JAPANESE INVESTMENT IN U.S. REAL ESTATE: STATUS, TRENDS AND OUTLOOK

by
Russell C. Lindner

B.A., The Johns Hopkins University
1977
J.D., The George Washington University
1980

and
Edward L. Monahan, Jr.

B.A., Providence College
1974
Diploma de Estudios Hispánicos
Universidad de Navarra
1978
M.A.L.D., The Fletcher School of Law and Diplomacy
Tufts University
1981

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Signatures of the authors

Russell C. Lindner
Department of Urban Studies & Planning
August 15, 1986

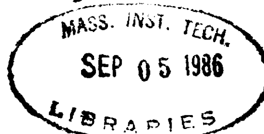
Edward L. Monahan, Jr.
Department of Urban Studies & Planning
August 15, 1986

Certified by

Lynne B. Sagalyn
Asst. Professor of Urban Studies & Real Estate Development
Thesis Supervisor

Accepted by

James McKellar
Chairman
Interdepartmental Degree Program in Real Estate Development



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This thesis is the effort of two budding students of Japanese real estate investment in the United States. Research was conducted over a period of three months, during which time the authors not only made their first visits to Japan, but for the first time evaluated in depth the character of Japanese investors and corporations.

Given such limitations, interviews were of critical importance. We wish to thank the more than one hundred individuals who agreed to be interviewed in over fifty sessions in Tokyo, New York, Washington, D.C. and Boston. Our special gratitude goes out to Ken Arata, Director of the Real Estate Industries Division of the Ministry of Construction, Hajime Suzuki, Subchief, and Makoto Taketoshi, Assistant Manager, for their cordial assistance on our behalf. Arthur Mitchell of Coudert Brothers provided experience and counsel throughout our study. We wish to thank Osamu Aoi, Junichi Kogo of Mitsui Real Estate Development Company, Ken Bartells of Morgan Stanley, and Kunio Ohsawa of the Sumitomo Corporation for their extended assistance. We likewise wish to express appreciation to our advisor, Professor Lynne B. Sagalyn of M.I.T.'s Department of Urban Studies, and Professors Michael Joroff of the School of Architecture and Planning and James McKellar of the Center for Real Estate Development at M.I.T.

JAPANESE INVESTMENT IN U.S. REAL ESTATE:

STATUS, TRENDS AND OUTLOOK

by

RUSSELL C. LINDNER and EDWARD L. MONAHAN, JR.

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ABSTRACT

The level and diversity of Japanese investment activity in the U.S. real estate market was evaluated. An historical perspective was offered to provide a framework for analysis of current investment activities. Five different kinds of sectors were independently evaluated, with emphasis given to both intrasector similarities and differences. Investor characteristics typical of all sectors were enumerated, and adaptations necessitated by U.S. market conditions were explored. A study of Japanese real estate investment activity in Washington, D.C. was used to illustrate investment patterns described earlier in the thesis.

It was found that Japanese investment in U.S. real estate has grown dramatically over the last five years and is likely to continue such expansion in both the near- and long-term. Large Japanese institutions and companies have begun to establish corporate infrastructure in the U.S., and are consequently well-prepared to invest capital outflow from Japan which is resulting from a host of macroeconomic, geopolitical and portfolio management factors. More recently, intermediaries acting on behalf of largely unregulated smaller Japanese investors have begun to penetrate the market, focusing upon investments which are largely ignored by large corporations. Consequently, while certain investments appeal to almost all investors, it was found that there is far greater diversity among Japanese investors than popularly thought. This presents new opportunities for many different kinds of American real estate players, and the authors elaborate upon a number of such opportunities.

Thesis Supervisor: Lynne B. Sagalyn

Title: Assistant Professor of Urban Studies and Real Estate Development

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PREFACE

> "We are patient. We have studied, we have prepared, and now, we are ready."
>
> Tadao Toyofuku
> Deputy General Manager
> Headquarters of Real Estate Department
> Sumitomo Trust & Banking Co., Ltd.

Japanese activity in U.S. real estate is commanding a growing amount of attention within the American real estate industry. Most discussion of the phenomenon, however, has lacked detail, particularly as to investor motivation and market segmentation. As a result, most U.S. real estate professionals whose product might be of interest to Japanese investors are unable to understand this capital source and to benefit from new investment, development and contracting opportunities which it might afford.

This paper will focus on two central themes. First, the Japanese are coming. Economic conditions and insufficient domestic Japanese real estate opportunities make substantial and sustained Japanese investment in U.S. realty an almost irreversible trend. Second, the diversity and depth of Japanese real estate activities are greater than is generally understood. There is no singular "Japan, Inc." approach towards U.S. real estate investment. The variation among favored investment products, development vehicles, project sizes and goals presents significant opportunities to almost all participants in the American

real estate community.

The thesis is organized as follows. Part I primarily offers background information, with Chapter I presenting a broad overview of current Japanese real estate investment in the U.S., and Chapter II elaborating upon macroeconomic and geopolitical factors which have a pronounced effect on such investment. This chapter also analyzes the role and effect Japanese governmental regulation has upon the export of capital into U.S. property, as well as how that regulation is being relaxed to permit more liberal outflows. Part II profiles five distinct kinds of Japanese investors -- life insurance companies, construction companies, real estate development companies, trading companies, and small non-institutional investors -- as a way of illustrating the diverse approaches to Japanese investment in U.S. realty. Interconnections between these distinct sectors are also explored, and the implications of such cooperation analyzed. In Part III, organizational and attitudinal similarities among different kinds of Japanese real estate investors are reviewed (Chapter VII), together with a case study of real estate investment activity in Washington D.C., where a surge of such activity within the last twelve months illustrates many of the trends analyzed in the body of the thesis (Chapter VIII). In Part IV, the authors elaborate upon their conclusions and enumerate perceived areas of opportunity for American real estate players.

A summary of conclusions reveals:

1. Favorable exchange rates and political pressure upon the Japanese to address a chronic trade imbalance, a lack of real estate investment opportunities in Japan, and perceived opportunities resulting from changes to the U.S. tax code will combine to promote significant Japanese investment in American real estate.

2. There is neither a "typical" Japanese investor nor developer. The nature of such real estate activity -- the vehicles employed, the cities and regions favored, the scale and risk of projects -- is more varied than generally perceived. Certain Japanese companies from different industry sectors are better prepared to expand their U.S. presence than others. Joint ventures between Japanese and U.S. partners will characterize many investment, development and construction activities.

3. Japanese life insurance companies, perhaps the largest and most visible Japanese investors in U.S. real estate over the last few years, will continue to expand the amount and diversity of their investments.

4. Japanese construction firms intend to compete against domestic contractors by providing fully integrated construction and development services, backed by financial access to Japanese capital.

5. Japanese real estate development companies will continue to expand development activities, including residential and industrial projects. Alternatively, rather than participate in the development process, trading companies will become key intermediaries for other Japanese wishing to participate in U.S. real estate activities.

6. There are opportunities for smaller U.S. property owners to tap Japanese capital. Intermediation services between smaller American real estate owners/developers and like-sized Japanese investors are available, promoting further diversification of Japanese investment in U.S. property.

7. Japanese decision-making, which adheres to strict corporate hierarchy and consensus-building, is adapting to market conditions in the U.S. The Japanese are learning that quick decisions are often vital to success in the American real estate business.

8. Price premiums which have been paid by the Japanese investors because of inexperience are becoming a thing of the past.

9. Japanese investment in the Washington, D.C. will continue to dramatically increase, both in relative and absolute terms. The Washington market is likely to remain a favored area of investment for the foreseeable future.

PART I:
AN INTRODUCTION TO THE JAPANESE REAL ESTATE INVESTOR

Chapter I:
A Broad Overview of Japanese Activity in U.S. Real Estate

> "We understand your way of thinking; we've studied your language, we've watched your movies, we play your national sport. Such comprehension is very important when we explain our analysis and recommendations to senior management."
>
> Junichi Kogo
> Associate Manager
> International Division
> Mitsui Real Estate Development Company, Ltd.

> "The real estate business is combat...between particular people and particular people."
>
> Kunio Ohsawa
> Manager, Real Estate Division
> Sumitomo Corporation

The Case for Japanese Investment in U.S. Real Estate

Japanese investment in U.S. real estate is driven by a host of mutually reinforcing factors, including financial investment criteria, macroeconomic and geopolitical trends, and domestic traditions.

Why real estate, rather than other kinds of assets ?

> Specific interest in real estate -- as opposed to such financial instruments as Eurobonds or U.S. Treasuries -- is based on the fact that land in Japan is in short supply . . . and consequently very expensive. [Also], land and buildings are seldom sold in Japan, so the emerging appetite for more speculative transaction-oriented investments

cannot be met at home.(1)

Furthermore, according to an executive of a large Japanese insurance company, "real estate is considered to be an effective investment target in any portfolio."(2) The reasons he cites do not differ greatly from the motives driving such investment by U.S. institutions: potential growth from rent reviews and property appreciation; depreciation that engenders tax savings; protection against currency risks in times of economic fluctuations; and a stable income source.(3)

But, why U.S. real estate, rather than that in other countries ?

> There are three reasons why many Japanese investors have recently entered the U.S. real estate market. First, the Japanese are here because the United States provides a stable political and economic environment that guarantees growth and free business conditions. [Secondly,] although the U.S. real estate market is not a perfectly open one, it is much larger in scale and more open than the Japanese markets. Most important, investment return may be higher in the United States than in Japan.(4)

Between 1973 and 1984, the U.S. Department of Commerce recorded 110 cases of Japanese direct investment in U.S. realty.(5) Standing alone, this information does not offer much insight, however, for the value of many of the investments went unreported, and many other known transactions were completely unreported. What most analysts agree upon is that, prior to 1982, aggregate Japanese direct investment in U.S. real estate was not great -- no more than $500 million.

Beginning in 1982, annual real estate investment by Japanese entities began to climb. Estimates by analysts on 1984 direct real estate investment range from $630 million (source: Department of Commerce)(6) to $1.7 billion (Real Estate Research Corp.)(7); these amounts, according to Japanese Ministry of Finance statistics, would have represented between 15% and 35% of all Japanese direct investment in the U.S. for that year.(8) A similar amount of direct real estate investment took place in 1985, although real estate's percentage of total Japanese investment fell in light of a 60% growth in non-real estate direct investment.(9)

Predictions for 1986 Japanese real estate investment vary significantly, but there is consensus on one critical point: it will increase rather dramatically, due to the convergence of numerous independent factors discussed later in this paper. Such predictions place the amount of 1986 direct real estate investment at between $2 billion and $5 billion.(10)

Assuming that the Japanese will increase their activity in U.S. real estate, the next question is: "how will it take place?"

Selective Investment Criteria

Location

Japanese have a strong preference for very well-

located property. The cliche, "location, location, location", was repeated in many of our interviews. "I believe that the Japanese are far more location-conscious than American investors. We tend to be a little more adventurous, while the Japanese will sometimes settle for less of a return in deference to location," says Bruce Fowler, president of Chesshire Gibson Fowler, a Los Angeles-based real estate consulting firm which acts as a U.S. representative for a large Japanese development/construction firm.(11)

There are a number of components in the Japanese definition of "good location." First, there are areas in which the Japanese have been involved for a long period of time and about which they have developed an intuitive "feel" from being local owners. Such areas would include Honolulu, Los Angeles and San Francisco. Large Japanese-American communities in those cities reinforce their desirability.

Second, there is a general desire to locate in commercial centers. Recently, this has led the Japanese to focus more attention on the East Coast. "The big money from Japan . . . is interested in 'Bowash' -- the Boston to Washington corridor -- and the epicenter of that, of course, is New York", claims Jack Shaffer, Managing Partner of Sonnenblick-Goldman Mortgage Banking who, for several years, has spent much of his time working with Japanese institutions.(12) New York has a special appeal for most

Japanese, for they believe that it epitomizes America and American real estate. "In Japan, people have an impression about the big skyscrapers. They think that they might be able to purchase those skyscrapers -- that's their dream," claims an official of Mitsubishi Trust & Banking.(13) As a result, New York is a preferred port of entry, with many Japanese purchasers willing to accept yields on Manhattan office buildings which are 100-200 basis points lower than in other prime cities. Nonetheless, demand for Manhattan product outstrips supply. "It is very difficult to find good buildings in Manhattan any more," said Tadao Toyofuku, the Tokyo-based Deputy General Manager of the Real Estate Department of Sumitomo Trust and Banking, "for everyone wants to invest there. Furthermore, while it is difficult [to locate good buildings of almost any size], it is almost impossible to find good buildings in the $5-$10 million range there."(14) Such tight market conditions in Manhattan have acted to enhance interest in the "Bowash" corridor in the last year. A further enticement is the fact that at each end of the corridor are cities with notable land-use restrictions built into their zoning regulations. Such restrictions reinforce Japanese interest because they are viewed as a mechanism to preserve property values through limitation of supply.

Product and Area

The vast majority of Japanese income-producing real

estate acquisitions has been in large-scale downtown office buildings. There are exceptions, such as The Essex House Hotel and Madison Square Garden condominia in Manhattan. Overall, office buildings almost certainly represent well over 50% of the portfolio value of Japanese investment in income-producing realty, which exceeds the percentage which such property represents in the aggregate portfolios of other foreign investors.(15)

To some degree, Japanese construction companies and real estate development companies represent exceptions to the general preference for downtown office product. While such property comprises a large percentage of their respective investment activities, they are also building and developing a variety of product across the U.S. in second-tier cities and regional markets. Japanese contractors are following direct investments of Japanese manufacturers and automakers in Michigan, Illinois, and Washington. Japanese real estate development companies, which began building residential subdivisions in Southern California in the early 1970s, have expanded to markets such as Houston, Dallas, Atlanta, and Phoenix. In both cases, major activity has been located outside major metropolitan downtown areas. Construction companies, for one, are hesitant to commit more resources to office tower construction for they rightly perceive that many metropolitan areas are currently overbuilt. Instead, they want to establish competitive advantage by providing integrated real estate services to high-growth sunbelt and

western locations. Meanwhile, the motives of real estate development firms are partially attributable to their accumulated expertise in suburban and residential markets.

Concentrated investment in large, downtown office buildings is explained by several factors. First, Japanese investors have been influenced by their experiences at home. There, office buildings, and particularly those in Tokyo, are considered the most stable and secure forms of real estate investments, due to extended periods of extraordinarily high demand resulting in a current vacancy factor of between 0.2% and 2%. On the other hand, the home experience has offered less choice. The segmentation between American downtown and suburban office markets is not as mature in Japan, where investment-grade real estate is located exclusively in urban centers. Consequently, those Japanese investing in the already alien and idiosyncratic U.S. market are often reluctant to look at suburban office buildings because they have no domestic point of reference. "Besides", notes one representative, " we prefer the commercial center."(16)

Second, the "first wave" Japanese investors have principally been very large institutions, capable of investing upwards of $100 million per project. The preference for large investments is, in part, a matter of efficiency: smaller projects are not necessarily any less complex to evaluate and negotiate than those costing $5 million-$15 million, and they do not allow for the effective

use of a large institution's clout and economies of scale. Also, smaller projects do not significantly expand the asset base of a large institution's U.S. real estate portfolio -- and portfolio size is an important consideration when budgets and staffing decisions are being established back in Tokyo. Furthermore, it is less likely that smaller projects are owned or developed by major American institutions or developers. "Name" figures prominently into the decision for many Japanese realty investors, particularly for the large institutions. The prestige of such Americans carries great weight with the reputation-conscious Japanese. Name-recognition also facilitates the approval process back in Tokyo, where many of the decision-makers may neither be real estate men nor familiar with the American market. For Japanese investors, such American institutions and developers embody a wealth of experience and market acceptance -- qualities which, by riding coattails, the Japanese hope to assimilate.

Finally, downtown office buildings are viewed as an easily managed annuity. The Japanese focus upon asset-management criteria for two key reasons. First, they want to maintain a high-quality physical plant, for their corporate culture emphasizes quality and a long-term investment perspective. Investor representatives believe that in a city, due to the large number of professional building management firms offering their services, one is more likely to find a company whose management standards match those of

the Japanese owners. Second, hotels and certain types of retail facilities (particularly those oriented towards percentage sales) are products deemed to be as much a "business" as a real estate investment. Unless the Japanese investor already has had considerable experience in the particular business, such as JAL with hotels and Daiei (Japan's largest retailing company) with retail centers, they believe it wise to shy away from such investment.

Yield and Return Requirements

Are Japanese investors willing to pay prices higher than the market? No longer, according to Timothy J. Welch, executive vice president of Equitable Real Estate Investment Management, Inc., and one who has worked directly with Equitable's Japanese joint venture partners over the last five years.

> There's been a lot of talk about Japanese investors paying more for properties than U.S. investors . . . But what was missed was the fact that the Japanese were willing to pay a premium to get top-quality, relatively low-risk buildings. If that period isn't over, it is approaching an end. (17)

Japanese investors target investment criteria within a relatively narrow band: going-in yields on office buildings of 8%-9% (except in Manhattan, where 5.5%-7% is the norm), and IRR's of 11%-13% (assuming a 3%-4% inflation assumption and a 10-year hold). These investors can accept a lower initial cash-on-cash yield, provided that the property is well-located and that a significant portion of the current

leases are both under-market and up for renewal or re-leasing in the next two-to-three years.

The Japanese do not place much reliance upon IRR as a measure of a project's investment quality. Granted, as a method of currently valuing project flows, IRR generates a healthy skepticism among many within the American real estate community, too -- particularly with respect to the assumptions about the reinvestment rate, and need for inflation and future-sale assumptions -- but it would be logical to assume that the Japanese, given their propensity to view real estate with a long-term perspective, would be quite favorably disposed towards its use. This is not the case, however. In many interviews, the investor had no specific IRR targeted or, if he did, it was neither well-defined nor founded upon clear assumptions. The experience of other Americans has been similar; "[the] Japanese investors are less enthusiastic than their American counterparts about the IRR as a measure of return. They are wary about the number of required assumptions and distrustful of the reliance on residual value."(18)

Investment Vehicles

Given the great and growing variety of Japanese investors active in the U.S. real estate market, it should come as no surprise that the forms of investment are similarly diverse. Nonetheless, most Americans are unaware of such variety among Japanese investment mechanisms.

The Japanese have employed many forms of real estate investment, such as:

1. All equity purchases (from 50%-100%)
2. Credit enhancement/ letters of credit
3. Convertible loans
4. Mini-permanent loans
5. Participating loans
6. Hybrid debt/equity development financing
7. Below-market financing associated with deals in which Japanese construction companies hold a position and perform construction-related services.

Moreover, a growing number of Japanese investors are showing a preference for convertible loans. This is a cautionary approach taken by many Japanese investors in response to the temporary oversupply of space in certain markets. They can enjoy the security of a priority lienor while retaining equity conversion rights should markets rebound and property values increase. Straight equity investments in existing and well-established office buildings are still favored by many, but equity investments in development deals are losing popularity -- for reasons which will be elaborated upon in Part II later in the paper.

Summary

In summary, if one were to choose a single generalized "activity profile" for Japanese investors, developers or contractors, the choice would be:

-a well-located, fully-leased downtown office building on which the Japanese investor has placed a convertible loan which currently yields 8%-9% and

shows an internal rate of return of 11%-13%;

-a medium-sized construction project in a western or south-central city in which the contractor can co-venture with an established local developer and contribute a portion of project financing; or,

-an attractive suburban development proposal in a sunbelt area in which the Japanese developer can invest while learning the essential elements of the development and brokerage businesses. Other Japanese investors may participate through the intermediation of a trading company or the development company itself.

However, such a profile would not do justice to the true diversity of Japanese investors, nor to their sophistication. As will be demonstrated later, investment strategies vary greatly. "Shadow" goals often play a factor in an investment decision. The desire to educate themselves is often a goal in itself; depending on a company's prior experience, a desire to explore new markets and new products may underpin investment decisions.

One thing is for certain: there is no "Japan, Inc."

Chapter II

Relevant Macroeconomic and Regulatory Factors

A. Economic Overview: Surplus-driven Investment

> "The exchange rate is like the Challenger booster rocket for Japanese real estate activity in the U.S...it keeps pushing up, up, up...and then, what?"
>
> Kunio Ohsawa
> Manager, Real Estate
> Sumitomo Corporation

Japanese real estate investment, development and construction activity in the U.S. are affected by four factors which collectively boost investment. First, trade surpluses and enormous domestics savings in Japan are fueling record levels of investment in U.S. financial instruments and real estate. Returns on U.S. government securities and real estate are higher than comparable investments in Japan, and the U.S. is politically stable. Second, volatile exchange rates are driving an increasing proportion of such investment into hard assets such as real estate, which will conserve value and generate capital gains when the yen eventually falls against the dollar. At present, Japanese real estate participants can invest, develop and construct in the U.S. with very inexpensive dollars, and it is less risky to hedge capital with real estate assets than with interest differentials on financial instruments. Third, pending U.S. tax reform discourages borrowing and encourages equity financing of real estate investment and development. This favors Japanese developers

and contractors who can finance investments and fund development projects because they are either cash-rich or enjoy close relationships with powerful Japanese banks. Fourth, there is more available capital than real estate opportunity in Japan. Since Japanese real estate owners rarely sell property and land is scarce for new development projects, real estate investors, developers and contractors must look overseas for business opportunities.

Japanese activity in U.S. real estate markets occurs in the context of profound economic disequilibrium between the two nations. A recent spate of trade negotiations involving Japanese semiconductor exports and U.S. import restrictions of textile and manufactured goods aims to decelerate a projected 1986 trade deficit of $66 billion. U.S. pressure on Japanese authorities to adopt market-opening measures and stimulate domestic demand is occuring against a backdrop of massive capital export to the U.S., projected to reach $77 billion this year. In 1986, as the U.S. became the world's largest debtor nation, Japan assumed the role of the world's largest creditor.

Japan's predominant role is the consequence of historic measures to reconstruct a war-ravaged economy. Japanese post-war economic policy conceived of economic competitiveness as the key to national survival without military power. Japan became a savings-intensive economy and a major exporter of capital. Japan's economic miracle and

subsequent industrial reconversion expanded Japanese goods and services worldwide, and structured economic power on a three-fold foundation of extended advantage: the "new industrial revolution" in manufacturing technology, concentration on service sectors, and expansion of research and development activities.(19) By 1980, Japan had surpassed the U.S. as the leading global producer of autos, and a year later it instituted a ten-year government plan to build a fifth generation computer system in order to become the world's number-one producer of advanced computer systems.(20) Japanese firms developed skills for managing technological change and achieving improvements in productivity. In the service sector, companies concentrated financial resources into fast growing areas such as fashion, publishing, tourism, construction, and real estate. Research and development of commercial technologies by large private sector companies led to rapid applications in such fields as microelectronics and biotechnology. Japanese human resources rivaled those of capital, for managers excelled at planning and high standards of quality, and Japanese trading companies successfully completed world-wide projects of great complexity.

Public discussion of Japan's competitive advantage has unfortunately been limited to economists' narrow views of exchange rates, interest differentials and savings rates. However, there is much to suggest that measures for reducing chronic trade imbalance must attack structural problems

rather than focus on cyclical patterns of Japanese external surpluses, such as those which occured in 1972 and 1978.(21) For example, the Japanese government's "neomercantilist policies help keep savings rates high, the cost of capital low, the commercialization of new inventions rapid, and trade barriers in line with national strategy."(22) Despite the recent call by the Nakasone administration for increased domestic spending, economic adjustment will be a long process, because manufacturing productivity improvements can lower price increases on Japanese export products and internal Japanese government deficits will constrain domestic policies to stimulate public works spending. History shows that, as in the case of Britain and the United States, countries accumulate growing current account surpluses as the result of long-term economic dynamism. Japanese capital outflows have more than offset trade profits over the last three years and this year, although the Japanese current-account surplus will reach US$66 billion, the long-term capital-account balance is projected to register a US$77 billion deficit.(23) Such capital exports play many roles, such as restraining U.S. interest rates and moderating inflation through the finance of cheap imports. Japanese capital exports account for approximately one-third of the U.S. current account deficit, and may increase in the present adjustment period following a sharply weaker dollar. Lower interest rates at home are forcing Ministry of Finance (MOF) officials to allow

Japanese investors to access better investments abroad in securities, options markets, and real estate. Massive capital outflows, which will impact U.S. real estate activity, are likely to continue at very high levels for a foreseeable future.

The yen's 40% appreciation against the dollar, from 260 in February 1985 to 154 in August 1986, has heightened dollar purchases of U.S. government securities and set the stage for huge Yen-financed U.S. investments once the exchange rate stabilizes at some future level. Japanese investors have greatly increased investments in long-term dollar bonds since U.S. short-term rates dropped during the spring of last year. Japanese purchases of foreign securities had historically been financed in the yen-conversion market. Some 60% of these recent purchases, however, were funded with short-term dollar borrowings from foreign branches of Japanese banks due to investor uncertainty over the exchange outlook. As a result, the yen has stayed high because of a lesser amount of investments financed with converted-yen funds. U.S. long-term rates decreased and short-term rates remained stable, in spite of discount rate cuts by the Federal Reserve, because dollar-financed purchases on long-term securities put upward pressure on short-term rates and reverse downward pressure on long-term rates. In turn, this has caused the difference between short- and long-term rates on U.S. securities to

narrow and plateau further financings of bonds with dollars. In Japan, short-term dollar funds are used to pay taxes, wages, and other obligations of corporations, and are not generally targeted for savings. When these dollars are used for bond purchases, however, corporations cannot borrow as usual and the net effect is to generate domestic Japanese savings in dollars. When the yen finally stabilizes against the dollar, Japanese investments in dollar bonds will once again be financed with yen-converted funds. Because Japanese domestic yields on investment will likely remain low, this should create another sizable pool of funds seeking good investment opportunities overseas.

Three factors indicate an increase in the popularity of futures transactions and, importantly, real estate as an outlet for these funds. First, floating exchange-rate systems have not worked well since countries began to relax capital movement restrictions in the early 1980s. As such, governments are compelled to more actively manage international capital transactions in order to allow exchange rates to balance current accounts. For example, recent initiatives by the Japanese Ministry of Finance (MOF) to permit trust banks to invest abroad and life insurance companies to purchase more foreign securities and real estate are driven by the rapid appreciation of the yen against the dollar. In particular, as of August 1986 trust banks will be allowed to operate trust accounts in foreign currencies. MOF deregulation should become a flexible tool

for increasing the government's ability to manipulate exchange rates.

