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SUMMARY

Since Prime Minister Shinzo Abe’s economic stimulus policy, so-called ABENOMICS, was implemented, Japan has been experiencing a robust trend of property values and rents in major cities. The Japanese real estate market is attracting overseas investors who make inroads capitalizing on the weak Japanese yen.

For investment in Japan, it is necessary to understand Japanese local market practices, in which there are several unique concepts. Rent review is one of them and is totally different from the U.S. and U.K. practices. Because a variety of factors are considered at a rent review in Japan, a resulted new rent possesses unique characteristics.

Unfortunately, the characteristics of the Japanese rent review system are not fully understood among overseas investors due to its complexity. Some overseas investors consider this unique system as one of the risks in real estate investment in Japan. In addition, real estate appraisers often have a hard time to make clear its concept to foreign clients (sometimes decision makers in their home countries), which would be a constraint on inbound investment and real estate appraiser’s business opportunities.

In this study, the unique concept, valuation method and challenges of valuation for rent review and lease renewal in Japan are explained. In addition, the following topics are covered:(i) the latest issues of leasing markets; (ii) the importance of understanding uniqueness in local market practices; and (iii) the significance of explaining it to clients from the viewpoint of both experts’ responsibility and business expansion based on the author’s own experience. This study could serve as an informative guide for the issues that overseas real estate appraisers might face in their own local markets under the ongoing globalization.

To stay competitive in the global investment market, local real estate markets need to attract overseas investors. Real estate appraisers play an important role to

encourage overseas investors to invest in the local market through appraisal assignments, and expectations for real estate appraisers are increasing under the globalization. There are great opportunities for appraisers to expand their businesses and to contribute to the society not only domestically but also globally. It is all up to the appraisers whether they could materialize these chances.

Key Words: Japanese Real Estate Market, Japanese Appraisal Standards, Market Rent, Continuance Rent, Rent Review

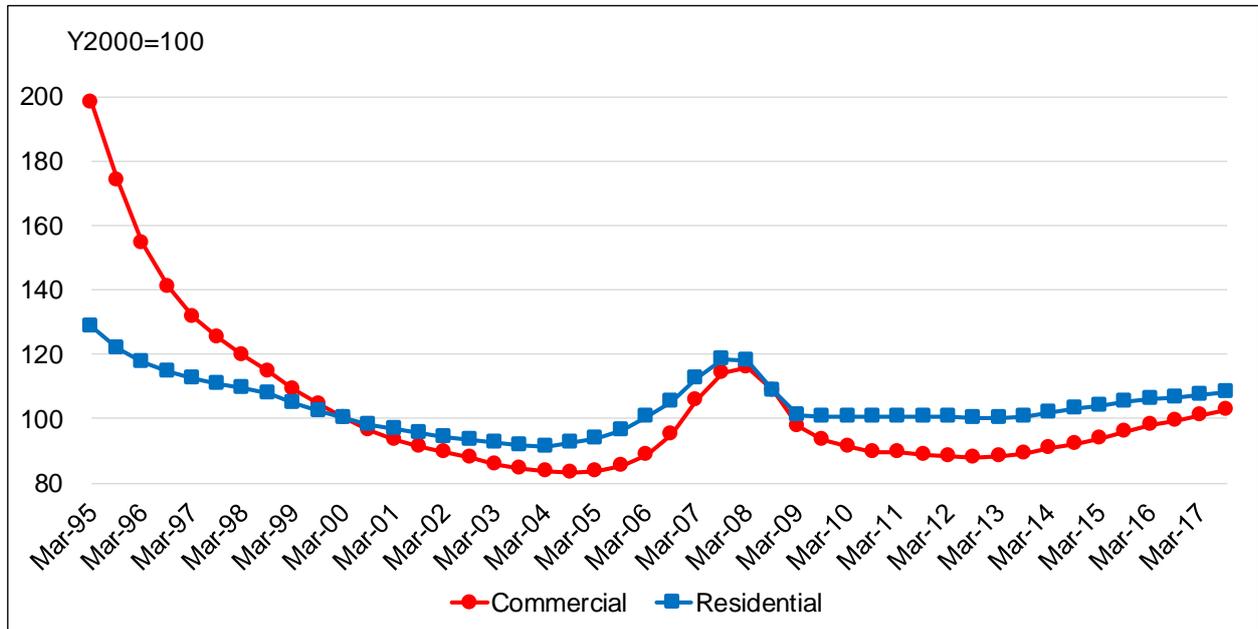
1. INTRODUCTION

Japan experienced a prolonged economic doldrum, which is called “lost two decades” after the bubble economy burst in 1993. After the Japanese Real Estate Investment Trust (J-REIT) scheme was introduced in 2000, the real estate investment market recovered gradually. Property prices and rents in major cities started to increase since 2006 thanks to a mini-bubble economy derived from a real estate investment fund boom. However, the market experienced a sharp downturn due to the global financial crisis in 2008 followed by the Great East Japan Earthquake in 2011. The Japanese economy and real estate market weakened thereafter.

