Macif, a French insurance company; and J.E. Roberts Cos. formed a joint venture with Finestate, a French property company, to facilitate American investment in French real estate.

Then in January 1996, the French subsidiary of Barclays Bank plc concluded the first French bulk sale of distressed real estate, selling U.S.$175 million of loans backed by office and residential properties to a consortium of U.S. investors led by Cargill Financial Services, Lehman Brothers, and LaSalle Partners.

Also in early 1996, Goldman, Sachs & Co. acquired U.S.$550 million of real estate loans from Cie. De Suez, one of the largest, single real estate transactions in French history. The purchase price was widely reported to have occurred at about *30 percent of book value*. In fact, Goldman's Whitehall Street LP has become one of the most active of the U.S.-based value oriented or vulture real estate funds, acquiring at least two other similar portfolios overseas.

In France, some other parallels to the United States included:

- many banks began setting up "good bank"/"bad bank" structures, turning over their problem real estate assets to the bad bank to remove them from the good bank's books;
- the job of the bad bank is to restructure and/or dispose of these loans, just as U.S. institutions accomplished their workouts during the early 1990s;
- equity investors have generally reacted favorably to the French restructurings, pushing up share prices as problem real estate is removed from a company's books.

Now that U.S. investors have paved the way, locally-based French investors have begun to follow suit. In March of this year, local French investor Walter Butler Capital Partners acquired a portfolio of 12 city-center buildings from insurer Union des Assurances de Paris for U.S.$60 million. Although financially a much smaller transaction than many of the bulk sales described above, this transaction is significant in that 1). it was the first portfolio sale to a local investor; and 2). it was the first institutional portfolio sale of buildings, rather than loans. The reported price was about 13,000 FF/m^2 (U.S.$240 PSF), about one-third of the 40,000 FF/m^2 these properties would have commanded five short years ago. Updating the mantra of the previous round of value-oriented investors in the United States, so far in France, *"It's 30 Cents on the Dollar, Stupid."*

JAPAN

While many opportunities remain in France, the same buying opportunities are just beginning to emerge in Japan.

The Japanese economy grew throughout the 1970s and 1980s at an average of about 4 percent per year in terms of real GNP (Gross National Product) growth. The Japanese government had adopted a low-interest rate policy, and with the economy booming and prices stable, the official discount rate was a record low 2.5 percent in February 1987. Between 1987 and 1989 however, the increase in the nation's money supply was greater than the growth in GNP, creating an excess of liquidity.

As a result, significant sums were invested in securities and real estate. Stock prices reached their highest level in December 1989, and real estate prices, particularly land, increased by even more than equities. In the six largest cities, urban land prices increased nearly fourfold between 1985 and 1991. The increase in urban land prices escalated in 1986 and 1987, and spread to Japan's rural areas as well. Nationwide, urban land prices increased by about 60 percent between 1985 and 1991. This abnormal increase in asset prices was termed the "bubble economy," and Japan's economic boom continued until asset prices finally collapsed during the Summer of 1991.

The downturn in Japan's economy, more severe than any other post-war recession in terms of duration and depth, officially lasted until March 1993. However, its aftershocks can still be felt today, particularly in the real estate market which now has an oversupply of office space brought about by a combination of over-building during the boom years and the collapse of the bubble economy with its associated economic downturn.

Although the Japanese economy has slowly recovered since 1994, one of its most important

aftereffects, the bad loan problem caused by overly optimistic financing for land acquisition and construction of office buildings, remains to be solved. It will continue to have a significant negative impact on the Japanese economy. According to the Ministry of Finance, the amount of bad loans at banks and other financial institutions was more than 85 trillion yen as of March 31, 1996.

To solve the bad loan problem, non-performing real estate will have to be liquidated. Whereas investment properties in France are frequently valued using the French version of the Income and Sales Comparison approaches, the high proportion of value attributable to land in Japan presents some unusual problems for American investors wishing to capitalize on that country's presently depressed real estate market. For example, land and improvements are legally severable properties in Japan, and their ownership is recorded separately, even if owned by the same entity. In addition, the land component typically accounts for such a disproportionately large percentage of property value that, during the bubble period, appraisers were frequently asked to ignore any existing improvements, and value the site as if vacant. Now appraisers more commonly take the existing improvements into consideration, whether the value of the improvements is positive or negative.

To illustrate the severity of the real estate crisis in Japan, one needs to look no further than the Urban Land Price Index published by the Japan Real Estate Institute *(see Table 1)*.

Note that after increasing by fourfold from 1985 to 1990, the price of commercial land in Japan's six largest cities has declined since then by nearly 70 percent, to about *"30 cents on the dollar."* (This is getting easy!)