Second, Japanese institutional investors are restricted from participating in overseas futures and options trading markets. In an increasingly volatile international interest rate environment, Japanese investors have bought foreign securities to stabilize and improve the rate of return on their assets. In effect, they must run considerable risks to take advantage of a difference between domestic and foreign interest rates in order to hedge against exchange risks. Since Japan is a huge exporter of capital, the MOF will be compelled to permit Japanese investors to take advantage of risk management products. Just as Japanese investors desire to hedge short-term exposures with futures products, and long-term positions with options, similarly institutions will desire to invest in hard real estate assets to maintain extended returns and security on overseas investments. Surplus funds and a keen desire to limit precarious exchange environments will drive Japanese institutional, corporate, and individuals buyers to invest in a diversified range of U.S. real estate products.

Third, a stronger yen and cheaper oil have combined to increase Japanese current account surpluses. Therefore, the MOF is likely to place emphasis on implementing structural measures to remedy the current imbalance. Foreign direct investment in U.S.-based manufacturing facilities will be a

key means to reduce exports and promote gradual trade balance and will benefit Japanese construction companies abroad. Tax incentives to the private sector should hasten industrial movement overseas, particularly to the U.S. Internal expansion of the economy will be limited, however, because Japanese government debt to GNP is among the highest of the industrialized nations and the anticipated burden of social programs for Japan's aging population is expected to grow. In essence, these measures suggest a forceful argument for increased Japanese investment in risk-hedging foreign assets such as futures, options, and real estate. In addition to these factors, Japanese investment in U.S. real estate is further boosted by favorable exchange rates, U.S. tax reform measures and domestic Japanese land scarcity.

Exchange rates provide additional incentive for asset diversification into overseas real estate. Japanese investors anticipate substantial capital gain from exchange shifts on dollar denominated assets, hence there will be a rush into dollar bonds and, to lesser extent, real estate when investors feel that the dollar will not fall any further. This explains, in part, the reluctance of Federal Reserve and Bank of Japan officials to intervene in currency markets of late, even when the exchange rate has become unruly. Support of the dollar will send signals to investors that the slide of the dollar has ended, and will only be undertaken when a weaker dollar threatens to drive up U.S.

interest rates.

Taxes in Japan have traditionally promoted savings, whereas in the U.S. they have incentivized borrowing. As such, tax reform measures in both nations are attempting to correct opposite economic extremes. Japanese tax incentives aim to increase new investment in housing and infrastructure and relieve exchange rate and trade pressures by the use of more capital at home. They serve to reduce artificial incentives to save and disincentives to invest. In the U.S., the opposite is true: tax law changes will attempt to reduce artificial incentives to borrow and disincentives to save. In Japan and the United States, the real estate sector is particularly impacted by these changes.

Domestic Japanese real estate conditions positively require investors to search for productive investments overseas. Tokyo suffers from an acute shortage of both office space and available land for development. Annual lease turnover rates average under .2%, and leasehold laws favor existing tenants. Evicting a tenant in order to increase rents is considered unacceptable behavior in Japanese business practice. Many tenants with interminably long leases pay less than half current market rates. Existing office space is nearly full and demand far exceeds projected new developments in commercial locations. Real estate companies estimate that 43 million square feet of office space is required for the future to satisfy the needs

of domestic and foreign corporations in Tokyo.(24) Major real estate companies' own fully depreciated assets with little debt and low expenses. Nevertheless, yields on leasing operations average barely 1-2%, less than one-fourth the comparable return on commercial properties in Manhattan. Real estate giants such as Mitsubishi Estate, which is Japan's largest commercial landlord, desperately seek developable land in order to be able to relocate existing tenants and build new, profitable office space. Investors are thwarted by leases which neither turn nor produce market returns, and contractors cannot build for lack of space. Developers can borrow, but have no projects which justify extension of credit. An apparent solution is to invest, build, and develop in the United States where tax reform encourages equity rather than strictly debt financing of major property acquisitions and development projects. Market conditions at home and tax reforms abroad are channeling real estate opportunities from Japan to the U.S. for an entire spectrum of Japanese institutional, corporate, and individual real estate participants.

Against the backdrop of these factors, economic measures have an objective of stimulating domestic Japanese demand and maintaining a high yen/dollar rate. This will moderate current account surpluses and increase Japan's external assets, which as of last year had reached $120 billion, the world's largest. Economic history shows that maintenance of external assets depends on free trade and

trading partner leverage, exchange risk hedging, and military power to preserve external credits. Japan is seeking to invest overseas to: diffuse trading partner anxiety and finance debtor country obligations; increase the use of yen-denominated capital; and, take a direct role (via MOF) in capital adjustment policies throughout the international monetary system.

B. The Japanese Ministry of Finance: A Force To Be Contended With

The Ministry of Finance (MOF) is an enormously powerful governmental agency. It combines regulatory, ministerial and discretionary functions in such a way as to influence Japan's economy far more comprehensively than any comparable U.S. body. It is a kind of Department of Treasury, Department of Commerce and Federal Reserve Board, all rolled into one. More relevantly, the role and effect of the MOF on Japanese investment in U.S. real estate is significant indeed, and Americans planning to work with Japanese investors should be aware of its impact.

Currently, real estate investments undertaken by Japanese life insurance companies, trust banks and pension funds are strictly regulated by the MOF. At present, due to many of the macroeconomic factors noted earlier, the MOF is relaxing some of its restrictions upon the export of Japanese capital into foreign currency denominated assets, including real estate. In March of 1986, life insurance companies and trust banks were permitted to increase the percentage of their assets held in foreign currency instruments from 10 % to 25%. Five months later, on August 6, the MOF increased the percentage again, this time to 30%; furthermore, it removed regulations which limited the speed with which a company could increase the holdings in its foreign asset portfolio up to the 30% benchmark.

One should not interpret such relaxations as an

abdication of power, however. First of all, there is nothing to suggest that these actions are permanent. MOF policy, and regulations related thereto, may change rapidly and almost without warning. For instance, in 1975, in order to stem a superheated domestic land boom, the MOF prohibited life insurance companies from investing in real estate. Prior to 1980, almost all investors in U.S. real estate -- not just life insurance companies, trust banks and pension funds -- were subject to strict regulation by the MOF. And prior to 1981, life insurance companies were prohibited from investing in overseas real estate. Other than the constraints of current governmental policy, there is nothing to prohibit the reinstatement of some or all of such regulatory restraints.

The Investment Approval Process

Even more than the broad policies established by the Ministry of Finance, it is important for American real estate professionals to understand the scrutiny which overseas real estate investments are given. Simply said, almost every such investment must be approved by the MOF. Investments by certain sectors, such as real estate development companies or trading companies, are lightly regulated and receive little more than perfunctory review. This is not the case with life insurance companies, trust banks and pension funds, however; because of the fiduciary role played by such organizations, MOF feels a special

obligation to closely scrutinize each prospective investment. According to the manager of the International Real Estate Division of Nippon Life Insurance Company, Japan's largest,

> The Ministry [of Finance] checks the submitted application to determine whether the project is healthy, stable, and especially whether the investment risks are minimized and a reasonable amount of investment return can be expected. Sometimes, the Ministry requires the applicant to provide explanations of the U.S. market, results of feasibility studies, information about the reliability and creditability of partners and whatever other information it deems pertinent.(24)

Furthermore, the absence of any clearly articulated standards and procedures to which a prospective Japanese investor must adhere further complicates the process.

The consequence of such a rigorous review process is that it may take up to six months for the MOF to make a decision, which may very well be a veto. Knowledgeable industry executives, however, claim that the time period has generally shortened as the MOF has become more familiar with the American real estate market and as their policy restrictions on overseas investments have relaxed. Furthermore, the larger Japanese institutions have special departments whose sole function is to work with the MOF to ensure that all information requests are honored expeditiously and that any questions are answered immediately. To further expedite the process, such institutions will apply to the MOF while still in the negotiation stage in the U.S., attempting to work a

parallel track in an effort to avoid disadvantageous delays. Consequently, institutions large enough to have such departments enjoy a comparative advantage over those that do not.

The Mystery of MOF, and How Americans Can Deal With It

To most American observers, and to many Japanese investors, the Ministry of Finance is a cryptic and byzantine agency. Certainly, the ad hoc review process injects an element of mystery -- and anxiety. Furthermore, on a larger scale, the MOF operates in a most discreet fashion, if not under a veil of secrecy. As with our own Federal Reserve Board, policy changes and tangible actions are often rumored, but rarely ensured; effective dates for new guidelines are generally the date of the public announcement, not some future date.

There are a number of steps which Americans can take to enhance their position when dealing with -- albeit vicariously -- the Ministry of Finance. The first is attitudinal; be prepared for contracts submitted by Japanese institutions to include the clause, "subject to review and approval by the Ministry of Finance." At an early stage in negotiations, one should ask the prospective investor to venture an opinion on how long it might take to gain MOF approval of the deal. While it would be unrealistic and unfair to expect a guarantee from said individual, the

information should be helpful, and could be of critical importance.

Secondly, the more information one can provide to the prospective Japanese investor, the better. Expect that the investor will be required to submit detailed information and sophisticated project analyses to the MOF. The better the quality of the information, and the earlier it is submitted to MOF, the better one's chances of a quick and favorable approval.

Finally, if the prospective investment requires an extremely quick decision, or is a particularly arcane venture which is unfamiliar to the MOF, one would do better to look to those Japanese investors who are not as rigorously regulated by the ministry. Even if a highly sophisticated investment is an extremely conservative one, thereby satisfying the "prudent investor" standard to which corporate fiduciaries such as life insurance companies must comply, one can be assured that the MOF will spend an inordinately long time getting into the details of the deal. This is not to in any way suggest, however, that MOF officials would have difficulty in comprehending the deal; indeed, almost all parties familiar with such officials have a very high regard for their sophistication and competence. Instead, it is meant to suggest that any deal, and particularly a complex one, takes longer to comprehend the first time through.

Thus, in conclusion, Americans dealing with Japanese

investors should always be attentive to the role played by the Ministry of Finance.

PART II:

DIFFERENT STROKES FOR DIFFERENT FOLKS: PROFILES OF DISTINCT TYPES OF INVESTORS

In this section the authors evaluate various "sectors" or categories of Japanese real estate investors active in the U.S. market. Understanding the traits and standards that are characteristic of each sector provides a base-line profile, while idiosyncracies which differentiate companies within each sector demonstrate the dynamism and diversity of investors wishing to place their money in U.S. real estate. Further, examples of cooperation between Japanese companies from different sectors are portrayed, and reviewed with an eye toward understanding how such interconnections would affect U.S. investment strategies.

At least nine distinct sectors of real estate investors exist within Japan. They are:

a. Life insurance companies
b. Construction companies
c. Development companies
d. Trading companies
e. Trust banks
f. Securities firms
g. Individuals
h. Commercial banks
i. Leasing companies

In addition, many related or hybrid organizations exist. Among these are consulting firms, brokers and merchant bankers. Other sectors, such as manufacturing, likewise have significant positions in real estate, although such ownership is typically ancillary to the principal corporate

activity and is not investment-oriented.

In the following chapters, we evaluate the U.S. real estate activities of six of the aforementioned sectors. Four of them -- life insurance companies, construction companies, real estate development companies, and trading companies -- are reviewed individually, while securities firms and individuals are analyzed together as examples of investments being made by non-institutional smaller investors.

First, however, a few words on two sectors which are not evaluated in detail. One of these sectors, trust banks, has actually been quite active in the U.S. real estate market. The staffs of trust banks are relatively large and very well trained. Many supplement these resources by affiliating with an American real-estate consulting firm. Yet, the Ministry of Finance does not permit trust banks to invest their own funds in U.S. real estate; instead, they may only represent and advise their clients on such investment. Accordingly, the "investment profile" of trust banks is functionally defined by the strategies and goals of their clients, to wit, life insurance companies, pension funds, corporations and high net-worth individuals.

The other sector, pension funds, is not yet permitted to directly invest in U.S. real estate. Restrictions prohibiting Japanese pension funds from making such investments are analogous to those suffered by American

pension funds prior to passage of ERISA in 1974. Pension-fund assets are managed either by life insurance companies or trust banks, and each is regulated by a separate department of the Ministry of Finance. Currently, a small, almost insignificant amount of that pension-fund money which is managed by life insurance companies in commingled funds has been invested in U.S. real estate; to date, however, the MOF has not permitted trust banks to make such investments on behalf of their pension fund clients.

While Japanese pension funds are not currently a major factor in American real estate, regulatory relaxations are reportedly imminent.(25) It is unknown to what degree such relaxation would permit pension-fund capital to flow into U.S. realty. Nonetheless, in view of the fact that Japan's four largest trust banks -- Mitsubishi, Mitsui, Sumitomo and Yasuda -- manage aggregate pension fund assets totaling more than $40 billion, while total Japanese pension fund assets exceed $250 billion, even a relatively small percentage allocated to American real estate would amount to a significant gross capital inflow.

Chapter III:

Life Insurance Companies: Growing Activity, Growing Conservatism

> " Our dream is to do everything ourselves."
>
> Takahide Moribe
> Manager
> International Real Estate Investment Division
> Nippon Life Insurance Company

Japanese life insurance companies are a major force behind Japanese investment in U.S. realty, and represent a major offshore capital market source for American real estate owners and developers. In the pages which follow, we evaluate not only the size and scale of this capital market sector, but also identify and highlight the intra-sector diversity in investment strategies, goals and criteria. First, we present a brief synopsis of the status of life insurance company investment in Japanese real estate, followed by an overview of life insurance company investment patterns. Third, a case study of a major investor in U.S. realty, Nippon Life, is used to illustrate the life insurance company approach and to illuminate salient industry characteristics. A section detailing U.S. investments made by other Japanese life insurance companies follows, with emphasis upon lessons learned. The chapter ends with a summary profile of investment characteristics of Japanese life insurance companies.

Overview

Japanese life insurance companies are not newcomers to real estate investment. There are twenty-three life insurance companies in Japan with aggregate assets in excess of $275 billion, and collectively they own approximately $13 billion of Japanese real estate, almost all of which is commercial office product.(26) This amount represents approximately 6.5% of their total book assets, a percentage which, although below the 20% permitted by the MOF, is understated in light of the fact that real estate assets are reported at book value. Two of the four largest owners of Japanese commercial real estate are life insurance companies: Nippon (second largest, with 17 million square feet of leasable space book valued at $2.75 billion in real estate assets) and Sumitomo (fourth largest, with 12.5 million square feet book valued at $1.75 billion).

Taken collectively, Japanese life insurance companies are among the largest investors in U.S. income-producing property of any of the aforementioned "sectors," holding in excess of $1.2 billion of American real estate. To date, however, only six of Japan's twenty-three lifes have invested in the U.S.: Nippon, Dai-ichi, Sumitomo, Meiji, Asahi and Mitsui. Such a small number of companies investing in the U.S. suggests a hierarchy within the life insurance industry, and one indeed exists: these six companies are also the six of the seven largest within

Japanese life insurance companies.

As it relates to U.S. investment, such a hierarchy is in large part attributable to the asset bases of the respective companies. As of December 31, 1985, the total corporate assets of these six companies were as follows:

Nippon Life:	$42,498,000,000	
Dai-Ichi Life:	$27,906,000,000	
Sumitomo Life:	$23,129,000,000	
Meiji Mutual Life:	$15,313,000,000	
Asahi Mutual Life:	$13,793,000,000	
Mitsui Mutual Life:	$10,446,000,000	(27)

By comparison, America's three largest life insurance companies -- Prudential, Metropolitan and Equitable -- had year-end 1985 assets of $91,139,140,000, $76,494,165,000 and $47,989,964,000 respectively,(28) while Aetna Life & Casualty had year-end 1985 assets of $58,294,000,000.(29)

Of those assets held in real estate, no more than twenty percent is allocated to U.S. realty. This allocation is a function of Ministry of Finance investment restrictions, together with in-house standards of portfolio prudence. As a consequence, even a company of Meiji's size -- Japan's sixth largest life insurance company, with assets exceeding those of MassMutual, New England Mutual and MONY -- is limited to $200 million-to-$250 million of U.S. real estate within its portfolio; its annual investment range is $50 - $100 million. Therefore, given the entry costs of establishing an organizational structure to coordinate direct investments in U.S. real estate -- capitalization and formation of a U.S. subsidiary, establishment of offices and staffing up -- only a suitably large insurance company can

easily afford to set up shop. Admittedly, one way to help cover such overhead costs would be to increase the amount of investment, in the form of commingled funds, made on behalf of clients and beneficiaries; indeed, this is a long-term goal. However, MOF regulations, together with a prudent desire to learn more about the U.S. market prior to using clients' money, limit the current ability of life insurance companies to do so.

Investment Patterns and Parameters

> " For equity investment, long-term investment is our motto"
>
> Nippon Life Annual Report, 1985

Japanese life insurance companies are generally credited with being the most conservative of the Japanese investors in U.S. real estate. "Typically," according to Arthur Mitchell, an lawyer with the international law firm of Coudert Brothers and one who will be profiled later in the paper, "Japanese life insurance companies prefer joint ventures with large developers or American insurance companies; typically, they look to a long investment horizon, for they do not readily entertain the thought of selling; typically, they accept a lower return, but they seek an income guarantee in the early years."(30) Most life insurance company representatives are quick to emphasize the underwriting limitations to which they must adhere:

obligations as fiduciaries for their policy holders; matching of assets against liabilities; and strict review by the Ministry of Finance. As noted in Sumitomo's 1985 annual report, "real estate investments are ideally suited to the operations of life insurance companies in view of their potential to yield long-term income."(31) "We cannot take risks," notes Akira Yashiro, chief representative of Dai-Ichi Life Company, Japan's second largest. "We take no short cuts, for we are a life insurance company having a very long view. It may take a long time, but we don't care."(32)

In the summer of 1984, a representative of Nippon Life's international real estate section wrote a sort of "investment manifesto" for those Japanese life insurance companies which invest in U.S. The author's words are applicable to the industry as a whole:

> Nippon Life seeks long-term, stable real estate investment in the United States that is compatible with the nature of funds available to life insurance companies. It avoids speculative investments such as those that promise short-term capital gain. An insurance company like Nippon Life has to make sure that every effort to minimize the investment risks that accompany high-return ventures is taken. This investment policy means that the company has focused on existing prime buildings in financial districts in major cities ...<u>It is reluctant to invest in growing cities, suburban areas and development projects because it believes that such investments are speculative and vulnerable to changes in the state of the economy.</u> (emphasis added) (33)

Furthermore, unlike their American counterparts, Japanese life insurance companies cannot make unsubordinated

permanent loans on U.S. property. The Ministry of Finance prohibits such investments; even participating debt vehicles do not satisfy its scrutiny. The result is that insurance companies are obligated to invest by way of convertible debt, outright purchase, or as an equity co-venturer in a joint venture; in the case of the latter, however, straight permanent loans are often permitted if used as leverage to acquire the equity stake.

Given such limited investment options, and in light of the putative conservatism of the life insurance companies, one might expect that a nascent Japanese investor would likely opt for the relatively conservative convertible loan or outright purchase vehicles, provided adequate coverage ratios and yield protections were put in place. As will be shown, however, this is not necessarily the case, for while there is uniform verbal adherence to the gospel of conservatism, the actions of the respective insurance companies suggest that they have chosen investment paths of varying risk. One man's conservatism is another man's "speculative and vulnerable" investment.

Case study: Nippon Life Insurance Company

It is generally acknowledged that Nippon Life is the leader among Japanese life insurance companies investing in U.S. real estate. "They are substantially, if not light years, ahead of their contemporaries in terms of

sophistication and experience," according to a knowledgeable institutional representative.(34)

Nippon's size allows them an advantage. Founded in 1889, they are Japan's largest life insurance company. Furthermore, with total assets in excess of $40 billion, they are the world's fourth largest, topped only by Prudential, Metropolitan and Equitable. Of that amount, $2.75 billion is in Japanese real estate, with another $500 million owned by their U.S. subsidiary, Nissei Realty, Inc. Because they are not licensed in the U.S., Japanese life insurance companies are not permitted to directly invest in the U.S. in their own name, and as a result, must invest through wholly-owned U.S. subsidiaries. Over $300 million was invested by Nissei in U.S. realty in 1985, alone.

Nissei's investment goals are not materially different from those of other Japanese life insurance companies:

> Nippon Life has been exploring investment opportunities giving the highest priorities to high quality buildings located in the business districts of major cities. Our major concern is to realize the highest possible income gain from long-term possession of such buildings. The Company accordingly has adopted a basic policy of working in partnership with major developers, insurance companies, pension funds or other concerns in the U.S. that have a similar objective.(35)

While this statement appears to be quite consistent with the investment parameters of the industry , it is interesting to note that, in the short period from the summer of 1984 to December 1985, Nippon's stated goals had evolved from investments strictly limited to existing buildings to

include those in previously unpalatable development joint ventures ("[we are reluctant to invest in] development projects because . . . such investments are speculative and vulnerable to changes in the state of the economy"). Such an evolution may be seen as a reflection of Nissei's dynamism and growing confidence; it is corporate methodology more than goals which seem to set Nissei at the forefront of those Japanese life insurance companies investing in U.S. realty.

The Organization

Nippon's presence in the U.S. real estate market antedates by far that of other Japanese life insurance companies. It began evaluating the market as a potential target in 1978 -- three years before the Ministry of Finance permitted direct investment by Japanese life insurance companies. This evaluation was largely coordinated by Takahide Moribe, whose decade of experience in Nippon's domestic real estate division in Osaka prepared him for the expansion abroad.

In 1979, two years before Ministry of Finance deregulation, Nippon formed Nissei Realty in New York and named Moribe as its vice president and office chief. The staff of Nissei (currently, four professionals) set out to absorb information about the U.S. market in anticipation of the day when they would be at liberty to invest. A strategic plan was formulated, calling essentially for four

separate stages: first, cautious investment with a respected U.S. institutional investor in existing properties; second, development projects with such institutions; third, direct investments in existing properties without institutional partners; and finally, directly and independently negotiated development deals.

Then, as now, Nissei underook its own research in-house and to develop its own information base, rather than rely solely upon consultants and other advisors. "Real estate is a local business," notes Moribe, "and we like fresh information."(36) Thus , with the structure in place and their level of expertise growing, Nissei awaited the opportunity to invest.

The Deals

As soon as the Ministry of Finance permitted life insurance companies to invest in U.S. realty in 1981, Nissei charted a cautious course of investment in accordance with the first stage of its strategic plan. Furthermore, it wanted to start on a relatively small scale. Accordingly, in July 1981, Nissei acquired a fifty percent of the Equitable's interest in 645 Madison Avenue, a 145,000-square-foot Manhattan office building. It was a landmark acquisition as well, for it was the first such purchase by a Japanese life insurance company. In this (and with all subsequent) investments, Nissei became a general partner in the project; "we like to be deeply involved in the

management of the project, so that we can acquire the know-how to do everything."(37) A spokesman for the Equitable confirms such involvement by Nissei, and welcomes it. "They are very well prepared, and by bringing a different perspective to the process, can be very helpful."(38)

Almost two years passed before Nissei acquired its next property interest. The time in between purchases was used to analyze the operations of 645 Madison Avenue thoroughly, as well as the market at large. In April 1983, Nissei acquired in excess of fifty percent of Gerald Hine's Continental Resources Center, a leased, 425,000-square-foot office building in Houston; Nissei reportedly paid $40 million for the stake.(39) This was followed in August 1984 with the purchase of a fifty percent interest in the Union Bank Square project, a 606,000-square-foot office building in the CBD of Los Angeles. Like 645 Madison Avenue, this interest was acquired from the Equitable, which retained the remaining fifty percent. Nissei's investment cost them approximately $85 million.(40)

Up to this point, all of Nissei's investments shared the same fundamental character: the acquisition of a partial interest in an existing office building in a major downtown, with a large, sophisticated institution as their partner. Their portfolio was diversified only in a regional sense; product type and investment vehicle lacked any diversification. By 1985, Nissei, in accordance with its plan, was prepared to embark on its second stage of

investment.

The first investment in 1985 was the financing of Japan Air Line's purchase of the Essex House from Marriott. Nissei issued a convertible loan against the property, which reportedly cost $175 million. This vehicle enabled Nissei to learn about American (or more specifically, New York) hotel operations without the accompanying managerial concerns, while retaining the ability to convert their debt into an equity stake. This transaction was followed by Nissei's first developmental joint venture, Texas Commerce Tower/2200 Ross Avenue in Dallas. This 53-story tower is scheduled for a 1987 completion, and is a blue-blood project: Trammell Crow is the developer, Johnson/Burgee the architect, and the Equitable is co-financier. Together, Equitable and Nissei are lending all of the development costs to the venture, in exchange for which they will receive annual debt service on their loan, together with a large equity stake in the project on which they receive a non-preferred return. The final transaction in 1985 was the acquisition of a forward purchase option for an office building in Washington, D.C. When purchased, this building will represent Nissei's first U.S. real estate investment in which it acquired one hundred percent of the deal, without any partners or co-venturers -- an investment which is characteristic of the third stage of Nissei's strategic plan.

Thus, by the end of 1985, Nissei had undertaken many

strategic advancements in a year's time: (1) the size of their portfolio had more than doubled, to in excess of $500 million; (2) their portfolio remained regionally diversified, while adding a little diversity in product type and investment vehicles; (3) important new partner relationships were established, giving it greater exposure within the real estate community and enabling it to expand its educational base; and (4) it had committed itself to going it alone on a project.

Nissei's view to the future seems to be well charted. Clearly, as noted in the introduction to this chapter, they at one point hope to "do everything ourselves," and the evolution of their investment portfolio suggests a systematic approach towards this goal. A likely next step -- and one consistent with the fourth stage of the strategic plan -- will be a joint venture in which they are the sole partner of an American developer.

Yet, there does not appear to be a firm timetable for fulfillment of the strategic plan, and representatives of Nippon exude patience. When asked about the risks of investing in the U.S. at a time when many markets are oversaturated, Moribe is philosophically sanguine. "People in the United States sometimes forget that real estate is a cyclical business. I recall when people laughed at Olympia & York's Manhattan acquisitions in the late '70s. Even Houston will recover within our investment cycle."(41)

Divergent Paths and Lessons Learned

Thus, Nippon is not only the largest Japanese life insurance company, but it was the first to establish an office in the U.S., the first to study the market closely, and the first to invest. Given this, one might naturally expect that the other Japanese life insurance companies which followed Nippon into U.S. real estate investment would largely pattern their investment strategies after Nippon's. Such parallels have been surprisingly infrequent, however, both as to investment characteristics and strategic plans (or lack thereof).