However, the trend of the Japanese economy changed since Prime Minister Shinzo Abe’s economic stimulus policy, so-called ABENOMICS, was implemented at the end of 2012. ABENOMICS is a coined word by combining Abe and Economics, relying on (i) a bold monetary policy targeting a 2 percent inflation rate, (ii) a flexible fiscal policy boosting public spending for reconstruction, defense, safety, and regional revitalization, and (iii) a growth strategy for helping investment from private sectors to strengthen industrial competitiveness. Since this policy worked well, the economy saw a rapid recovery. The Japanese yen weakened and stock prices rose with recovering consumption due to wealth effect. Tourism revenues and retail sales increased thanks to overseas visitors to the country derived from relaxing visa requirements and prevailing low-cost carrier (LCC) operations. A large number of development projects moved ahead toward Tokyo Olympics 2020 and construction rush has been continuing. Therefore, land prices and construction costs increased significantly thus raising the prices of both residential and commercial properties. Office and retail rents trended upward due to high demand.

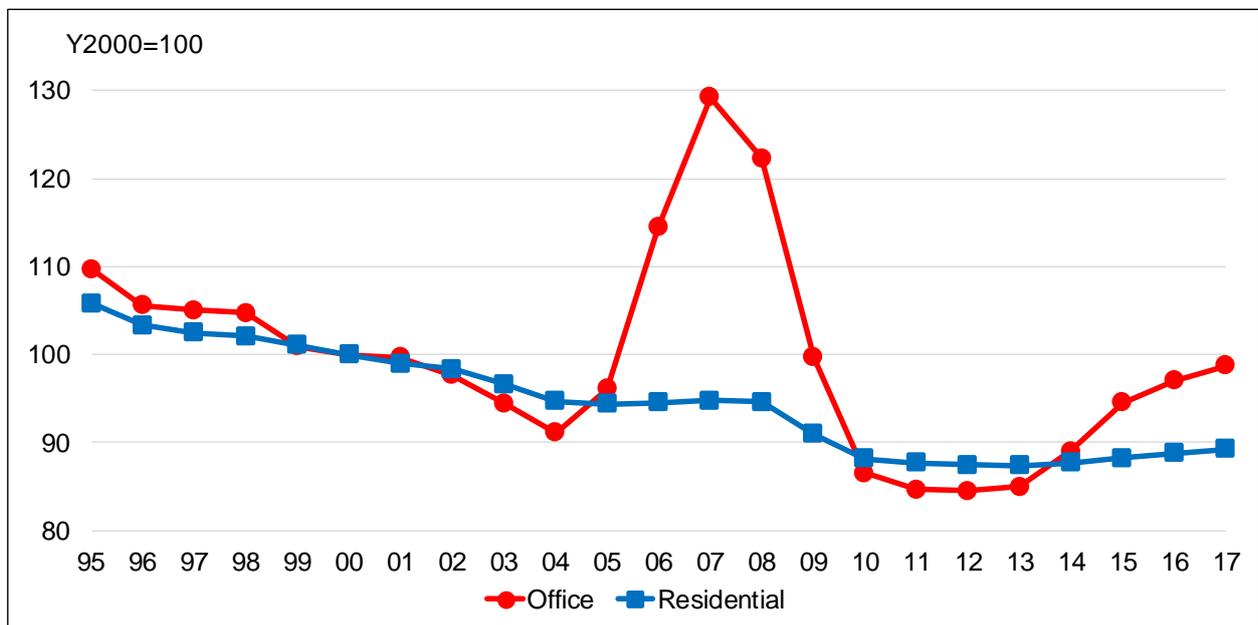
The figures below show the trends of land value and rent indices. Although the land value and rent indices indicated downward movements during the Great Recession, they bottomed out around 2012 and trended upward thereafter.

Figure 1-1 Tokyo Metropolitan District Land Value Index



Source: Japan Real Estate Institute (JREI)

