FOREIGN INVESTMENT
IN THE LOS ANGELES REAL ESTATE MARKET

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at the
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ABSTRACT

This research represents one segment of a joint study sponsored by the Massachusetts Institute of Technology's Center for Real Estate Development and the National Association of Realtors. The purpose of this research was to analyze foreign investment in U.S. real estate in three major markets: Chicago, Los Angeles and Washington, D.C. Our thesis focuses on the Los Angeles market.

The central question of our research was, "How are foreign investors in U.S. real estate different from domestic investors?" We found the following: for the last two years the Japanese have been the most active foreign investors in Los Angeles' central business district, almost to the complete exclusion of all other nationalities; they prefer well located, high quality, fully leased "signature" properties; low capitalization rates are mostly a thing of the past; large Japanese real estate companies are moving beyond simply investing and are beginning to develop property in the U.S.; they pay cash for the properties they acquire; they avoid speculative investments and generally intend to hold properties for a long time; they are most comfortable conducting business with people and firms with whom they have a long-standing relationship; they are only beginning to explore the use of syndications and convertible debt instruments; distinctions between foreign and domestic investors will become more obscure in the future.

We conclude that foreign investment in U.S. real estate is not a fad but a long term trend that will lead to the internationalization of real estate markets.

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INTRODUCTION

Little is known about how foreign investors make decisions and what they look for in a property. Given differences in language and culture, many Americans assume that foreign investors and their domestic counterparts are fundamentally dissimilar, and that therefore dealing with foreigners must be different than dealing with U.S. institutions. Our report examines this perception.

The specific questions we asked were: 1) Are foreign investors in U.S. real estate really different than domestic investors? and 2) If they are different, in what ways? These questions were examined through a research of current literature and our formulation of brief profiles which examined selected foreign investors, as well as their recent acquisitions in the U.S. These profiles looked at the parties involved and how they came together; the structure of the transations; the nature and terms of the financing used; the role of outside professionals and advisors; and the goals and concerns of the buyers, as well as the buyers' methods of doing business. Our methodology included extensive interviews with principals involved in the acquisition of U.S. properties, and with other real estate professionals and intermediaries.

Because a study of the entire U.S. was beyond the scope of this report, we focused solely on the Los Angeles market. Note, however, that this paper is one part of a larger study which is specifically examining foreign investment in three U.S. cities: Chicago, Los Angeles and Washington, D.C. It is expected that our findings will be combined with those from the other two cities and incorporated in a broader report.

Our study was further focused on downtown Los Angeles because that is where almost all the important transactions by large foreign institutional investors have occurred. In addition, although all foreign real estate investment was eligible for this study, we discovered that since 1985 the Japanese had become, by far, the most active foreign investors in this market, almost to the complete exclusion of any other nationality. As a result, much of our report addresses the Japanese situation specifically, rather than foreign investors generally. We believe this is appropriate in light of the overwhelming predominance of the Japanese in Los Angeles, which we expect to continue for the foreseeable future.

This report presents an overview of the economic factors which have made U.S. real estate such an attractive target for Japanese institutional investors (Chapter I) and why Los Angeles in particular has received such a disproportionate

share of their investment (Chapter II). Next, brief profiles take a closer look at a cross section of five different foreign investors and their specific investments and situations in Los Angeles (Chapter III). We then examine what is different about foreign investors (Chapter IV), and identify anticipated future trends (Chapter V).

CHAPTER I

FOREIGN INVESTMENT IN THE UNITED STATES

"I LOVE AMERICA"
Title of cover page, Faces of Shuwa
informational brochure of Shuwa Corporation

Foreign interests have been major purchasers of U.S. real estate since the late 1970's. According to The Survey of Current Business (1), between 1977 and 1984, $57 billion was directly invested in the U.S. (See Exhibit 1-1.) The major foreign investors and each one's percentage of total investment over this period included the United Kingdom (19%), Canada (17%), the Netherlands (15%), West Germany (6%), OPEC countries (5%) and Japan (3%). The remaining 34% was distributed among the rest of the world.

Within this timeframe, individual countries experienced radical shifts in their investment strategies. (See Exhibit 1-2.) For example, Canada and the Netherlands, buoyed by oil profits, recorded their highest level of investment activity in 1980. Coincidentally, oil consuming nations such as West Germany and the United Kingdom (prior to viable extraction of oil from the North Sea) recorded sharply lower activity in 1980. OPEC investment levels in U.S. property declined precipitiously throughout the period as oil profits were devoted to internal capital improvements.

EXHIBIT 1-1

FOREIGN DIRECT INVESTMENT in U.S. REAL PROPERTY
(in millions of dollars)

COUNTRY	1977	1979	1980	1981	1982	1983	1984	TOTALS
Canada	98	334	542	1,743	1,881	2,274	2,717	9,589
W. Germany	30	103	120	650	778	893	969	3,543
Netherlands	38	208	504	1,554	1,821	2,254	2,304	8,683
England	81	188	191	1,221	2,060	3,196	4,008	10,945
Japan	30	68	109	205	395	515	653	1,985
OPEC	182	267	280	376	555	614	669	2,943
Other	320	552	683	3,215	4,029	4,890	5,559	19,258
TOTAL	779	1,820	2,429	8,954	11,520	14,635	16,839	57,047

Source: Survey of Current Business

EXHIBIT 1-2

FOREIGN DIRECT INVESTMENT in U.S. REAL PROPERTY
(by country as a percent of total)

COUNTRY	1977	1979	1980	1981	1982	1983	1984	Total
Canada	13%	18%	22%	19%	16%	16%	16%	17%
W. Germany	4	6	5	7	7	6	6	6
Netherlands	5	11	21	17	16	15	14	15
England	10	10	8	14	18	22	24	19
Japan	4	4	4	2	3	4	4	3
OPEC	23	15	12	4	5	4	4	5
Other	41	35	28	36	35	33	33	34
	100%	100%	100%	100%	100%	100%	100%	100%

Source: Survey of Current Business

Since this data was compiled, the Japanese have become the leading foreign investors in U.S. property and, as discussed throughout this paper, the major foreign presence in the Los Angeles real estate market.

In 1984, the Japanese purchased $663 million of U.S. real estate. According to a report prepared by Salomon Brothers (2), in 1985 this figure increased to $1.5 billion and by 1986 swelled three times that level to $4.5 billion. Projections by the Real Estate Research Corporation estimate Japanese investment in U.S. real estate for 1987 at just under $6 billion.

There are a variety of reasons that explain Japanese interest in U.S. real estate.

Limited Opportunities in Home Martkets

The Japanese commercial real estate market is land-supply constrained. Containing 146,000 square miles, Japan is roughly the size of California, yet it holds 120 million people, or half the U.S. population. Approximately 85% of the land is either reserved for farming or is too mountainous for development. Competition for the remaining land is therefore intense, particularly within Tokyo's central business district.

Due to its scarcity, land rarely sells. For example, the largest owner of real estate in Japan, Mitsubishi Estate, owns over 24 million square feet of office space and is said to have never sold a major property in its fifty year history. In those rare instances when a corporation does sell real property, it is widely perceived as an indication of financial difficulty.

The acute demand for land has caused prices to increase dramatically. For example, in October, 1985, a tiny plot of 2900 square feet of land in Tokyo's central business district sold for $61.5 million or $21,000 per square foot. The value of real estate in Tokyo jumped 54% in 1986 alone (3). Hajime Tsuboi, President of Mitsui Real Estate Development Company, Ltd., predicted in the company's 1986 annual report that "The increase in Tokyo land prices will slow over the next couple of years, but prices will not fall."

Efforts are underway, in fact, to contain Tokyo's skyrocketing real estate prices. In mid-July, 1987, the Japan Federation of Bankers and the Association of Trust Banks directed their members to stop issuing loans for speculative real estate ventures.

Land prices are now so high in Japan that they typically comprise up to 80% of a project's development cost. Such land costs have diminished returns on commercial real estate

investments to the 1% to 4% range. Comparable annual returns for U.S. property range from 6% to 9%. For a host of reasons, similarly low rates of return on commercial properties are also the rule in the home countries of the other primary foreign investors in U.S. real estate (4).

Another reason for Japanese landowners to hold property for the long-term is an onerous capital gains tax. In Japan if a company sells land it has owned for less than ten years, any gain is subject to a 20% capital gains tax, in addition to the regular 42% corporate income tax.

Strong cultural and financial disincentives to sell real property limit opportunities at home and have made U.S. investments more attractive. According to an executive of Nomura Real Estate International, Inc., "Due to market constraints, we can't do the kind of real estate business that we want in Japan. We expect to do most of our future business in the United States" (5).

In addition, a variety of macro-economic and political pressures have transpired to encourage Japanese investment here.

Increased Value of the Yen and Trade Balance

Japan's balance of trade with the United States reached record levels in 1986, $86 billion versus $46 billion in 1985 (6). Japanese firms have acquired more cash than can be reasonably utilized in their domestic economy. The increasing hostility of the U.S. government over the trade imbalance has, among other things, caused Japan's Ministry of Finance ("MOF") to liberalize regulations regarding foreign investment by Japanese firms. The MOF hopes that increased Japanese investment in the United States will help defuse the protectionist impulses of the U.S. Congress.

While all foreign investment is subject to review by the MOF, in most cases such review is cursory. By early 1986, only fiduciaries, such as insurance companies, trust banks and pension funds were subject to stringent MOF review. The MOF initially permited 10 percent of the assets of these fiduciaries to be invested in foreign securities, including real estate. Since then, the limit for insurance companies has been raised to 25% of assets. A similar increase for trust banks is expected soon.

Investment approval for fiduciaries is granted after an exhaustive MOF analysis of a proposed transaction. The MOF seeks assurances that a project is viable, that risks are minimized and that the level of return is accurately

projected. This is a time-consuming process and can take up to three months, depending on a transaction's size and familiarity.

Another factor that has made U.S. real estate investments attractive is the precipitous rise in the value of the yen versus the dollar. Between June, 1985, and December, 1986, the yen appreciated 45% against the dollar, from 249 to 137. As a result, U.S. property has become relatively inexpensive for the Japanese buyer, particularly when compared to the prices in Japan for similar property. A senior officer of Nomura Real Estate International, Inc., cited this as the "prime reason for (his) company's presence in the United States".

Strength of the yen relative to the dollar is not expected to affect continued Japanese investment in the U.S. because returns here will remain above comparable returns found in Japan. If the dollar strengthens against the yen, Japanese investors who purchased U.S. property when the dollar was weak, will realize a currency gain and will have hedged some of the acquisition/development risk. Although their compatriates who bought U.S. property when the dollar was stronger have realized a currency exchange loss, another dramatic fall by the dollar does not appear likely at this time.