A large condominium project in a midwest city was the initial U.S. investment for one of the "gang of six.". The company, according to one of its representatives, would have preferred to "get its feet wet" with an investment in an U.S. office building. Nevertheless, the decision to proceed as an equity co-venturer was made, prompted in part by their preexisting relationship with the other venture partner, a Japanese construction company. Condominium sales have sagged, due in part to a glut of product. Currently, the units are being leased pending the return of a stronger market. "[I]t was a test," said a company spokesman, "and we paid the tuition."(42)

Another company's initial entry in to the U.S. market enjoyed similarly mixed success. Relying in part upon the development expertise of the American developer, and gaining

comfort from an association with a Japanese institutional co-venturer, the life insurance company -- also one of the "gang of six" -- invested in a 300,000-square-foot office development on the West Coast, a project which "represents the first investment by a Japanese life insurance company in the construction of a landmark office building in the United States."(43) The company enjoys both an equity and debt position in the project, which has leased very slowly in a depressed market and is only 85% leased over two years after delivery. While all of the parties involved in the project express various degrees of pleasure and optimism about the deal, outside observers are not as sanguine. "It didn't make sense," opined an investor knowledgeable about the goals and limitations of Japanese life insurance companies.(44) " It may well end up being a solid, good deal, but we would not have recommended such a project to a first-time investor, under almost any circumstances. It was a development deal, not an existing property. The market was soft, the local economy weak. A major employer was moving its headquarters to the Sunbelt. The risk profile was higher than we would have recommended." (45) An advisor who is familiar with the Japanese investor questions whether the they were aware of the market dynamics and the planned headquarters move.(46)

Both of these investment experiences exhibited some common qualities: they were to-be-built projects located in relatively small, but major, cities (neither is among the

ten largest in the U.S.) that are not known for their well-diversified economies. In addition, both projects were developed by experienced, but relatively small, non-institutional developers. Both projects included another Japanese institutional investor which not only enjoyed a pre-existing relationship with the respective Japanese life insurance company, but also had a pre-existing relationship with the respective American participants -- relationships which had been galvanized by earlier successful ventures. And perhaps most importantly, neither company had formulated a well-developed strategic plan towards investment in U.S. real estate.

Not surprisingly, both of these investors have altered their investment criteria and strategies in subsequent projects. The second U.S. project for the latter company is a joint venture with the Equitable. Together, they own fifty percent of a well-located office project, in addition to enjoying a first position as the project's permanent lender. This deal varies dramatically from the investor's West Coast project, despite some superficial similarities. It is located in a large city with a well-diversified economy; it was introduced to the project by and is a partner with Equitable, an investment relationship which was not swayed by a pre-existing Japanese relationship. Reliance upon Equitable's clout and expertise is viewed as a form of laying off risk, and even though the market has shown some signs of oversupply, the company's representative notes that

he is "not nervous, because we have a long investment window, and I trust Equitable."(47)

Notwithstanding such confidence, however, this company plans to shy away from away from development deals in the near future. "Our [current] strategy of investment is one that primarily emphasizes cash flow -- not capital gain. Given this, we favor existing properties."(48)

Similarly, a senior representative of the first life insurance company is charting a more cautious, wait-and-see course in keeping with a strategic plan:

> We are in our second stage. The first was the "tuition stage." The second: existing office buildings and co-ventures [with American institutions]. The third will come, but we're not exactly sure what it will be.(49)

Subsequent purchases have been consistent with this plan. Among them are large, fully-tenanted downtown office buildings in San Francisco and Dallas. In both instances, an American institution is a co-venturer.

The experiences of these two Japanese life insurance companies should not suggest, however, that those companies which have opted instead for all-equity investments have enjoyed thoroughly satisfying experiences. Another "gang of six" life insurance company, which has been active in a number of markets and which has invested via different vehicles, acquired an existing office building in a suburb of a major city within the Boston-to-Washington corridor in 1985. In addition to watching the value of the dollar slide thirty percent against the yen almost immediately following

closing, this company paid a price which many knowledgeable individuals believe incorporated an unwarranted premium. Of course, opinions about price often vary widely, and often do not incorporate considerations which are idiosyncratic to the purchaser. Nonetheless, in this instance, there appears to be some objective verification of such an assessment; according to a employee of another Japanese institution, this life insurance company, in contravention of a cultural and institutional disinclination to sell real estate (elaborated upon in Chapter VI), is quietly seeking to unload the property in Tokyo.

Unlike the two life insurance companies noted earlier, however, this life insurance company, in keeping with a strategic plan for investment, has attempted to spread its risk by investing through different vehicles in different cities. In New York, it acquired a fifty-percent interest in a new office building currently in the lease-up stage, protecting itself with a three-year yield guarantee of approximately ten percent, together with a bifurcated funding schedule; the developer, depending on the success of leasing efforts twenty-four months after building delivery, will "either get a bonus or suffer a penalty."(50) Active management of the venture is left to the developer, who claims that "the arrangement is a splendid one. Although [his Japanese partners] are very well informed and very well prepared, I am the managing partner and they are the sleeping partner."(51) In a similarly sophisticated

venture, the company made the construction loan and issued a convertible loan commitment on an $80 million mixed-use project in downtown Chicago. The loan is convertible in "between five and fifteen years"(52), and the project, forty percent pre-leased to a major corporation, gives every indication of being a rather successful venture.

In both of these projects, the life insurance company is a general partner (although technically, it is a corporate subscriber in the former case, a fact which the American developer believes gives the Japanese institution great comfort: "They know that I'm not in a position to pocket the cash and run"[53]). Such a status is desired not so much to exert greater control over the project, but instead to ensure that the educational process is richly enhanced -- an important goal emphasized by all Japanese institutional investors.

Despite its initial and arguable investment stumble, this life insurance company appears to be well-prepared to expand its scale of investment in the U.S. One of its chief employees in Tokyo apprenticed with the Equitable in New York, and is comfortable with the American market. A strategic plan has been formulated, and while they are rather secretive about its components, it appears to emphasize regional and product diversification. Why does this company feel comfortable with such a diversified investment strategy ? "We -- both in Tokyo and in New York -- systematically monitor our selected thirty cities on a

quarterly basis, and on a monthly basis go into great detail on four or five cities. This process ensures that we stay fresh, stay current."(54) So, while they may in fact be the "sleeping partner" in a particular deal, they certainly are not sleepy in their evaluation of the markets.

SUMMARY

The disparity between investment patterns of different Japanese life insurance companies is likely to continue for at least a number of years. Such disparities are not just a function of size, staffing and experience; just as important is a company's structural preparedness, often in the form of a strategic plan. A company whose office head notes that "we have no concrete idea on how to invest in the United States" (55) may well enjoy great success with its investments, but is probably less likely to be on the cutting edge of new programs or to show high responsiveness to new opportunities. Of course, higher risk often attends novel investment programs and vehicles, so such a "go slow" investment strategy may be not be inappropriate for a life insurance company, after all.

Notwithstanding such differences, certain generalizations can be made with some confidence about the Japanese life insurance companies as investors in U.S. real estate:

1) Existing office buildings will remain the

favored product. Particular emphasis is being placed on cities within the "Bowash"(Boston-Washington) corridor. Interest in suburban areas is slow to develop, as most companies are still not familiar with the dynamics of such markets; notwithstanding this, some of the more advanced companies are beginning to look seriously at different kinds of product, including suburban.

2) Satisfactory cash-on-cash yields are of paramount importance, while upside potential takes a decided back seat. Yield enhancements, via income guarantees, are a growing standard, with two or three years as the norm. Current yield requirements on existing propoerties fall in the 7.5%-9% range, with the exception of Manhattan, where yields of 6%-7% are bought. Yields on buildings currently in the lease-up stage run 100-300 basis points higher. IRRs fall within the 10.5%-13% range, using a ten-year schedule and a 3.5%-4.5% inflation assumption.

3) Affiliations with "big name" American developers and institutions are preferred. Such affiliations not only give the relationship-oriented Japanese greater comfort, but they also make a prospective investment easier to sell to the bosses back in Tokyo. Such an affiliation is

particularly important on a developmental joint venture.

4) None of the companies expressed an interest in an investment of less than $10 million, while $100 million appears to be the effective upper limit. Some current annual investment ranges are approximately as follows:

- Nissei: $200-400 million
- Sumitomo: $100-300 million
- Meiji: $50-100 million (1-2 deals per year)

5) While the traditional long-term view towards real estate investment still predominates, certain experts who work closely with the Japanese see a growing tendency to adopt a more "American-like" -- hence, a shorter-term, more commodity-like -- perspective. Such tendencies are apparently seen more frequently in the more experienced and advanced companies, such as Nissei and Sumitomo.

6) All U.S. offices are trying to beef up their staffs in order to cover more territory and to enhance their ability to make quick decisions. The home offices in Tokyo, however, are apparently not quite as anxious to increase staff size and overhead.

7) According to Gordon Clagett, Executive Vice

President of Equitable Real Estate Group, Inc.,

> There are two opposing trends, but they balance out to greater conservatism -- a better informed, rather than reactionary, conservatism.
>
> On the one hand, the Japanese have spent a lot of time learning about the market in a short period of time. They are now better educated, and may be more inclined to take greater risks. For instance, some who used to look exclusively at downtown office buildings are now looking at retail and industrial.
>
> On the other hand, as they view the current oversaturation within the market, they are becoming more conservative.(56)

One manifestation of such conservatism is a growing appetite for debt-oriented investments, rather than equity. Whenever possible, such instruments are structured to allow for conversion into an equity stake, so most of the same underwriting standards are being employed.

In sum, Japanese life insurance companies are positioning themselves to play an even greater role in the U.S. real estate industry.

Chapter IV:

Construction Companies: Financiers in Builder's Clothing

> "There are peaks and valleys. The peaks have always been to follow the Japanese investor; you find valleys trying to go it alone before understanding the market."
>
> Fujio Suzuki
> Asst. to the President
> Kajima Corporation

Japanese construction companies generated $1.7 billion in 1985 revenues in the U.S., which more than doubled earnings from the previous year. This year these companies are projected to capture a 4% share of the domestic U.S. construction market.(57) Yet, the role of these large-scale construction concerns remains relatively obscure.

The U.S. domestic construction industry is regional, competitive, and primarily supplied by local inputs of labor, materials, and management. Unlike industries in automobiles, consumer electronics, and steel, success in the construction industry is not wholly dependent on low-cost production, quality, and distributive efficiencies. Some success factors are intangible, such as knowledge of local customs and work habits, politics, and regulatory environments. "You can't just walk into this city and start doing projects," notes John Johnson, Vice President of Tishman Construction in New York which has recently collaborated with a Japanese developer on a high-rise condominium project. "You have to deal with so, so many

different sectors: the unions, the suppliers, the city, the agents, not least of all the contractors and building management companies. It takes years, and even then, most folks don't make it."(58) In spite of apparent obstacles, however, our research indicates that major Japanese contractors are preparing and, in certain cases, already implementing a long-term, methodical entry strategy for the U.S. marketplace.

The Japanese construction firms which are actively pursuing business in the U.S. are some of Japan's largest contractors which began offshore activities over a decade ago in response to the decline of domestic Japanese construction markets. These firms are staking their future, both overseas and in Japan, on technological innovation and advanced construction techniques. Japanese contractors view several facets of the domestic U.S. construction industry, such as project scheduling, quality controls, and building-systems innovation, as inefficient and ripe for improvement. Japanese products have a reputation for quality and performance, and these contractors want to extend that impression to the construction industry. Furthermore, Japanese contractors will attempt to transfer a vertically-integrated construction service approach to the United States. The combined effect of technology and service integration is the comparative advantage which Japanese construction firms are intent on bringing to the U.S. They do not believe that there is a sustainable niche for foreign

contractors in the pure "build and sell" business. Japanese contractors want to create a new dimension in construction services and quality rather than copy or compete against existing market mechanisms.

Joint ventures with U.S. developers are a prevalent means by which Japanese contractors are absorbing the essential day-to-day details of the U.S. construction business. These companies can bring substantial capital to U.S. construction projects, frequently in the form of limited-partner equity contribution. In return, they want to participate in the construction process and earn a reasonable return. As Japanese construction firms learn the business practices and methodology of U.S. general contractors, they likewise plan for future application of new technologies and service concepts. In Middle Eastern and Southeast Asian countries, these construction companies successfully introduced expertise not available in those markets. In the U.S. the situation is different, for Japanese contractors must learn the U.S. construction business first before attempting to revolutionize it.

An anticipated increase in foreign direct investment in the U.S. by Japanese manufacturing firms will provide construction firms with a transitional foothold to the U.S. market. Because Japanese clients are accustomed to integrated project planning and construction services, contracts for manufacturing facilities throughout the U.S. will offer Japanese construction companies an opportunity to

test new methods and technologies as they learn the U.S. market through joint ventures on purely U.S. projects.

The scale of projects and the expertise of such contractors vary considerably. Yet, little is known of the underlying motives for rapid expansion into the U.S., the world's largest construction market. Equally obscure are the critical relationships which link large Japanese contractors to other Japanese firms currently investing, developing, and brokering throughout key metropolitan areas of the U.S. Although Japanese construction firms will confront entry barriers that are distinct from those of the investment, development, trading, and financial sectors, their eventual success is closely tied to the related activities of these Japanese firms operating in the U.S. Moreover, the Japanese government has traditionally supported the overseas expansion of key industries, such as autos and steel, and regards their success as a matter of national priority. Because construction industry health is very important to the Japanese economy, the government can be expected to promote construction industry activity in the U.S. Our analysis intends, therefore, to explore the objectives of construction companies from a broad perspective which includes:

Objectives and Strategy;
Comparative Industry Characteristics;
Construction Industry Background;
Movement to Offshore Markets;
Recent experience;
Case Study: Hasegawa Komuten Ltd.;
Conclusions

Objectives and Strategies

Japanese construction companies moved to generate overseas business when domestic markets, adversely affected by economic adjustments and oil shocks, could no longer promise sustained periods of new construction projects. Most were immediately successful in transferring proven expertise for large infrastructure projects, plant construction, and high-rise residential facilities to developing country environments. Japanese construction firms built projects that could not be delivered by domestic Middle Eastern or Southeast Asian contractors. Entry into foreign markets succeeded by providing differentiated services in terms of scale and complexity. As a reaction to the decline of domestic Japanese construction activity, overseas expansion was less a clearly articulated plan than an urgent, ad hoc extension of existing business to new markets. Success reinforced a commitment of these big companies to vertical integration, which combined with financial strength, allowed contractors to adapt to differing conditions of individual markets. Japanese contractors offered expertise based on responsibility for all aspects of a project, an approach which characterizes the way they view themselves as competitors in the U.S. market. Michael Porter observes in Competitive Strategy that previous business patterns may determine competitive strategy:

> Every firm operates on a set of assumptions about its own situation ... These assumptions about its own situation will guide the way the firm behaves and the way it reacts to events ... Companies develop perceptions or images of themselves and their relative capabilities, which are reflected in the implicit assumptions that form the basis of their strategies.(59)

Major Japanese construction companies which operate in the U.S. today have adopted a strategy based on acknowledged strengths in financing ability and potential advantages in areas of technology and construction management. The objective of most companies is to build profitable real estate development operations which utilize existing expertise in wide-ranging, fully integrated project services. Few are interested in simply building and selling, because they believe that the breadth of U.S. real estate activity offers profit opportunity in design, engineering, research, and property management businesses, in addition to building and construction. They recognize that large-scale infrastructure projects, such as the ones they built in developing countries, will not be a stable source of revenue in the U.S. While Japanese contractors earned success in the Middle East and Southeast Asia by transferring conventional expertise, penetration of the U.S. market will require a different strategy: implementing new technologies and work methods to the overall development business. "Development allows for general contracting work, but not the reverse," says Shimizu America's Naoshi Oinuma.(60) Most companies believe that it will be difficult, at best, to

compete on a head-to-head basis with established U.S. contractors and builders. "We want to emphasize the sum of the parts rather than each individual element," observes Keisuke Mine of Kajima Corporation's Real Estate Development Division in Tokyo. "Our idea is that there is more profit in development than pure construction in the U.S." (61)

Their objectives for the U.S. market are, therefore, more expansive and ambitious than previous experience in other countries might suggest. These goals reflect long-term diversification strategies which have changed large, family-held contractors into sophisticated multi-national construction engineers and developers. Japanese construction firms view the U.S. market as both testing ground and long-term payoff for expensive R&D investments and adaptive innovations. Construction expertise and technology successfully implemented in the U.S. can be subsequently transferred to other countries. Sustainable advantage in the U.S. market will broaden firms' capacity to withstand cyclical swings of narrowly-focused construction activity, such as those which many suffered in Middle Eastern markets.

These common objectives are being pursued, nonetheless, through a variety of short- and medium-term strategies. Top-ten firms such as Kajima, Shimizu, and Ohbayashi plan to gain a foothold in the U.S. by securing contracts on Japanese direct investment in automotive and electronics manufacturing facilities, but meanwhile have co-ventured several medium-sized development projects in

regional cities. For example, second-ranked Kumagai-Gumi is a joint venture partner in over $1.2 billion of developments with the Zeckendorf Company in New York City, and Aoki Corporation activities range from residential development in Dallas to a hotel project for Japan Air Lines in Chicago's Riverfront Park. Hasegawa Komuten has invested in, developed, and sold smaller-scale condominium projects in Manhattan. Each strategy is a beginning step toward total involvement in the U.S. development business.

Joint venture relationships with contractors and developers are a common strategic means to become familiar with doing business in the United States. Japanese contractors understand that developers seek capital in exchange for market access and experience, but they do not regard their role in projects as limited to mere passive equity investment. They seek temporary, intensive apprenticeships in local regulations, relationships, and business realities in order to cope with complicated approval procedures, frequent litigation, and on-going negotiations over cost-plus contracts. Formerly, equity participations were debt disguised as equity or "dequity", cautions Jack Shaffer of Sonnenblick Goldman, who brought Kumagai-Gumi together with the Zeckendorf Company, "because (Japanese) contractors really didn't do anything other than contribute funds similar to a non-involved lender."(62) Now, however, cautions Cushman & Wakefield's Jim Montanari, construction companies are taking more active roles in

projects so that "developers who are looking for purely passive partners aren't necessarily going to find them."(63) "It took me five years to build land location expertise," says Katsu K. Kiuchi, Chief New York Officer at Hasegawa Komuten, a condominium builder, "to the point where we are now known and acknowledged in the local marketplace. We have the ability to serve as genuine general partners."(64) Joint venture agreements allow Japanese contractors to spread project risk to American partners. They instruct Japanese firms unaccustomed to the U.S. market on the development process, out of which competitive advantages can be first identified and subsequently implemented. Over an extended period, joint ventures help overcome subtle costs of entry barriers to an industry,(65) such as expense overruns and scheduling delays to which newcomers to the development business are particularly susceptible. Japanese contractors are utilizing joint ventures to transform the comparative advantage of financing ability into a long-term strategic weapon.

Comparative Industry Characteristics

Japanese construction activity overseas is limited to the top 20-30 ranked, very large, integrated construction-engineering firms. Although these firms are of a scale comparable to some of the principal U.S. construction giants, dependence on overseas contracts has historically

been less than for major U.S. firms:

Table 1: Comparison of U.S. & Japanese Construction Firms (1984)

Rank	Firm	Total Contracts (US$ MM)	Percent Overseas
U.S. FIRMS:			
1	Kellog Rust	10,855	80
2	Fluor	8,353	18
3	Bechtel	8,220	60
4	Parsons	7,514	40
5	Stearn	4,932	11
6	Brown & Root	3,884	33
JAPANESE FIRMS:			
1	Taisei	4,192	7
2	Kajima	4,034	7
3	Shimizu	3,998	9
4	Ohbayashi	3,317	5
5	Takenaka	2,972	7
6	Kumagai	2,660	21

Source: (66)

Japanese firms generate stable annual revenues from many small and medium-sized projects in Japan, whereas U.S. firms experience wide year-to-year fluctuations because of the variability of huge overseas projects. Also, Japanese firms are not differentiated from each other in terms of the integrated services they provide. U.S. construction majors, by comparison, tend to specialize in specific technical-industrial project capabilities. Only the largest firms of either country possess the qualified staff, experience, varied know-how, and financial strength to be able to venture into international markets. In Japan, executives and engineers with requisite language skills and international

training from prestigious universities are recruited almost exclusively for the largest firms. Smaller firms have neither an appetite for overseas activity nor an ability to absorb the costs of overcoming unfamiliar competitive entry barriers. For these reasons an understanding of Japanese construction companies operating in the United States is necessarily limited to a review of large scale, well-known firms.

The ability of construction firms to adapt and succeed in an unfamilar environment depends not only on how well they are able to transfer advantages, but also the skill with which they adjust to different competitive ground rules and work relations. The Japanese domestic construction industry is more stable and regulated than that of the U.S. Therefore, Japanese firms bring to the U.S. expectations formed from a different kind of competitive environment.

The Japanese domestic construction industry differs in notable respects from the U.S. construction industry. Although labor and material costs have risen steadily in the U.S. and Japanese construction industries, cost structure in domestic Japanese construction depends on a multi-layered subcontracting system. General contractors provide engineers to coordinate and manage subcontractors under a uniform lump-sum contract system. Japanese general contractors neither employ large staffs nor maintain a permanent force of workers as do some large U.S. contractors. U.S. contractors negotiate and bid with labor unions and open

shop workers when staffing a project, and maintain a payroll until project completion. Japanese contractors deal exclusively with selected major subcontracting firms with which they have long-term relationships. Although labor costs are similar for both large and small-scale contractors in the U.S., in Japan larger firms extract lower labor costs due to bargaining power over subcontractors with which they have steady relationships.

The standard bidding system used in private and public projects in Japan constitutes a form of restricted competition among similar sized firms. A small group of firms determined by size and relationship to the public or private client, will be selected to bid on projects. Open competitive bidding is uncommon in Japan. This system is particularly important on contracts awarded by the Ministry of Construction for domestic public-sector projects. The Ministry of Construction annually ranks and selects firms according to a "pointing system" based on size, capital sufficiency, total project volume (i.e. billings worldwide), research and development strength, staff expertise, and previous project experience. Eligibility for public sector contracts depends very much on position in ranking, so contractors must be particularly attentive to maintaining a consistent, year-to-year volume of work. An example of 1985 rankings is:

Table 2: Japanese Construction Company Ranking (1985)

Rating	Company	Points Awarded 1985	1984	Change
1	Shimizu Construction	466	462	4
2	Kumagai Gumi	462	466	-4
2	Toda Construction	462	462	0
2	Maeda Construction	462	462	0
5	Kajima	459	456	3
5	Ohbayashi	459	459	0

Source: (67)

Japanese construction firms are, therefore, unfamiliar with an open competitive bidding process and must adjust to the cyclical nature of the U.S. construction industry.

The Japanese system functions in the context of long-term professional and personal relationships which underscore the bidding process. Taken as a whole, this process ensures earnings stability by channeling small projects to small firms, medium projects to medium firms, and large projects to large firms. "Large general contractors have enjoyed this system," notes Makoto Taketoshi of the Ministry of Construction, "because it buffers them against cyclical risks of the business."(68) The competitive restrictions underlying the Japanese construction industry further emphasize the differing expectations and problems which contractors may encounter in the United States.

Japanese firms are integrated to provide a complete range of construction services and in-house construction management. Major firms which have recently entered the U.S. market are planning to offer services from initial site

selection to building maintenance and brokerage services. Japanese construction companies view this fully integrated capability as their key advantage for success in the U.S., where construction projects frequently bring together independent participants at separate stages of the feasibility -> planning -> design -> construction -> operation -> maintenance process. In this sense, Japanese construction firms view U.S. construction methods as poorly organized and inefficient, so much so that owners require construction managers to supervise all elements of a project from start to finish. Japanese construction executives are convinced that they can deliver U.S. projects at cost and on time, and as such differentiate their product by service quality. Yet, some Japanese admit that established traditions of the U.S. marketplace, such as union power, local regulations, and accepted ways of doing business could reduce or eliminate this quality advantage and, by extension, profits. Others doubt that much money can be made over the medium term in the U.S. marketplace. "Until Japanese construction companies have been able, over several years time, to learn the day-to-day aspects of U.S. business methods, there is no money to be made at this game,"(69) noted Tsuneyoshi Shimizu of the Kajima Corporation, who is an intern with a well-known Boston developer/broker.

The largest Japanese contractors devote significant resources to research and development. In doing so they follow a consistent pattern of process-oriented, long-term

planning characteristic of Japanese industry in general. The significance of research and development helps to explain the belief held by Japanese construction executives that process efficiency will translate to competitive advantage in the U.S. In The Japanese Industrial System, McMillan observes that for research and development activities:

> The emphasis is on the long term, not the short term. The emphasis is on learning and know-how, or process, rather than end product. The rationale is to develop sunrise sectors...Technological policies and practices go hand in hand with many micro and macro strategies at the level of the firm, industry, and society. For example, Japan's R & D policies help explain the strong emphasis and skills at process development and enviable record in quality control.(70)

Research and development of construction technology and intelligent structures is a key long-term goal of Japanese contractors operating in the U.S. They view the scant attention paid by U.S. contractors to R & D as a critical oversight which will work to their competitive advantage. "We have techniques," says Shinzo Matsumiya, General Manager of international planning at Shimizu Construction, "for land reclamation, high-tech ventures, and anti-seismic buildings which keep us ahead ... for the moment." (71) As an example, the annual report of the Shimizu Construction Company, ranked first by the Ministry of Construction in 1985, states that "On the basis of abundant experience and results, Shimizu has risen above being a systems organizer and taken a new step forward as an 'engineering constructor'." (72) Japanese contractors view themselves as technology leaders,

and believe that this advantage will help them to become winners in the U.S. construction business.

Family and financial institution ownership characterize most major Japanese contruction firms. Some firms, such as number-five ranked Kajima Corporation, are controlled and operated by founding family groups. Others, such as number-two ranked Kumagai-Gumi and Takanaka Komuten, are private companies which have not issued public shares. Large Japanese banks are principal shareholders of these same firms and are, by extension, principal sources of borrowing. A page from the 1985 Kajima Corporation Annual Report illustrates these relationships:

Table 3: Principal Shareholders of Kajima Corporation (1985)

Company Stock: (at 11/30/85) Name	% Shares
The Sumitomo Bank, Ltd.	4.7
Shoichi Kajima	3.4
The Kyowa Bank, Ltd.	3.4
The Mitsui Bank, Ltd.	3.3
The Sumitomo Trust and Banking Co., Ltd.	3.3
The Mitsui Trust and Banking Co., Ltd.	2.4
Sumitomo Life Insurance Company	2.2
Nippon Life Insurance Co.	2.0

Principal Borrowing Sources:

The Sumitomo Bank, Ltd.
The Kyowa Bank, Ltd.
The Mitsui Bank, Ltd.
The Mitsui Trust and Banking Co., Ltd.
The Sumitomo Trust and Banking Co., Ltd.