Figure 1-2 Tokyo Metropolitan District Rent Index



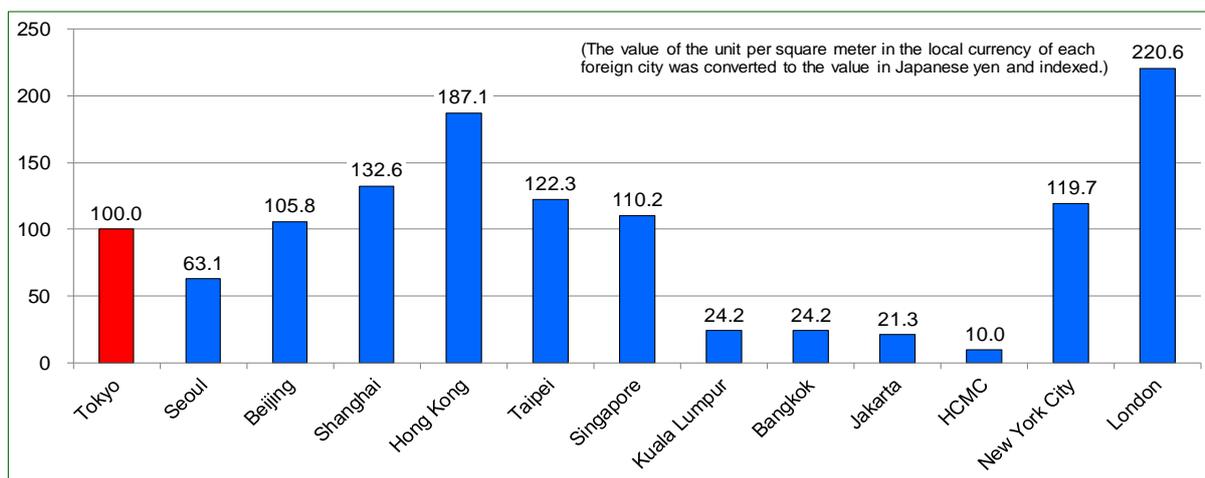
Source: Japan Real Estate Institute (JREI)

It should be noted that this favorable market condition is vastly supported by the increase and diversification of real estate market players, especially overseas investors. In the past, the Japanese real estate market did not have a strong

competitive edge in the global market because of a low growth rate, less transparency of market information compared to western countries, etc. However, the Japanese real estate market was revalued as a promising market thanks to the stable political and economic environment of the country, relatively weak currency, and other strength compared to other Asian countries.

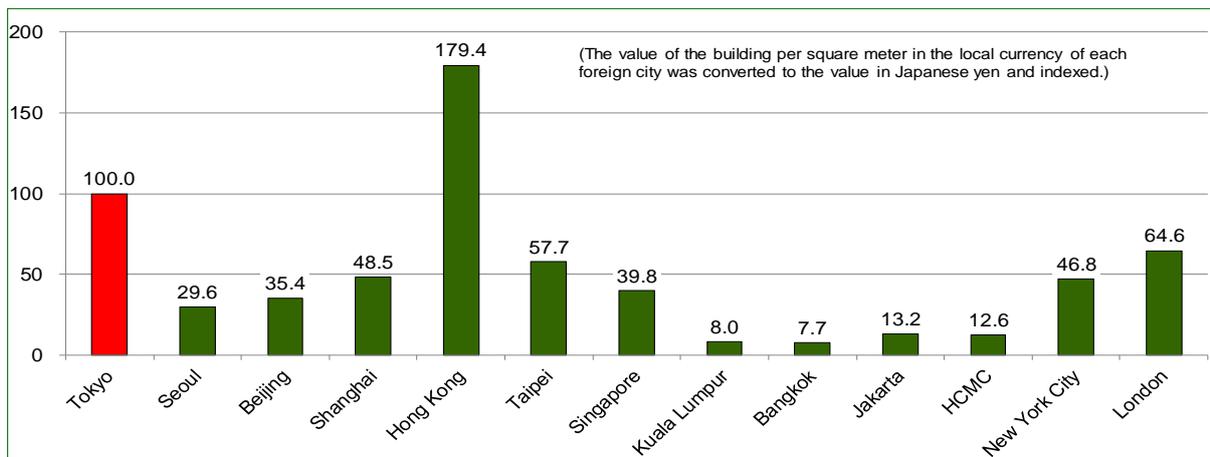
The figures below show a comparison of values, rents and cap rates of major cities in the world. High-end condominiums in Tokyo attract overseas investors due to its affordability compared to some other Asian countries along with the weak Japanese yen. On the contrary, although the prime CBD office building value of Tokyo is higher than most of major cities, the difference between the cap rate (3.0%) and the JGB yield rate (0.1%) is almost 300 basis points, which is large enough for overseas investors to expect a satisfactory return for their long-term investment. These favorable factors encouraged overseas investors to enter the Japanese real estate market and boosted the market.