A final economic factor favoring Japanese investors is the availability of cheap institutional capital. For a variety of reasons, Japanese banks have a huge amount of money to lend. The Japanese people have possibly the highest personal savings rate in the world. They save approximately 22% of disposable income while the United States savings rate is on the order of 2% to 4% (7). Further, Japanese banks are allowed to retain lower capital reserves than comparable U.S. institutions. In addition, the value of hidden reserves held by these banks, i.e. the difference between the book value and market value of common stock and real estate holdings, has increased dramatically due to rises in stock prices and the value of real estate in Tokyo. This has swelled the capital ratio of Japanese banks to 8% to 10%, approximately 50% stronger than U.S. banks. Because of this value and their negligible loan loss ratios, Japanese banks have the highest credit ratings in the world.

In addition, Japanese companies have more than adequate assets to collateralize major loans. Due to the dramatic appreciation of Japanese land, the value of real estate owned by Japanese businesses is far in excess of its original cost (book value), sometimes exponentially so. Because accounting principles do not permit this tremendous increase in value to appear on a company's balance sheet, the term "hidden assets" has arisen to describe the situation.

In Japan, banks do not make non-recourse loans, even when the borrower uses the funds to purchase real estate. The loan is made on the basis of a company's overall credit worthiness and ability to repay. The banks, of course, are fully aware of the borrower's "hidden assets" and are therefore willing to lend large sums based on this value.

In 1986, such funds could be borrowed in Japanese yen at an annual interest rate of about 3%. If this money had been invested in U.S. real estate, however, the borrower would have been exposed to currency fluctuations. To avoid this exposure, Japanese firms often borrowed in U.S. dollars and paid an interest rate of approximately 7%. (It is unclear why Japanese banks would lend dollars to a Japanese company at 7% when it could invest those same dollars in U.S. government securities and receive a return of 8% or higher. This would be an interesting topic for future research.)

The practical result of these factors is that Japanese banks lend funds at lower rates, providing Japanese real estate investors with leverage to pay more for a property and/or accept a lower rate of return than other investors.

Other Factors

There are several other factors that make the U.S. particularly attractive to the Japanese, as well as any other

foreign investor. First, the U.S. has one of the most stable political and economic environments in the world. Its free enterprise system has few barriers to entry and is considered to be among the safest capital havens. The United States has a relatively unblemished record regarding confiscation of property and discriminatory taxation. In addition, the American people are generally perceived as being indifferent, if not receptive, to foreign investment.

The United States provides a much larger market than found in most foreign countries. This creates an opportunity for diversification by property type and location. A senior executive of Ohbayashi America Corporation, stated "we could have 100 projects underway in the States if we want, while it is difficult to find any reasonable opportunities in Japan" (8). As indicated, the scarcity of land and its high cost have diminished development opportunities there.

Also, the United States provides foreign investors with a laboratory to learn and experiment with heretofore unavailable investment vehicles. Mitsui Real Estate Development Company, Inc. cites this as one of their primary reasons for investing here. Among the sophisticated financing techniques that the Japanese are familiarizing themselves with are real estate investment trusts (REITs), joint ventures, syndications and convertible mortgages. U.S. investors are well versed in these techniques and find the

Japanese willing students.

Some recent examples include Japanese institutional purchase of approximately $550 million of the $1.3 billion REIT used to sell Rockefeller Center in New York City. In another case, Haseko, the U.S. subsidiary of Hasegawa Komuten Company, Ltd., brought a $60 million public syndication to market in Japan that included two office buildings, one at Los Angeles Airport and another in downtown Tokyo. Haseko's representative indicated that it was the first attempt by a Japanese firm to package properties from two different countries in the same investment.

Finally, the U.S. tax code also offers incentives to foreign investors in real property. Depreciation schedules are much more generous here than other countries. For example, commercial property in Japan is depreciated over a 65 year period while a 31.5 year period is used here, recently increased from 19 years. Further, tax rates are lower here than in most industrialized countries. A recent Wall Street Journal survey found the following corporate tax rates: U.S. 34%, England 35%, Switzerland 36%, Netherlands 42%, Japan 43%, France 45%, Canada 46%, Australia 49%, Sweden 52% and West Germany 56%.

The Tax Reform Act ("TRA") of 1986 helped stimulate foreign interest in U.S. real estate by essentially repealing

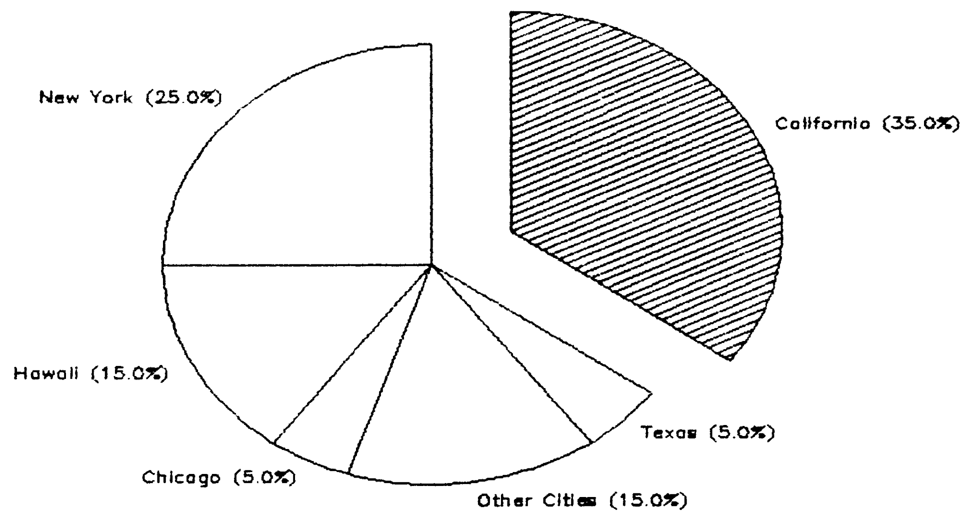
the 1980 Foreign Investment in Real Property Tax Act ("FIRPTA"). FIRPTA and its amendments had imposed taxes on foreign sellers of U.S. property and a bevy of reporting and withholding requirements. Further, most of the tax shelter advantages available to U.S. investors were also removed by the TRA. Domestic real estate syndicators were particularly hard hit by the strong disincentives for tax driven deals contained in the new law. Syndicators were among the primary competitors to foreign investors because of their willingness to pay top dollar for property. The Japanese investor's view of the new playing field was summarized by an officer of Shuwa Investment Company, who said that "The changes in the tax code got the amateurs out of the business". (9)

The Tax Reform Act also motivated many Americans who owned property to sell their holdings before the end of 1986. The repeal of favorable capital gains tax rates and the new passive loss restrictions, both beginning in 1987, were factors that compelled such sales. Thus, two key ingredients, the willingness to sell and the value of the yen, both peaked towards the end of 1986, creating an irresistable buyer's environment for the Japanese.

For the above reasons, the United States real estate market is uniquely attractive to foreign investors, particularily the Japanese. Most initial Japanese investment activity in the U.S. has been concentrated in Los Angeles,

the gateway city to the Pacific Rim. According to a Morgan Stanley estimate, as much as 35 percent of Japanese real estate investment activity to date has been made in California, mostly in the Los Angeles area. (See Exhibit 1-3.) The features of the Los Angeles market that attracted Japanese investment are described in the next chapter.

EXHIBIT 1-3



Source: Morgan Stanley

CHAPTER II

OVERVIEW of LOS ANGELES and its REAL ESTATE MARKET

Business and Financial Center of the West Coast

The Los Angeles region is typically defined as a sixty mile circle including all of Los Angeles and Orange counties and most of Riverside, San Bernadino and Ventura counties. This area covers only five percent of the State of California, yet it dominates the state's economy.

Within the past decade, Los Angeles became the headquarters for half of California's largest savings and loan institutions, four of the five top insurance firms and seven of the top ten financial holding companies. Growth within the Finance, Insurance and Real Estate ("FIRE") sectors is expected to continue for the foreseeable future.

Furthermore, the Los Angeles area contains the second largest concentration of business, population, employment, and finance activity in the United States today. Only the greater New York area boasts more economic activity. Exhibit 2-1 displays a comparative analysis of economic growth patterns among major U.S. financial centers.

EXHIBIT 2-1

POPULATION, PERSONAL INCOME and EMPLOYMENT GROWTH

	POPULATION (000)			TOTAL PERSONAL INCOME ($ MILLIONS)		
	July 1 1985	1975-85 NET CHANGE	%	1984	1974-84 NET CHANGE	%
GR. LOS ANGELES	11,974	1,967	19.7	170,421	108,437	175.0
GR. NEW YORK	17,931	135	0.8	282,070	153,198	137.3
GR. CHICAGO	8,085	281	3.6	116,152	63,597	121.2
CALIFORNIA	26,365	5,252	24.9	370,775	242,633	189.3
UNITED STATES	238,740	22,767	10.5	3,016,317	1,812,217	150.5

	NONAGRICULTURAL EMPLOYMENT (000)			MANUFACTURING EMPLOYMENT (000)		
	1985 AVERAGE	1975-85 NET CHANGE	%	1985 AVERAGE	1975-85 NET CHANGE	%
GR. LOS ANGELES	5,189	1,567	43.3	1,158	263	29.4
GR. NEW YORK	8,743	813	10.3	1,402	(97)	-6.4
GR. CHICAGO	3,581	107	3.1	753	(204)	-21.3
CALIFORNIA	10,955	3,118	39.7	2,090	495	31.1
UNITED STATES	97,699	20,648	26.8	19,425	151	0.8

Source: Security Pacific National Bank, Sixty Mile Report, 9th Edition, p. 6

The Greater New York regional economy is the largest in the United States. However, the growth rate for population, personal income and employment in the Los Angeles region between 1975 and 1985 easily outdistanced New York City, Chicago and the nation as a whole (10). Population gain within the region was 14 times greater than New York's and seven times greater than Chicago's. Total personal income

jumped 175% between 1974 and 1984, far exceeding the increases of New York (+137%) and Chicago (+121%). Further, of these three areas, Los Angeles is the only one to record a gain in manufacturing employment, while the other two lost 6% and 21% of their manufacturing employment base, respectively. Nonagricultural employment grew at four times the rate of New York's and 14 times the rate of Chicago's during the ten years ended 1985.

According to data compiled by Salomon Brothers (11), the Los Angeles region has a current population of 12.8 million people and 5.6 million non-argricultural jobs, demonstrating continued growth since 1985. This market also features an elaborate transportation network consisting of five major airports, two large ports, more than fifteen railway companies and an extensive system of freeways. Furthermore, three new public transit projects are now in the planning or construction stage.

In addition to the above, there are several other factors that help attract the Japanese to Los Angeles. For one, this market is already home to a significant number of foreign companies. According to a March, 1987, report prepared by the California Department of Commerce (12), California has the second greatest concentration of total foreign investment activity in the U.S. and the highest annual growth rate of foreign investment for any State, 31%.