Source: (73)

The closely-held nature of these firms and their

interlocking relationships with banks provide major Japanese contractors with a wide range of financing sources and techniques. Japanese contractors' entry strategies for the U.S. market will be facilitated by significant financial strength. Although U.S. lenders may frequently reserve the right of approval over the choice of a project's general contractor, the relationship of financing source and builder is usually at arms-length. Furthermore, it is rather uncommon for a U.S. general contractor to arrange financing for a developer. In Japan, however, project financing is often contingent upon use of a designated contractor. Moreover, Japanese contractors are themselves developing sophisticated capital-market operations. For example, number-one ranked Shimizu Construction Company, in which financial giant Dai-ichi Kangyo Bank is a major shareholder, organized a financial subsidiary in Amsterdam in 1979 to raise funding for international projects. "Our traditional role in projects is expanding quite rapidly," states Naoshi Oinuma, Vice President of Shimizu America Corporation. "We are becoming fiduciaries of a sort, bringing Japanese investors to U.S. development projects."(74) "American developers expect low-cost financing in order for us to become involved in a project," notes Mikio Ishikawa, Manager of International Planning at Shimizu headquarters in Tokyo, "and we can raise money, our own money, at below-market rates in Euromarkets. However," he adds, "where we take risks, currency risks above all, we will want to become very

involved."(75)

The ability to deliver financing to projects endows Japanese contractors with a potent competitive advantage for winning contracts in the U.S. market. A recent article in Institutional Investor notes that "Japanese equity investors act as a magnet for other Japanese money. Such Japanese banks as Bank of Tokyo, Fuji Bank and Sumitomo Bank are making construction and bridge loans to their Japanese colleagues, and some have also been involved more directly, making loans to American developers."(76) U.S. developers will search for capital and find construction contracts linked to loans. Many future projects financed by Japanese banks will be built by Japanese construction firms. For this reason, clarifies Shinzo Matsumiya, General Manager of International Planning at Shimizu Construction Co., "we are studying your development process from beginning to end." (77)

An understanding of these facets of the Japanese construction industry suggests a perspective from which to evaluate key strengths and weaknesses of major firms' strategies in the U.S. market. Some aspects of the Japanese construction industry, such as cost structure, restricted competition, long-term relationships, and fully integrated capability, are not advantages transferable to the U.S., where ad hoc subcontracting, open bidding, deal-by-deal partnerships, and segmented business units are common methods of operation. Other characteristics, such as

intensive research and development efforts of major firms, should yield benefits in the long term, especially in areas such as quality control and intelligent-building technolgy.

The outstanding advantage which major Japanese construction companies bring to the United States is financial strength. Most are capable of funding projects themselves, at attractive rates, through a variety of instruments in national and international markets. The largest firms operate in-house money market trading operations. Relationships with financial institutions, some of which are major construction company shareholders, is an additional source of capital. "Developers have no cash," observes Hasegawa Komuten's Kiuchi, "and we fill the bill."(78)

Construction Industry Background

Governmental agencies have exerted considerable influence over Japanese economic development since the period immediately preceding World War II. The Ministries of International Trade and Industry (MITI) and Finance (MOF) set policy for industrial development, which moved from textile manufacturing to heavy industry during the build-up of munitions industries under a series of military governments prior to 1945. Industry was destroyed at the end of the war, and post-war administrations understood that heavy, export-oriented manufacturing was essential to the

survival of a resource-poor nation. The task of reconstructing plants, ports, transportation, and homes fell squarely on the shoulders of the construction industry.

The construction industry was viewed by government, most Japanese people, and firms as an essentially domestic business, a supporter of the national priority of rapid industrialization. The market for Japanese construction firms was wholly domestic, and was deep enough to provide prosperity for the industry until the first energy crisis of 1973. In fact, from 1960 to 1973 construction investment grew 20% annually, divided roughly between 40% public- and 60% private-sector investment; overseas construction activity amounted to less than .25% of total industry revenues.(79)

By 1980 the Japanese domestic construction market had become second only in size to the U.S. However, it accounted for slightly more than 20% of Japanese GNP, fully double the comparable impact of U.S. construction activity on its own domestic market. Moreover, industries such as steel, glass, wood, and mining sold half of production to the construction industry, which in 1984 employed almost 9% of the total domestic workforce.

The construction industry was harshly affected by the oil shock of 1973. Year-to-year construction industry growth had often outpaced a phenomenal 10% annual increase in GNP which lasted almost 20 years. Costlier oil acted to reduce private-sector investment, curtail public spending, make

inputs for construction materials more expensive, and provoke credit restrictions by the Bank of Japan. Construction investment in Japan decreased in 1974 for the first time since World War II. Following a brief recovery stimulated by government contracts, the construction industry was jolted by a second oil crisis in 1980. Since then both public and private investment have shifted downward, and the value of real and nominal construction has decreased. Furthermore, the character of Japanese industry began shifting to accomodate new energy realities, moving away from heavy industries such as steel, shipbuilding, and chemicals to high-tech, less capital-intensive businesses. These companies chose to invest in R & D rather than in construction of plants as had been the practice in the declining industries. Manufacturing businesses began to make direct investments overseas in order to maintain cost competitiveness and allay protectionist sentiments of foreign governments. Japan itself, much like the United States, was moving toward a service-oriented economy in which major capital investment declined. Decreasing returns on investment property and scarcity of available urban land for new development projects reduced the number of large-scale domestic construction projects. These combined factors lessened opportunities for sustained construction activity and pushed Japanese contractors to search for new markets overseas.

Movement to Offshore Markets

Large Japanese construction firms began to focus on foreign activities in the late 70s and early 80s, primarily in Southeast Asia and the Middle East -- project volumes which accounted for 84% of total Japanese overseas activity by 1980. As subsequent declines in oil prices curtailed development plans and construction activity in oil-producing states, international contractors invaded the Southeast Asian market, which had been the major arena for Japanese international construction activity. Japanese contractors shifted an important portion of work to the United States, which, by 1984 became their largest single market for overseas activity.

Table 4: Geographical Spread of Japanese Contractors

	1980	1981	1982	1983	1984
SE Asia	45%	61%	76%	67%	54%
Middle East	39%	27%	13%	16%	8%
United States	3%	3%	4%	8%	22%
Australia	1%	1%	1%	6%	12%
Other	12%	8%	6%	3%	4%
TOTAL	100%	100%	100%	100%	100%

Source:(80)

The U.S. construction market had a undeniable allure for Japanese contractors. First, the U.S. construction market is three times larger than the entire international market shared by some 250 multinational contracting companies.(81) Second, the American market is characterized by established participants: clients, design

firms, contractors, sub-contractors, suppliers, and engineers. Third, project expense can be reasonably predicted due to stable costs of labor and materials, and transportation and communications systems allow for relative certainty in planning and scheduling operations. Fourth, political stability assures against abrupt, unforeseen changes in government policy, exchange controls, capital requirements and long-term commitments. Fifth, the great triumphs of Japanese automotive, electronic, and steel exports in the vast U.S. market, although indirectly related to construction, was assuredly not lost on major contractors. Comparing experience in developing country environments to that of U.S., Ryuichi Komori, Overseas Business Manager of Hasegawa Komuten in Tokyo, Japan's largest builder of residential condominiums, stated that in some countries negotiations can be virtually impossible. In the U.S., he counters, "We can negotiate. We can understand one another very quickly."(82)

Recent Experience: Project Ventures

Japanese construction companies are following differing strategies in geographically diverse markets throughout the U.S. Some firms are taking on many differing projects while others focus on a particular market segment and area. For example, Kitano Corporation has targeted residential subdivisions in suburban Maryland, while

Hasegawa has keyed on the New York condominium market. Shimizu has co-ventured a Phoenix office park and invested with Japan Air Lines in New York's Essex House while constructing Toyota's Toronto assembly facility. Kajima Corporation is involved in two Southern California residental projects, mixed-use joint ventures in Minneapolis, office parks in Dallas and Long Beach, California, and is building Mitsubishi and Mazda auto plants in Chicago and Detroit.

Plant construction serves as a transitional step into the U.S. market, and allows contractors to test service capability, gain credibility, and profit from large Japanese contracts. "Kajima has good quality and, after the big projects have succeeded, we'll have credibility," predicted Fujio Suzuki, Assistant to the President of Kajima Corporation. "Our plan is to go through stages: Stage one is general construction, like Turner; Stage two is engineering, like Bechtel; and Stage three is construction and development, like Tishman."(83) As an example, Shimizu Construction has organized four U.S. subsidiaries to implement separate business plans: Shimizu America Corporation for construction, Shimizu Development Inc., for property management and hotel operations, Shimizu Land Corporation for real estate development, and Shimizu Equities Inc., for high-tech building information, money market operations, and venture capital investment. Porter notes in Competitive Advantage that diversified firms

require horizontal strategy to face a dual set of issues in corporate planning: first, the selection of industries in which to compete; second, the coordination of the chosen business strategies. Japanese construction companies are implementing horizontal strategies to leverage the advantages of vertical integration in the fragmented U.S. construction market:

> Horizontal strategy is a coordinated set of goals and policies across distinct but interrelated business units. Horizontal strategy is a concept of group, sector, and corporate strategy based on competitive advantage, not on financial considerations...It encompasses both existing business units and the selection of new industries to enter based on interrelationships with existing units. (84)

Japanese construction firms do not view competition across individual businesses, but rather seek to establish competitive advantage from the mutually reinforcing activities of different businesses. Bringing Japanese construction expertise to new businesses, however, such as U.S. real esate development, involves risk and has thus far yielded uneven results. In one successful example, Shimizu co-ventured the development of an Arizona office park with partners Mitsui & Co., Ltd., a leading Japanese trading company, and Westcor, a local developer. Mitsui provided market knowledge, introductions, and equity along with Shimizu Land Corp., which established an office in Phoenix to monitor day-to-day progress. This project has led to a follow-up joint venture with the same partners for hotel development in Tempe, Arizona. However, while Kajima

Corporation successfully co-ventured with Dai-Ichi Life and developer Bob Boisclair on Minneapolis' first high-rise condominium, Lake Point Tower, it stumbled on a follow-up project, River Place, a downtown condominium which failed to sell. Both Shimizu and Kajima view these results as learning experiences which rework and redefine strategic plans.

Case Study: Hasegawa Komuten Co., Ltd.

Hasegawa Komuten (Haseko) is a leading Tokyo-based developer of residential high-rise condominiums; it has diversified operations in office buildings, land brokerage, property management, condominium sales, structural refinishing, and commercial rentals. It is a closely-held, family-operated concern among whose principal shareholders figure the Mitsui Trust & Banking Co., Asahi Mutual Life Insurance Co., The Daiwa Bank Ltd., and the Yasuda Trust & Banking Co. Although net sales exceeded $700 million in 1985, it is less than one-fifth the size of such giants as Shimizu or Kajima. Haseko has built more than 160,000 condominium units in Japan and invests in R & D, aiming to create an "integrated condominium apartment production system," according to their 1985 annual report. Haseko began overseas activity in Hawaii in 1973 as a high-rise condominium, hotel, and office building developer. It extended U.S. operations to California and New York in 1982 and has pursued a cautious and deliberate strategy of

learning the U.S. development business.

In Japan, Haseko is implementing a vertically integrated shift away from dependence on the construction business to increased reliance on broad real estate development and brokerage activities. Its main domestic business segment, residential condominium development and sales, is vulnerable to macroeconomic conditions which influence government policy in housing construction. In 1985, for the first time in company history, a greater portion of revenues resulted from real estate sales than from construction activities. Overbuilding in the Japanese condominium market has slowed new construction, and Haseko is responding with horizontal strategies which include Tokyo land speculation, luxury condominium development, and six office building developments for financial institution clients. Land brokerage is an important new business in which Haseko sells, transacts, analyzes, and constructs residential properties for client investors. It invests in information systems which provide brokerage and property management data to clients in domestic branch offices, and is developing features such as computer-assisted design presentations of investment opportunities. The company views itself as a leader in residential project technolgy, and desires to implement a similar strategy in foreign markets.

Haseko's objective in the U.S. is to provide fully integrated investment, feasibility, transaction, and construction services to Japanese and American clients.

It started with a strategy of gaining experience in condominium and hotel construction in Hawaii, where Japanese investors represent a strong investment market. The company established offices in Los Angeles and New York in 1982 to expand U.S. activities and reduce exposure to the cyclical and overbuilt Hawaiian market. In Los Angeles, Haseko Townhomes, Inc. is building low-rise, townhouse condominiums in the suburb of Pasadena. These units, modeled after closely studied Colorado resort developments, reflect some of the technology-intensive marketing themes which characterize Haseko's real estate sales approach in Japan. The units are designed with multiple-option features for individual buyer modification and carry a 10-year structural warranty as a result of advanced anti-seismic construction techniques. Earthquake resistent residential structures, in which Haseko has invested R & D and developed proprietary know-how, are a unique and desirable feature for the Southern California home market. In New York, Haseko has co-ventured condominium projects with a Japanese trading company and, most recently, a local developer, W.J. Haines. This New York experience illustrates a learning progression of strategy and objectives similar to those experienced by other Japanese contractors in the U.S. real estate market.

Haseko's first step in the Manhattan market was a series of purchases of 46 apartments in recently completed East-Side condominiums as a means to study buyer/renter preferences. The successful sale and rental of all units

within a year prepared Chief Officer Katsu K. Kiuchi for active development of a similar East Side location. "Kiuchi learned quickly by getting involved in very basic aspects of the New York real estate business," says Kunio Ohsawa, who spent eight years in Manhattan with Sumitomo Corporation and managed to observe Haseko's strategy. "He learned timing, when to get in and out of condominium markets, and also capitalized on a key strength of the Hasegawa organization: lean staff and quick decison-making."(85)

Next, Haseko formed a "124 East 79th Partnership" with Nissho Iwai, Japan's sixth largest trading company, to purchase a suitable site for development of a high-rise condominium project. After an eight-month special-permit approval process, construction began on the 22-story, 66-unit Belgravia condominiums in March, 1984. Architect Peter Samton of Gruzen, Samton, Steinglass Architects recalls that Haseko executives were committed to the idea of 30 stories, smaller units, lower prices, and maximum density, but "listened to our advice that 22 stories was optimum and thereby learned a tremendous amount about neighborhood goodwill and approvals."(86) Logistics on the tiny 6743 square foot site were difficult and time consuming. Construction management was handled by Tishman Construction because, Kiuchi observed, "major contractors are able provide working drawings quickly and sales agents can become involved from the outset. Also, there is no worry about materials delivery or completion bonds."(87)

Nevertheless, there were significant cost overruns and scheduling fell five months behind because delivery of high quality materials was delayed, window frames had to be rejected, and interior work redone. Furthermore, almost one year after completion of the building in November, 1985, 13 of the 66 units remain unsold. Haseko learned about U.S. methods of design, construction management, and marketing. For example, when costs exceeded budget, Haseko assumed that prices could likewise be raised on units. However, when the higher-priced condominiums did not sell, "they learned about the prices which buyers in a soft market will pay," observed Jim Stuart, President of Gilbert, Charles, Baylen real estate brokers.(88)

In October 1984, Haseko and Nissho Iwai formed a subsequent joint venture "584 Anderson Partnership" to develop the Cliff Heights condominium project in Cliffside Park, New Jersey. The five-story, 24-unit project, was brokered to Haseko by a Japanese/American who introduced the local developer/land owner. The project was completed on schedule in October, 1985 and sold out within 24 hours. The units were aimed at investors rather than users, and many were purchased by Far Eastern expatriate executives who live in the area. The example of this project taught Haseko that user and investor preferences are sometimes very different, according to Jim Stuart, whose firm was not involved in Cliff Heights. "Cliff Heights was an effective lesson in the smaller condominium market," says analyst Makoto Kaimasu,

who follows the Japanese construction industry for the Nomura Research Institute in Tokyo. "It is a small, simple project which taught a lesson in real estate marketing. Haseko's interest is to become a sales company, similar to its strategy in Tokyo."(89) "Timing was excellent," notes Ryoitsu Mukai of Nissho Iwai America, "and it was the type of project with which we were more familar than the Belgravia. We didn't use consultants nor even have enough time to raise the prices!"(90)

Currently, Haseko has joined in "225 West 83rd Associates" as a 30% limited partner with Manhattan developer W.J. Haines on the 306-unit Bromley condominiums on Manhattan's Upper West Side. Nissho Iwai was invited to join the project, but declined as many of the Belgravia's units remain unsold. As an example of the financial flexibility which Japanese contractors bring to U.S. development projects, Haseko both contributed $10 million cash and guaranteed a similar sum via a standby letter of credit from a Japanese bank, the same one which had introduced them to the W.J. Haines. The developer complied with project completion guarantees and a nominal amount of collateral. Introductions between the developer and the equity partner were arranged by the local subsidiary of a Japanese bank. "We understand why we were offered this project," reveals Kiuchi, "but this is the only way for us to get into this business."(91) The 400,089-square-foot project is targeted for a different, more moderate-income,

non-investor buyer than was the upper-end Belgravia, and is being aggressively pre-sold a year before expected completion date by Market Directors, Inc. The new market segment which Haseko hopes to understand lies somewhere in between the Belgravia and Cliff Heights. The marketing firm "has a different philosophy, of extensive pre-selling, which by experience seems sensible to us,"(92) says Hiro Higashi, who served as Haseko's project manager on the Belgravia as well as the present site.

These New York projects suggest that Haseko is proceeding to learn the subtle distinctions of New York condominium markets as groundwork for eventual full-product capability. Such a strategy would be an extension of its Japanese domestic experience and commitment to full-service, high-tech residential development. It believes it can establish a niche for full-service capability because it has found no comparable service in New York, where buyers confront a confusing array of brokers, bankers, and building managers. The scope of its U.S. projects has purposefully ranged from Hawaiian hotels to New Jersey townhouses, and from luxury Manhattan condominiums to moderate California rental units. Haseko contributes capital in return for project experience and marketing know-how, and is taking the initial steps toward implementing a horizontal strategy similar in scope to those of other Japanese construction firms. These strategies aim to create market conditions in which real estate development businesses can thrive on

integrated service transactions rather than traditional build-and-sell relationships.

Conclusions

The United States will be the principal arena for overseas activities of major Japanese contractors in the future. The U.S. market presents a unique range of opportunities for companies to implement full-project service businesses in all categories of development activity. Japanese construction companies have adopted ambitious horizontal strategies aimed at penetrating the real estate development business, because they do not believe that construction alone can overcome entry barriers nor become a separate, profitable business. It will, however, be employed to drive a number of peripheral, new businesses such as land development, planning, construction management services, building technology, and property management. Japanese contractors are convinced that integrated project services will bring comparative advantage and help to differentiate them from many highly fragmented real estate development competitors. It is their key business objective.

Strong incentives exist for Japanese general contractors to engage in overseas activities. Scarcity of available land, shrinking property investment returns, and construction industry overcapacity in Japan have

incrementally pushed contractors to international projects. Importantly, contract awards for public sector projects depend, in part, on steady construction volume which can be supplemented by strong overseas billings. Overseas projects boost rankings of top companies which follow each other's activities closely and are especially sensitive to changes in position. For example, although international contracts have historically been a small portion of a large contractor's billings (less than 3%), Kumagai-Gumi set a precedent in 1985 by achieving number-one ranking on the basis of strong (21% of total) overseas activity. There is an historic gearing-up in the industry for increased foreign work.

The Japanese government has historically assisted key industrial expansion into foreign markets, and will promote overseas construction company success. Further, contractors are relatively free of cumbersome MOF restrictions such as those placed on financial institution foreign investment. The construction industry is among Japan's most important contributors to GNP, and employs almost 10% of the stable workforce.

Direct foreign investment of Japanese manufacturers in U.S. facilities will provide a transitional source of revenue for contractors over the immediate future, and will school organizations in land use planning, regulatory constraints, political negotiations, supplier relationships, and labor disputes. Japanese banks and multinational trading

companies will provide financial backing and market knowledge to construction companies. Financing ability provides access to the development process, which in turn permits Japanese construction companies to define goals, structure capabilities, and position resources.

Many domestic characteristics of the Japanese construction industry, such as cost structure and competitive relationships, cannot be transferred to the U.S. market. Contractors are aware that favorable exchange rates and excess liquidity provide an immediate boost for long-range objectives, but are not content to invest in a passive manner.

Joint ventures with established developers are a strategic alternative currently used by most Japanese contractors to begin business in the U.S. Active project involvement allows contractors to overcome entry barriers and learn the processes of competition in the development business. It provides invaluable perspective from which Japanese construction companies can adjust horizontal strategies. Joint ventures form relationships and share responsibilities, and set a context in which Japanese contractors can overcome difficult cultural obstacles.

It is uncertain whether Japanese construction firms can achieve their ambitious objectives for the U.S. real estate development business. Industries open to competition are usually distinguished by either high-growth environments or scant proprietary information. The legendary entrance of

Japanese automakers and television producers to the U.S. market involved the export of domestically developed Japanese competencies, such as lower costs, durability, innovation, and quality. The domestic U.S. construction and development industries present an entirely differing scenario, in which Japanese entrants must make substantial adjustments to the local marketplace. We believe that many of these adjustments will be made by means of intense joint venture activity on many projects throughout the U.S. Successful projects increasingly depend on, and benefit from, a coordinated approach of large, fully integrated development companies. Japanese construction companies have historically prospered along these lines, both at home and abroad. They will commit substantial resources to create a demand for full service U.S. real estate services in the future.

Chapter V:

Real Estate Development Companies & Trading Companies

"It's a wilderness out there...
if you cannot find a buyer,
you're lost."
N. Ide
Property and Service
Business Group
Mitsui & Co., Ltd.

"We have been involved in Real
Estate for 20 years, we think we
understand this business."
Kenichi Tsuboi
Property and Service
Business Group
Mitsui & Co., Ltd.

Overview

Japanese real estate development companies began operating in California, Arizona and Texas in the early 1970s as land and residential subdivision developers. Although some are investors, their primary focus is sales development of land, homes, commercial and industrial property. These companies generate U.S. development investment opportunities for their own account, for Japanese institutional and individual capital sources, and provide joint venture funding for domestic U.S. real estate developers. Leading firms such as Mitsui Fudosan, Mitsubishi Estate and Sumitomo Realty are associated with huge banking/trading concerns of the same names, but operate independently of group-wide corporate management.

By comparison, trading companies such as Mitsui & Co., Mitsubishi and Sumitomo form the hub of massive multinational corporations which are not oriented to real estate, but are intermediaries of goods and services in international markets. They have traditionally managed the overseas activities of virtually all Japanese manufacturers, investors and financial institutions. Japanese investment in the U.S., in securities, industrial plants and real estate, is expected to double in 1986 and trading companies want to play a role in the process. Although they may be somewhat unfamiliar with individual activities, such as real estate and financial services, Professor Michael Yoshino observes in The Invisible Link that trading companies adjust to new opportunities in order to survive as intermediaries:

> . . . The basic strategy of a sogo shosha (trading company) must be to build series of relationships with major as well as minor actors. . . and always be searching for new business opportunities to add to its existing array of services to specific clients. It also means that the sogo shosha must constantly strive to identify the emerging points of greatest leverage over a particular product system and then undertake activities, such as research or investment, that give them influence or control over those points.(emphasis added)(93)

Trading company interest in U.S. real estate is based upon adopting an intermediary role between Japanese and U.S. real estate participants. They want to find, analyze, finance, manage and market all types of U.S. real estate for every kind of Japanese client. Trading companies view real estate as "an emerging point of leverage" among a number of new

intermediary activities which result from increased Japanese investment in the U.S.

Real estate development companies need outlets for the investment opportunities which they create. Trading companies require real estate product for their vast network of Japanese investors. Each performs a complementary role in matching Japanese capital with U.S. real estate opportunity.

Real estate development companies possess an important comparative advantage over other U.S.-based Japanese real estate companies because of their links to major multinational financial/trading conglomerates such as Mitsubishi, Mitsui and Sumitomo, as well as the fact that their activities are not severely restricted by Japanese MOF authorities. Over time they have accumulated development experience and U.S. real estate know-how which in many ways is superior to that of other prominent Japanese participants in U.S. real estate markets. Real estate development companies have in-house expertise for varied activities such as residential development, income-producing joint ventures and project consulting. Moreover, while real estate companies are engaged in an effort to build up each of these businesses to profitable self-sufficiency, they likewise have a fiduciary-type objective to invest, develop, and sell for others. They intend to provide diverse development and investment alternatives for many types of Japanese client institutions and individuals. Some will

attempt to provide these services directly to Japanese clients, whereas the larger firms will use affiliated trading companies to intermediate the investor developer process.

Background History

The U.S. real estate activity of both development and trading companies occurs within the context of an evolving pattern of Japanese direct foreign investment. Prior to 1972 virtually all forms of overseas investment were restricted by the Ministry of Finance. Foreign investment was limited to raw materials, natural resources, and small scale manufacturing in developing countries targeted for Japanese government bilateral aid. Japanese overseas activity differed historically from that of western countries such as the U.S., Britain, West Germany and France because penetration of foreign markets was promoted by sophisticated export products rather than direct overseas investment in plant and equipment.

Foreign investment strategies were led by major financial/trading firms, termed "Zaibatsu" (zai=business, batsu=group), which managed Japan's traditional supply dependence overseas and either controlled or coordinated every aspect of foreign involvement by Japanese client companies. Author Edwin Reischauer notes in The Japanese that:

> Japan entered its modern period with a complex, even if pre-industrial, economy. There was a unified nationwide market, banking institutions were well developed, large family enterprises like Mitsui operated in several regions and diverse fields, such as banking and dry goods...The distinctive new Japanese economic institution that first caught the attention of the outside world was the zaibatsu system, as this had developed by the 1920s. The zaibatsu were the great commercial and industrial combines, which embraced a remarkably large proportion of the upper level of the economy...The four greatest zaibatsu combines were Mitsui, Mitsubishi, Sumitomo, and Yasuda. . . (which) spread widely across the fields of banking, manufacturing, mining, shipping, and foreign marketing. Each centered around its own bank, which financed the component parts. Another key institution was the general trading company (sogo shosha), which started in foreign trade...(94)

Real estate development companies and trading companies share a common zaibatsu heritage. The development companies were originally formed to administer the domestic Japanese real estate holdings of the zaibatsu families and, during the 1930s, became Japan's forerunner of modern property management and brokerage firms. Nowadays firms such as Mitsui Real Estate and Mitsubishi Estate are among the largest property owners, managers and brokers in Japan; as of March 1985, Mitsubishi Estate, owner of 24.6 million square feet, was by far Japan's largest property owner, while Mitsui (13.7 million square feet) was the third largest.(95) The trading companies continue to act as the centerpieces of pre-World War II conglomerate umbrellas described by Yoshino as follows:

> A holding company extended over a network of subsidiaries and affiliates, through linkages of intercorporate stockholdings, interlocking directorates, management help, personnel transfers, and bank credit. Operating decisions for the subsidiaries and affiliates were made by

American occupation forces dissolved the formal holding company ties in 1946, splitting off the real estate development and trading companies from ownership by zaibatsu group banks. Individual companies were incorporated under separate charters with independent managements. Today former zaibatsu banks, trading companies and real estate development companies, many of which share the same corporate names, operate in close informal cooperation with each other through interlocking corporate ownership patterns. Real estate development companies provide U.S. development projects for trading companies to market in Japan, either directly to clients or via small investor commingled funds. Trading companies have extensive, long-established business contacts in the U.S. and can introduce development companies to developers and entrepreneurs. Zaibatsu banks such as Mitsubishi, Sumitomo and Fuji (formerly Yasuda zaibatsu) are among the largest in the world and stand behind the efforts of both trading and real estate development companies. These long-standing inter-company (but intra-zaibatsu) linkages can be potent forces in connecting Japanese capital to real estate opportunity.