Figure 1-3 Value Comparison of High-End Condominium Unit



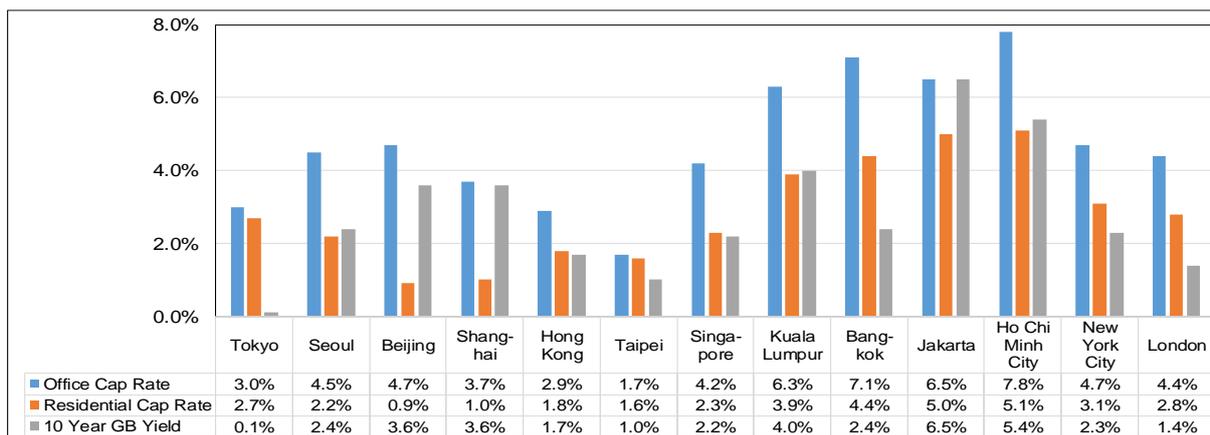
Source: Japan Real Estate Institute (JREI)

Figure 1-4 Value Comparison of Prime CBD Office Building



Source: Japan Real Estate Institute (JREI)

Figure 1-5 Comparison of Office and Residential Cap Rates



Source: Japan Real Estate Institute (JREI)

2. CONCEPT OF RENT REVIEW SYSTEM IN JAPAN

2-1 ACT ON LAND AND BUILDING LEASES

Understanding a local market in question is necessary for overseas investment. There are several noteworthy real estate practices in Japan, the most unique of which is related to lease contracts. Real estate leases are stipulated in the Civil Code, a general law, and the Act on Land and Building Leases, a special law. There are two types of leases, general lease and non-renewable lease, which are explained below.

Table 2-1: Comparison of General Lease and Non-Renewable Lease

	General Lease (Renewable Lease)	Non-Renewable Lease
Contract	<i>By oral or in writing</i>	<i>Must be in writing</i>
Lease Length	<i>Determined by agreement. (Up to 20 years contract before March 2003)</i>	<i>Determined by agreement</i>
Rent Review	<i>Both parties can request rent reviews at any time during the lease. (Commonly performed at the time of lease renewal)</i>	<i>A rent review option can be included in the lease agreement.</i>
Renewal	<i>Option to renew or terminate in an agreement. Renewed automatically without notice to terminate the lease from either party. Justifiable grounds are necessary to terminate the lease from the lessor.</i>	<i>No renewal options A new lease agreement is required for the tenant to continue occupancy.</i>
Break	<i>A break clause can be included in the lease agreement. Justifiable grounds are necessary to break the lease from the lessor.</i>	<i>A break clause can be included in the lease agreement.</i>

The parties of a non-renewable lease do not have a renewal option. But, as of the expiration, they could enter into another lease contract, in which the rent is adjusted to the market rent at that time. This kind of lease was created in 2000 and is becoming a main lease type for new lease agreements.

In terms of older leases, however, the general lease type (automatic renewal) is more common than the non-renewable one. Both the landlord and tenant possess

rights to either renew or terminate the lease at the expiration, but the lessor must demonstrate justifiable grounds to end it. Justifiable grounds must be socioeconomically reasonable (e.g., an emergency reason for seismic retrofitting) to terminate the lease. This is because an original version of the Act on Land and Building Leases was enacted to counteract a shortage of residences in prewar and postwar eras, and a spirit of the act focuses on the tenant's right protection. Usually, a general lease contract continues until the tenant leaves the premises. The lessor and tenant could agree to include a break clause in the lease. In this case, too, the lessor must present justifiable grounds to break the lease.

Another important point to be noted for general lease agreements is related to rent reviews. Paragraph 1, Article 32 of the Act on Land and Building Leases is shown below. A contract rent is legally bound during the lease and rent reviews are commonly performed at the time of lease renewal simultaneously but, the rule stipulated in the Paragraph allows the parties of a general lease contract to request for upward or downward rent reviews under certain circumstances at any time. According to the last part of the Paragraph, it is permitted for them to include a downward only rent review clause in the lease agreement. On the contrary, an upward only rent review clause is prohibited by the Law for general lease contracts. Moreover, in a general lease, it is almost impossible for the landlord to raise the current rent to the market rent level at a rent review. Instead, the new rent hinges on the negotiation between the parties, who consider the history of the lease. In other words, the rent of a general lease agreement tends to be inelastic. This indicates that investors could face a difficulty in securing desirable income gains by investing in income-producing real estate in Japan.

Paragraph 1, Article 32, Act on Land and Building Leases

[Right to Request Increase or Decrease in Rent]

When the building rent becomes unreasonable, as a result of an increase or decrease in tax and other burdens relating to the land or the buildings, as a result of the rise or fall of land or building prices or fluctuations in other economic circumstances, or in comparison to the rents on similar buildings in the vicinity, the parties may, notwithstanding the contract conditions, request future increases or decreases in the amount of the building rent; provided, however, when special provisions exist to the effect that building rent will not be increased for a fixed period, those provisions apply.