As of 1984, the last year for which data is available, the total value of foreign investment in California property, plant and equipment was $31.3 billion. Los Angeles County captured 25% of this investment, the highest amount of any county in the state.

Furthermore, California has attracted the highest percentage of overall Japanese investment in the United States, 25%. According to a May, 1987, study by the Los Angeles-based Japan Business Association of Southern California (13), there are more than 500 Japanese companies located in Southern California which directly employ some 64,600 persons. Compared to a similar study conducted in 1983, employment levels have increased 58% and the number of firms has increased 28% in the intervening period. These Japanese firms represent a diversified range of industries: real estate, manufacturing, financial services, construction and trade.

Los Angeles also features a diverse economy that is not heavily dependent on any one industry. In fact, the five largest nonagricultural industries employ only 36% of the workforce. (See Exhibit 2-2.) These industries are office employment, wholesale trade, research and development, electronic media and apparel.

EXHIBIT 2-2

CONCENTRATION OF LOS ANGELES COUNTY'S KEY INDUSTRIES, 1986
(Employment in Thousands)

Category	L.A. 1986	% of L.A.	U.S. 1986*	% of U.S.	L.A. Share of U.S.
Total Employment	3,910		100,000		3.9%
Office Intensive	632	16.2%	13,090	13.1%	4.8%
- FIRE	268	6.9%	6,250	6.3%	4.3%
- Bus. Services	264	6.8%	4,800	4.8%	5.5%
- Legal	39	1.0%	740	0.7%	5.3%
- Misc. Services	61	1.6%	1,300	1.3%	4.7%
Wholesale Trade	293	7.5%	5,860	5.9%	5.0%
Research & Development	328	8.4%	3,640	3.6%	9.0%
- Aircraft/Missiles	145	3.7%	860	0.9%	16.9%
Electronic Media	73	1.9%	345	0.3%	21.2%
Apparel	80	2.0%	1,110	1.1%	7.2%

* - Salomon Brothers Estimate

Source: Salomon Brothers Inc., Report on the Los Angeles Real Estate Market, January 1987, p.5

The high tech, apparel and manufacturing industries have demonstrated economic strength. For example, the Los Angeles area houses the largest concentration of high tech industries in the United States, easily surpassing the Route 128 area of Boston and Silicon Valley near San Jose. Supporting this industry is the country's largest concentration of scientists, mathematicians, engineers and skilled technicians and the third largest concentration of colleges and universities, numbering 150, in the U.S.

A further example of the dynamic nature of the Los Angeles economy is its apparel industry. According to Salomon Brothers, U.S. employment in the garment industry declined by 19% over the 1972 to 1986 period, yet it increased by 36% in the Los Angeles area (14).

Another characteristic of this area is its attractiveness to immigrants. Los Angeles is home to one of the country's largest undocumented immigrant populations. The large pool of both legal and illegal workers enables the area's manufacturing and apparel industries to pay below average wages, which makes their products more price competitive. According to Salomon Brothers, manufacturing wages in Los Angeles during 1970 to 1980 increased 15% more slowly than the rest of the country (15). This situation partially explains the city's relative strength in light of a nationwide reduction in manufacturing employment.

Immigration has made Los Angeles one of this country's most prominent "melting pots". Approximately one and a half million new residents migrated to California between 1980 and 1985 (16). In the the City of Los Angeles, according to Census Bureau data, 49% of the population is Hispanic and 12% Asian (17). While more recent data than 1980 is not available, today the proportion of Asian residents is believed to be closer to 20%. The composition of the Asian

population has also undergone substantial changes. Historically comprised of Japanese and Chinese immigrants, the city has recently attracted substantial migration from such other Pacific Rim countries as Korea, Thailand and Vietnam. In fact, according to Frank Jansen, Vice President in Chicago Title's Los Angeles office, by 1986 this area contained "the largest Japanese, Chinese, Korean, Phillipine, and Viet Namese populations in the world outside of those home countries."

Due to its economic and cultural ties with Pacific Rim countries, Los Angeles has evolved into the leading port on the West coast. San Francisco, its nearest competitor, ships and receives 60% fewer goods than Los Angeles, based on gross tonnage (18). Furthermore, as shown in Exhibit 2-3, the aggregate value of import and export activity in the Los Angeles area is second only to that of New York. However, international trade in the Los Angeles area grew at a far greater rate (+193%) than the New York did (+45%) during the period from 1975 to 1985.

Based on this high level of economic activity, domestic and foreign banks are gravitating to Los Angeles, as well as other financial institutions, law firms and professional service companies. For example, 173 non-California banks, including 126 from foreign countries, have opened offices in Los Angeles. Most of the domestic banks have done so in

EXHIBIT 2-3

INTERNATIONAL TRADE*
(\$ MILLIONS)

	1985	Net Change 1975 to 1985 Amount	%
Los Angeles Customs District	\$63,781	\$42,009	193
New York Customs District	90,376	27,955	45
Chicago Customs District	16,821	10,578	169
California	94,002	57,194	155
United States	558,422	215,836	63

* - Includes exports and imports via air and land transportation as well as waterborne trade.

Source: Security Pacific National Bank, Sixty Mile Report, 9th Edition, p.5

anticipation of banking deregulation. The number of these out-of-state firms is up substantially from 1980 when only 69 foreign banks and 45 domestic non-California banks were located in Los Angeles (19). Financial institutions' exuberance for Los Angeles was best expressed by Walter C. Butcher, Chase Manhatten's Chairman and chief executive officer who said,

> "Los Angeles is the principle business center for the entire Pacific Basin. It is an extremely important market. In fact, if interstate banking had been in existence three decades ago, Chase would have beaten Walter O'Malley and the Brooklyn Dodgers into the

city." (20)

Re-location and expansion of these businesses is expected to lead demand for office space in the city through the end of the decade.

While the electronic media's share of the workforce is only two percent, the value of that industry to the region's economy far outweighs that figure. The TV and motion picture industry provides an on-going advertisement to the world of Southern California's attractiveness and thereby kindles interest in this market from tourists, immigrants and investors.

Lastly, the State of California recently modified its unitary tax law. The change limits taxation to only include a firm's California operations and does not tax its worldwide profits. This amendment was widely supported in the foreign business community.

In summary, Los Angeles is blessed by enormous business, population, trade and employment growth and this dynamic economy will continue to expand for the foreseeable future. It is a gateway for Japanese goods into the U.S. and is home to a large concentration of businesses from that country. It should be no surprise, therefore, that the Japanese have concentrated so much investment activity in this area. An

overview of the greater Los Angeles market follows.

<u>The Los Angeles Real Estate Market</u>

The Los Angeles real estate market is the sixth largest in the U.S. with more than 108 million square feet of office space. Inventory grew by 39 million square feet between 1970 and 1980, and by another 47 million square feet since then.

The greater Los Angeles real estate market is comprised of several significant sub-markets: Downtown, Westside, San Fernando, West Central, South Bay, Glendale/Pasadena, Long Beach/Mid Cities and San Gabriel. Exhibit 2-4 describes current and projected size and market conditions of each of these sub-markets. A map of the Greater Los Angeles market is found at Exhibit 2-5.

Of all submarkets, the Westside has emerged as the most prestigious alternative to downtown for office space users. Currently, the Westside has the lowest vacancy levels in the Los Angeles market. Even though it is projected to have the highest absorption rate in the region, its vacancy rate will not decline greatly due to record construction activity. Similar levels of construction activity coupled with slower than expected absorption will dramatically increase vacancy rates in Pasadena and South Bay. These two areas have attracted the most speculative office development activity in

EXHIBIT 2-4

METROPOLITAN LOS ANGELES OFFICE MARKET CONDITIONS, DEC 86E - DEC 88P

MARKET AREA	EXISTING INVENTORY	VACANCY AMOUNT	VACANCY %	ESTIMATED COMPLETION IN 2 YEARS	ABSORPTION FORECAST 1987-88a	VACANCY FORECAST (Dec 88)	CLASS "A" RENTS (December 1986) CONTRACT	CLASS "A" RENTS (December 1986) EFFECTIVE
Westside	29.2 Msf	3.8 Msf	13.0%	5.4 Msf	1.9 Msf	15.6%	$25-$32	$22-$30
South Bay	21.7	3.4	15.7	3	1.1	17.0	22-24	15-18
San Fernando	16.0	3.3	20.6	2.2	1.1	18.1	23-25	19-22
Pasadena/Glendale San Gabriel	10.3	2.6	25.2	2.4	0.9	25.2	19-22	16-18
Mid-Wilshire	7.4	1.3	17.6	0	0.1	14.9	18-20	12-14
Downtown/CBD	23.9	3.5	14.6	2.2	1.1	13.4	26-28	24-25
TOTAL LOS ANGELES	108.5 Msf	17.9 Msf	16.5%	15.2 Msf	6.2 Msf	16.7%	$22-25	$18-21

a - Annual Average
E - Salomon Bros. Inc. estimate
P - Salomon Bros. Inc. projection
Msf - Millions of square feet

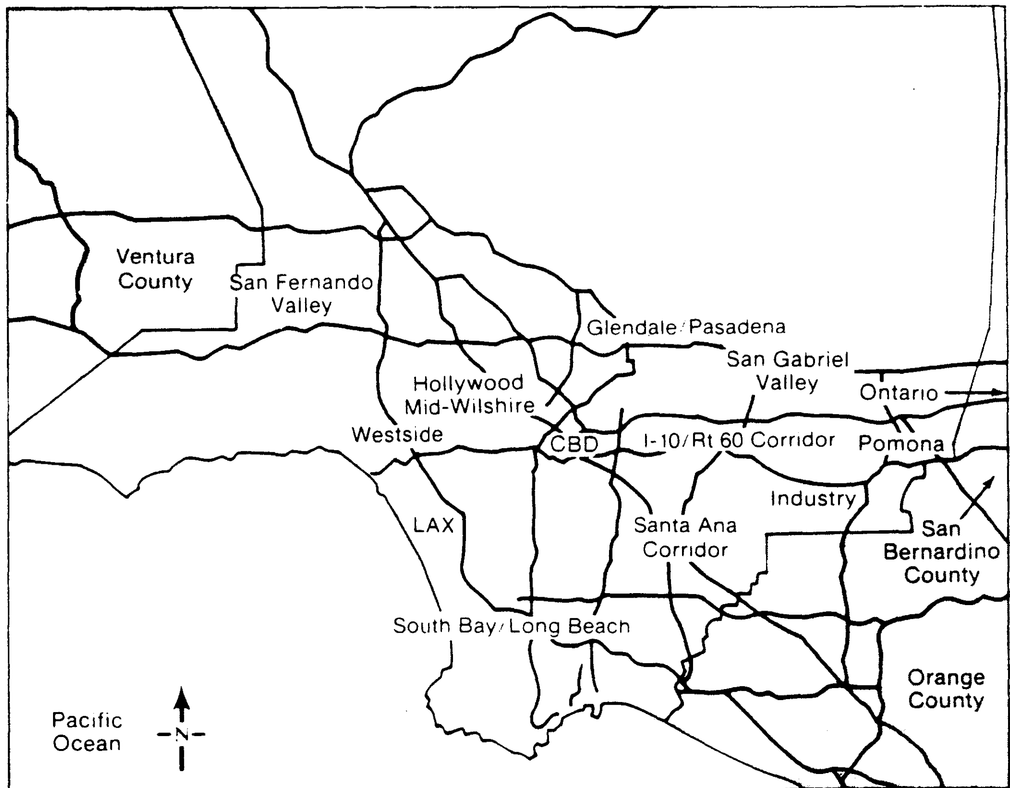
Source: Salomon Brothers Inc., Report on the Los Angeles Real Estate Market, January 1987, p.12.

the region. Areas such as the San Fernando Valley and the Mid-Wilshire district should improve as construction activity drops below absorption levels throughout the remainder of the decade.