Real Estate Development Companies

Real estate development companies began operations in Hawaii and California prior to the arrival of most other Japanese real estate investors and contractors now active in

the U.S. marketplace. Establishment of a U.S. development business offered an "emerging point of leverage" in U.S.-based real estate businesses for bank, trading and property management arms of the former zaibatsu groups. The group idea was to strategically position these companies over an extended period in U.S. real estate development businesses so that they would be able to generate development opportunities in geographically diverse markets for Japanese institutional and individual investors. Establishing a foothold in this business was perceived as a long-term effort because Japanese executives and investors share a common perception that the U.S. development business is quite risky. "Although experience is helpful in consistently choosing above-average investment properties, it is absolutely essential to be able to cope with the high risk of on-going development," observed Toshio Koga, Manager of Planning and Development for Toyo Real Estate Co., the development arm of Sanwa Bank.(97) Trading companies could complement and coordinate, rather than compete against, the efforts of these Japanese real estate development companies in the U.S.

Trading Companies

The process of bringing Japanese capital together with U.S. real estate investment will be managed by zaibatsu-related trading companies, because they can provide access

to medium-to-large scale Japanese investors and channel funds to real estate development companies in the U.S. It is an intermediary service similar to the one they have traditionally offered in the now-declining export sector.

Different trading companies will accomplish this objective, however, through distinct approaches to the U.S. real estate development and investment process. Yet, although a common strategy for the development business does not exist even among the largest trading firms, some similar patterns of trading company real estate objectives are beginning to emerge. A few large trading companies, such as Mitsui and Sumitomo, want to concentrate on brokerage rather than direct investment and partnership involvement in development projects. Some of these trading firms invested in Californian and Hawaiian income-producing properties in the early 1970s. They acknowledge, however, that many ventures have not been profitable. These trading firms made initial approaches to the marketplace without a clear idea of objectives or eventual goals. "The attitude was 'OK, let's buy a property and study it'," admits Kunio Ohsawa of Sumitomo Corporation.(98) Today, most are turning attention to finding, rather than investing in existing properties and development projects. Although they will co-venture on U.S. projects with Japanese client firms which are new to the U.S. market, they intend for this direct role to be a temporary means for establishing intermediary relationships in the U.S. real estate business.

Alternatively, other trading companies such as C. Itoh & Co. pursue co-venture development projects for their own account. In 1985, for example, C. Itoh & Co. increased the value of its U.S. development projects from $50 million to $375 million. "We are unique because we take leadership roles on our projects," stresses Hiroshi Abe, General Manager of Overseas Construction and Contracting at C.Itoh & Co. in Tokyo. "If a developer has a good project we must be able to analyze it ourselves rather than depend on a bank or consultant, because Japanese clients look to us for guidance."(99)

Both of these approaches underlie, albeit through differing means, the basic intermediary role of the trading companies. It is a role with which trading companies are comfortable and confident. "I joined this company 27 years ago," observed N. Ide of Mitsui & Co., "when cement, sugar, and rubber were key businesses; later, textiles dominated, but they have also dropped away, . . . now, real estate. There is no difference, except its immobility."(100)

Inter-Company and Intra-Zaibatsu Relations

Relations between real estate development companies and trading firms may lead to vertically-integrated development activities by zaibatsu-group companies. Since World War II the major businesses of the zaibatsu holding companies have operated with what might best be termed "coordinated autonomy." There is potential for group-related businesses

to impact on U.S. real estate projects at different stages of the development process. For example, whereas Mitsubishi Estate (the development company) may not have a strict reporting relationship to the board of directors of the Mitsubishi Bank or the Mitsubishi Trading Company, each real estate project it undertakes in the U.S. is nonetheless likely to be affected in some fashion by other businesses in the Mitsubishi Group. A Portland, Oregon office tower project in which Mitsubishi Estate invested was partially funded by a group-related insurance company, Meiji Mutual Life. The trading company marketed steel and elevators for the building to the U.S. contractor, and portions of the project may eventually be sold off as securities to the Mitsubishi Banks' client base. Marketing of the securities will be accomplished by the financial services division of the Mitsubishi Bank.

There are many other aspects in which group-related companies can contribute to a project. For example, Mitsui & Co. Finance Inc., (trading company affiliate) was recently formed to provide "financial services to Mitsui-related companies in the U.S. and Canada, and for Japanese companies making direct investments in these countries." (101) These services will include residential mortgage financing, general construction loans, and intelligent-building construction financing. Additionally, Mitsui U.S.A. (trading company subsidiary) has recently formed a venture capital fund with U.S. investors, Japanese banks, and the Shimizu

America Corporation for the purpose of technology application to a variety of projects, among them intelligent buildings.

Two brief overviews of zaibatsu group companies engaged in U.S. real estate-related businesses, and the relation between the development and trading companies operating in the U.S., suggest future patterns of group interrelations in the U.S. real estate market:

a) Mitsui Real Estate Development Co., Ltd. (MRED) is the real estate development operation arm of the Mitsui Group. It is just one of many Mitsui-group companies engaged in real estate activities, as the following list demonstrates:

Company	Business (principal and otherwise)
Mitsui Matsushima Co., Ltd.	Real Estate Services
Mitsui Construction Co., Ltd.	Construction/Engineering
Mitsui Harbour & Urban Construction,Ltd.	Land development; construction materials
Mitsui Home Co., Ltd.	Land sales; design; construction, and sale of housing
Mitsui Lumber Co., Ltd.	Building materials
Mitsui Road Co., Ltd.	Civil Engineering
Mitsui Real Estate Sales Co., Ltd.	Commercial/Residential Brokerage
Mitsui Real Estate Development Co., Ltd.	Real Estate Development

Mitsui Kanko Development Co., Ltd.	Commercial/Residential Hotel Management
Sunland Co., Ltd.	Recreational Development and Management

Source: (102)

The trading company began U.S. real estate activities as a strict investor, but has shifted to co-venturing development projects as a transitional step in the direction of providing intermediary real estate services such as brokerage. For example, Mitsui & Co., Ltd. (trading firm) initially entered into Southern California development projects in the early 1970s. After mixed financial performance on some projects, such as the Portman-designed Bonaventure Hotel in Los Angeles, the development business was largely entrusted to MRED's U.S. subsidiary, Mitsui Fudosan. In addition to development activities, the development company later expanded into investments. It owns two prominent Manhattan office towers, as well as the Crocker Bank Center and adjacent land in Los Angeles.

Mitsui & Co.(trading company) is currently involved in high-tech communications ventures with the Enhanced Network Services group of AT&T, a part of which operates out of the AT&T Center, a Los Angeles office building recently purchased by MRED and the Dai-ichi Life Insurance Company. MRED (development company) generally assumes a joint venture partnership position in these purchases, but is brought to the joint venture by Mitsui & Co.(trading company). However,

occasionally Mitsui & Co. (trading company) will be obligated to ease U.S. market entry for a Japanese client via direct joint venture participation, which provides the client with a degree of comfort in the unfamiliar U.S. market environment. For example, Mitsui & Co. has recently arranged and invested in a joint venture with Shimizu Construction Company and a local developer in a Phoenix, Arizona office park and hotel/recreational facility. Shimizu had desired to become involved in the fast-growing Southwest area, and Mitsui & Co. (trading company), which maintains offices in Dallas/Fort worth, El Paso, Phoenix, and Los Angeles was able to prospect on a Sunbelt area-wide basis to find an appropriate match of project with developer and investor.

b) The Sumitomo Realty & Development Company (SRDC) is the real estate development arm of the Sumitomo Group which began U.S. operations in 1973 with a Hawaiian hotel project. It then moved on to Southern California residential subdivision development and sales, before further diversifying into commercial properties in 1983. Only after ten years of development projects did it invest in existing U.S. property, but less for strategic than financial reasons. It purchased a New York City office building in 1985, according to Yoshiteru Nishimoto, Executive Vice President of East Coast operations, "because we foresaw a downturn in the profitability of the California residential development business and wanted to protect ourselves from

the cyclical nature of the development business."(103) SRDC's principal focus remains real estate development, and in a fashion similar to Mitsui Real Estate Development Company's, they view their sister trading company (Sumitomo Corporation) as a means to eventually market U.S. real estate product in Japan. For example, the company has recently co-ventured a $20 million mixed-used commercial center in Ontario, California, portions of which it desires to syndicate in the future. "We would like to begin to liquefy our investments," observes Takaaki Ono, SRDC's Overseas Business Director and former head of the U.S. operation, "and obviously the Sumitomo Bank and Trading Corporation could handle the marketing and distribution aspects with the Japanese investors."(104) The New York City investment could likewise be sold or syndicated to a wide range of Sumitomo Corporation (trading company) Japanese clients.

The Sumitomo Group's trading company, Sumitomo Corporation, is primarily an investor in U.S. real estate, but appears to be moving toward an intermediary role similar to that of Mitsui & Co. (trading company). It boasts, like the Mitsui Group, of a wide range of real estate activities and services. For example, Sumitomo Corporation's (trading company) 1985 annual report describes its group's Construction and Real Estate Division "as investor, developer, contractor, and investment consultant for real estate and construction operations in domestic and overseas

markets. This division is engaged in real estate businesses and in the construction of private homes, condominiums, offices, shopping centers and industrial facilities."(105) The Sumitomo America Corporation (trading company subsidiary) owns the 42-story, 600 Third Avenue building in New York City, has developed an office tower and hotel complex in Hawaii, and purchased industrial warehouse properties in Houston and Kansas City. The Sumitomo Corporation (trading company) is investing in U.S. real estate in order to satisfy Japanese investor appetite for existing U.S. property opportunities. The SRDC (development company) is poised to develop U.S. real estate projects that can be sold by the Sumitomo Corporation (trading company) in Japan to these same institutional and individual investors.

A closer look at Mitsui Fudosan will help highlight many of the underlying motivations and goals of Japanese real estate development companies active in the U.S. market.

Case Study: Mitsui Real Estate Development Company, Ltd.

Corporate Heritage

Mitsui Real Estate Development Company, Ltd. ("MRED") owns 14 million square feet of office space in Japan, an inventory which is exceeded only by landlords Mitsubishi Estate (25 million) and Nippon Life (17 million). Its FY 1985 assets of $4.025 billion would rank it in the top half of the Fortune 500, ahead of such companies as TRW, NCR,

Reynolds Metals and Delta Airlines. Moreover, with 75% of its land holdings carried at book value, asset value is understated on the balance sheet.

In the past, MRED's principal activities in Japan were development oriented. Income-producing property was largely represented by office buildings held for rental income and long-term appreciation. Sales or short-term investment were not a principal component of the MRED modus operendi, a philosophy consistent with that of most Japanese real estate investors who, whether large or small, generally share a strong disinclination towards selling real estate.

In the early 1980s, however, MRED began to formulate a new corporate strategy. The Japanese economy had slowed and office leasing stagnated, so MRED's board sought to diversify corporate activities. This included, where appropriate, the development and sale of office buildings. In the 1984 annual report, Mr. Hajime Tsuboi wrote, " . . . increasingly diverse strategies are becoming essential. Until recently, most energies have been directed toward building construction and leasing. Now, the Company is expanding its scope of operations into such diverse areas as sales of office buildings [and] construction and management of hotels .... "(106) This goal to effect a more blended portfolio was stated even more explicitly in another section of the annual report:

> In the real estate industry, maintaining a healthy balance between sales and income requires constant and careful consideration. It is no longer desirable to concentrate solely on leasing buildings, a long-term capital investment. This area must be complemented by the construction and development of buldings for sale, a short-term capital investment. As a result, profitability will be raised, and income flow will become more stable. In other words, we at Mitsui Real Estate believe that a long-term stable income source in the form of leasing activities supplemented by short-term capital gains anticipated from our new area of operations is the best combination to ensure continuing prosperity. (emphasis added)(107)

U.S. Activities

MRED's activities in the U.S. are largely defined by policy set in Tokyo. The long-term strategic plan calls for the development and sale of a small number of select U.S. properties. Sales-oriented activities have yet to be implemented in the U.S., however, in large part because MRED executives want to learn all facets of the American development process before putting the firm's name on the line.

MRED opened its U.S. subsidiary, Mitsui Fudosan ("MF") in 1972 in Los Angeles, and subsequently expanded to New York in 1983. Among the thirteen recorded real estate transactions in which MRED and MF have participated are the following:

1. The AT & T Tower -- a 1 million square foot office in L.A. Equity purchase with Dai-Ichi Life (Date of completion/execution:1984).

2. Palomar Airport Business Park -- a 340-acre

business park near San Diego (1984).

3. The Hyde Park Hotel -- a 16-story Manhattan hotel at 77th and Madison which is currently being refurbished (1984).

4. Suburban Chicago office building -- a $48 million participating permanent loan, from which MF receives coupon yield plus cash flow and future sale upsides (1985).

5. Development project -- a planned 260,000-square foot office building at the corner of 40th and Fifth in Manhattan. MF will co-develop and has a forward purchase commitment. (1987).

Mitsui Fudosan desires to assemble an American portfolio that is risk-diversified (by property type, investment vehicle, development stage and region) at the same time that it creates opportunities to gain first-hand experience for maximum educational benefit. The projects noted above confirm such dual objectives. For example, the Hyde Park hotel project, in which MF is a limited partner with a New York developer, adds a hotel to the portfolio while enabling management to witness a thorough renovation job and assess its impact upon hotel operations. Financing arrangements test their ability to underwrite deals in new and distant markets, as well as innovate an investment facility which is unprecedented among Japanese investors.

The 40th & Fifth office project, in which MF is a general partner, will test its ability to develop a major Manhattan office building.

There are two components to this educational process. First, like its principal competitors (Mitsubishi and Sumitomo), MRED categorically supports learning experiences which familiarize them with U.S. business methods and markets. This is evident in the educational backgrounds of management; among the ten or so individuals currently assigned to the U.S. is a senior executive who was educated at Cornell Business School and a junior executive who is matriculated at Harvard Business School. Their knowledge of Americans and the U.S. real estate market is impressive by any standards.

Second, MRED wants to learn about many different investment products and vehicles, for they intend ultimately to export such techniques back to Japan. The Japanese real estate market has neither the sophisticated financial instruments nor the varied techniques of the U.S. market. In an article appearing in a Mitsui & Co. market update report, a Japanese real estate analyst writes that "the United States and Europe are still far ahead of Japan in the real estate industry, so it is very likely that the opportunity to gain broader experience is part of the allure for Japanese companies to move abroad." (108) MRED believes that participants in the Japanese real estate market desire to utilize such advanced techniques, a belief reconfirmed by

the reaction to their Chicago participating loan. "When word got out that we had placed the [heretofore unprecedented] loan on the Chicago office building, many Japanese banks and securities companies contacted us for details," claimed an MRED executive in the Tokyo office.(109) MRED prides itself on innovation and speed. "A solid understanding of market needs, an eye for new opportunites, and most importantly, the flexibility to respond quickly and creatively" are corporate characteristics which the company lauds.(110) When dealing in an overseas market, however, the risks attending the practice of such traits may be high. Nonetheless, MRED considers such risk essential to both the educational and long-term investment exercise.

Strategy, Strengths, and Weaknesses

Real estate development companies have expertise and knowledge in differing aspects of the business, such as land banking and development, residential subdivision and sales, and industrial property prospecting and development. Until recently, large commercial office projects have been an exception rather than a rule for most group-related as well as smaller, independent development companies. For example, Mitsubishi Estate (development company) has developed the following residential projects over a ten-year period in the

U.S.:

Houston, TX 1981	470 single family lots on 122 acres Commercial center on 14 acres
Atlanta, GA 1982	300 single family lots on 174 acres Commercial strip center on 6 acres
	110 single family lots on 89 acres
Palm Beach, FL 1983	120 single family lots on 115 acres 10 Condominiums on 5 acres

In 1984, Mitsubishi Estate co-ventured a 736,000-square-foot office tower in Portland, Oregon with Meiji Mutual Life, a zaibatsu group-related insurance company.

For all of these organizations, practical experience has seasoned management and places them in an exceptional position to generate geographically diverse development projects for Japanese investors. Additionally, development company managements have experienced good and bad times in the U.S. real estate business, and in many cases were fortunate to be able to shift away from regional markets before boom conditions turned to bust environments. Takaaki Ono, Director of Overseas Business at Sumitomo Realty, and Akihiro Inouye, Overseas Business Manager at Mitsubishi Estate, have each spent over 12 years in a variety of development assignments, and consider themselves local U.S. developers. "I know what will sell, where it should be built, and who is best qualified to build it," noted Ono, "and I understand equally well the dynamics of the Southern California market."(111)

Real estate development companies are confident that

project capabilities will permit lucrative tie-ins to Japanese investors through trading company contacts. "We used to leave details to general partners, but no longer," cautions Mitsubishi Estate's Akihiro Inouye. "We now have experience and alternatives in each market area. We believe," he adds in referring to future trading company links, "that these companies will come with us."(112)

The fact that development companies have learned about the U.S. real estate development process liberates trading companies to concentrate on recognized strengths for selling and brokering, rather than building or buying. Therefore, although strategies and objectives have occasionally overlapped between real estate development companies and trading firms, there appears to be an increased awareness on the part of each of the benefits involved in coordinating long-term goals and the means used to achieve them. Trading firms are moving from direct investment and project involvement to concentrate on intermediary and transactional aspects of the real estate business. "Trading companies are getting away from long-term return situations with which they are basically unfamiliar and uncomfortable," advises Makoto Kaimasu, construction and real estate securities analyst for the Nomura Research Institute in Tokyo, a division of Japan's largest securities trading firm. "They are aiming for brokerage as a strategic direction for involvement in U.S. real estate."(113) Trading companies are neither accustomed to holding assets nor comfortable in the

production phase of products, but are rather buyers and sellers of goods. As such, they want to clearly define and limit the extent of their involvement in the U.S. real estate business. "Recall that a trading company has few depreciable assets," cautions Sumitomo's Ohsawa, "and that until the 1970s, even after 30 years of U.S. activity, we just started to think about depreciation!"(114) "The trading company is in the business of organizing," states Mitsui & Co.'s Ide, "so that we foresee three distinct stages of involvement: development, brokerage, and securitization."(115) Having decided to pass stage one to development companies, the trading companies are emphasizing the second stage of involvement.

Both development and trading companies possess complementary strengths and weaknesses. Development companies do not have mechanisms to bring their projects directly to Japanese investors, because investment packages must be brokered through banks, securities firms, and trading companies. Alternatively, trading companies have not had great success in generating development opportunities for the sources of capital which they are uniquely capable of channeling. Zaibatsu group companies are increasingly aware that strategies may be coordinated by promoting trading company sales of development company projects, and development company access to trading company sources of capital. This is a way for both kinds of company to eliminate the significant weakness and avoidable costs of

failing to focus on available strengths.

Conclusion

Our treatment of Japanese real estate activity in the U.S. encompasses a diverse range of participants. Development companies are positioned to substantially increase the size and scope of real estate projects available for investment by principally institutional investors in Japan. They have been active developers in the U.S. for longer than any other category of Japanese real estate concerns. They now have the product and require a distribution mechanism. Meanwhile, trading companies are withdrawing gradually from direct investment in order to concentrate on marketing, rather than generating, real estate products for investors. It is an appropriate match.

Trading companies occupy a unique place in the spectrum of buyers and sellers of properties and developers of projects. The trading firms are moving into the basic service of putting capital together with investment opportunities. "Bankers have a limited audience, they have only their depositors," suggested Ide of Mitsui, "but we are connected to almost everyone."(116) They will operate on the development side of real estate through a relatively small group of zaibatsu-related development firms.

Successful coordination of development companies with investors will create an important, and as yet unrealized, product segment within the Japanese market for U.S. real

estate. Currently, it is presenting opportunities for the large as well as medium and smaller-sized institutions; in the future, they will intermediate for the huge individual investor market which is analyzed ahead in chapter five. There is potential for an integrated chain of investment and development, with Japanese investors setting parameters, trading companies determining markets, and development companies providing varied projects. It is within the proven capabilities of major zaibatsu concerns to manage this process of real estate capital allocation and investment.

Chapter V:

Small Investors: An Overlooked Market Coming Of Age

> "There are countless people who wish to invest in U.S. real estate. The problem is finding the product. What we need are American developers to present us with product."
>
> Hideo Niou
> President
> Jones Lang Wootton (KK)

This section treats, in an omnibus fashion, the subject of investment in U.S. real estate by smaller Japanese investors, including individuals. Examples of such investment and potential areas of opportunity for Americans will be reviewed.

Partially because such U.S. investment is a new and untested area, market segmentation is not well defined in terms of prospective investors or sorts of vehicles available. But although there is disagreement among some observers as to the "investor profiles" within this sector, almost all agree that it is a sector which holds a huge potential for capital inflow into U.S. realty.

Investor Personality Traits and Investment Biases

"Small investors" are small-to-medium non-financial corporations, closely-held companies, high-net-worth individuals, and middle-income individuals. Not surprisingly, there are

investment disparities among these groups.

Notwithstanding such differences, however, the investment personalities of these groups show a correlation on most issues. Among these are the following:

a. Such investors are increasingly edgy about investing in Japanese real estate. While they used to be quite comfortable with reasonable 4%-6% yields and capital appreciation, they are finding it difficult to tolerate the current 1%-2% yields. Furthermore, the high gross entry costs put much real estate beyond the means of such investors. The allure of America's 8%-10% yields is great, as is the potential availability of product of varying price ranges within a large market and stable country.

b. Small investors have found it difficult to locate appealing and affordable U.S. product, and they believe that only those products offered by "name" institutions can be treated without skepticism. Yet, such institutions are disinclined to trade in small investment magnitudes, due to diseconomies of scale. The result: a severe shortfall in supply of "endorsed" product.

c. These Japanese are unfamiliar with most American cities, with the exception of Honolulu, Los Angeles, San Francisco and Manhattan. This is not to say that they

have not heard of Dallas, Chicago, Philadelphia and, certainly, Washington, D.C., but the Japanese are no more familiar with their location or respective city dynamics than Americans are familiar with, say, Yokohama, Osaka, Nagasaki and Kyoto. Such unfamiliarity breeds reluctance and suspicion, and dissuades investment.

d. The preferred real estate product is urban office buildings, but not so exclusively as with larger institutions. Other kinds of products may appeal to small investors who are personally familiar with the their operation in Japan. Second homes in Hawaii, though not investment-driven purchases, have been popular.

e. Japanese are unfamiliar with partnerships as legal vehicles for investment (although, if passage of the germane provisions of the Senate version of the new tax bill takes place, such unfamiliarity may be moot as a barrier). There is no legal concept of partnership within Japanese law. Thus, deals which call for special allocations to various partners for tax reasons and the like are unacceptable. Importantly, such investors are not favorably disposed towards shared ownership. "They want to see their property -- they don't want a percentage of a pool. There's some mystique to

ownership."(117) They prefer direct investment in hard real estate assets rather than financial securities.

f. These individuals are not market risk-takers. They prefer to wait not only until larger and more knowledgeable institutions have invested in a market, but also until the verdict is in. "[They want] to be close to where Mitsui and others have put their money down. In other words, we find them wanting to be in clusters ."(118) However . . . while slow to be convinced, smaller investors, once comfortable with a market, often exhibit a characteristic lacking in most large institutions: the ability to make a quick decision. "Any company owned by one person can make a quick decision -- regardless of size."(119)

h. Difficulty in comprehending U.S. real estate goes beyond regional unfamiliarity; it is compounded by different investment and underwriting norms used by the respective countries. For instance, the American norm (and often, goal) of assigning the greatest amount of a building's value to its improvements is contrary to the Japanese valuation system, which places most of the value in the underlying land -- a difference partially explained by dramatic differences in the respective depreciation schedules (U.S.: 19 years, likely to be increased to 30 or more years under the proposed tax bill; Japan: 65 years).

i. There is growing moderation in the traditional Japanese aversion towards selling real estate; real estate is slowly being viewed as more of a transactional commodity. Intermediaries who have worked with such investors claim that they may be somewhat receptive to deals calling for a shorter hold. This may be particularly true of smaller investors because of their relative freedom from "public perception" considerations (specifically, "loss of face") which tends to inhibit the sale of real estate.

In order to develop these and other points further, we address the issue of "smaller investor" investment by focusing upon the vehicles available to them: direct investments, sponsored programs, and securitized real estate and pooled funds.

Opportunities for Direct Investment

Japanese real estate investors of almost any size generally prefer to own all of a small building than part of a pool. "It's very difficult for them to invest in a basket of properties."(120)

A principle deterrent to such acquisitions by Japanese investors has been the absence of product -- particularly in Manhattan. This shortage is largely a function of two

factors: the disinterest of large institutions and brokers for such product, together with a fairly efficient market for such smaller properties in the U.S. More U.S. individuals and institutions are interested in and capable of acquiring properties costing $1 million-$15 million than in the "mega-deals," and such investors often enjoy all of the benefits coming with a home-field advantage.

Nonetheless, a corollary problem exists. Notwithstanding the relative efficiency of the American small property "market," situations exist where a prospective American seller would find an even greater demand for his product in Japan. Currently, however, few mechanisms exist whereby American property owners can tap into Japanese smaller investors.

Such truly global market inefficiencies create opportunity. One who is attempting to capitalize upon such opportunities is K.S. Wu, president of Peers & Company, a U.S.-based merchant banking house devoted to facilitating trade -- including real estate investment -- between the U.S. and Japan. "My observation is that the bottleneck of trade between the U.S. and Japan doesn't lie between multi-nationals like IBM and Sony. The real bottleneck lies in medium and small companies unable to find access on the other side of the Pacific."(121) Peers & Co. employs American and Asian employees with long backgrounds in international business and investment banking. It also takes advantage of both the capital and the market knowledge

of the $ 73 billion Japan Long-Term Credit Bank (LTCB), a shareholder in Peers. To date, most of its investments have been in non-real estate fields, but Wu sees a growing market demand for U.S. realty.