Despite the decline, land prices in Japan remain expensive by U.S. standards. According to a survey by the Japanese government released this year, the price of commercial land in Tokyo averaged U.S.$79,568 per square meter, or U.S.$7,392 per square foot; a decline of 45 percent since January 1995. Needless to say, many of Japan's lending institutions have become saddled with bad real estate loans. At least 13 Japanese banks closed their New York offices between March 1993 and April 1997.

For example, an affiliate of Nippon Credit Bank, Crown Leasing, had lent money to real estate developer Sueno Kosan. Sueno Kosan was forced into bankruptcy in 1996 by Japan's Housing Loan Debt Administration Organization. This forced Nippon Credit to immediately write off U.S.$968 million owed to it by Crown Leasing, starting a chain reaction that ultimately lead to Nippon Credit's restructuring. In a move that would have been unthinkable just five years ago, in April of this year, Bankers Trust announced an agreement with Nippon Credit Bank Ltd. to take over U.S.$18 billion of the latter's overseas assets. Nippon Credit is Japan's 17th largest bank, with about U.S.$125 billion in assets. (Bankers Trust has also been a key player in the sale of French assets, having advised the French Barclays subsidiary in its 1996 sale of distressed real estate to a U.S. group.)

In effect, Bankers Trust will be helping to "bail out" Nippon Credit, much as the United States Federal Deposit Insurance Corporation bailed out Continental Illinois National Bank in 1984. In addition to being required to liquidate its foreign assets, Nippon Credit's plight has necessitated the sale of its corporate headquarters. Several of Japan's other banks may also have to collectively contribute up

Table 1

Urban Land Price Index of Commercial Land
Six Largest Cities in Japan
(Tokyo 23 wards, Yokohama, Nagoya, Kyoto, Osaka, and Kobe)

1990 = 100

Year	Index
1985	25.6
1986	33.0
1987	44.2
1988	62.6
1989	78.3
1990	**100.0**
1991	103.3
1992	87.5
1993	67.9
1994	55.3
1995	41.9
1996	**30.3**

Source: Japan Real Estate Institute

to U.S.$1.3 billion to Nippon Credit as well, raising investor's fears that bailouts will become a precedent that could weaken healthy banks too.

The importance of this agreement should not be underestimated in terms of the opportunities it creates for U.S. real estate investors. First, Japan's important Ministry of Finance had to approve, if not recommend the Bankers Trust agreement. (This event speaks volumes about the weakness of Japan's domestic banking system, as normally Japanese banks would have only been permitted to seek help from their domestic partners.) Secondly, the magnitude of Japan's non-performing loan problem has created a psychological shift in the way that Japanese institutions have begun doing business, opening their doors to foreign investors for the first time. One unidentified senior Japanese banking regulator was recently quoted in *The Wall Street Journal* as saying, "The markets are proving better at forcing change than the authorities." Perhaps most importantly, the arrangement between Bankers Trust and Nippon Credit could result in many of Nippon Credit's loans being repackaged into securities and offered to investors. Nippon Credit has approximately U.S.$40 billion of real estate and loans, of which approximately U.S.$12 billion are estimated to be under-performing real estate loans.

And just as in the United States, the problem has spread from Japan's banks to its insurance companies. In June 1990, Salomon Brothers presciently forecast the spread of the impact of bad real estate loans from financial institutions to insurance companies.[2] The Japanese insurance industry accounts for about 12 percent of total savings in Japan and a significant amount of pension money as well. Just days after word of the Nippon Credit/Bankers Trust agreement was announced, and insolvent banks and credit unions were threatened with closure, Wall Street analysts began making predictions of consolidation in Japan's U.S.$935 billion insurance industry, brought about by the industry's exposure to bad loans. These predictions proved accurate, as later that same month, the Ministry of Finance shuttered Nissan Life, the country's 16th largest life insurer, and the first Japanese insurance company to be closed in 50 years. Nissan Life had invested heavily in real estate and securities, promising high returns to its investors. When the bubble burst and land and equity prices fell precipitously, Nissan Life was left with an insurmountable gap between its investment income and the returns it had promised investors.

Although Japan's securitization market (as we know it) has been slow to develop thus far, the country has a long history of quasi-securitization structures. In fact, Japanese securitization began with mortgage loans, and these securitizations have since evolved into three distinct types:

- ***Teito Shoken (Mortgage Securities)***
  This first quasi-securitization appeared in 1931 and was revised in 1987. Under this arrangement, mortgage companies provide housing loans to borrowers, and obtain approvals from the borrowers to sell the loans. As mortgage companies guarantee payment to investors, the credit risk associated with the mortgage securities reflects the credit of the mortgage company, rather than that of the borrowers.