In spite of all of the activity in the suburban market, the focus of this analysis is on the Downtown's Central Business District ("CBD"). We concentrate on this market for several reasons. For one, it is the most prestigious site of development activity in the region and is therefore the focus of most foreign investment. It is also the target address

EXHIBIT 2-5

MAP OF LOS ANGELES COUNTY OFFICE AND INDUSTRIAL REAL ESTATE MARKETS



Sources: *Los Angeles Times* and Salomon Brothers Inc.

for most East Coast and Asian financial and legal concerns that are seeking to establish a West Coast base. This is evidenced by names such as Citicorp, Chase and Dai-Ichi Kangyo Bank which are found atop an increasing number of Downtown buildings. In addition, over the next decade, the CBD will become the hub of the new subway and light rail system.

Finally, real estate development in the CBD is less constrained than the sub-markets. Spurred by such groups as the "Not Yet NY Coalition" who decried the "Manhattanization

of L.A.", local residents recently voted to limit development in most of the sub-markets by a two to one margin. Dubbed "Proposition U", the measure reduced by 50% the amount of floor space allowed in future commercial buildings. Only the Downtown, parts of Hollywood and a few other established business districts were exempted from its provisions. Thus Downtown will become increasingly important as developers will have fewer alternatives in the future.

Market Characteristics

The Downtown area covers 2.5 square miles and is bordered by the Harbor Freeway on the west, the Hollywood Freeway on the north, the Santa Monica Freeway on the south and Broadway on the east. Fortune 500 companies, law firms and financial services companies are the major tenants in this market.

The CBD has a total of approximately 23.5 million square feet of office space, of which 10.8 million square feet was constructed between 1982 and today. (See Exhibit 2-6.) This explosion in office construction has had profound effects on vacancy, absorption and rental rates. Absorption rates have lagged construction completions throughout the post-1982 period causing vacancy rates to soar from 3% in 1982 to 17% in the first quarter of 1986. (See Exhibit 2-7.)

EXHIBIT 2-6

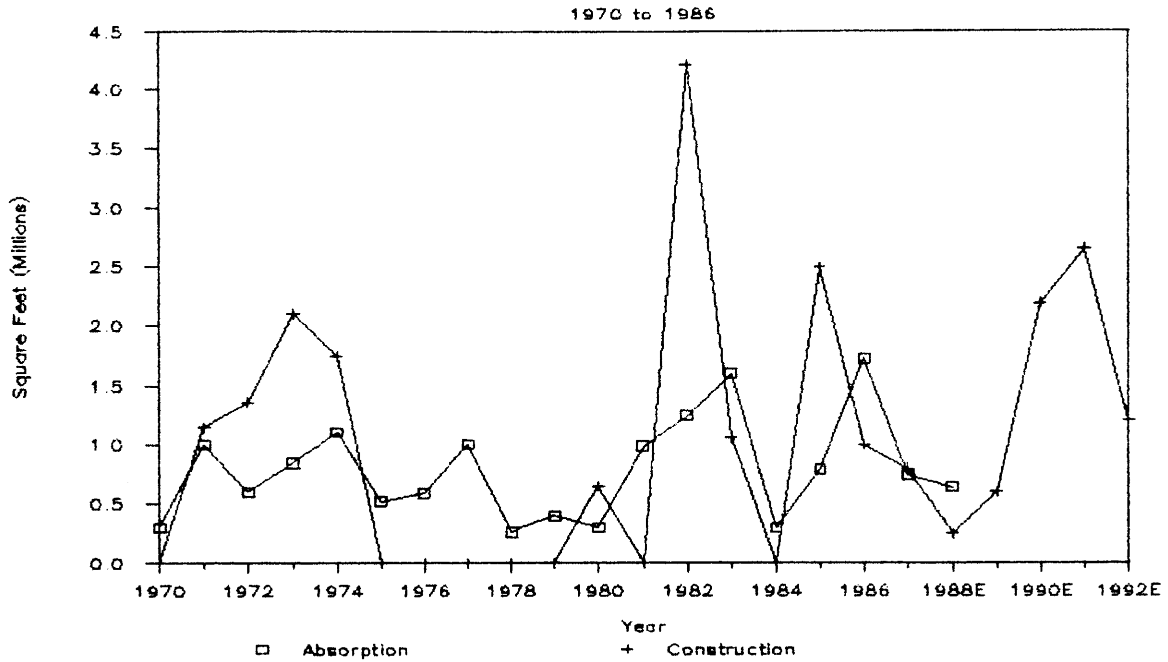
DOWNTOWN OFFICE CONSTRUCTION 1970-1988

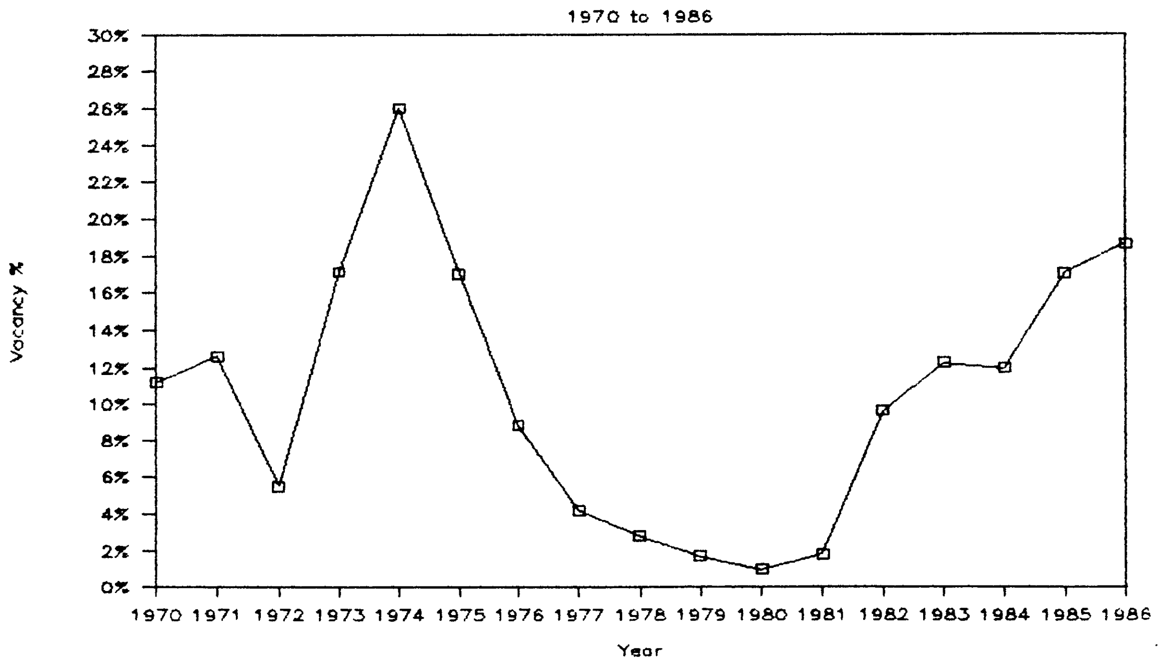
OPENING YEAR	ANNUAL ADDITIONS		CUMULATIVE	
	NUMBER of BUILDINGS	SQUARE FEET	NUMBER of BUILDINGS	SQUARE FEET
1970	-	-	-	-
1971	-	-	-	-
1972	1	201,000	1	201,000
1973	7	4,258,000	8	4,459,000
1974	1	174,000	9	4,633,000
1975	1	1,363,000	10	5,996,000
1976	-	-	10	5,996,000
1977	-	-	10	5,996,000
1978	-	-	10	5,996,000
1979	-	-	10	5,996,000
1980	2	637,000	12	6,633,000
1981	1	274,000	13	6,907,000
1982	6	3,766,000	19	10,673,000
1983	4	2,053,000	23	12,726,000
1984	-	-	23	12,726,000
1985	6	2,930,000	29	15,656,000
1986	5	1,201,000	34	16,857,000
1987	2	864,000	36	17,721,000
1988	2	896,000	38	18,617,000

Source: Grubb & Ellis, "Office Space Absorbtion Study Greater Los Angeles Area", First Quarter 1987, p.15

With construction significantly outpacing absorption, overbuilding resulted in a tenants' market. Lease concessions typically included six months free rent for each five year lease commitment, tenant improvement allowances ranging up to $35 per square foot and liberal renewal and expansion clauses.

EXHIBIT 2-7





Source: Jones Lang Wootton

Nonetheless, demand for office space has grown significantly throughout the 1980's, reflecting the strength of the local economy. Occupancy rates should increase through the end of 1988 as only two new buildings are slated for completion - the 225,000 square foot Home Savings Bank building and the 625,000 square foot Trans-Pacific Center. Vacancies will fall as supply and demand come more into balance. Reduced construction activity has allowed the vacancy rate to ease from a high of 17% in 1986 to 15% by mid-year 1987. This trend is expected to continue, barring any retrenchment in the economy. Jones Lang Wootton and Coldwell Banker project a 1988 CBD vacancy rate of 7% to 8% while Salomon Brothers takes a more conservative position at 13.4%. Regardless, the short-term development prognosis appears favorable.

The dearth of construction in the CBD has opened up certain niches in the market. For example, property owners and brokers are having a difficult time meeting tenant demand for 40,000 or more square feet of contiguous space. However, these opportunities will be short-lived, as construction is expected to resume at its frantic mid-1980's pace through the remainder of this decade.