Not surprisingly, given such market barriers, together with the disaggregation and lack of coordination within the small-investor market, a variety of remedial steps are being tried. Some companies have attempted to go directly into the U.S. market, with apparently mixed success. A case in point is the experience of Kato Kagaku Corporation's Masao Kato, chairman of the Japanese malt syrup and cornstarch manufacturer. "Spending a week in Manhattan to look for a major hotel for sale, Kato learned of a few . . . possible deals. But 'our negotiating partners didn't appear at the appointed hours, and the selling prices were never fixed'." (122) He returned to Japan empty-handed.

Another step has been the establishment of Japan-based consulting firms which affiliate with an American consultant or broker. One such company is Pacific Rim Research, Ltd. (PRR). PRR acts strictly as an intermediary; furthermore, it does not pretend to be a real estate expert, and relies heavily upon advice obtained through a cooperative agreement with the international law firm of Coudert Brothers in New York, together with information obtained through other American contacts. According to its marketing brochure, current consulting activities by Pacific Rim Research

include introducing "Japanese investors to investment opportunities in United States, Western European and Australian real estate and introduc[ing] foreign real estate owners and developers from such jurisdictions to Japanese investors."(123) The chief of the Tokyo office, Yoshinori Takagi, claims that "we want to be known within the market as being able to produce quick decisions." (124) PRR has been in business for a number of years, but its office in Japan is a new one; therefore, there is no track record on which to judge its success. Nonetheless, it is noteworthy that a company such as PRR has identified a market demand for such intermediation.

A similar step is the opening of U.S. offices by Japanese real estate companies which have established networks of smaller-sized clients. In Japan, these companies exhibit organizational structures and orientations somewhat similar to a Century 21. Toyo Real Estate Company, which has incorporated a U.S. subsidiary in Los Angeles, is one such company. With an emphasis upon smaller properties, it brokers "dwellings, small shopping centers, office buildings, Hawaiian condominiums and other properties to Japanese investors."(125) One typical Toyo activity is to select "dwellings for Japanese residing in [L.A.], drawing up a prospectus for each such home and soliciting rich Japanese to become the owner."(126) Toyo's success clearly demonstrates that a market for their services exists, and that it is growing fast; "our 1986 commissions should double

to $15 million," claims Toyo's vice president, Imao Kawai.(127)

A Case Study of What a Small Investor Seeks : 1001 Pennsylvania Avenue

In early 1986, Kokusai Kogyo, a Japanese aerial survey company, purchased 10%-15% of the equity in a 700,000 square- foot, two-stage office building in Washington, D.C. "The investment marks a significant milestone for the non-institutional investor. This is the first-ever investment by a non-institutional investor," claimed Daniel M. Murphy, president of Lehndorff-Pacific, Inc., a subsidiary of the major international consulting and brokerage firm, Lehndorff U.S.A. While such a statement borders on hyperbole, the Kokusai purchase is most significant for a number of reasons.

First, the project represented the sort of "name" project which Japanese investors prefer, and Kokusai saw plenty of prestigious names on the project list. Approximately 50% pre-leased upon opening, 1001 Pennsylvania Avenue is a high-visibility building. It is equidistant from the Capitol and the White House, was designed by highly regarded Hartmann-Cox/Smith Segreti Tepper McMahon & Hargred, and was developed by Cadillac Fairview. Other equity investors include the pension funds of Kodak, United Technologies, The World Bank and a British utility company. The size of Kokusai's investment is estimated to fall in the

$10-$20 million range, and was selected because "Kokusai believes the United States to be the safest market and also provides the best return on such investments."(128) Because Kokusai is not a real estate company, its investment gives testimony to the depth of Japanese demand for real estate as a component of an investment portfolio.

Secondly, the purchase was facilitated by a strategic plan that targets small investors. According to Murphy, "Lehndorff formed an alliance with the Mitsui companies to invest Japanese funds in U.S. properties to meet the growing need of medium-to-small sized investors to invest their surplus funds in attractive foreign assets."(empahasis added)(129) He claims that Lehndorff is currently working on two more deals "involving non-institutional investors." (130)

Finally, the 1001 Pennsylvania Avenue purchase gives an example of the role which Japanese firms can play in such deals; in particular, Mitsui Trust & Banking (MTB), which has Kokusai as a client, and Mitsui Real Estate Sales (MRES), which is making a market in locating suitable investment opportunities for smaller Japanese investors. In this particular deal, Lehndorff contacted MRES to inform them of the availability of the stake; MRES then contacted its sister organization, which originally wanted to acquire the stake for the portfolio of one of it pension fund clients. Approval of the pension fund investment could not

be obtained from the Ministry of Finance, however, so MTB turned to Kokusai, another client, and the deal was quickly done.

A closer look at Mitsui Real Estate Sales provides an example of this small investor market and how it will be serviced.

<u>A Case Study of a Small Investor Intermediary: Mitsui Real Estate Sales</u>

> "In Japan business society, the name of the company is critically important. Companies are eager to keep the good name,so people trust it".
>
> Takahiro Fujiwara
> Vice President
> Mitsui Fudosan (N.Y.), Inc.

Mitsui is one of the more heralded names in Japanese real estate. And Mitsui Real Estate Sales, as one of the many independent companies operating under the Mitsui umbrella, enjoys substantial corporate goodwill.

Within Japan, MRES is best known for its domestic residential and small properties brokerage business. However, in 1982, a feasibility study identified a potential demand by smaller Japanese investors for U.S. real estate. As a result of these conclusions, an international operations department ws formed.

In 1983, "we began to knock on the doors of the middle-sized real estate holding companies in Japan, principally

Tokyo," says Mayumi Oda, manager of MRES's international operations department.(131) Despite these efforts, clients were slow to respond. Most individuals were content to invest in the market they knew best -- Tokyo. Yields at that time were satisfactorily high, and real estate opportunities were available. Furthermore, despite the ackowledgement on the part of such prospective investors that "the U.S. is the world's most stable country," discrepancies between the norms of the American and Japanese markets "caused the Japanese big problems."(132) As a result of these factors, little international business was transacted in 1984, and Oda and his staff (eight individuals in Tokyo, two in L.A.) used this time as an opportunity to learn about the U.S. market.

Things began to change in 1985. Two macroeconomic conditions began to make Japanese investment in U.S. real estate a more desirable proposition for smaller investors. First, the real estate market of Tokyo became superheated; not only did prices, due in part to the involvement of large companies, rise beyond the means of many smaller investors, but yields (due to a host of factors, including governmental rental accomodations policies which favor existing commercial tenants) fell to 1%-2%. A related phenomenon was that property, affordable or not, became less available; "now, transactions are becoming less frequent and slower, and the holding period is becoming even longer."(133)

Second, the yen, starting in late 1985, began a forty

percent climb against the dollar. Combined with the market constriction in Tokyo and other macroeconomic factors, the currency-induced fall in U.S. real estate prices increased interest in the product MRES was selling.

MRES acquires information about available U.S. real estate through its staff in L.A., as well as through non-exclusive brokerage relationships such as Cushman & Wakefield or Jones Lang & Wootton. Properties which satisfy its "investment standards" are generally urban office buildings costing between $5 million - $10 million and throwing off a going-in cash-on-cash yield in the nine percent range; the internal rate of return, assuming a four percent inflation factor and a nine percent cap, should be approximately twelve percent.

Currently, most of the investment opportunities come to MRES through brokers, while most of their Japanese customers come in without having been solicited; they are either referred by Mitsui Trust & Banking or other like institutions, or respond to articles which publicize MRES' efforts. "We don't have to pay for our ads," claims Oda. "[The newspapers] write about us."(134)

But how does MRES deal with the bogeyman of Japanese investors -- slow decision-making ? Slow decisions may be even more fatal in the small property market, where a larger number of prospective buyers exist. Even small Japanese investors may be slow to make decisions. Furthermore, "many

of them are first-time offshore investors. They are thus very cautious, and they want to rely on somebody."(135)

MRES' answer is to acquire the desirable property in its own name. This allows MRES time to find the appropriate investor for the property, who will doubtless be comforted by the MRES stamp of approval. MRES will then sell all of the property to a single investor, parcel it off to two or three investors as tenants-in-common, or hold onto all or part of the property itself.

But how did MRES itself develop the ability to make such decisions, in contravention of the traditional decision-making norms ? "It was tough," admits Oda, and for three years he and his staff had to conform to the system. But by 1985, his department had developed in-house investment criteria and experience which satisfied his board, and since then Oda has enjoyed fairly broad discretion on deals of up to $10 million.

In 1985, MRES transacted approximately $30 million in sales. However, in 1986, the number is expected to more than double into the $75 million - $100 million range. It is a growth pattern which is likely to continue.

Sponsored Investments

Mitsui Real Estate Sales, while predominantly and preferably acting as an intermediary on behalf of Japanese investors, occasionally must act as a sort of sponsor. Such

a role -- that is, where an investment advisor is also a sort of merchant banker or equity co-venturer -- is being evaluated by a number of large Japanese real estate companies which are currently active in the U.S. market. Such programs would be targeted towards the larger small investors, such as small-to-medium sized companies and second-tier institutions. However, given the sizable capitalization and natural orientation of those firms currently studying such programs, such as Mitsui Trading Co., Mitsui Fudosan and Japan Long-Term Credit Bank, one might wonder why they would trouble themselves with such investment vehicles when they are fully equipped to buy on their own account.

Some corporate representatives express ambivalence about such sponsored programs. On the one hand, they view such programs as an opportunity to enjoy significant returns in the form of fees, return on equity and appreciation. It is also a method by which they can gain greater market exposure and expertise while concurrently laying off risk. Most importantly, however, it is an opportunity to reinforce existing client relationships by helping to introduce them into a desirable market which they might not otherwise be able to enter efficiently. "Many of our clients come to us for advice on American real estate," claims an executive of Japan Long-Term Credit Bank.(136)

Some of these representatives express trepidation about

such programs targeted to the smaller investor. Most concerns center around the issue of relationships, and more specifically, the potential damage one might suffer in the event a sponsored investment sours. One experienced individual familiar with the issue noted:

> [Working with small investors] is a two-edged sword. Smaller investors tend to be less sophisticated about real estate. They do not understand that a pro forma is not a guarantee, not written in stone. If actual performance falls even slightly below our projections, I will get a telephone call, and no matter how much I explain, they will not be satisfied. They will say, "I invested with you because of your [company's reputation and] name. You should make me whole." This is very serious, because Japan is not a contractually based society. Very often we will make investors whole, to protect the relationship and our name.(137)

But, these companies are almost certainly going to give such programs a try. Such cooperative efforts are not completely without precedent; some companies have gotten their feet wet by "sponsoring" investment opportunities whereby pre-existing relationships are brought into a large-scale joint venture. Nonetheless, many large institution programs geared toward the smaller investor are still in the planning stage. For Mitsui & Co. (trading company), small-investor-oriented programs are "stage three" of a three-stage strategic plan which is just beginning, while for LTCB, such deals are stage two -- "about five years away."(138)

Given the pendency of such programs, it is impossible to precisely predict what form they will take. "It would

probably be structured like a participating loan, where we would take the lead position and would bring clients in as participants," says a representative of LTCB. The likely clients would be "smaller corporations and institutions -- not individuals, who are more disposed to securities with a fixed return."(139)

However, this same representative knew of two separate programs currently being formulated to tap the Japanese small institutional investor market. In one program, a "famous American developer," in concert with a U.S. investment bank, is creating a program targeted at such investors; another developer, together with an investment bank, is seeking to acquire a Manhattan office building by raising capital in Japan. Unfortunately, the exact nature, structure and goals of these vehicles "are still secret," and because they have not yet been booked, their relative success cannot be measured.(140)

A novel way in which LTCB exploits this small institutional investor market, and served its client base, is through its investment in Peers & Co., the relatively small (original capitalization: $12 million) merchant banking house based in Washington, D.C. Formed to help circumnavigate the "bottlenecks" which obstruct easy access between smaller Japanese and American companies and investors, its president notes that "I have started to germinate this concept in business and investment banking.

We tend to put our money where our mouth is, instead of just putting deals [together] and earning fees from that."(141)

Thus, the current status of sponsored U.S. real estate vehicles which are targeted towards smaller Japanese corporate investors is just beginning. Most programs are in the planning stage and are just now being offered. Institutions which plan to one day offer such programs would prefer to gain more experience in the U.S. market before putting their name on a product targeted towards some of their more valued customers.

Small Investor Securities and Pooled Funds

It can be seen from the preceding two sections that the distinctions between different kinds of U.S. real estate investment vehicles available to small-to-medium sized corporations and institutions are somewhat blurred. Whether a direct or a sponsored investment, such investors prefer vehicles which bear the imprimatur of a reputable Japanese or American institution, are in familiar locations and offer high and predictable returns.

Investment instruments geared towards the small individual investor are not any more distinctive or adventurous; indeed, they are less so, with an even higher orientation towards fixed-income annuities, yield security and name underwriting than the relatively larger corporate small investor.

Ironically, most of the Japanese interest in U.S. real estate-backed securitization has been pushed by the large institutionals towards like-sized institutions rather than smaller investors. The level of interest from both kinds of investors appears to be growing. "While much of the initial activity [in real estate securitization] was centered in Europe, 'the Japanese are rapidly overtaking everyone else ....'"(142) One of the biggest impediments to even greater growth, however, is mere comprehension -- not only of the American real estate market, but the secondary market, to boot. Before such knowledge can trickle down to the "man in the street," the Japanese brokers must both be educated and convinced:

> The major foriegn investment houses also have undertaken their own education efforts. "Virtually every international financial institution has someone who is aware of securitization and is doing studies for senior management" ... For example, Nomura, one of Japan's largest investment firms, has developed a number of brochures and publications on U.S. mortgage securities, and the Nomura Research Institute, which is the biggest think tank in Japan, has done several reports ... (143)

Such educational efforts extend to the U.S., as well. Shuko Akita, a vice president in Nomura's New York headquarters, has a library of information on U.S. real estate, which reflects the amount of time and energy he devotes to the issue. According to his associate, Kazuhito Kondo of the Nomura Research Institute, an author and noted expert on

Japan's real estate market, there is growing interest among the Japanese in U.S. master limited partnerships. Consequently, a good deal of his time is now spent studying this new real estate investment vehicle.

Educational efforts notwithstanding, real estate securitization is being met with tepid enthusiasm by the Japanese brokers themselves. Although Yukio Moro of Yamaichi Securities (N.Y.) was quoted in the Wall Street Journal as claiming that "Japanese investors are very eager to make more investments in [U.S.] real estate (144), he later noted in a conversation that Yamaichi was not currently active in such securitization. "Many of my colleagues are afraid that they will ultimately lose part of their securities business if their customers become too interested in real estate as an investment."(145)

If such reluctance truly exists within the securities brokerage community, one might expect that it has been reinforced by the mixed performance of and contoversy surrounding the Rockefeller Center REIT. This program is generally considered to have been the first in which the Japanese investment community took a large position in a real estate offering; it is estimated that approximately $100 million of the $750 million program was purchased by Japanese investors, and Nomura, under the slogan "Let's Become Manhattan Landlords," both underwrote and placed a large portion of that amount. Although many critics of the

offering are willing to concede to the long-term potential of the deal -- an element of great importance to the far-sighted Japanese -- a large number of Nomura branch managers are feeling burnt. Initially skeptical, these branch managers had to be strongly lobbied to support the program, and now their clients are reportedly grumbling over the stagnant issue. Without the full support of these branch managers, no future offering is likely to be a success. "[Rock Center] will dampen enthusiasm, not only of investors but of the Nomura branch managers as well. I think that it will be very hard to overcome," predicts one experienced Japanese analyst of the U.S.real estate market.(146)Nomura's Akita has a completely different point-of-view, however. "Rockefeller Center was more of a financial asset deal than a real estate deal. Those who are interested in U.S. real estate have not been deterred." (147) Others agree; speaking before the Asia Society in New York City on June 12, 1986, Ken Miyao, Executive Vice President and Chief Executive Officer of Mitsui Fudosan (U.S.A.), alluded to Rockefeller Center and said: "We are sure that there is a large market for such investment vehicles in Japan, and we are conducting a preliminary study on the subject."(148)

The Bank of America is one American company which has not only committed itself to developing U.S. real estate investment instruments targeted towards the Japanese market, but has also taken tangible steps towards their creation.

According to Jack S. Cooper, Vice President and Managing Director of Bank of America Investment Real Estate, BOA has developed similar "real estate funds" for other foreign investors, and they have developed four different investment prototypes which are designed to appeal to Japanese investors of various size, structure and liquidity. These funds would be offered in an investment climate which he summarized as follows:

<u>Typical Expected Returns, U.S. Real Estate, 1986</u>

Downtown U.S. office buildings: Initial return (cap rate) of 5%-7%; long-term return (IRR) of 11%-13%.

Other U.S. institutional real estate: Initial return of 7%-9%; long-term return of 12%-14%.

Participating and convertible mortgages: Initial return (coupon rate) of 9%-10%; long-term return of 11%-12%. Given the relatively low rate of U.S. interest rates, participating mortgages are currently less attractive to developers.

Conventional mortgages: Initial and long-term return of 10%-12%.

Source: (149)

The four generic types of funds being formulated by Bank of America are: a real estate certificate of deposit; a real estate open-ended trust fund; a real estate "security'; and a real estate limited partnership. According to Cooper, only the open-ended trust program would be targeted principally towards institutional investors, this in light of a typical minimum subscription of $500,000 due to the ability of the investor to redeem shares without penalty;

the other programs would have minimum subscriptions running from $1000 (the real estate "security") to $50,000. Although the respective funds vary in terms of liquidity, minimum subscription and underlying security, their yield characteristics are quite similar: 6%-9% going-in, 11%-14% internal rate of return. Fund proceeds would be used to place conventional and participating loans against income-producing properties, or to buy such property for the account.

To date, however, BOA's program has not been offered to Japanese investors because the Ministry of Finance has balked at approving them for sale. Despite the fact that both Nomura Securities and Toyo Land are co-sponsoring the instruments, Cooper notes that

> the Ministry of Finance is somewhat reluctant to embrace a real estate fund at this time which might compete with ongoing Japanese interest rates. However, I feel that a fund structured so that it does not compete with those rates, but rather keeps in line with them, where gains would be realized on the sale of the property, should meet with a greater measure of approval by the Ministry of Finance.(150)

Thus, in conclusion, while a significant number of authorities and brokers insist that a strong latent demand real estate-backed instruments exists among the Japanese small individual investors, programs designed to tap that demand have gotten off to an erratic start. Blame can be assigned to a number of parties: overly zealous brokers; overly cautious investors; overly ministerial governmental

officials.

Nonetheless, such investment seems almost destined to become a potent source of capital outflow, for it fits into the past pattern of Japanese investment in the U.S. Specifically, while programs attempt to work the kinks out, larger Japanese institutions will continue to expand their penetration of the market and with that, expand their base of knowledge. By the time securitization programs are smoothed out and have developed a track record of sorts, the investors will be able to look to experienced Japanese institutions for investment guidance. And assuming yield spreads remain sufficiently high, small investor capital is likely to chase products offered by "name" institutions.

Summary

Opportunities to tap into "small investor" capital markets are proliferating. Although the number of formal programs and vehicles currently in place is relatively small, many of the large players -- Nomura, Mitsui Fudosan, Bank of America and LTCB, -- are committing significant resources to their study and formulation. Concurrently, intermediaries which specialize in finding direct investment opportunities for such investors are appearing on the scene in growing numbers. The presence of such a capital market will increase the options available to smaller American real

estate owners and developers. Such participants will be able to look to the Japanese capital markets when contemplating development, finance or sale. Increasingly, the small American real estate investor will become a beneficiary of the internationalization of real estate.

PART III:
INVISIBLE LINKS -- THE TIES THAT BIND

Chapter VII:
Characteristics Common To All Japanese Investors

In Section III, we studied some of the distinct sectors of Japanese investors in U.S. real estate, placing emphasis upon their respective investment strategies and idiosyncracies. One of the principal pedagogical goals was to demonstrate that, contrary to popular wisdom, Japanese "consumers" of American real estate manifest significant diversity in style, experience, preferences and goals.

In this section, we identify and discuss some important investor characteristics which are almost universally shared by Japanese investors. The empirical and sociological underpinnings of such characteristics are addressed, and their effect on investment behavior are portrayed. In a few instances, the authors present strategies which enable American real estate players to capitalize upon such Japanese traits.

A. The Corporate Method of Decision-Making

> " Traditional Japanese decision-making takes too long. We have to behave like American developers, which are generally closely held, or we will miss opportunities."
>
> Senior official of a large Japanese construction company

Mention "Japanese investor" to an American developer and he is bound to respond: "Too slow." The American development community has formed the expectation that dealing with the Japanese is a slow, tedious and sometimes tortuous exercise -- qualities which are anything but heralded by American developers. Accounts such as the following only tend to reinforce the stereotype:

> The developer had scarcely put the prime San Francisco office property on the market when he received a call from a Japanese institution eager to talk about a deal. Discussions followed in California in August, then a few phone calls, then -- nothing. The developer found another buyer and by December had completed the sale. Six months later he got a letter from Tokyo. To his amazement, the Japanese institution indicated that its lawyers were finally ready to return to San Francisco and complete the deal.(151)

Japanese, too, are critical of such inculcated slowness. Hideo Niou, president of Jones Lang Wootton KK (Japan) and a former executive of a large Japanese real estate firm, complains that "when [Japanese] are ready to buy, all the good property is gone. And, if the property is still available, it's either no good or too expensive."(152)

Such sentiments seem to be a bit on the extreme side, however. Furthermore, not all Americans are uncomfortable with such glacial tendencies; many have learned to adapt to the Japanese process and pace. Tishman Construction Company, for instance, has enjoyed substantial success in working with the Japanese. "When the Japanese examine a project, they are not subjective . . . They do an incredible amount of homework, and it takes a long time to get them to

the table," notes Christopher McGratty , a senior vice president with Tishman.(153) And for those patient enough to play the waiting game, there is often an incentive. According to Gordon Clagett, executive vice president of Equitable Real Estate Group, Inc., " [The Japanese] realized that for people to undergo the type of time-consuming process they have in place to make a major decision about real estate, they may have to pay for the extra consideration . . . ."(154)

Nonetheless, most of the Japanese interviewed are extremely sensitive to the criticism, and believe that steps must be taken to expedite the process if they are to be a competitive force in the U.S. However, before describing such remedial steps being evaluated and undertaken, a brief background on the decision-making process will be offered.

The Corporate Method of Decision-Making: The "Ringe" System

Most corporate decisions of consequence are made in accordance with the "ringe" system (loosely, "consulting on a problem"). It calls for a formal, hierarchical review process, called "nemawashi" (literally, "root binding"), starting at the bottom of the corporate ladder and moving up until a consensus is obtained. While certain exceptions can be made in order to fast-track a decision, such situations are a rarity and must be of an extraordinary nature.

The practical effect of the unadulterated ringe review process as it relates to U.S. real estate investment is that decisions cannot be rendered in much less than two or three months. (It is important to note, however, that the process is further slowed by MOF review, addressed earlier in Chapter II). An example of how the system works was offered by the Tokyo-based deputy general manager of a major real estate development company's foreign section. He described a ten-step process, as follows:

> Step 1: Information on a prospective deal is received in New York office. After a thorough review, a decision is made on whether to recommend further study. Business days elapsed: Three.
>
> Step 2: Information and recommendation is forwarded to Tokyo. A junior official reviews and presents preliminary report to his superior. Days: Three.
>
> Step 3: If interested, Tokyo requests more detailed cash flow and related information. In response, New York gathers information, analyzes, and if satisfied, forwards to Tokyo. Days: Five - seven.
>
> Step 4: Junior official undertakes a thorough analysis, including but not limited to computer runs. Such junior officials have an impressive knowledge of the expanded real estate market. Days: Four-five.
>
> Step 5: New York is contacted and consulted. Senior Tokyo official ascertains whether project warrants trip to the site. If so, requires two or three days to obtain approvals for the trip. Days:Three-four.
>
> Step 6: Senior official travels to States. Days: Three.
>
> Step 7: If satisfied, senior official, upon return, begins explaining the project to his superiors. Normally requires about three contacts,

"and they are all very busy people." Depending on their availabilty and familiarity with the market: Seven -ten days.

Step 8: For a large scale investment (approximately $50 million), a managing director may have to fly to the site. Days: Four-seven.

Step 9: A formal presentation is made to the chairman and his board. Days: Unpredictable

Step 10: If a really large scale investment, the company president will travel to the site. Days: Unpredictable (155)

Thus, after a minimum of a month and a half (and more frequently, two-to-three months) has elapsed, a decision can be made. At this point, if the votes are favorable, approval is given -- to begin negotiations.

Given such a laborious process, it should come as no surprise that opportunities are lost in an industry which heralds -- and occasionally deifies -- quick decisions, deals which are made on the back of an envelope. Kurt Kilstock, president of London & Leeds, a company which is co-venturing with Sumitomo Life on an apparently successful office project at 52nd & Lexington in Manhattan, claims that Sumitomo missed an opportunity to co-venture on a site in Washington, D.C. solely because it deliberated too long; by the time Sumitomo responded affirmatively, the position had been taken by a British pension fund.(156) Similar examples are numerous. During a recent meeting with the authors, Arthur Mitchell of Coudert Brothers, who has represented over fifty Japanese clients (more on him in a later subsection), received a telephone call from a developer who

advised him that a deal had been closed with another party and that, as a consequence, Mitchell's Japanese client had been shut out. "I tell my Japanese clients that they have no more than two weeks in which to make a decision," states Mitchell.(157)

Initial Steps to Mold Ringe to the American Real Estate Market

Heeding advice such as Mitchell's is one way of expediting or circumnavigating certain layers of the ringe system. However, Mitchell believes that, in actuality, strict adherence to the ringe system is fairly rare. "It exists in form, but not in substance," he claims. Instead, there is often a key person "who may not be on the organizational chart" who, if convinced of the propriety of a certain action, will act as the ramrod. "The key thing to understand is that there are 'anointed ones'."(158)

Nonetheless, Japanese employees themselves feel that the decision-making process is at times too cumbersome to permit them to compete in the U.S. "We, like others, have missed good opportunities [because of slowness], and we are going to change," claims an executive of Mitsui Real Estate Development Company, Ltd. (Tokyo).(159) According to one of his subordinates, those changes include the assignment of a senior officer to the Los Angeles office of their U.S. subsidiary (Mitsui Fudosan (U.S.A.), Inc.) who would be specially vested with the discretion to sign off on deals,

up to a certain amount.(160) A similar sort of plan is under study at Yasuda Trust & Banking, according to the manager of its Foreign Real Estate Group.(161)

A company which has already taken tangible steps to hasten the decision-making process is Nippon Life. Among other things, a senior managing director is vested with the ability to approve certain deals (up to approximately $50 million) without obtaining full board approval. Also, a special section exists which deals exclusively with Ministry of Finance officials, helping to ensure that no delays or snags occur due to misunderstandings by or inadequate information supplied to such officials. As a result, a senior manager of Nippon claims that they can submit a proposal on a U.S. project in about a month, and can close within three. This may not seem like a particularly speedy process to most Americans, but when compared to the normal three-to-four months required by most Japanese institutions to prepare a mere proposal, it is positively fast-track.