2-2 VALUATION METHODS FOR RENT REVIEW

Based on the legal system of real estate leases described above, it is important to know that there are two rent concepts in Japan: market rent; and continuance rent. The Japanese Real Estate Appraisal Standards provide the following definitions of the two types of rents:

Market Rent :	Market rent is the appropriate rent (new rent) reflecting the probable economic value of the real estate. Market rent is the rent that would be negotiated in a new lease agreement granting the rights to use or benefit from real estate interests; such rights may be conveyed by means of regular leases, leases to superficies, or easements. Market rent is premised upon the same market concept as market value.
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Continuance Rent :	Continuance rent is the appropriate indication of the probable economic value of the real estate only applicable to the landlord and tenant of an existing lease agreement, i.e., the rent that would be negotiated between the involved parties to extend the term of a real estate lease or to review the current rent.
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As one of the characteristics of the Japanese real estate market, market rent is not used for a rent review. The valuation methods of both market rent and continuance rent are described in the Japanese Real Estate Appraisal Standards.

A real estate appraiser is often retained to appraise the rental value (continuance rent) of the subject property for a rent review and lease renewal. Main clients are landlords, who attempt to improve the value of their properties by increasing the rental income, and tenants, who need to save their costs. These parties generally first try to negotiate with each other and reach an agreement. When they could not solve the issue among themselves, they would file a lawsuit. There are more and more cases, in which clients are overseas investors (e.g., foreign real estate equity funds as landlords and luxury brand retailers as tenants).

When real estate appraisers perform their appraisal in Japan, they must comply with the Japanese Real Estate Appraisal Standards. The following descriptions of the Standards explain the appraisal of continuance rent.

Section 2, 1, 4, Chapter 7, The Japanese Real Estate Appraisal Standards

Appraisal Approaches for Continuance Rent

A real estate appraiser determines continuance rent by analyzing thoroughly the following factors: (a) the existing contract rent of the subject property; (b) the trends of property taxes, land and building prices, rents of real estate similar to the subject property in the local market since the date of the current rent started; (c) the history

of the lease contract, including previous rent reviews; and (d) the contents of the lease contract.

The Japanese Real Estate Appraisal Standards list the following four methods for the appraisal of continuance rent.

Rental Disparity Analysis Approach

The rental disparity analysis approach arrives at the continuance rent of the subject property by adding an estimated increase to, or deducting an estimated decrease from, the current contract rent. The increased or decreased amount is obtained by first determining the difference between the market rent of the subject property and the current contract rent. The appraiser then estimates the portion of the difference assignable to the lessor by a thorough analysis of lease terms, the history of the lease contract and so forth. Finally, the assignable amount is either added to, or deducted from, the current contract rent.

[Rental Disparity Analysis Approach]

$$\begin{array}{rcl}
 (\text{Market Rent} - \text{Current Contract Rent}) & \times & \text{Ratio Assignable to the Lessor} \\
 & + & \text{Current Contract Rent} \\
 & = & \text{Continuance Rent}
 \end{array}$$

Yield Approach

The yield approach reaches the continuance rent of the subject property by adding the operating expenses to the value, which is calculated by multiplying the capital value of the subject property by its expected rental yield rate.

[Yield Approach]

$$\begin{array}{rcl}
 (\text{Capital Value} \times \text{Expected Rental Yield Rate}) & + & \text{Operating Expenses} \\
 & = & \text{Continuance Rent}
 \end{array}$$

Trend Approach

The trend approach calculates the continuance rent of the subject property by multiplying the current contract rent by a trend factor for the rental growth rate.

[Trend Approach]

$$\text{Current Contract Rent} \times \text{Rental Growth Rate} = \text{Continuance Rent}$$

Rental Data Comparison Approach

The rental data comparison approach uses rental comparables to determine the continuance rent of the subject property. The comparable rental data are adjusted in terms of market-specific and property-specific value factors.

[Rental Data Comparison Approach]

$$\text{Rental Comparable} \times \text{Adjustment Factor} = \text{Continuance Rent}$$

Although the concept and appraisal methods of continuance rent were stipulated in the older versions of the Japanese Real Estate Appraisal Standards, their practical application was considerably difficult due to its complexity. Rental valuation is, more or less, subject to the discretion of each appraiser. Therefore, it was pointed out, especially by lawyers, who utilize appraisal reports for their court cases, that the value conclusions of continuance rent valuation highly depend on the appraiser’s judgment. Considering this, the Japanese government amended the Standards in 2014 based on past court cases over the years to clarify the concept of continuance rent.