After 1988, approximately 4.8 million square feet of additional class A office construction is planned for completion through 1991. (See Exhibit 2-8.) Since plans for

EXHIBIT 2-8

PLANNED OFFICE BUILDINGS with COMPLETION DATES in the 1989 to 1991 PERIOD

PROJECT	SQUARE FEET	ESTIMATED COMPLETION DATE
1. Figueroa Plaza II	307,000	1989
2. Treptow II	527,000	1989
3. 865 S. Figueroa (Manulife II)	592,600	1990
4. Library Square	1,300,000	1990
5. Mitsui Tower	1,000,000	1990
6. Grand Place Tower	950,000	1991
TOTAL	4,776,600	

SOURCE: CUSHMAN REALTY CORP.

many of these projects have not been finalized, it is difficult to project their impact on absorption, rent and vacancy rates. However, unless demand picks up, the projected 1.1 million square foot absorption rate will lag construction completions, increasing the vacancy level to double digits once again.

In looking to the future of downtown office development there are at least four constraints to continued growth of this market: inadequate and expensive parking, traffic congestion, high land costs and the threat of a slow growth environment which might envelope the CBD as well. Failure to mitigate these constraints could cause investors and tenants to seek space in more hospitable suburban locations.

In the following chapter, we describe the extent of foreign ownership in Los Angeles and look at a cross-section of prominent foreign investors.

CHAPTER III

PROFILES OF FOREIGN INVESTORS IN LOS ANGELES

"The Japanese Land Rush in America"
Lead story, Real Estate section, Los Angeles Times, Sunday, February 1, 1987

Foreign investment in Los Angeles real estate, especially by the Japanese, is no secret. At present foreign interests own over 12 million square feet of office space in the downtown's central business district, where most foreign investment is concentrated. This amounts to more than half of the total office space available there. (See Exhibit 4-1.)

Of course, the total amount of space in the CBD is a matter of opinion, to some degree, and depends on a number of factors. These include the following: where the boundary line for the CBD is drawn; whether or not a given building on the fringe is included in the total; whether or not the quoted square footage for a building is the net rentable amount and whether it includes retail space; etc. Thus, certain parties may disagree with some of the figures used in Exhibit 4-1. The important point, however, is not whether 51.6% is the exact amount of foreign ownership. Rather, it is to simply demonstrate that a very significant portion of

EXHIBIT 3-1

OFFICE BUILDINGS IN DOWNTOWN LOS ANGELES OWNED WHOLLY OR PARTIALLY BY FOREIGN INTERESTS

	Building			Foreign Owner				
No.	Name & Address	Year Built	Approx. Rentable Sq. Ft.	Name	Nationality	% Owned	Year Bought	Purchase Price
1.	Arco Plaza 515 & 555 S. Flower St.	1971	2,220,000	Shuwa	Japanese	100%	1986	$620 mill.
2.	AT&T Center 611 W. 6th St.	1968	715,000	Mitsui Fudosan Dai Ichi Life	Japanese Japanese	50% 50%	1979 1985	(A) (A)
3.	Bank of Calif. Bldg. 550 S. Flower St.		135,000	Not disclosed	Japanese	100%		
4.	Broadway Plaza Block 7th & Flower Streets	1973	678,000	Not disclosed	Japanese	100%	1987	$210 mill. (B)
5.	Brooks Brothers Bldg. 520 7th Street	1910	95,000	USA Pacific Atlas	Japanese	100%		
6.	California First Bank 630 W. 6th St.	1956	110,000	Nomura Real Estste	Japanese	100%	1983	$20.25 mill.
7.	Calif. Pac. Nat'l Bank 609 S. Grand Ave.	1925	104,000	Lehndorff	German	100%		
8.	California Plaza 300 S. Grand Ave.	1985	937,000	Cadillac Fairview	Canadian	40%		
9.	Chase Plaza 801 S. Grand Ave.	1986	447,000	Shuwa	Japanese	100%	1986	$137 mill.
10.	Giannini Place Olive & 7th Streets		114,000	Individual	British	100%		
11.	Heron Bldg. Olive & 6th Streets		220,000	Heron Properties	British	100%		
12.	International Tower 888 S. Figueroa St.	1985	410,000	Metro Bank of Manilla	Phillipine	100%		
13.	Linder Bldg. 845 S. Figueroa St.	1970	116,000	Bank of Tokyo	Japanese	100%		
14.	Manulife Plaza 515 S. Figueroa St.	1982	393,000	Mfgrs. Life Nomura Real Es.	Canadian Japanese	50% 50%	1982 1986	 $62 mill.

EXHIBIT 3-1 (Con't)

OFFICE BUILDINGS IN DOWNTOWN LOS ANGELES OWNED WHOLLY OR PARTIALLY BY FOREIGN INTERESTS

	Building			Foreign Owner				
No.	Name & Address	Year Built	Rentable Sq. Ft.	Name	Nationality	% Owned	Year Bought	Purchase Price
15.	O'Melveny & Myers Bldg. 400 S. Hope St.	1982	662,000	Olympia & York	Canadian	50%		
16.	One Wilshire Bldg. 624 S. Grand Ave.	1967	569,000	Paramount Group	German	100%		
17.	Oviatt Bldg. 617 S. Olive St.	1928	95,000	Lehndorff Mitsui Fudosan	German Japanese	55% 45%		
18.	Pacific Financial Ctr. 800 W. 6th St.		207,000	Capital Courties	British	100%		
19.	The Park 201-261 Figueroa St.		268,000	Individual	Iranian	100%		
20.	Standard Oil Bldg. 609 W. Olympic Blvd.	1930	100,000	Not disclosed	Japanese	100%		
21.	State Mutual Bldg. 626 Wilshire Blvd.	1967	125,000	Toyo Real Estate	Japanese	100%	1985	$25.75 mill.
22.	Union Bank Square 445 S. Figueroa St.	1967	608,000	Nissei	Japanese	50%	1984	$87.5 mill.
23.	Wells Fargo Bldg. 444 S. Flower St.	1981	894,000	Lehndorff Grosvenor Int'l	German British	50% 50%	1983 1983	$171 mill.
24.	Wilshire Finance Bldg. 1100 Wilshire Blvd.	1986	298,000	World Chinese Trust	Taiwanese	100%		
25.	World Trade Center 350 S. Figueroa St.	1974	160,000	Haseko Inc.	Japanese	100%	1987	$75 mill. (C)
26.	617 W. 7th St. Bldg. 617 W. 7th St.	1923	196,000	Hiro Properties	Japanese	100%		
27.	655 S. Hope Bldg. 655 S. Hope St.	1986	96,000	Hammerson	British	100%		
28.	800 S. Figueroa Bldg. 800 S. Figueroa St.	1982	122,000	Shuwa	Japanese	100%	1986	$34 mill.

EXHIBIT 3-1 (Con't)

OFFICE BUILDINGS IN DOWNTOWN LOS ANGELES OWNED WHOLLY OR PARTIALLY BY FOREIGN INTERESTS

	Building			Foreign Owner				
No.	Name & Address	Year Built	Rentable Sq. Ft.	Name	Nationality	% Owned	Year Bought	Purchase Price
29.	800 Wilshire Bldg. 800 Wilshire Blvd.	1972	215,000	Sumitomo Life	Japanese	100%	1986	$47.5 mill.
30.	818 Building 818 W. 7th St.	1924	370,000	Hammerson	British	100%	1984	
31.	1000 Wilshire Bldg. 1000 Wilshire Blvd.	1987	452,000	Sumitomo Life	Japanese	100%	1987	$145 mill.
	Total Square Footage Wholly or Partially Foreign Owned		12,133,000					
	Total Downtown Office Space		23,500,000	(Approximate Square Footage)				
	% Owned Wholly or Partially by Foreign Interests		51.6%					

(A) Mitsui purchased a 100% interest in 1979 for $79 million. In 1983, Dai Ichi acquired a 50% interest from Mitsui for $75 million.

(B) This a mixed-use property containing 678,000 square feet of office space, a Hyatt Hotel with an estimated 350 rooms, and approximately 358,000 square feet of retail space, including a Broadway department store.

(C) This project contains office and retail space, parking and a health club, all totaling 345,000 square feet.

SOURCES: Coldwell Banker, Los Angeles, CA
Cushman Realty Corp., Los Angeles, CA
Cushman & Wakefield, Los Angeles, CA
Los Angeles Times, Los Angeles, CA

the CBD is foreign owned.

Exhibit 4-1 also shows the purchase price for 13 of the 31 buildings identified as owned by foreigners. Just these 13 buildings cost more than $1.7 billion. Thus, even with limited information, it is obvious that huge sums of money have been invested in the CBD by foreigners.

The degree of foreign ownership in Los Angeles also seems somewhat overwhelming because the downtown CBD is rather small for a city of this size. As was discussed in Chapter II, Los Angeles has several major markets which total about 108 million square feet of office space, but of this, the downtown accounts for less than 22%. Because foreign investment has been concentrated in the CBD, it has become a big "fish" in the relatively small downtown "pond". Therefore, its preponderance may, in fact, be somewhat exaggerated.

Of course, every foreign investor in the Los Angeles market starts off new at some point. All have to learn about the local economy and business practices, to establish their own network of contacts and information, and to assess this real estate market and the level of competition. For many firms, the initial project will be something which they consider somewhat safe and conservative, in order to "get their feet wet." As each company becomes more comfortable and

experienced, and progresses along its own learning curve, it may expand the scope of its activities or pick a niche where it feels it can be most effective.

Some foreign firms, like life insurance companies, may never expand their activities beyond the acquisition of existing first class office buildings. Others definitely expect to develop new properties in the future. A growth path which some firms are pursuing consists of the following four basic steps: 1) acquire a partial ownership interest in an existing building; 2) acquire full ownership by itself of an existing building; 3) form a joint venture with an experienced domestic developer to develop property; and 4) develop property on its own. Not all companies follow this path and some may skip certain steps, but it serves as a useful way to gauge where a given company is on its learning curve.

The remainder of this chapter contains brief profiles of five foreign companies that own property in downtown Los Angeles. The purpose is to provide the reader with some feel for the different players in this market and where each one is on its learning curve, as well as to illustrate the size and type of projects that are involved. The discussion is in alphabetical order and includes one British and four Japanese companies.

Hammerson Property (West U.S.A.) Corporation (21)

Hammerson Property Investment and Development Corporation PLC has assets in excess of $2.5 billion. Founded in England in 1931, Hammerson first began to make international real estate investments in the early 1960's. Today it owns, with its subsidiaries, more than 14 million square feet of office buildings, shopping centers and other commercial properties in the United Kingdom, France, West Germany, Holland, Canada, the United States, Australia and New Zealand.

Unlike many domestic developers, Hammerson is not interested in, or motivated by, the tax benefits available for real estate investments. Also, it prefers to own its projects 100% and therefore does not consider joint ventures. Although, like many foreign investors, Hammerson generally intends to hold its properties for a long period of time, it will nonetheless sell a building if the growth prospects no longer appear promising.