Exceptions to the Ringe System

The formalized ringe system is a creature of larger institutions which have well-developed bureaucratic infrastructures. However, in those instances when the corporation is either smaller or is closely held, the ringe system may not exist at all. The decision-making "body" may be a single individual, perhaps even the one who has handled the deal from the onset. In such instances, one can

expect a far quicker response.

The contrast can be quite striking. According to Mayumi Oda of Mitsui Real Estate Sales Co., Ltd.,(MRES) smaller investors in Japan often make deals over the telephone, in the quickest of fashions and not unlike some of their American counterparts. Such speed is principally attributable to the absence of ringe. MRES, as noted earlier in the paper, is focusing its attention upon the smaller Japanese investor, and it views such speediness as a key asset which is transferable to the U.S. market. In the aforementioned 1001 Pennsylvania Avenue deal, Kokusai was able to approve the deal in a matter of weeks.

The Equitable has witnessed a similar disparity between the speed shown by institutions which are subject to the ringe system and those that are not. Since 1981, Equitable has participated in six joint ventures with Japanese institutions: five with life insurance companies, and one with Daiei, a retailer which, with 1985 sales of $6.5 billion, a net worth in excess of $1 billion, and 14,500 employees, is only slightly smaller than K-mart or J.C. Penney. Each project has been large-scale and structurally complex. Yet the largest of the six -- the Daiei deal, calling for the development of a regional shopping mall and complex in Hawaii in which the retailer contributed (according to Department of Commerce statistics) $330 million of its own capital -- took the least amount of time to negotiate and close: one month to finalize the

principles, and two more to close the deal. Why was this project a relative breeze to negotiate and commence, notwithstanding the immense size of the Japanese company? Daiei's corporate structure, according to Equitable's Clagett; "it is largely a closely-held corporation."(162)

Such an experience confirms what many observers of Japanese activity have long believed: that, all things being equal, Japanese companies which are equipped and willing to make quick decisions will enjoy far more real estate investment opportunities in the U.S. than those companies wedded to the unadulterated ringe system.

B. American-based Employees: Staffing Levels and Acquisition Targets

All blame for slow decision-making cannot be attributed to the ringe system. Some must be assigned to the staffing policies exhibited by Japanese institutions. Such policies affect the ability to comprehensively gather and process information, not to mention the ability to effect a market presence. Two of the most pronounced factors affecting the ability of Japanese companies to make quick decisions about American real estate investment opportunities are (1) the size of the staffs in the offices of the U.S. subsidiaries of Japanese institutions, and (2) the general hiring policies manifested by such companies.

In general, the size of such staffs is small.

Notwithstanding the fact that annual investment goals range from $50 million (Meiji Life) to $300 million (Nippon Life) while total U.S.-based real estate assets held within respective portfolios range fron $100 million to $600 million, staffs of U.S. subsidiaries are stretched thin: Meiji Life has one real estate specialist in its U.S. offices; Dai-Ichi Life, three; Nippon Life, four; Mitsui Fudosan, three in New York and four in Los Angeles; Japan Long-Term Credit Bank, two. Add to this lean condition the fact that these employees are not only foreign nationals, but are generally both young and marginally fluent in English, and the inevitability of workload bottlenecks is guaranteed. "A lot of my Japanese friends here are overworked," notes Jon Minikes, senior portfolio manager for Jones Lang Wootton Realty Advisors.(163) Our experience seemed to confirm such a judgment; during a single trip to New York, we learned that two of our interviewees -- the chief representative of Dai-Ichi, and the deputy general manager of Meiji -- were returning to Tokyo in part to make special requests for more personnel.

A seemingly logical way to both beef up a staff and quickly enhance its expertise regarding American real estate would be to hire American employees. Such a step would be inconsistent with the hiring policies of many Japanese concerns, however. Akira Yashiro, chief representative of Dai-Ichi's New York office, voiced a representative sentiment: "Dai-Ichi prefers to teach and use its own

employees, and that is why we are moving slowly. We take no short cuts . . . ; it may take a long time, but we don't care."(164) Nonetheless, a recent trip to Tokyo in search of more staff suggests that he does in fact care. Similar ambivalence was expressed by Takahide Moribe, the Tokyo-based manager of Nippon Life's International Real Estate Investment department. While he acknowledged that hiring American employees might be a good idea for a variety of reasons -- visibility, local knowledge, and influence upon other employees, -- he doubted that such a step would be taken. "To date, the personnel policy of Nippon Life is one of 'pure blood' -- we breed our own from within."(165)

A more dramatic step by the Japanese to "localize" their expertise in order to facilitate efficient penetration into the U.S. market would be the acquisition of an existing, well-established U.S. real estate firm. This is a strategy which has been pursued in non-real estate areas, perhaps the most notable example being Sumitomo Bank's recent purchase of a large stake in Goldman Sachs for $500 million. Given the large percentage of closely-held corporations and partnerships which make up the U.S. industry, complicated entry barriers would be relatively small for a well-capitalized Japanese firm.

Indeed, such steps have indeed been begun by some in the real estate field. In 1984, Fuji Bank acquired Walter E. Heller & Co., a $3 billion commercial-finance company based in Chicago. Part of the prize was Abacus Mortgage, a

large and nationally-recognized interim and permanent lender. As noted earlier, Japan Long-Term Credit Bank (LTCB) owns approximately five percent of Peers & Co., the Washington, D.C.-based merchant banking concern which, among other things, identifies U.S. real estate investment opportunities for Japanese investors. From LTCB's point-of-view, a collateral benefit is their affiliation with Kemper Financial Cos. (an affiliate of Kemper Insurance), which owns approximately 40% of Peers. Finally, according to a knowledgeable source, Sumitomo Life talked to the Ministry of Finance about the possibility of making such an acquisition about four years ago, but was dissuaded from pursuing it further by the ministry's tepid response. However, given recent regulatory relaxation undertaken by the Ministry of Finance, together with the fact that other companies have already charted a similar course, the ministry should be more amenable to such a discussion today.

At least two knowledgeable observers are convinced that further acquisitions of U.S. real estate companies are inevitable and are likely to take place on a large scale. One , a leading national mortgage banker, claims that many Japanese construction companies are searching out and structuring deals which permit them to get close to major American construction firms and position themselves for a buy. Commenting upon a recent project on the East Coast, he noted that "these guys don't really care about [the

developer] or the deal. What they really want is the opportunity to cuddle up to [the contractor]," a major, closely-held general contracting firm.(166)

Arthur Mitchell of Coudert Brothers predicts that a similar step will be taken by another industry sector: large Japanese securities firms. "Currently, they are not terribly sophisticated about U.S. real estate. But I'll tell you, they are very sharp, and they in many ways want to model themselves after Goldman or Salomon. They want to play the sort of role Goldman played in the Rockefeller Center offering."(167) To do so, Mitchell predicts that such Japanese firms will gain market entry and position through acquisitions. "Much as 20% of Babcock & Brown (an equipment leasing firm) was acquired by a securities firm, a real estate company will be bought."(168)

Thus, in conclusion, while it appears unlikely that Americans will witness a change in the composition and character of U.S. subsidiaries in the very near term, the Japanese will continue to expand their penetration into the U.S. real estate market through company acquisitions and horizontal integration.

C. The Cultural Disinclination to Sell Real Estate

> "In Japan, for a company to sell property, it would be conduct of shame."
>
> Akihiro Inouye

Deputy General Manager
Overseas Business Dept.
Mitsubishi Estate Co., Ltd.

Standing alone, the idea that most real estate owners and developers are reluctant to sell their land does not seem particularly extraordinary; phrases such as , "I'm in this business for the long haul," and, "I'm not interested in flipping property" are well-worn and often-hallowed passwords in the American real estate fraternity. But as is often the case, practice varies from dogma, and many of those who publicly denounce sales strategies are, under a variety of circumstances, really quite receptive to them. After all, the phrase, " I don't really want to sell, but my partner" (choose one or all) (a) "is impossible to deal with," (b) "wants to sell, and I wish to accomodate him out of a sense of obligation," (c) "suffered some business setbacks and needs the cash", is no less venerated in the annals of real estate idiom.

Nonetheless, such investment "flexibility" does not appear to reasonably exist within the strategies of the Japanese real estate investor. In fact, what is quite remarkable is the overt, unsolicited aversion most of our interviewees held towards the notion of selling their real estate investments. "If a Japanese financial institution were to sell one of its properties in Tokyo it would be a sign that it is in some kind of financial trouble," claims a Japanese venture partner.(169) According to Hideo Niou of Jones Lang Wootton KK (Japan), "most people will hold the

property forever. They will sell only if they have problems." (170)

This disinclnation to sell is a function of a number of factors. One is geographic. Japan is a densely populated country of 125 million individuals living in an area slightly smaller than California; of this land mass, less than 33% is reasonably habitable or arable, and urban sprawl is confined by the politically sacrosanct farm lobby. "Because land is so scarce, the Japanese have an emotional attachment to land and a disinclination to sell any property they might own. This attitude prevails not only among individuals but among corporations."(171)

Another factor is economic. The Japanese tax system penalizes near-term sales:

> [O]wners hesitate to sell property [because of] the capital gain tax. When a Japanese company sells property that has been in its possession for less than 10 years, any capital gain from the sale is treated as short-term capital gain and is subject to an additional 20% capital gain tax levied on top of the 42% corporate income tax.(172)

Other economically-based considerations, such as a lending institution's policy of matching long-term liabilities with long-term assets, also play a significant role, as was noted in Section III.

Finally, certain somewhat philosophical factors exist which influence the national personality and tend to reinforce the disinclination to sell. In a country where honor and "saving face" are deeply inculcated, the mere belief that one's peers are going to conclude -- whether

correctly or not -- that business problems are necessitating the sale of property is enough to dissuade most individuals from taking such action. There are even explanations which border on esoterica, yet have a ring of truth; one of our favorites was a comment by Nomura's Shuko Akita, whose specialty is U.S. real estate investment vehicles: "The American investment personality seems to have been shaped by its history as a cattle society, where the asset is mobile and a commodity. In Japan, we are traditionally an agricultural society, and land is venerated."(173)

So how do such factors influence the scope and character of Japanese investment in U.S. real estate ? In a least two ways. First, these factors artificially restrict the number of real estate transactions within Japan; "in Japan, when a major company announces that it will sell property, most observers conclude that the company is in a tight financial spot. <u>This attitude cuts the number of potential sellers and reduces real estate investment opportunities</u>" (emphasis added).(174) A consequence of such artificial restrictions is that real estate becomes an even more illiquid asset. Thus, prudent real estate investors are enticed to look at different markets in order to achieve a portfolio which balances yield, liquidity and risk.

Secondly, such factors naturally affect the investment personality of the Japanese. Having been weaned on a diet of non-transactional conservatism, the Japanese are more

inclined to choose U.S. investments and deal structures which are similarly conservative. A deal featuring a steady and satisfactorily high income stream is likely to be preferred to ones whose returns are disproportionately weighted towards future-sale proceeds. Being long-term investors by nature, they are well aware of the vagaries of the market and the unpredictability of long-term forecasts.

Of course, the Japanese have proven themselves to be geniuses in their ability to learn and adapt to new products and markets, and many American real estate people who have worked with the Japanese on U.S. real estate projects claim that they can already see some manifestations of changed thinking on the issue of selling realty investments; furthermore, certain kinds of real estate investors are better equipped and more inclined to accept a shorter holding period, as noted earlier in this paper. Notwithstanding such trends, however, current Japanese real estate investment behavior is greatly slanted towards a long-term hold of property, and most investors are likely to retain such a bias well into the future.

D. The Importance and Role of Relationships

> "We're not going to make a decision based upon the deal; we base it upon the people."
>
> Hitoshi Suga
> New Business Development
> Mitsui & Co. (USA), Inc.

Japanese companies are renowned for the emphasis they place upon the development and nourishment of business relationships. Our experience confirmed such an orientation; every interviewee spoke of his company's desire to associate with owners, developers and institutions of high reputation and competence. Such relationships are developed slowly, over time and deals, and are preferably done in a direct fashion between principals.

Given this, it is no great surprise that Japanese real estate companies harbor "almost an animus" towards consultants and intermediaries.(175) "The Japanese have an inherent distaste -- or rather, apprehension -- about dealing with middlemen," notes an institutional representative who has worked with a number of Japanese institutions on real estate co-ventures.(176) Such discomfort with intermediaries is never far from the surface, claims Leonard Barr Smith, senior partner and former chairman of Jones Lang Wootton, and can be easily provoked. In 1982, Barr Smith claims that his efforts to slowly and properly cultivate Japanese relationships were brought to a screeching halt when "scores of bag-carrying Americans arrived in Japan."(177) What these American brokers failed to realize is that "you just can''t 'sell' the Japanese; in fact, nothing could be worse. They much prefer to do their own analysis and let the numbers, not the broker, tell the story."(178) According to Barr Smith, such salesmanship tactics "put the Japanese on guard," and set

back his and other's efforts by a couple of years.

But the Japanese find themselves in a dilemma. On one hand, they instinctively eschew intermediaries; on the other, they realize that they are not only new players in a large and idiosyncratic industry, but they are foreigners without established networks, contacts or cultural bonds. This absence of connections is particularly unsettling for the Japanese, for, as Barr Smith notes, "the 'old boy' network is stronger in Japan than anywhere else -- even Britain."(179)

Steps Taken

As a result, certain Japanese concerns have decided that it is advisable to enter into consulting agreements with well-placed firms. This is particularly (and almost exclusively) the case with Japanese trust banks. Sumitomo Trust & Banking is in the third year of a five-year contract with Richard Ellis, Inc., Yasuda Trust & Banking is represented by Citibank Real Estate Advisors on the East Coast and Grubb & Ellis on the West, and Mitsubishi Trust & Banking has recently affiliated with Cushman & Wakefield. It is quite natural for such trust banks to be the most willing to affiliate with consultants, for they themselves act primarily as advisors to clients and as fiduciaries to pension funds back in Japan. "They are beginning to acknowledge that the use of consultants in America is important, and that the lack of their use may well have

contributed to past mistakes."(180)

Nonetheless, most Japanese firms continue to operate within the U.S. without a formal consulting relationship. That is not to say that they categorically disdain information generally available from consultants; like most of their American counterparts, they avail themselves of the numerous -- and often free -- market-status reports and like information regularly provided by consulting and brokerage houses.

Central to the Japanese vein of independence is a desire to build up their own corporate infrastructure without undue reliance upon outside assistance. "Dai-Ichi prefers to teach and use its own employees . . .", asserts the head of the New York office.(181) "We like to do our own evaluations," notes the Tokyo-based manager of another life insurance company. "We do not want to limit ourselves to a single consultant. If we do this, we feel that many deals [offered by other consultants or brokers] will decide to go elsewhere."(182) Clearly, when it comes to information, the Japanese prefer an open-door policy.

Another factor which makes the consultants' lot a difficult one is the innate Japanese expectation of unwavering fidelity. "The Japanese expect absolute exclusivity on a deal, and this is a real problem as to timing. I mean, they can take so long! And yet, it's death to invite, say, four potential competitors to review an investment opportunity, for each one will invariably

ask,'who else have you talked to?'."(183) The chief foreign real estate manager for one of the Japanese trust banks is currently reevaluating its relationship with its American consultant and evaluating potential replacements; "I am concerned with the relationship because our consultant also represents sellers." (184) Wise American partners are careful to honor the expectation of fidelity. "I would never even talk to another Japanese concern unless and until I had first received permission from [my partner]," claims Will Zeckendorf of Zeckendorf Company, which is currently co-developing six Manhattan projects with KG Land, the U.S. subsidiary of Kumagai Gumi, a large Japanese construction company.

Those consultants and partners who have succeeded in establishing relationships with Japanese concerns know that such success is more than a function of possessing good information or development opportunities. "It is a lot of dinners and getting to know each other. It is really learning about the entire company," notes Evan Hellar, vice president of Richard Ellis, Inc.(185) The Japanese want to lay a groundwork for "a long term alliance. They want to know if you are the kind of company where there will be mutual respect, trust and understanding."(186)

The Equitable Life Assurance Co. Experience

One American real estate company which appears to be without peer in understanding the importance and process of

relationships to the Japanese is the Equitable. On a general corporate (i.e., non-real estate) level, Equitable began to initiate relationships with Japanese institutions in the mid-1960's. Employees from Meiji, Sumitomo and other life insurance companies had clerked at Equitable for anywhere from six months to two years. The result of such exchange, according to Kazunobu Nisawa of Meiji (NY)'s real estate section, is that "the mid-level staffs know each other real well."(187) And although approximately ten years passed before any cooperative real estate transactions took place, Equitable's patient cultivation bore fruit. To date, Equitable has entered into six joint ventures with Japanese institutions, and Equitable's Gordon Clagett believes that "our willingness to cultivate a relationship slowly has helped to cement our relationship."(188) Others are following the lead; such an apprenticeship program is in place at Cabot Cabot & Forbes in Boston, where an employee of Kajima Construction Company is currently working.

But, in light of the earlier observation about the Japanese insistence upon exclusivity and fidelity, how is Equitable able to work with four different Japanese companies, three of which (Nippon Life, Meiji Life and Asahi Life) being direct competitors? "It's not a problem for us, because our partners know that information about each deal is kept in absolute confidentiality. Furthermore, they know that because we are so big, no single partner can possibly accomodate all of our business," claims Tim Welch of

Equitable. "We are very careful about our the sanctity of our relationships."(189)

Equitable has recently announced plans to open up a real estate office in Tokyo -- a first among American realty firms. This office, to be headed by a senior vice president who has a long history of working with the Equitable's Japanese partners, is certain to cement existing relationships while facilitating the cultivation of new ones.

Trends

But even for Equitable, the long-term prospects for mutually beneficial relationships with the Japanese are uncertain. Most Japanese are quite candid about their desire to ultimately handle almost all components of the real estate investment and development business. They are simply required to temper this desire, as well as their inculcated dislike for intermediaries, in order to conform to the current realities of their inexperience and the market. Nevertheless, a senior official of a large Japanese development firm which has had a long-time affiliation with an American company notes that "we are beginning to stand on our own two feet," and adds that over the past few years, they have begun to look for investment opportunities on their own.(190) Equitable's Clagett believes that, while there probably will always be a demand by certain Japanese

for the sort of services an affiliation with Equitable brings, the nature of the relationship will change. "It will be on their terms, not ours."(191)

Lawyers

Curiously enough, one of the growth areas for consultants is in legal-related services. What makes this appear so odd is the heralded Japanese animus for lawyers. "The Japanese believe that parties with problems should first try to settle them through reasoned discussion, and an injured party will enter into a lawsuit only after all other efforts have been in vain."(192) There are fewer than 12,000 attorneys in Japan, compared to more than 600,000 in the U.S.; Washington, D.C. alone has almost three times as many as all of Japan. Legal departments within major Japanese corporations are often staffed, and even headed, by laypersons; Toyota Motors is an example. Commenting on an aggregate Japanese corporate entertainment expenditure of $37 million a day, a director of one such Japanese company explained:

> Americans spend more than that each day on legal fees. We prefer to invest the money in more pleasant activity that lets us see if a person is worthy of trust. If there is trust, there is little need for lawyers. In Japan, we have a saying: "You get through to a man's soul at night".(193)

A senior official of Sumitomo Life provided a graphic example of the role such trust plays in the Japanese real

estate world. During our interview in Tokyo, the representative was lamenting the fact that a recent purchase of an American office building required almost two thousand pages of documentation. He then pointed to a rendering of a $150 million Japanese mixed-use project in which Sumitomo had recently acquired a majority interest. "The total length of that purchase agreement was four pages."(194)

Notwithstanding such dislike, the Japanese are not only aware that they must play the game according to American rules and norms, but they are extremely anxious about the potential consequences of failing to do so. Granted, "sometimes an American lawyer is thought to be taking too much initiative,"(195) but the Japanese are learning to accept the lawyer's role much as their American counterparts have -- as a necessary evil. The Japanese investor, although "amazed when he sees the high charges billed by outside experts . . .ends up paying the fees because he treats them as a kind of 'insurance' or 'security' cost that is necessary if he is to do business in this country."(196) Furthermore, some Japanese actually gain comfort from the thorough process by which property interests are transferred in the U.S. "In the U.S., it is safer, for you have title insurance as well as many experts involved in the process." (197)

One lawyer who was early to recognize the potential benefits of working with the Japanese is Arthur Mitchell of Coudert Brothers, an international law firm based in New

York. Mitchell lived in Japan for over ten years, studied Japanese law at Kyoto University under a grant from the Japanese Ministry of Education, and was the principal American attorney at a major Tokyo law firm. Actively involved in real estate, he has a client list of more than fifty Japanese companies, including Dai-Ichi Life, Sumitomo Life and Japan Air Lines. Among the deals in which he played an instrumental role was the purchase of the Essex House by JAL, and his stature was confirmed by a recent front-page Wall Street Journal article in which he was featured.

Perhaps what cements his position as a top attorney acting on behalf of Japanese clients is his role as a counselor, in the generic sense of the word. For example, Mitchell was instrumental in orchestrating the recent cooperative agreement between Mitsubishi Trust & Banking and Cushman & Wakefield, a relationship which goes beyond mere consulting to a form of loose joint venture. During negotiations, the proposed affiliation ran into some difficulties at the Ministry of Finance; it appeared to both principals that the deal was in jeopardy. Due to his intimate familiarity with the legal and regulatory systems in both countries, Mitchell was ultimately able to craft an agreement which was satisfactory both to the parties and the Ministry of Finance. According to Kevin Haggerty, executive vice president of Cushman & Wakefield,

> There's no doubt in my mind that the deal came about because of Arthur Mitchell and Coudert . . . He was the ideal matchmaker. He understands the people and the culture, and also the regulatory agencies, the protocol, licensing requirements, fee structures. No one ever left the table with a misunderstanding.(198)

Summary

In conclusion, it appears that the long-term prospects for various kinds of relationships differ. For American brokers, consultants and other intermediaries who seek exclusive relationships but who provide arguably fungible services which either can be acquired for free, performed in-house or provided by direct dealing with principals, the long-term future is not terribly bright. Granted, as new Japanese firms enter the U.S. market, they, like their Japanese predecessors, will require assistance in penetrating the market. According to Equitable's Clagett, however, such companies may well look to the Japanese pioneers for such services, rather than U.S. brokerage houses or consultants.

The future for other sectors is rosier. American lawyers, offering services which the Japanese are in no way equipped to provide, should be the greatest beneficiaries. And American joint venture partners who provide sustained market access and acceptability in preferred markets should likewise fare well, although expansion of their relationship with a Japanese partner may prove increasingly difficult as the partner becomes more acclimated and self-sufficient.

Chapter VIII:

Washington, D.C.: A Target City, And Why

"Today, Washington is our next target."

senior representative,
Japanese life insurance company

In July of 1985, there had yet to be a single recorded acquisition of Washington real estate by a Japanese entity.

Today, one year later, Washington has witnessed no less than three Japanese purchases of interests in office buildings. Additionally, at least one office building is subject to a forward-purchase commitment and will be closed upon this fall, and active negotiations are underway on no less than four other projects.

Washington, D.C. serves as an example of Japanese activity in U.S. real estate. Representatives of almost all sectors have invested or are negotiating to invest there: life insurance companies, construction firms, real estate development companies and small non-institutional companies. Forms and scale of investment have varied. And almost all of the activity has taken place within the last nine months, allowing for a fresh snapshot of Japanese investment patterns.

The Reasons for Coming to Washington, D.C.

Why has Washington enjoyed such an increase in demand, an increase which, with the possible exception of Boston, is

seemingly unmatched in the nation ? Most of our Japanese interviewees cited some or all of the following:

1. Size and zoning limitations
2. Growing familiarity
3. Presence of federal government
4. Smaller dollar size of transactions
5. Large size of base market
6. Current and historically favorable vacancy rates
7. Emotional appeal

1. Size and Zoning Restrictions

Washington is a relatively small city of sixty-nine square miles. Its effective size is shrunk even further, however, given the fact that a very large portion of its area is dedicated to the federal government, together with the fact that it has one of the proportions of area dedicated to parkland and public greenspace any major American city.

The zoning regulations of the District of Columbia are among the more restrictive of major American cities. The zoning code has effectively incorporates a 1910 Congressional Act which severely limits the height of Washington buildings; although originally legislated to ensure that fire ladders could reach the top of all buildings, it has been popularized and preserved as a protector of the low scale of the city while enhancing the prominence of Washington's two tallest buildings, The Washington Monument and the Capitol. The practical effect of these zoning restrictions is to limit the height (exclusive of penthouse) of most buildings to ninety feet; a

relatively small area (less than two square miles) allows structures of 130 feet, while buildings along Pennsylvania Avenue between the White House and the Capitol may, under certain circumstances, reach to 160 feet. Applicable floor-area ratios within the CBD range from 6.5 to 10.

Together, these size and zoning limitations act to control the amount of space which can be delivered into the market; one is not going to awake one morning and learn that his project will soon be competing with a forty-story office tower. Such restrictiveness appeals to both American and foreign real estate investors, including the Japanese. Writing about factors which foreign investors consider favorably, Mahlon Apgar IV notes in an Urban Land Institute report that "[i]n zoning and physical limitations and in the procedures for development, cities like Boston and Washington, D.C., New Orleans and San Antonio are more predictable and structured, making competition and growth more predictable and structured."(199)

2. Growing Familiarity

Although Washington is the Nation's Capital, it is not now nor has it ever been a center of commerce. Without a bona fide port or industrial base, Washington had little to draw the interest of Japanese mercantilists who were actively pursuing business in such cities as New York and San Francisco. As companies such as Mitsui & Co., which established its New York office in 1879, proliferated, it

was only natural that familiarity bred interest in the host city's real estate market.