3. RENTAL VALUATION PRACTICE IN JAPAN

3-1 UNIQUE FACTORS OF RENT REVIEW

Since the ABENOMICS policies implemented, the Japanese real estate market has been on a robust trend, in which continuance rent has been increasing along with an upward movement of market rent in major cities. The major characteristics of continuance rent can be summarized as follows in comparison with market rent:

- Continuance rent is a revised rent of the current rent, which was agreed in the past between the parties involved.
- The increment or decline of continuance rent from the current rent is basically determined by the negotiation power of the landlord and tenant. However, the value of continuance rent is also affected by the trend of market rent.
- A rent review usually takes place after market rent fluctuates. The change of continuance rent is generally slower and smaller than that of market rent. As shown in the following two diagrams, the increase rate of continuance rent is smaller than that of market rent when the market rent is on an upward trend. Also, the decrease rate of continuance rent is smaller than that of market rent when the market rent is on a downward trend.

Figure 3-1-1 Diagram for Positive Rental Growth in Upward Trend

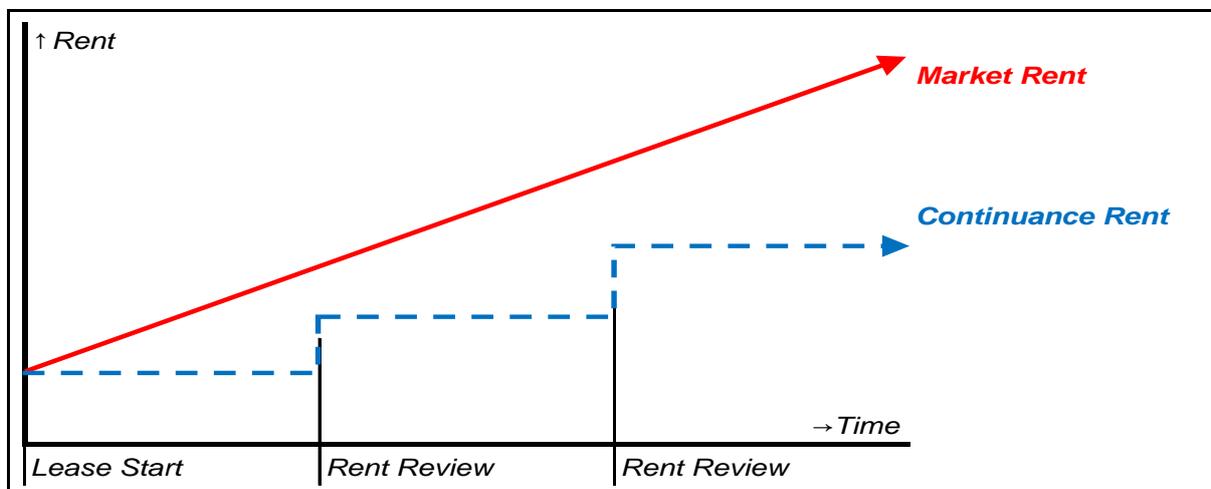
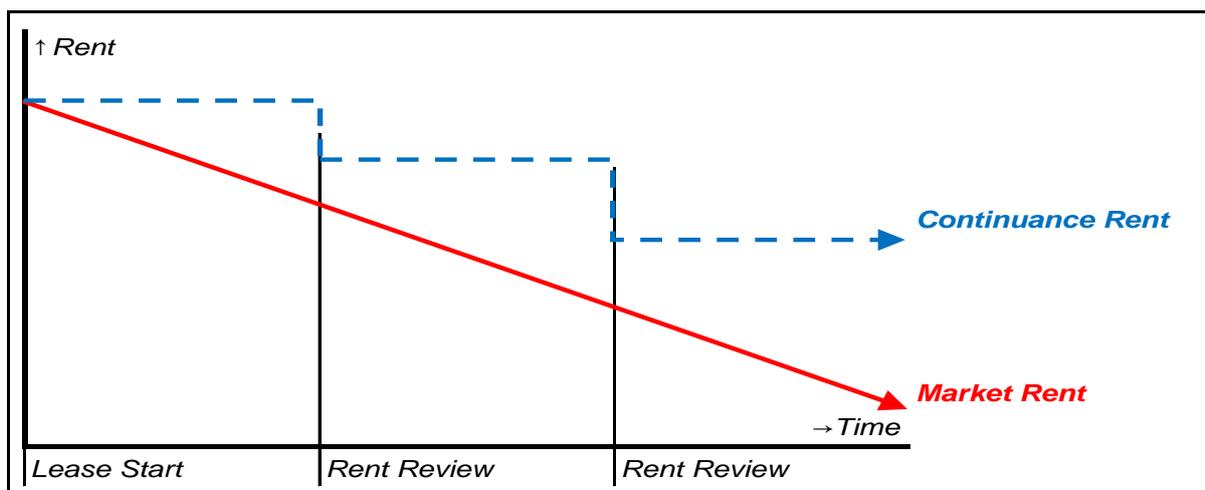


Figure 3-1-2 Diagram for Negative Rental Growth in Down ward Trend



This rent review system of Japan seems to be a negative factor when market rent is on an upward trend from the viewpoint of investment because of the upward rigidity of continuance rent. However, when market rent is on a downward trend, this system in turn would be a safety net reducing rental volatility. Some overseas investors instantaneously recognize the Japanese rent review system as a risk factor, but this is a biased view. It should be noted that this rent review system would be either a risk or an advantage depending on a case-by-case basis. It is a very balanced system in a sense, so a correct understanding is recommended.