Hammerson Property, the U.S. subsidiary, seeks a return of 10% or more on its investments. However, in Los Angeles a return this high is not available on existing first class properties due to strong competition, especially from Japanese investors. Therefore, the company concentrates on

under-performing properties where it can use its development expertise to create additional value in order to achieve the higher return it needs. Furthermore, it is currently involved only in office projects, as its staff lacks the experience needed to compete against shopping center specialists.

Before any investment can be made, final approval must be obtained from the company's Executive Director in London. Obviously this slows down the decision-making process. However, it has not caused Hammerson to miss out on any deals because the projects it is pursuing, primarily rehabs, are in a less competitive niche in the market.

The Los Angeles office was first opened in 1982 and today is completely staffed by Americans. Its initial project was the acquisition in 1984 of a 12 story, 370,000 square foot building at 818 West 7th Street. This property met the firm's requirement of being well located within downtown's central business district and Hammerson liked its potential. After paying about $57 million in cash to purchase the structure and buy out existing leases, Hammerson then undertook a complete renovation of the building, which was originally constructed in 1924. Renovations were complete in early 1986 and today the building is about 90% occupied.

Its next project began with the acquisition of an existing ten story office building at 655 South Hope Street. Hammerson then built an additional seven floors on top of the original ten, and added a new exterior to the entire structure. With an average floorplate of 7,400 square feet, the smallest in the CBD, this building was targeted for mid-size financial and professional tenants. Leasing has been somewhat disappointing, with only about half of the space currently occupied. However, this project again demonstrates Hammerson's willingness to take on development and leasing risks in exchange for potentially higher returns. In addition, because one of the stations in the CBD for the new subway system will be located in the basement of this building, leasing is expected to improve in the longer run.

Hammerson does not perform the leasing or management for its Los Angeles properties itself because its portfolio is not big enough to support such activities. It does, however, want to expand its portfolio, and like many foreign investors, it has the ability to pay cash.

At the present time, Hammerson can finance major acquisitions in the U.S. very inexpensively through the sale of additional capital stock. A Hammerson official indicated that in London the stock of real estate companies usually sells at a discount of roughly 20% from its asset value. However, Hammerson's stock is currently selling at about 100%

of asset value. Considering its annual dividend rate of 2.5%, Hammerson can raise a substantial amount of cash with a yearly expense far less than the 8% to 10% it would cost to borrow such funds. This factor, coupled with a favorable currency exchange rate for pounds sterling, is providing Hammerson with the opportunity to achieve a significant presence in the U.S. real estate market in a short period of time.

Mitsui Fudosan (U.S.A.), Inc.(22)

With book-value assets of almost $6.5 billion, Mitsui Real Estate Development Co. is one of the largest real estate firms in Japan. Its most famous project is probably Tokyo Disneyland, but it also develops office buildings, hotels, shopping centers, health clubs and about 5,000 residential units per year in its home country.

Mitsui's experience with U.S. real estate started in the early 1970's when its U.S. subsidiary, Mitsui Fudosan, became the financial partner with Cabot, Cabot & Forbes in the development of large industrial parks in Seattle, WA and Carlsbad, CA. However, Mitsui owns 70 office buildings in Japan and so it was only a matter of time before it became involved in U.S. office properties as well. In 1979, wanting to establish itself in the Los Angeles market, Mitsui bought

an existing building, the 42 story AT&T Center at 611 West 6th Street for $79 million.

The purpose of this initial acquisition was to enable Mitsui to get a feel for the Los Angeles market and how business was done there. They learned how to negotiate for a large office building and how to negotiate with existing and prospective tenants. However, according to a senior official of the firm, this building was purchased with "a Japanese mentality" regarding leasing. In Japan, the term of a lease for office space is typically two years, but with Tokyo's very low vacancy rate, tenants almost always renew the lease. In the U.S., of course, lease terms of five, ten and even 15 years are not unusual. Furthermore, tenants often move when a lease expires, as Mitsui discovered: Shortly after its purchase, two large tenants moved out, and this 715,000 square foot building became more than 35% vacant. "If we had known that leasing was so volatile we would have bought a smaller building." (Today, the building is again fully leased.)

Like many of the large Japanese firms, Mitsui is inundated with information on properties and deals available to them. These investment opportunities are brought to the company by a plethora of investment bankers, banks, national, regional and local real estate brokers, and other contacts within the business community. Mitsui has formed no special

relationship with any of these parties, but rather keeps them all at an equal distance. Mitsui has been in the real estate business for over 300 years. It is, therefore, interested in determining which of these firms it will be comfortable doing business with for many years to come, not just which firm has the best deal this week.

Any investment decisions must be approved by the Executive Committee in Tokyo. This, of course, limits the speed with which the company can move and it ability to react to special opportunities. Like most large, publicly-held companies, Mitsui is concerned about maintaining and increasing corporate profits every year and is not interested in a one-time gain. Criteria such as an internal rate of return or a cash on cash return, which are standard methods used by Americans to evaluate investments, are not relevant to an investment decision by Mitsui.

When the company does decide to make an investment, money is not a problem. Based on its strong record of success and the value of its "hidden assets", Mitsui has an almost unlimited line of credit with Japanese banks. It will usually borrow funds in the local currency in order to limit its exposure to exchange rate fluctuations. Although it owns properties in France, Hong Kong and other countries, 90% of its investment outside Japan is in the U.S.

Mitsui has acquired a number of existing properties, but its main goal in the U.S. is to be a developer. To this end, several years ago it bought three vacant parcels in Los Angeles' CBD. One of these, at 1000 Wilshire Blvd., was sold to a domestic developer, Reliance Corp., who built a 452,000 square foot office building on it which was then sold to Sumitomo Life. The second site, at the Northeast corner of 8th and Figueroa Streets, is currently used as a parking lot and there are no plans to develop it in the immediate future.

The final parcel, at the corner of Wilshire Blvd. and Figueroa St., is almost universally considered the best location in the city. After sitting on this jewel for several years, and after some well publicized false starts, Mitsui will break ground on this site in January, 1988, to begin construction of a 52 story, 1,000,000 square foot office building, currently called Mitsui Tower.

As this will be its first development of an office building in the U.S., Mitsui recognized the need for assistance from an experienced domestic developer. Gerald D. Hines Interests, of Houston, was selected to provide the needed expertise based on its professionalism and its track record of developing major high rise office buildings in downtown locations throughout the U.S. Hines will oversee the design, marketing and approval processes of this $200 million project and will manage the building upon its

completion. However, Hines is working on a fee basis only and will not receive an ownership interest in the property.

One noteworthy aspect of this development is that Mitsui is going ahead with construction despite a current vacancy rate of about 15% in the CBD, and without having any tenants committed to occupy space in the building. Obviously, a U.S. developer would need substantial preleasing commitments from tenants in order to obtain its construction and permanent financing. Mitsui can proceed, however, because its loans from Japanese banks are general obligations of the corporation, and are not secured solely by the property. A domestic developer's borrowings, on the other hand, are almost always non-recourse and secured only by the property.

Mitsui's decision to proceed with construction is indicative of its confidence in the Los Angeles office market. However, the company expects to complete its current project with Hines and then probably develop the other site mentioned above before it considers any further investment in the CBD.

Although most other foreign investors in the Los Angeles area hire a domestic company to manage their U.S. properties, Mitsui manages its own properties through a subsidiary, Aspen Property Management. In addition, it does not have a long term view toward all the property it acquires

or develops. It considers industrial parks to be short term investments which will be sold after a few years. However, Mitsui does intend to hold onto its office buildings for a very long time.

<u>Nomura Real Estate International, Inc.</u>(23)

In July, 1986, Nomura Real Estate Development Co. purchased a 50% interest in Manulife Plaza, at 515 S. Figueroa St., for approximately $60 million in cash. This high-rise building contains 393,000 square feet of rentable office space, and had been developed by Manufacturers Life Insurance Co. ("Manulife") of Canada only four years earlier. At the time of Nomura's purchase the building was fully occupied, and many of the leases were for more than 10 years.

These factors were very important to Nomura. Their only previous investment in U.S. real estate occurred in 1983 when they bought the California First Bank building, which is also in downtown Los Angeles (630 W. 6th St.). Nomura paid $20 million for this 110,000 square foot structure that, at the date of acquisition, was about 27 years old. This initial investment proved disappointing because, as Nomura discovered, the building had elevator and structural problems which were very expensive to repair.

As a result of this experience, Nomura resolved to buy only office buildings that were recently constructed. According to a senior official in Los Angeles, "Professional fees are very expensive when there are problems in a building." Therefore Nomura feels it must buy the best building possible, "even though the price is very high." Its criteria for evaluating properties now are: location, credit-worthiness of tenants, and the age and condition of the building ("the newer, the better").

Nomura found out about the opportunity for the above two investments from contacts within the Japanese banking community. However, they are now also kept informed by numerous American brokers and other real estate professionals. A officer of the firm stressed that Nomura needs to "establish a strong relationship with a trustworthy American company," because with so many markets it is difficult to know them all and to find the best buildings.

In Los Angeles, when a promising building is identified, Nomura's local staff will inspect the asset and then send all information, along with a recommendation, to headquarters in Tokyo. If, after analyzing the information package, Tokyo wants to continue, a supervisor from headquarters will come to the U.S. to look at the property. However, even if the supervisor agrees, approval from the Board of Directors is

still required. As a result, it takes at least two to three months to reach a final decision to purchase a building.

Nomura feels that most of its competition for buying U.S. properties comes from other Japanese companies, and it is concerned about the possible distortion of the market that can result from greatly overpaying, as some Japanese firms have supposedly done. Nomura uses a target capitalization rate of 8% for its acquisitions. In some cases it may be willing to wait a year or two to achieve this return, but even in the first year of ownership returns should be no less than 6%.

Nomura's Manulife Plaza investment had a cap rate of 8%, which was guaranteed by Manulife for the first few years. Nomura is paying interest of 7% on the funds it borrowed from its Japanese lenders to make this investment. Therefore, it is earning net income (pre-tax) of 1% on its $60 million investment, all of which was borrowed.

Nomura plans to continue to invest in the Los Angeles real estate market and hopes to become active in other markets in the U.S. as well. It recognizes that to do so it must increase its manpower in the U.S., and Nomura wants to accomplish this by hiring American real estate professionals onto its staff. It also plans to open a New York City office within the next few years.

Ohbayashi America Corporation(24)

Ohbayashi Corporation is one of the largest general contractors in Japan and has been involved in major construction projects all over the world. For its fiscal year 1986, revenues exceeded $4.2 billion and it owned assets with a book value of almost $5.4 billion. Its U.S. projects include the Toyota Motor Corporation's factory in Georgetown, Kentucky and the Sheraton Kauai Hotel in Hawaii, which it owns.

