KENSHO INVESTMENT GROUP

June 17, 2024

CEO Insight: Japan has learnt its lessons from the Great Financial Crisis

While the US is seeing a resurgence of risky real estate securitization to the detriment of investors, Japan has strengthened its financial supervision and will not abandon foreign real estate investors.

It is hard to believe but despite all the lessons learned from risky market practices that have caused the global financial crisis, investors in the top-rated US commercial mortgage-backed securities have once again lost money. The loss occurred on $308 million (48.4 billion yen) worth of mortgage-backed notes on 1740 Broadway, a building in Manhattan, New York City. The buyers of the triple-A rated tranche of the loan were only able to recover 74% of their investment as the loan was sold at a significant discount. Five lower-ranked creditor groups holding double and single A tranches and below lost all their money.

Investment firm Blackstone acquired the property in 2014 for $605 million. The firm took out a $308 million mortgage to finance the transaction. The mortgage was securitized via CMBS bonds and purchased by Travelers, Endurance American Insurance, and others. Deutsche Bank arranged the transaction and the rating agency DBRS Morningstar awarded about half of the mortgage amount, $157.5 million, a triple A class rating, a $38.6 million tranche received a double-A and $26.7 million tranche a single A rating. However, even without the benefit of hindsight, this rating was hardly justifiable.

First, the building was old (though renovated) and had a large single-tenant risk, with one tenant representing 71% of the rental income and a lease term shorter than the loan term. Second, there was no cash sweep trigger in favor of the bondholders. Even after the tenant decided in early 2021 not to extend the lease, the equity holder, Blackstone, was allowed to receive dividends until the end of the lease in March 2022. Only after the tenant actually had moved out and stopped paying rent did the cash sweep trigger kick in.

This case illustrates the dark side of the capital-driven US property market. Investors in mortgage-backed bonds should not regard a class A rating as 100% insurance against high or total losses and should thoroughly scrutinize the CMBS small print. Japan, on the other hand, has learnt its lessons from the global financial crisis. Here, also foreign property investors can be sure that they will be treated fairly and will not be left in the lurch in the event of a crisis.

Following the Lehman Brothers crash, Japan is probably the only industrialized country to have concentrated all financial supervisory functions in a single authority, the Financial Services Agency, which monitors banks, insurance companies, the stock exchange and securities trading. The central bank assesses the stability of the financial system every six months and issues warnings in a public report based on defined criteria if a sector is running hot, for example measured by a significant change in the volume of loans. The commercial banks of the three major financial groups MUFG, SMFG and Mizuho, which emerged from the merger of 13 financial institutions in the wake of the severe banking crisis in Japan at the beginning of the noughties, only grant property loans with a high safety buffer.

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The rapid rise in US interest rates has caught at least one Japanese bank on the wrong foot. Aozora Bank, number 16 in Japan in terms of market capitalization, surprisingly posted its first annual loss in 15 years because it had to write down its office property loans in the US. However, the Japanese banks that have followed their Japanese corporate clients to the US and financed their investments there are working through difficult investments together with their clients. Unlike Blackstone, the companies are holding on to their investments and the Japanese banks are not simply selling their loans at a discount. Both sides recognize their responsibility.

The Japanese commercial property market is also much more resilient than the US market in other respects: the high office vacancy rate of 50% in some cases because employees prefer to work from home is the main cause of the current crisis. Japan is different: here, confidence in office investments remains high, partly because most employees work from home only a few days a week at the most.

The different attitudes towards office work can be explained by a serious difference in loyalty to one's own employer, the cause of which can also be assumed to be a pay gap that can hardly be justified. For example, the CEO of an S&P 500 company earns 400 times as much as the average of their workforce. In the 2,100 or so Topix companies, the bosses earn only 12 times as much as their employees. In Japan, everyone shares in the success of a company - capitalism works here.

This is why the large US funds invested in Japan are planning to further expand their already considerable investments. The shares held by Warren Buffett's Bershire Hathaway in five Japanese trading companies (more on this in CEO Insight from December 2022) now amount to 24 billion dollars. Bain Capital recently announced plans to double its investment in Japan to USD 10 billion. KKR, Carlyle and others have announced similar plans, citing in particular the "rebirth of dynamism" in Japan, as companies focus on return on investment and the government encourages citizens to save in securities.

In the real estate sector, hotels, data centers and residential buildings in the major cities are the current target of foreign investors. Their sustained interest should make German investors sit up and take notice. We are still experiencing golden times for Japanese property, and there is also a currency premium due to the weakness of the yen.

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