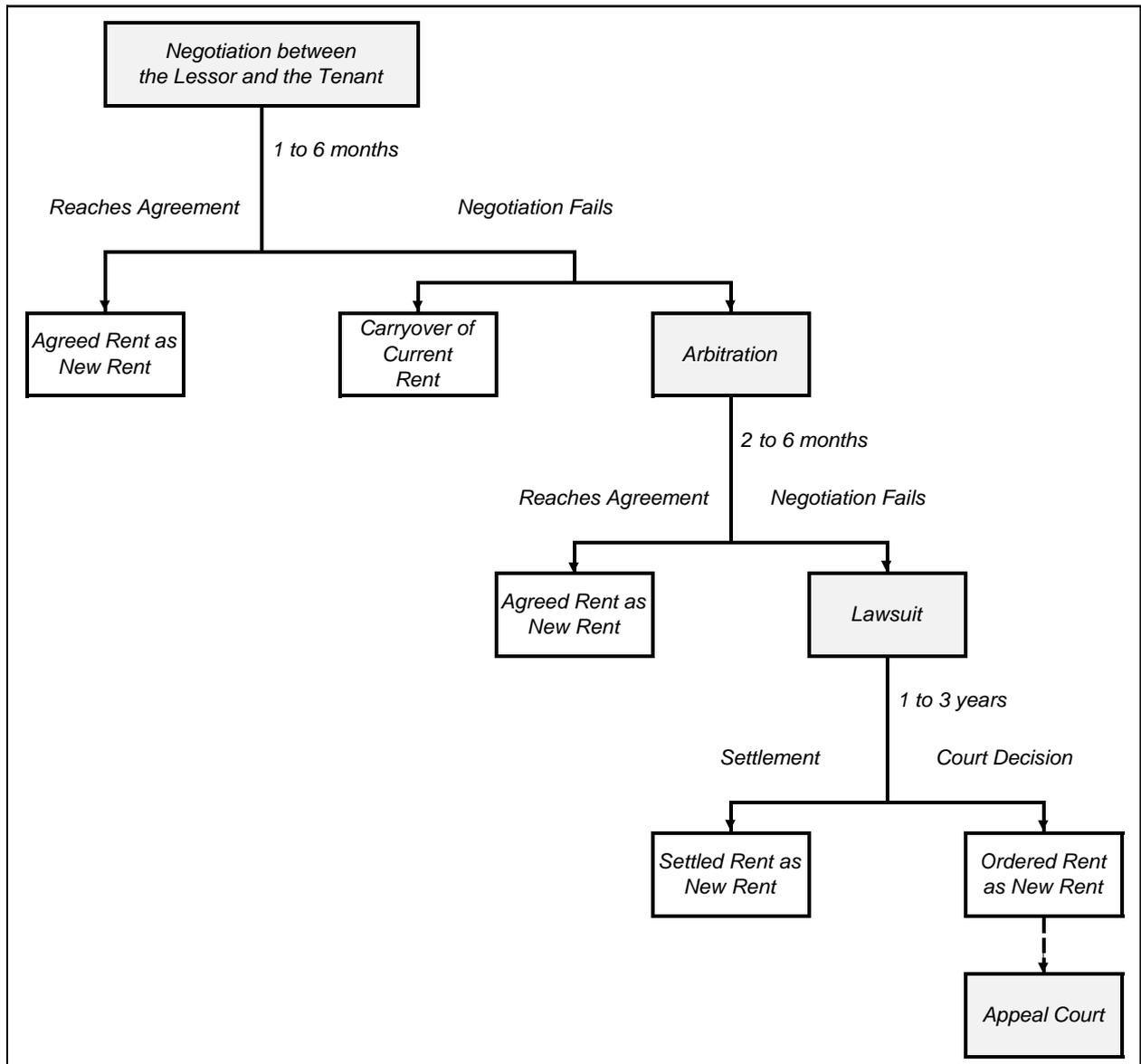
3-2 THINGS TO BE NOTED FOR APPRAISAL ASSIGNMENTS

The author, a member of Japan Association of Real Estate Appraisers and a staff real estate appraiser at the Japan Real Estate Institute, is frequently in charge of rental valuation as well as consultation for rent reviews. Recently, the number of such valuation/consulting assignments from overseas clients is on the rise. From the experience, the author would like to touch on the following two assignment types: (a) Continuous Rent Valuation; and (b) DCF Method, especially for property acquisition. In both types, the client’s poor understanding of local market practices, especially continuance rent, could create a serious issue for appraisers. These two cases might provide useful implications for overseas real estate appraisers in their own countries.