Despite its size and experience, however, Ohbayashi has found the American construction industry somewhat difficult to enter. Its Los Angeles subsidiary, Ohbayashi America Corp., has therefore decided to create its own construction opportunities by engaging in joint ventures with local developers. For these ventures Ohbayashi will typically provide very attractive financing for the project and will always serve as the general contractor.

Negotiations with developers are conducted at the local level, but Tokyo provides constant feedback and must approve any final agreement. As part of this process, the company must satisfy itself as to the feasibility of the project, the reliability and experience of the developer, and Ohbayashi's

own capacity to do the work within the required time frame. Due to the distance, language barrier and unfamiliarity with each other, a partnership agreement may take from three to 18 months to be finalized.

The financial criteria considered for such projects typically include cash on cash return for the first three years and sensitivity analyses. Cap rates are usually greater than 10%, but in some cases may be as low as 8%. One thing that differentiates them from institutional investors is that Ohbayashi expects to sell the property within ten years. This is because in order to generate new construction opportunities, it needs to rollover its old projects. In addition, its U.S. partners are usually small firms who also want to sell.

Finding good American partners is difficult because, although they are usually very creative, they are not always good in administrative areas. As a large company, Ohbayashi needs certain written reports on a regular basis which it often does not receive. Also, keeping projects within budget has been difficult, due to the long approval process. If a project is successful, however, Ohbayashi would work with that partner again.

An official of the company indicated that Ohbayashi is currently involved with many different types of projects and

that it considers this to be a time of experimentation, in order to determine which project types are most suitable for them. Of course, office buildings and hotel projects are easier for those in Tokyo to understand, and are therefore more likely to be approved, but that has not been the exclusive result.

For example, Ohbayashi's first joint venture in Los Angeles was a 220,000 square foot project which included a supermarket, a retail shopping mall and a 40-lane bowling alley, along with an adjacent 700 car garage. Known as Little Tokyo Square, this project is in the downtown's Little Tokyo section and was finished in June of 1986 at a cost of approximately $35 million. Next, in March, 1987, the company completed a $17 million hotel containing 174 rooms, also in Little Tokyo. Current projects include an 80,000 square foot, $12 million office building in Pasadena and a 204 unit retirement center in Canyon Hills budgeted at $23 million.

Shuwa Investments Corporation(25)

The largest real estate transaction in Southern California's history took place in September, 1986 when Shuwa Corporation purchased the Atlantic Richfield ("Arco") Plaza for $620 million. This property consisted of twin 52-story towers, totaling 2.2 million rentable square feet of office

space, and 200,000 square feet of below-ground retail space. The Bank of America was the main tenant in one tower (555 S. Flower St.), while Arco occupied much of the other tower (515 S. Flower St.) as its world headquarters.

The $620 million purchase price for Arco Plaza was paid in cash. Shuwa had obtained the funds by borrowing $62 million from each of ten Japanese banks. Although a lower interest rate could have been obtained if Shuwa had borrowed these funds as Japanese yen, it decided to accept the higher interest rate (about 7%) and instead borrowed in the form of U.S. dollars, in order to avoid any exchange rate risk.

The owner of Arco Plaza was Flower Street Limited Partnership, which was owned 48% each by ARCO and Bank of America, with the remaining 4% interest held by a third party. The partnership hired two investment banking firms, Eastdil Realty Inc. and First Boston Corporation, to market the property and represent the sellers. The investment bankers prepared brochures and made presentations which generated interest from several investors.

Despite an occupancy level near 100% and a prime location in the middle of Los Angeles' central business district, this was not an easy property to sell. Its sheer size limited the number of candidates who could even consider it. Futhermore, the buildings contained asbestos which had

to be removed. Many prospective buyers decided they did not want this additional cost and the exposure to unknown potential liabilites which accompanied it.

Shuwa had seen the presentation on Arco Plaza some months earlier, but did not really become interested until July of 1986. However, it then outbid Canadian giant Olympia & York and eight other firms by paying $30 million more than the next highest bid to acquire the property. The sale was announced on August 4 and closed on September 17, 1986.

Other than the size of this transaction, a representative of Arco who was involved in the sale felt its most unusual aspect was Shuwa's speed. Shuwa evaluated the property, including the physical inspection and a review of the financial records, very quickly and actually closed within two months after initial negotiations began. In addition, he felt that Shuwa was easier to deal with than many American landlords regarding certain lease terms for the space which the Bank of America and Arco would continue to occupy. For example, Shuwa was less picky about the language relating to options, rights to change their own space, subleasing and improvements in public areas. He also indicated that although Shuwa understood the asbestos issue, they were less concerned about it than most domestic bidders. (26)

Shuwa agrees that it can move fast. In the U.S. the approval of only three people decides whether the company will pursue a given property: the project manager, the head of acquisitions and the head of its U.S. operations, Takaji Kobayashi. Of course, the final approval for any purchase must come from Tokyo. However, this can also be done quickly, for two reasons. First, Tokyo is kept abreast of all U.S. real estate being considered for acquisition, and is therefore already familiar with each property. Secondly, Shuwa is not a public company, but rather is privately owned by its president, Shigeru Kobayashi (father of Takaji Kobayashi). As a result, it does not need to assemble and convince a Board of Directors in order to make a decision.

In addition to speed, Shuwa feels that now, with its experience in buying U.S. office buildings and with an increase in its U.S. staff (including the hiring of several Americans), it has improved its ability to analyze properties, and to know what it will take to manage them once they are acquired. The main criteria they use in evaluating properties are: (1) location, (2) quality of the building and (3) cap rate, which may vary depending on (1) and (2). Shuwa does not speculate. It plans to own its properties for a very long time and therefore is interested in security. It requires a steady income and wants credit tenants. Often it will obtain rental guarantees from a building's seller in order to assure its cash flow for the first few years of its

ownership.

The purchase of Arco Plaza accomplished another key objective for the company. As previously mentioned, this purchase was the largest in the history of Southern California. With this one transaction, Shuwa "put (its) name on the map" and established itself as a major force in American real estate.

The publicity which accompanied this acquisition ensured that Shuwa would become known to all the key players in U.S. real estate. It generated important contacts throughout the real estate community, so that now, Shuwa believes, it has access to every major deal in this country. Currently, Shuwa owns about $2 billion of property in the United States, including three major office buildings in downtown Los Angeles.

Unlike most other Japanese companies, however, it has acquired properties not only in the CBD but also throughout the Greater Los Angeles area. Exhibit 4-2 details all of Shuwa's commercial holdings in this region.

The following chapter examines the observed differences between these and other foreign investors and their domestic counterparts.

EXHIBIT 3-2

OFFICE PROPERTIES IN GREATER LOS ANGELES AREA OWNED BY SHUWA CORPORATION

	Property Name & Address	Year Built	Year Acq'd	Total Floor Area (Sq. Ft.)
1.	Atlantic Richfield Plaza 505, 555 South Flower St. Downtown, Los Angeles, CA	1971	1986	4,679,304
2.	Chase Plaza 801 South Grand Ave. Downtown, Los Angeles, CA	1986	1986	748,485
3.	800 Figueroa Building 800 Figueroa St. Downtown, Los Angeles, CA	1981	1986	215,618
4.	6222 Wilshire Building 6222 Wilshire Blvd. Los Angeles, CA	1986	1987	161,187
5.	1900 Avenue of the Stars Century City, Los Angeles, CA	1969	1986	1,045,024
6.	1901 Avenue of the Stars Century City, Los Angeles, CA	1967	1986	911,704
7.	Hughes Building 101 North Sepulveda Blvd. El Segundo, CA	1985	1986	454,368
8.	Anaheim Office Park Building 1200 North Magnolia Ave. Anaheim, CA	1984	1984	21,069
9.	Mitsubishi Electric Building 5757 Plaza Dr. Cypress, CA	1985	1985	306,333
10.	Bay Corporate Center 2000, 2080 Anaheim Blvd. Anaheim, CA	1985	1987	128,635

EXHIBIT 3-2 (Con't)

OFFICE PROPERTIES IN GREATER LOS ANGELES AREA OWNED BY SHUWA CORPORATION

	Property Name & Address	Year Built	Year Acq'd	Total Floor Area (Sq. Ft.)
11.	Downey Savings Building 3200 Bristle St. Costa Mesa, CA	1979	1986	213,330
12.	Ultimate Building 1063 McGaw Ave. Irvine, Ca	1986	1987	54,768
13.	Rolm Building 17781 Cowan Ave. Irvine, CA	1982	1987	63,514
14.	Fitch Building 17601 Fithc St. Irvine, CA	1981	1986	41,091
15.	Tacobell Building 17901 Von Karman Ave. Irvine, CA	1986	1987	277,588
16.	19000 MacArthur Building 19000 MacArthur Blvd. Irvine, CA	1982	1986	334,883
17.	Doelz Building 9501 Jeronimo Rd. Irvine, CA	1985	1986	91,154
18.	Baldwin Industrial Park Office 13441 Dalewood St. Baldwin Park, CA	1981	1981	32,524
	Total Floor Area for All Properties			9,780,579

Source: "Faces of Shuwa", informational brochure of Shuwa Corporation

CHAPTER IV

INVESTMENT CRITERIA AND DIFFERENCES

Real estate in the U.S. is no more mysterious than in foreign countries. Consequently, when foreigners evaluate Los Angeles properties they use the same basic criteria as domestic investors do and, like their American counterparts, they have individual risk and diversification preferences. Some, like Shuwa, have developed formal investment requirements which are stringently adhered to, while others, like Ohbayashi, in the words of one of its officers, do not have "firm standards" and are "still in the trial and error stage." However, in all instances the decision criteria would include a building's location and quality, tenant mix and quality, the expiration of leases, etc. A senior officer of La Solana Corporation (U.S. subsidiary of Sumitomo Realty & Development Co.) summarized that he, "like everyone else," simply looked for "the best building with the best location."

The real differences, then, lie not in the basic criteria themselves but in how foreigners look at them. This chapter will identify some of the observed differences between foreign and domestic investors and attempt to put them in proper perspective by examining why they occur.

Strong downtown preference

It has been widely observed that foreign real estate investment is concentrated in the downtown areas of large U.S. cities. As newcomers to the Los Angeles market, foreign investors naturally want to avoid any undue risk and they perceive that downtown is the most stable real estate location. They buy what they are most familiar with, and that is the downtown. As one observer from James Felt Realty commented about Japanese investors, "They are an urban people who believe that the CBD will always be viable." (27)

The suburban development and living patterns in America, and especially in the Los Angeles area, are not analogous to foreigners' own experiences back home. In Japan, and even Europe, land is much less plentiful and the highway systems are far less extensive than in the U.S. In these places, it is important to be in the city, and as close to downtown as possible. Thus, there is a significant cultural difference that takes time for foreigners to understand. Even after foreign companies have operated in the U.S. for several years and have gained an understanding of the market, it often remains difficult to convince an executive committee back home to approve investment decisions.