- ***Jutaku Teito Shosho (Housing Mortgage Certificate)***
  Begun in 1974, financial institutions such as banks and housing loan companies offer a pool of common housing mortgage certificates to other financial institution investors. Further transfer of these certificates is prohibited.

- ***Jutaku Loan Saiken Shintaku (Housing Loan Receivables Certificate)***
  Started in 1972, financial institutions and housing loan companies pool their housing loans with trust banks, which in turn issue trust certificates backed by pools of housing loans. Although the credit quality should reflect the quality of the underlying assets, most securitized offerings are supplemented with guarantees from the loan originators.

Note that in each instance above, the securitizations are structured to reflect a guarantee from the originator, rather than relying exclusively upon the credit quality of the underlying assets. This is a function of the long-held belief in Japan that corporate credit is the most cost-effective means of financing an investment. The acquisition of most real estate has historically been arranged through corporate finance means, based on an entity's creditworthiness, rather than by valuing the underlying real estate. Non-recourse loans that ascribe value to specific assets such as real property have not been widely used in Japan. In fact, specific project financing has been practically non-existent. More importantly, until now the necessity to liquidate specific assets or properties has rarely, if ever, arisen.

Secondly, the nature of "secured credit" is different in Japan than in the U.S. In the case of a default, a

claim on secured property cannot be transferred to other creditors because the security consists of all the assets owned by the debtor, not just the secured asset.

In July 1995, Tokyo Mitsubishi Bank issued U.S.$10 million in zero coupon bonds by skirting Japanese regulations and establishing a special purpose corporation overseas. They were the first offering to securitize mortgages on non-performing real estate in Japan. In August 1996, Fuji Bank issued JAF No.1, an interest-bearing Euro-yen bond that became the second securitized product based on non-performing loans held by a bank.

Spurred by a weakening economy, there has been increasing talk in Japan over the past three years of expanding the securitization process further. Many government officials hold the view that the real estate market will have to become more liquid to assist in solving their banks' bad debt problems. They believe that a fresh round of investment in securitized real estate, like we experienced in the United States during the early part of this decade, is necessary to stimulate the market.

In March of this year, the Ministry of Finance announced its real estate asset securitization plan, known as the "General Strategy for Liquidation of Mortgaged Real Estate." The plan outlined four methods of developing a securitization market. The goal of the plan is to implement policies and procedures that will allow Japan to establish a liquid market for real estate asset-backed securities. As outlined in *Grant's Asia Observes*, the plan will work like this:

> "Real estate held as collateral on defaulted loans will be purchased from creditors by special purpose corporations (SPCs). The SPCs will then sell trust certificates or bonds to investors who will be paid with the income from the properties or the proceeds from their sale. Tax breaks are being considered to exempt SPCs from punitive real estate transaction taxes. In addition, casualty insurance companies will be allowed to issue financial guarantees against the underlying properties to protect investors against a loss of principal."[3]

In addition, Japan's Big Bang, the country's plan to reform its financial system, is scheduled to take effect by the year 2001. The name comes from the deregulation of the London securities market on October 27, 1986, also known as the Big Bang. It is comparable to May Day in the U.S. when brokerage commissions were deregulated. Besides deregulating the securities transaction tax and liberalizing brokerage commissions, the Japanese Big Bang will offer substantial tax advantages to healthy banks that take control of weaker institutions. This should result in the liquidation of numerous non-performing real estate loans, either by the present holders of the loans in an attempt to clean up their balance sheets, or by the acquiring institution. Whatever form of securitization ultimately proves most prevalent, one thing appears certain: we can expect to see a large volume of securitized real estate offerings based on prices far lower than these assets commanded just a few short years ago.

OUTLOOK

Several trends are at work that will affect the globalization of securitization. Among them are:

- the recovery of the domestic real estate market that has made it increasingly difficult to buy U.S. assets at attractive prices;
- the increasingly global focus of all investors, (not just those that focus on real estate), that has made investing overseas more commonplace;
- the earlier stage that many overseas real estate markets are in, (in terms of their recovery from the world-wide recession of the early 1990s);
- the shift in institutional investment away from single-asset investing and into more liquid securitized offerings such as pools of loans, real estate investment trusts, and value-oriented funds; and
- the historical success that U.S. contrarian real estate investors experienced during the early 1990s.

If the returns are commensurate with the rewards, as they now are in several corners of the globe, the globalization of securitization will continue to spread. REI

NOTES

1. Giliberto, Michael S., "It's 50 Cents on the Dollar, Stupid," Salomon Brothers United States Real Estate Research, March 12, 1993.
2. Shulman, David, "Yesterday, Today and Tomorrow: The Coming Default Crisis in Commercial Mortgages," Salomon Brothers Bond Market Research, June 14, 1990.
3. "Sand Trap," *Grant's Asia Observer*, March 31, 1997, p.9.

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