3-2-1 CASE 1: VALUATION OF CONTINUANCE RENT

A rent review is a complex process due to the unique factors and practices in Japan as mentioned above. A general rent review schedule and pattern in Japan is shown in Figure 3-2. The amount of continuance rent is first negotiated between the lessor and the tenant. If the negotiation fell through, the parties would most likely file a lawsuit at the court. An appraisal assignment for continuance rent is generally requested from six months to one year before the time of a rent review or lease renewal for the negotiation. When the rental market is on an upward trend, assignments from landlords increase to make sure capitalizing on the upturn market condition. On the other hand, when the rental market is trending downward, those from tenants rise to ensure that they can reduce their rental costs. It should be also noted that an increasing number of appraisers have opportunities to involve in a rent review process to support the landlord or tenant and their lawyer in addition to providing a valuation.

Figure 3-2 Process of Rent Review and Lawsuit Thereafter



Most appraisal reports are admitted by the court as evidence. The appraiser must arrive at a final rental value opinion in an objective and impartial way instead of considering the client’s benefit only. In addition, his/her appraisal report, which tends to be larger in volume and higher in appraisal fee than regular reports, is required to possess a trustworthy and sophisticated quality for the court to be able to depend on. Therefore, the appraiser has a significant responsibility for the court’s decision and client’s interest.

In a lawsuit regarding continuance rent, either the plaintiff or the defendant, or both, usually retain their own appraisers. The court appoints an additional independent appraiser for supporting its final judgment. It is very important for an appraiser, who was engaged in the assignment by either a landlord or a tenant, to let the client know that the outcome of the court case would not always be desirable to the clients. An appraiser sometimes needs to decline his/her potential appraisal assignment when the client does not accept the appraiser’s suggestion about the possible outcome.

When the client is an overseas investor or when a domestic client reports to their foreign boss, the appraiser needs to explain thoroughly in the client’s language about the unique process of a rent review in order to complete an appraisal assignment of continuance rent properly. Although this kind of explanation is a highly demanding task for an appraiser, overcoming this difficulty must help expand appraisal businesses in this era of globalization.

3-2-2 CASE 2: DCF METHOD FOR PROPERTY ACQUISITION

When the Discounted Cash Flow method is applied especially to valuation for property acquisition purposes, the understanding of continuance rent is also essential. The unique factors of continuance rent should be considered adequately when forecasting future income streams. In other words, a rental growth scenario in line with the change in market rent cannot be employed due to the distinct nature of rent reviews.

Some real estate investors, especially those from abroad, face a disappointing income growth of the property because they failed to incorporate the characteristics of rent reviews in Japan. Their cash flow expectation was too optimistic due to their lack of knowledge about the factors of continuance rent. Appraisers cannot make the same mistake as those investors when they forecast future cash flows in the DCF method by considering the factors of continuance rent.

It should also be remembered that this rent review system has both positive and negative aspects as written above. Appraisers must make their best efforts to provide explanation and support the client’s understanding in order to expand their business opportunities.

4. CONCLUSION

There are several real estate practices worth noting in Japan, the most of which is the rent review system. Although it might be tricky for overseas investors to understand the rent review system and continuance rent, it cannot be avoided. As globalization makes progress, overseas investors face this unique issue more often. Real estate appraisers in Japan are expected to explain the rent review system correctly to foreign investors in their valuation assignments. Failing to do so could create a situation, where foreign investors consider the rent review system as a risk factor and become negative about investment in the Japanese real estate market.

To stay competitive in the global investment market, the Japanese real estate market needs to attract overseas investors. To encourage overseas investors to invest in the market, the factors of local real estate practices must be understood correctly by those investors. The necessary actions are to provide information to the world and to improve the explanation skills of appraisers. More Japanese real estate market information must be disseminated to the world. This is also effective for improving the transparency of the Japanese real estate market. Although it has been improving over the years, the transparency of the Japanese market remains behind Singapore and Hong Kong in Asia according to JLL’s Global Real Estate Transparency Index. Correct and ample information must be necessary for investors to evaluate the risks of investment quantitatively. Also, appraisers must make efforts to improve their expertise and explanation skills through daily appraisal assignments enough for overseas investors to evaluate these risks.

Real estate appraisers play an important part for real estate transactions. The author believes that this role will become more important in the years ahead not only in Japan but also in other countries. Local real estate market practices in a country could provoke information asymmetry between domestic and overseas investors. Appraisers would be able to resolve the situation through appraisal assignments. In this sense, expectations for real estate appraisers are increasing under the globalization. Therefore, there are great opportunities for appraisers to expand their businesses and to contribute to the society not only domestically but also globally. It is all up to the appraisers whether they could materialize these chances.

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