Today, however, Washington has become a much more familiar town to the Japanese, due to a variety of factors. First, most Japanese corporate real estate investors have targeted Washington in their strategic plans for expansion ever since their U.S. subsidiaries opened around 1981. Given its proximity to New York, Washington was viewed as regionally compatible as well as easily accessible to the relatively thin staffs of the Japanese companies. Secondly, in the last six years, Washington has gained new prestige as a center of real estate development; within that period, national developers such as Boston Properties, Beacon Companies, Cabot Cabot & Forbes, Cadillac Fairview, Gerald Hines, Lincoln Property Company, Prudential, Rose Associates, Spaulding & Slye and Trammell Crow completed their first D.C. projects. The presence of such developers is a natural draw for the Japanese, giving a city the stamp of approval. Finally, in light of the high demand for Manhattan property by foreign investors of almost every origin, it is increasingly difficult for the Japanese to satisfy their investment parameters through realty investments there; as a result, they have embarked on a special effort to familiarize themselves with Washington and other East Coast cities.

3. The Presence of the Federal Government

The fact that Washington is the home of the federal government is an immensely important factor for most Japanese investors. It implies a special underlying stability in the marketplace, and while Washington may not be as "recession-proof" as some of the interviewees suggested (and as many Washingtonians used to herald), statistics do suggest that the Washington market has historically been one of the most stable in the U.S. "It is the center of politics," noted one such person , "and we don't see much change in the economy. Lawyers and lobbyists will always be in demand."(200) A number of interviewees expanded on this point, stating that while they could envision various factors, including the advent and improvement of telecommunications, eventually eroding the importance of locating within any one of many cities, they did not forsee such factors undermining the importance for certain tenants to locate in Washington. "Politics and diplomacy will always be person-to-person 'businesses'," noted one Japanese institutional investor, " and their home will always be Washington."(201)

Finally, on a related theme, Washington is the beneficiary of analogy and transference, for Tokyo, home of the most highly desired and richly priced real estate in Japan, is likewise the home of the federal government, and Japanese investors are well aware of the strength and stability such a presence brings to that city.

4. Smaller Dollar Size of Transactions

In many ways, the entry costs of acquiring a real estate presence in Washington are less than in other comparably sized cities.

A number of factors conspire to keep the average value of Washington buildings at a relatively low level. Although land costs for premium downtown commercial sites are among the highest in the nation (ranging from $90 to $120 per F.A.R. square foot), buildings tend to be a good deal smaller due to the aforementioned height and bulk restrictions, together with the fact that due to the maturity of the market there are relatively few opportunities to put together large-scale assemblages in established premium locations. The effect of these various factors is demonstrated in a review of the downtown office buildings completed or scheduled to be completed from 1985-1987:

1985 -- Number of buildings: 20
Average square footage: 158,850

1986 -- Number of buildings: 19
Average square footage: 185,750

1987 -- Number of buildings: 23
Average square footage: 208,875

Source: (202)

Of all these buildings, only three are in excess of 400,000

square feet in size, and none are in excess of 600,000 square feet (although 1001 Pennsylvania Avenue, developed in two separate phases, totals slightly in excess of 700,000 square feet).

Finally, certain construction-related factors act to limit the total development cost of Washington, D.C. product. First, the lower height permits the use of poured-in-place concrete construction in addition to other (and often more costly) methods, particularly steel. And secondly, Washington contracting is not predominantly union; in recent years, more than fifty percent of the downtown jobs have gone to open-shop contractors, and many of the larger contracting firms have both closed- and open-shop subsidiaries. Testimony to the dominance of open-shop contractors was the adoption, in 1984, of a "Market Recovery Plan" by the metropolitan Washington trades council, which incorporated a number of cost-reduction and no-strike provisions designed to recapture a portion of the market.

The net effect of all these factors is that the value -- and hence, the cost, assuming a willing seller -- of the typical investment-grade Washington office building is less expensive than in Manhattan, San Francisco or Chicago. Current total building costs for new developments are running in the $180-to-$220 per F.A.R.(net leasable) foot range, and sales prices of premium leased properties have exceeded $300 per F.A.R. foot. Such numbers would place the majority of new buildings in the $30 million-to-$40 million

cost range, while the sales price of the majority of new fully leased product might range from $35 million-to-$55 million -- all numbers which are well within the "comfort" zone of most Japanese institutions now active in the U.S.

5. Large Base Size of Market

Perhaps almost as important as acquisition cost is the potential availability of product; after all, as noted earlier, it is lack of satisfactory product in Manhattan which is partially fueling Japanese interest in other markets. Washington's existing inventory of downtown office space is one of the largest in the nation. This fact, combined with the relatively low entry costs, expands the opportunities for a variety of Japanese investors to acquire product.

6. Current and Historically Favorable Vacancy Rates

The current office vacancy rate for the city of Washington is approximately ten percent (203), with it projected to increase to approximately 15% in the wake of market oversaturation which is characteristic throughout the nation. (204). Both figures compare most favorably against those of other major American cities (205).

Furthermore, Washington has historically fared comparatively well against such cities. According to information contained within two separate market reports,

over the last eight years Washington has not suffered a downtown office vacancy rate in excess of 14%; only Manhattan (midtown: 7.4%; downtown: 10%) and Boston (13.7%) boast better maximum numbers. During that period, Washington has enjoyed six bi-annual periods in which its vacancy rate was below 1% (San Francisco: 7; Los Angeles: 5; Manhattan and Boston: 0), and its unweighted average vacancy rate for the entire period (5.6%) is surpassed only by San Francisco (4.2%) and midtown Manhattan (5.4%).(206)

7. Emotional Appeal

The low-slung scale of Washington -- a function of Pierre L'Enfant's city plan, in concert with the aforementioned 1910 congressional act -- appeals to many people; Europeans, finding the scale and urban design to be pleasantly reminiscent of Paris, Rome, Munich and some of their other more hallowed cities, seem to be particularly impressed.

Apparently, such features appeal to some Japanese, for the same reasons. "There are no high buildings. This is very similar to many cities within Japan, and appeals to many of us." (207)

Current Japanese Activity in the Washington, D.C. Market

In the summer of 1985, four years after Japanese life insurance companies were permitted to invest in U.S. real

estate, Meiji Mutual Life Insurance Company became the first Japanese company to acquire an interest in a Washington, D.C. office building. Meiji and the Equitable (which introduced the Japanese life to the project) agreed to co-venture on the development of Lafayette Center III, a 200,000-square-foot office building which is the third of a planned five-phase office complex. In exchange for approximately half of the deal, Meiji/Equitable made a very full loan (approximately 100% of total project cost) at a below-par coupon rate, and will provide a similarly priced permanent loan. The project is scheduled for delivery in late 1986 or early 1987.

This deal incorporates many of those characteristics which are quite typical of most Japanese investors. First of all, the project is a well-located one; it is nestled within Washington's "Golden Triangle," that area bounded by Connecticut, Pennsylvania and New Hampshire avenues and which, for the last twenty-five years, has been the premier office submarket in Washington. Secondly, it is a joint venture with the Equitable, an association which many Japanese investors covet both as a learning vehicle as well as a security blanket; furthermore, according to a representative of Equitable, " Meiji is somewhat less experienced and a good deal more conservative than some of our other Japanese partners, and they take special solace in our involvement."(208) Finally, the local developer which sold part of its interest to the life insurance companies

(Farr-Jewett, on behalf of a development partnership) is an experienced one, having succesfully developed the first two phases of Lafayette Center.

At least three other deals involving Japanese investors have been made or committed to in the last twelve months, and each of them varies from the above. As noted earlier in the paper, Kokusai Kangyo Aerial Surveys acquired a partial interest in Cadillac Fairview's 1001 Pennsylvania Avenue project. Nissei Realty, Nippon Life's U.S. subsidiary, will close on an as-yet unnamed office building later this fall. Finally, a life insurance company (as yet unrevealed) has reputedly purchased one half of One Thomas Circle, a fully leased 225,000-square-foot office building located outside of the Golden Triangle, from Prudential.

Not all Japanese investments have been in the form of equity or "dequity," however. At least two other Washington real estate ventures have involved Japanese concerns. The first, an office building in Northern Virginia, is being built by Kajima Construction Company on behalf of its future tenant and owner, N.E.C. (the large Japanese electronics firm).

The second is a more intriguing one. About three months ago, a seven-year open-ended mini-perm was placed against Washington Square, a new (completed in 1984), fully-leased 680,000-square-foot office building located not only within the Golden Triangle but at arguably the best location in the city. The lender, Mitsubishi Bank (in participation

with a local bank, American Security, and a consortium of other lenders) sought to enter the Washington market but was only interested in absolutely premier projects. In Washington Square, they found such a building: heavily capitalized and renowned local developers; prestigious tenants; high (if somewhat controversial) design; a strong rent roll; a superior location over a Metro subway station. And, having found a building which met their investment criteria, Mitsubishi was prepared to be most aggressive in order to obtain the loan. Although none of the loan participants would comment on the terms of the loan, reputable sources cited a rate which floats at forty basis points below prime, with a 6% floor and a 13% ceiling.

Not every Japanese effort to penetrate the Washington market has met with success, however. Sumitomo Life has expressed great interest in D.C., yet despite extended negotiations on two joint venture opportunities (one, in the Golden Triangle, with London & Leeds, its partner in Manhattan; the other with Gerald Hines Interests on a site at Franklin Square, a hot new submarket in the East End) it has yet to close on a property. A similar fate has been suffered by KG Land, the U.S. subsididary of Kumagai Construction Company which, among other projects, is co-venturing with Zeckendorf Company on their $500 million Madison Square Garden site. Protracted negotiations with a major Washington general contractor and major Washington developer were recently terminated, to the surprise of many

knowledgeable parties. The package deal called for the development of three separate sites -- one in D.C., the other two in Northern Virginia. According to an individual close to the deal, "they [KG] were tough, but quite responsible and fair. They also showed that they are subject to some of the same restrictions as we Americans, for they claimed that, while they wanted to do the deal, their home office just couldn't approve it." (209) At least a half dozen other developers and contractors claim to have had "substantive" discussions about a potential co-venture with a Japanese entity, but nothing has yet come to fruition.

Finally, there is one Washington project which offers interesting insight into Japanese investment methodology. At the same time, it serves to illustrate the point that underwriting standards and investment goals may vary as much between Japanese companies and industries as they do between their American counterparts.

The subject project is currently under construction at a prominent location within the Golden Triangle. Approximately 150,000 square feet in size, its design and construction quality are of the highest order -- factors which have undoubtedly contributed to its being 55% pre-leased two months prior to completion.

To date, two Japanese companies have made unsolicited offers on the property. One, a real estate development company, was introduced to the property by an American

company with which it has a pre-existing relationship. Their interest is limited to a 100% purchase, based upon an 8%-9% cap of the stabilized first-year income. The second entity, introduced to the project following a blind call from a Washington broker, is a life insurance company. They are proposing a convertible mortgage, which would have a coupon rate based upon an 7.5%-8.5% cap of stabilized first year income; in addition, credit would be given for any stipulated rent bumps incorporated into leases. At some point between five and ten years, the company could opt to convert the outstanding debt into a 70%-80% stake in the building. One apparent problem, as yet unresolved, is the desire on the part of the Japanese company to receive a preferred return on its equity stake following conversion, a requirement which could well limit the developer's ability to finance the project.

C. Summary

The dramatic increase in investment interest in Washington real estate over the last twelve months seems to foreshadow a sustained influx of Japanese capital into the metropolitan area. The variety of the kinds of investors -- life insurance companies, construction companies, banks, real estate companies and "individuals" (corporations, as well) -- attests to the diversity which the market seems to offer.

The nature of the Japanese investments in Washington is consistent with investment patterns described throughout this paper. Well-located downtown office buildings are the preferred product. Whenever possible, an affiliation with a prestigious developer or institution is sought. The buildings should be existing and fully or substantially leased, unless the development project is a co-venture with a strong and experienced developer or institution.

Of course, the predicted influx of Japanese capital into Washington could well be stemmed by one or two highly publicized investment mistakes which would induce anxiety among nascent Japanese real estate investors. Judging from the first wave of investments which have been noted above, however, there would seem to be little chance of such a catastrophe; all but one are equity investments in well-established buildings, and the other is a fairly conservatively-structured joint venture enjoying a fine location and a strong institutional partner. Thus, given the predicted success of these initial investments, more Japanese capital is almost certain to flow into Washington.

PART IV:

SUMMARY

Chapter IX:

"So What Does This All Mean, And How Can I Take Advantage of It ?"

The authors have demonstrated Japanese activity to be a broad and diverse real estate phenomenon. Japanese activity in U.S. real estate has expanded into all product and service areas of the investment, development, construction and management businesses. Firms in each of these areas operate with different goals and business philosophies.

We have observed that life insurance companies and trust banks are MOF regulated, risk-averse and conservative investors. They are fiduciaries and not operators, investors and not developers. While the quantitative amount of their U.S. investments must increase due to higher U.S. than domestic Japanese property returns and scarcity of domestic Japanese real estate product, nevertheless the qualitative extent of their presence in the U.S. will grow within a slow, evolutionary process. These companies will be allowed to invest more but will be no less regulated by MOF. They will follow a step-by-step incremental investment approach rather than innovate the expansion of Japanese real estate activities into products, areas and services. As Japanese development companies and contractors seek new geographical markets and project opportunities, life and non-life

companies and trust banks will cautiously follow them into second-tier cities and non-prestige investment deals. These institutions are oriented to size and location, and the nature of their activities will not change over the medium-term future. They transact with major U.S. institutional counterparts and not smaller investors, developers or builders. Innovations in strategy and operating procedure will come from learning through association with U.S. joint venture partners.

Real estate development companies are involved in different geographical areas and a variety of businesses. They generate product and often need intermediary services to be able to understand local U.S. real estate markets. Real estate development firms associated with "Zaibatsu" groups benefit from ties to big banks and powerful trading companies which ease adjustment to unfamiliar environments and provide local U.S. intermediaries for project partnerships. Medium-sized and smaller Japanese development companies want to enter the U.S. market, but do not have group-related advantages as do the larger firms. Therefore, medium-sized and small U.S. real estate developers, financiers and brokers can establish relationships with these companies through domestic U.S. banks, brokers and personal intermediaries. Though larger Japanese real estate development companies understand regional U.S. markets well enough to progressively dispense with expensive intermediation services of investment bankers and brokers,

U.S. intermediaries must help newer Japanese developer entrants to the U.S. market to overcome entry barriers.

Construction companies need to learn the intricacies of the U.S. construction business before they can implement strategies for full-scale, full-service operations. Construction companies have neither the experience of real estate development companies nor the limited strategies of institutional investors. Because they wish to provide many services to clients of differing size, construction companies will want to learn about real estate markets and participants via an ample range of joint ventures in scattered markets throughout the U.S. Therefore, medium-sized developers and builders have a chance to form joint ventures with Japanese contractors. The plant construction phase of Japanese foreign direct investment is a transitional cushion for Japanese contractors. During this period they want to become fully involved in mainstream U.S. real estate contracting with medium and small developer/builders in geographically diverse markets.

Small Japanese investors have few opportunities to invest in U.S. real estate. There is little supply of direct investment vehicles, and institutions gearing up to market U.S. real estate investment to smaller Japanese investors face significant MOF approvals and scrutiny. However, the opportunities are great and at every stage of the real estate process, Japanese securities firms will attempt to create markets for U.S. product. Pending MOF approval,

pooled investment funds will co-venture with insurance companies, make construction loans to contractors and joint venture with development companies. U.S. brokers and developers who can identify product segments and develop business strategies should be able to generate exciting new business opportunities. But, the development of this aspect of Japanese real estate activity in the U.S. is likely to be an extremely time consuming process for Japanese and U.S. participants.

We target, therefore, five areas of immediate business opportunity for U.S. real estate participants interested in working with Japanese institutions, developers and contractors, or in gaining access to sources of Japanese capital. Whereas some opportunities are longer-term than others, all can be actively probed for relationship development.

OPPORTUNITY #1:

AMERICAN REAL ESTATE PROFESSIONALS CAN INTERMEDIATE ON BEHALF OF JAPANESE AND U.S. PARTIES WISHING TO JOINT VENTURE. FURTHERMORE, AMERICANS WISHING TO CO-VENTURE WITH JAPANESE MAY EMPLOY JOINT VENTURE STRUCTURES AS A FORM OF INTERMEDIATION.

Opportunities for U.S. intermediaries of Japanese activity in U.S. real estate are considerable. Japanese contractors and developers in U.S. real estate separately lack a key dimension of their respective business processes. Real estate development companies want to liquify their

projects by packaging and selling residential, industrial and suburban office projects to medium-sized and, eventually, smaller investors in Japan. These types of U.S. real estate are not traditional forms of investment for most Japanese. Therefore, particular care must be taken in the early stages of business development to ensure that project mix, geographical location and deal structures are managed well. For this reason, smaller U.S. developers with quality projects and proven expertise can capitalize on joint venture opportunities with Japanese real estate development companies. Newer Japanese development company arrivals are particularly vulnerable, through inexperience, to errors in risk management and partner selection. Japanese trading companies expect to fulfill intermediary roles with Japanese investors for these projects in Japan, but may have problems in providing coverage of diverse and distinct local markets. Although Japanese companies dislike having to deal with intermediaries, there is little alternative to U.S.-based intermediation services for most developers. Real estate development companies eschew dealing with Wall Street firms because of exorbitant commissions, together with Wall Street's apparent lack of interest in small and medium-sized development businesses. Consequently, there is a clear role for U.S. intermediaries to link between Japanese real estate development companies with local markets. Japanese real estate activity outside major metropolitan areas has potential but has not been understood by U.S. real estate

participants. The move to second-tier cities and suburbs is a logical extension of current activities for most Japanese real estate development companies. They need local representatives to help them adjust to these markets.

Similarly, construction companies need help in learning the construction business and judging appropriate joint venture partners. In situations where a Japanese construction firm contributes equity to become involved in a project, project analysis and market judgment are essential to success. Major institutional investment banks do not operate in these markets nor command contacts with which the contractor can enter into business. Japanese trading firms, once again, want to play an intermediary role in the introduction of contractor with local developer. However, these companies neither have local expertise nor cover regional markets with a depth of knowledge required by construction company managements. Intermediation possibilities exist for introducing Japanese and U.S. participants to each other, as well as for presenting new markets for Japanese contractors and developers to enter.

Life and non-life insurance companies and trust banks are large-scale investors with narrow geographical and project parameters. They are adequately served by Wall Street investment banks and major national brokerage houses. Opportunities for smaller and medium-sized intermediaries are limited, for these firms deal exclusively on an institutional basis within major metropolitan areas. Future

business opportunities should develop along lines similar to those of domestic U.S. insurance company real estate investment. Japanese life and non-life insurance companies and trust banks have been given regulatory approval to invest a greater percentage of total portfolio in foreign currency denominated assets, among them real estate. In the future these companies may target different types of investment in regional U.S. markets, such as major U.S. pension funds have done in recent years. Nevertheless, unfamiliarity with development projects and extreme aversion to risk make this a longer-term perspective. U.S. intermediaries wishing to create opportunities in marketing development projects and regional marketplaces to Japanese institutional investors thus must adopt a similarly long view. It will not happen in the near term future. Furthermore, although these life, non-life and trust investors can invest greater amounts than before, their activity will continue to be heavily regulated by the MOF, which approves individual investments on a case-by-case basis. Decision times are slow and are not expected to change dramatically.

Securitization of real estate oportunities is an important focus of large institutional U.S. firms. The sale of U.S. securities to the Japanese market offers direct opportunities for U.S. product developers, marketers and managers. Major Wall Street firms have devoted substantial resources to building a direct sales capability in Japan for

U.S. securities as have Japanese firms in New York. Matching good real estate projects with financing and distribution potential is a high growth area of opportunity for U.S. institutions. Also, foreign investment by Japanese savings institutions can be facilitated by creative, new links between small Japanese investors and U.S. markets. These are very long-term prospects.

OPPORTUNITY #2:

ESTABLISHED AMERICAN REAL ESTATE FIRMS WHICH DESIRE TO TAKE PROFITS OR TO RE-CAPITALIZE THROUGH THE ADMISSION OF PARTNERS SHOULD CONSIDER CO-VENTURING WITH JAPANESE INSTITUTIONS AND REALTY FIRMS.

Large Japanese institutions which are investing in U.S. real estate have many valuable assets: significant capital resources; deep and firm relationships with other Japanese investors, builders and financiers; hard-working and well-trained staffs. At the same time, they lack many of those qualities which they recognize as being critical to sustained success within the U.S. real estate market: large and experienced staffs, established client bases and a mature, well-developed network of contacts. While the Japanese can effect purchases on an ad hoc basis, such an approach does not permit them to establish the well-integrated, long-term market presence which they desire. Some Japanese companies, such as life insurance companies and trust banks, which are fiduciaries, are content to wait until they unilaterally develop in-house expertise. Others,

however, do not appear to be as patient.

Such impatience presents a real opportunity for certain American companies. Established U.S. brokerage firms incorporate the market knowledge, staffing, and networking system which all Japanese real estate investors covet, while American development companies possess a highly specialized and non-fungible expertise. The bigger, the better; firms which specialize in a variety of different regional markets would be an especially attractive purchase for large institutions intent on diversifying their real estate portfolio on a national basis. This is not to say that highly-regarded regional firms lack any appeal whatsoever; rather, if the market is large and attractive, and the credibilty and expertise of the firm great enough, certain Japanese firms would want to acquire a stake in such a regional company.

However, it is unlikely that a Japanese firm would wish to buy the entire company and its goodwill. Such an action would be counterproductive; it would reduce incentives for the principal "asset" -- the personnel -- to perform, and may well lead to an exodus of staff. This would not only leave the Japanese with a shell corporation, but would make them business managers, as well -- a status which they do not currently desire. Consequently, those American firms whose principals desire to sell only a part of the business and remain actively involved in the firm's management and profit participation are likely to receive a more receptive

audience from Japanese investors.

Such acquisitions are not without precedent. The Long-Term Credit Bank took a position in Peers & Company, and Fuji Bank acquired Abacus Mortgage. Knowledgeable sources believe that it is only a matter of time before Japanese construction companies and securities firms undertake similar acquisitions. Therefore, qualified U.S. firms may enjoy a seller's market.

OPPORTUNITY #3:

SMALL AMERICAN REAL ESTATE OWNERS AND DEVELOPERS SHOULD BEGIN TO CONSIDER THE JAPANESE SMALL INVESTOR CAPITAL MARKET AS A VIABLE ALTERNATIVE SOURCE OF FUNDING. NOW IS A GOOD TIME FOR SUCH AMERICANS TO BEGIN RELATIONSHIPS WITH INTERMEDIARIES ACTING ON BEHALF OF SUCH INVESTORS, BECAUSE THESE INTERMEDIARIES NEED MORE PRODUCT IN ORDER TO CONVERT SMALL INVESTOR CURIOSITY INTO INVESTMENT ACTIVITY.

The time is ripe for smaller American real estate players to tap the Japanese small investor capital market. Tokyo real estate investment opportunities have evaporated, due to a superheated market which has priced property beyond the means of most small investors. Yields on Tokyo investment-grade real estate have dropped to the 1%-2% range, compared to the 8%-10% range extant in the U.S. The yen has appreciated forty percent against the dollar in the last eleven months, but is likely to fall against the dollar over a foreseeable future. Large Japanese companies have pioneered investment in U.S. real estate, developed a track record and thereby established both the credibility and

desirability of such investment.

But, the supply line is clogged. Neither large American brokers nor large Japanese institutional investors have any interest in such product, so there is relatively little information transfer between small American owners/developers and small Japanese investors. As a consequence, Americans who are able to circumnavigate the informational "roadblocks" will enjoy a fairly broad field of potential buyers who do not enjoy many U.S.real estate investment options.

How does one go about charting such a course ? For the time being, through established intermediaries and contacts. Firms such as Mitsui Real Estate Sales and Toyo Real Estate Sales are well-recognized and highly-regarded companies which possess extensive client bases and substantial knowledge about the U.S. real estate market. Jones Lang Wootton KK, although a new corporate presence in Japan, is headed by an experienced and well-connected native who is targeting the smaller investor market. Pacific Rim Research Limited is similarly new and shares a similar focus. American lawyers such as Arthur Mitchell of Coudert Brothers and Jeff Dwyer of Lane & Edson have overcome the Japanese animus towards attorneys and become trusted advisors, thus illustrating how lawyers can serve as valuable intermediaries and counselors.

OPPORTUNITY #4:

CULTIVATE WITH NUMBERS, NOT SALESMANSHIP: AMERICAN DEVELOPERS AND PROPERTY OWNERS WHO ARE CAPABLE OF PRODUCING STATE-OF-THE-ART QUANTITATIVE ANALYSIS ARE GENERALLY PREFERRED OVER THOSE WHO LACK SUCH CAPABILITIES.

When evaluating a project, Japanese do not like to be "sold." The information which is submitted to them should be principally "objective" measures of a project's value or feasibility, such as spreadsheets, appraisals and feasibility studies, together with maps and aerial photographs. Personnel of the large Japanese institutions, who possess their own computer models, closely evaluate all information provided and are not at all hesitant to ask probative, detailed questions.

Consequently, all things being equal, American real estate professionals who are facile with computers enjoy a substantial advantage over those who are not. The advantage is particularly pronounced when required to quickly respond to Japanese follow-up questions which require the use of new assumptions or a re-programming. The Japanese may be slow to decide, but they expect quick responses.

OPPORTUNITY #5:

MANHATTAN, WASHINGTON, D.C., BOSTON AND SAN FRANCISCO REMAIN THE MOST FAVORED CITIES FOR A MAJORITY OF JAPANESE REAL ESTATE INVESTORS. THE FAVORED PRODUCT REMAINS DOWNTOWN OFFICE BUILDINGS. CONSEQUENTLY, OWNERS AND DEVELOPERS OF SUCH BUILDINGS IN THESE CITIES ARE MORE LIKELY TO RECEIVE A FRIENDLY AUDIENCE FROM JAPANESE INVESTORS THAN THEIR PEERS HAVING OTHER PRODUCT IN OTHER CITIES.

The Japanese prefer real estate investments in these cities. San Francisco's long experience with the Japanese, its tight market and tough zoning restrictions give it special appeal, while Manhattan, Boston and Washington -- the epicenter and anchors of the "Bowash" corridor -- all combine a number of desired factors.

Projects in other cities do continue to appeal to Japanese investors, however. For instance, Mitsui Fudosan and Sumitomo Life's recent investments in Chicago is likely to stimulate further interest in that city. Due to its large Japanese-American community, Los Angeles is familiar to representatives of Japanese investors; it has a large base of Japanese real estate investment. Currently, it is perceived as being oversaturated with product; however, the right deal with the right parties is likely to elicit quick and favorable Japanese interest.

In conclusion, the authors believe that an increasing Japanese presence in the U.S. marketplace will present great opportunities for almost all kinds of U.S. real estate players. Japanese capital will be available and will promote new development and management techniques that can strengthen U.S. industry efficiency. The rising sun will shine a most favorable light on the American real estate game.

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