As investment opportunities within Los Angeles' CBD

diminish, due to intense competition for the finite number of existing properties, companies will be forced to consider other, more suburban areas. As they become more experienced, firms will also be more comfortable with this course of action. An example of this, as was previously mentioned, is that Mitsui Fudosan currently plans no further acquisitions in the CBD and is now exploring opportunities throughout the Greater Los Angeles area. The only alternative would be to stop investing or to go to "second tier cities" in the U.S., which are far less familiar.

At least one Japanese investor sees some advantages to moving to suburban markets. A spokesman for Haseko (California) Inc. (subsidiary of Hasegawa Komuten Co., a large Japanese contractor) cited the following benefits: diminished competition for deals, minimum cap rates of 8.5% and purchase prices approximately $100 less per square foot for first class office space. Others are less enthused. Ohbayashi, for instance, is skeptical of higher cap rates in markets that do not offer a broad cross-section of tenants.

Willingness to pay

For the last two years, Japanese companies have been by far the most active, and most visible, foreign investors in the Los Angeles real estate market. They have invested huge

sums in first rate office properties which typically have been less than 15 years old and more than 85% occupied, with several long-term leases to large tenants. However, in many cases they have been accused of overpaying for these buildings, sometimes grossly so.

Many Japanese firms, especially those which are publicly owned, see real estate as a vehicle for obtaining a steady and reliable stream of income for an extended period of time. Companies such as La Solana, Mitsui Fudosan and Nomura will project cash flows for an office building over a period of 20 years or more when analyzing it for acquisition. In order to ensure this income stream, they have often required that the seller of property in Los Angeles guarantee the rent for the first few years. The seller is generally willing to do this because the Japanese buyer has paid a premium for the project.

However, a record setting price does not necessarily prove that a buyer paid too much. For instance, in early 1987, Chiyoda Trading of Tokyo purchased La Colonnade, a three story, 30,000 square foot office building in Beverly Hills, located at the corner of Santa Monica Blvd. and Camden Drive. Chiyoda paid $16.5 million, or $550 per square foot, for the property. However, the building's sole tenant was Merrill Lynch, which had seven years remaining on its lease, with two automatic 5% rent increases. Given the excellent

location and a sole credit tenant, the buyer was happy to pay a 7.5% cap rate for this building. The seller, incidentally, was French Kier Development, a British firm.

It is important to remember too that real estate is not a fungible commodity. Each property is unique and, in effect, is sold at auction. Obviously, whoever buys at an auction will always pay more than anyone else. Further, the Japanese are buying high quality "signature" properties. Because this is a thin market and such buildings do not turn over very often, it is not unreasonable to expect that when such a property is sold, it will set a record in terms of sale price per square foot. Therefore, it should be no surprise that Japanese firms are paying record prices for signature properties. Further, they should not be considered foolish for doing so, given that these properties will not be on the market again for many years. As Dick Stanson, Sr. Vice President for Landauer Associates in Los Angeles, observed, "These buildings will not be back in the marketplace during our lifetime." (28)

Simpler deals and offers

In almost every case during the past few years in the CBD, foreigners have paid cash for the properties they bought. This precluded the need for complicated formulas and

deal structures. If the funds used were not all equity, then the foreign buyer had at least arranged its financing separately.

As was discussed in the preceding chapter, companies like Hammerson can raise money rather easily through the capital markets. Japanese companies as well, with their strong banking relationships in Japan and the value of their "hidden assets", have ready access to huge amounts of cash.

Shuwa and Nomura indicated that for their purchases of Arco Plaza and Manulife Plaza, respectively, funds were available, if borrowed in Japanese yen, at an annual interest rate of about 3%. Because this money was to be invested in U.S. real estate, however, the companies would have been exposed to the risk of currency fluctuations. To avoid this exposure, they decided to borrow from their Japanese banks in U.S. dollars instead and are paying interst at a rate of about 7%. These loans were easily arranged and, even at the 7% rate, are more favorable than domestic companies could have obtained by borrowing from U.S. lenders.

Long term view

It is a cliche to say that foreign investors have a long term view and will hold properties for many years. This, of

course, is a generalization. The business of the investor and the type of property play an important role in determining whether this is true in a given instance. For example, construction companies like Ohbayashi and Haseko expect to sell any properties they own within ten years, whereas a developer like Mitsui Fudosan will sell some properties (industrial parks) but will keep others (office buildings).

Nor are foreigners unique in expecting to hold properties for many years. U.S. insurance companies and pension plans are obvious examples of domestic investors which also have long term attitudes towards real estate.

Certain cultural and attitudinal differences regarding realty do exist, however. As discussed in Chapter I, the relative scarcity of land in other countries, especially Japan, causes foreigners to place a greater value on it, both monetarily and psychologically, than most Americans do. The Japanese also tend to eschew speculative investments and therefore do not expect to turn a quick profit. In addition, some investors view U.S. real estate as a safe haven for capital. Therefore, if they already own valuable property in the U.S. there is no incentive to sell, as the proceeds would just be reinvested in other, perhaps riskier, property. They prefer to leave their money invested where it already is.

Relationship oriented

Japanese companies rely heavily on relationships when conducting business in their home country. Such relationships are directly between the principal parties of a transaction and no middlemen are involved. As a result, Japanese firms are usually not comfortable dealing with the hordes of consultants, brokers, attorneys and other intermediaries that are part of the U.S. real estate industry.

The Japanese realize that, as newcomers to this market, they need information. However, they currently lack effective connections in the business community. Some Japanese concerns have therefore formed alliances with large American firms, such as Cushman & Wakefield's consulting/ joint venture agreement with Mitsubishi Trust. Others remain unconvinced of the need for such an arrangement. La Solana, for instance, does not hire consulting firms to analyze the market. Instead they do their own analysis using data that is readily available from area brokers. Mitsui Fudosan is somewhere in between. Although they have no special relationship with any intermediaries, they did have two separate market studies prepared by outside consultants in connection with their development of the Mitsui Tower project.

The Ego Factor

The quality of a project is important for more than just financial reasons. Although none of the Japanese investors we interviewed discussed the role that institutional ego plays in the investment decision process, there is undeniable competition among them to acquire the best location, and the largest or most prestigious building. A Los Angeles developer who is joint venturing a local project confided that his Japanese partner wants to spend a considerable amount of money for certain building design features which, in his opinion, will not result in higher rents. He believes they are willing to pay for "perceived prestige" just to enhance their image within the Japanese business community.

An obvious example occurred in January, 1987, when Shuwa ran full page advertisements in a number of business journals and newspapers, including the Los Angeles Times and the New York Times. Under the banner "A Landmark Year" Shuwa touted its many 1986 acquisitions, including Arco Plaza in Los Angeles and the ABC Building in New York. Thus, although the ego value of a specific property cannot be measured, it does exist.

Of course, egos are not unknown in American real estate

either. However, they tend to appear in the actions of developers, not in the newspaper ads of institutional investors.

CHAPTER V

TRENDS IN FOREIGN INVESTMENT IN LOS ANGELES

Based on our discussions with principals of Japanese and U.S. firms and with other real estate professionals and intermediaries, we have formed the following conclusions regarding future trends in foreign investment in the Los Angeles real estate market.

Portfolio Diversification

Geographic and property-type diversification will be pursued by foreign investors so that portfolios do not become too heavily concentrated in one market or property type. Just like the Europeans and Canadians who preceded them, the Japanese will begin to mitigate this risk through acquisition of properties outside the CBD.

The finite number of premium office buildings and comparitively low yields on major properties in the Los Angeles CBD constrain further investment in this market. According to Carl Muhlstein, Senior Vice President of Cushman & Wakefield, "There are only 25 key buildings in downtown Los Angeles whose location and other attributes qualify for Japanese investment" (29). Similar limitations exist in

other major coastal markets as well. A senior officer of Haseko feels that "Deals are few and far between on the coasts". These limitations led Cushman & Wakefield to sponsor tours of major suburban markets, such as Orange County, to acquaint Japanese investors with new market types.

Japanese investors will seek smaller, less expensive properties in the Los Angeles sub-markets and Orange County. However, they will not compromise their investment criteria when acquiring or developing properties in these markets. For example, Shuwa recently purchased the Irvine Commercial Center for $10 million. This property was fully leased, recently constructed and had superb highway access. While dwarfed in terms of acquisition cost by many of Shuwa's other properties, this purchase is evidence of Shuwa's willingness to acquire quality suburban projects. We expect other investors to follow Shuwa's lead, particularly when they realize that they can achieve higher returns outside the CBD.

Due to limited opportunities in major downtown areas, European firms became active in suburban and second-tier city markets several years ago. They did not invest in such markets, however, until they had studied them over a period of years. The Japanese are adopting a similar approach.

This trend will accelerate as high net worth Japanese individuals and corporations also become attracted to the

U.S. market. These investors will pursue smaller but never the less significant deals, typically under $25 million. Due to the high cost of downtown property, these investors will focus on areas outside of the traditional central business district. They will be attracted to these markets by the same factors that interest large institutional investors: quality product, low entry cost and higher returns.

As opportunities for office acquisitions diminish within the CBD, we expect Japanese investors to focus on different kinds of property, e.g. shopping centers, industrial parks, etc. Joint venture development agreements with domestic partners will also be used until the Japanese become comfortable with these property types. For example, La Solana Corporation is currently undertaking a 160,000 square foot mixed-use commercial project in Ontario, California with an American partner.

One approach that the Japanese will adopt to mitigate risk in new markets is convertible debt. This mechanism will allow them to observe how a property performs over a period of years before converting their position from debt to equity. Dai Ichi Life Insurance Company recently commited to loan $25 million in the form of a convertible mortgage for a U.S. office development project.

Capitalization Rates

Japanese investors are largely responsible for the lower capitalization rates now common for investment grade properties in Los Angeles. However, within recent months, capitalization rates have edged up as the Japanese have stopped paying premiums, although they still tend to pay somewhat ahead of the market for signature properties.

We expect this trend to continue. The Japanese have been here long enough to understand the market and they have been criticized at home by the press and the government for paying high acquisition prices. Also, higher yields are now being sought because some of the institutions have begun to syndicate their properties to smaller investors in Japan.

Project Development

Japanese real estate companies will continue their steady evolution from acquisition of existing buildings to project development. To mitigate development risk, these firms will form joint ventures with American partners. Mitsui is on the forefront of this trend. They currently have two major commercial joint venture development projects totaling in excess of 1.2 million square feet underway in Manhatten and Downtown Los Angeles.

More Japanese investors will seek the prestige and higher returns associated with project development as they acquire the experience needed to undertake this task. Eventually, these companies will seek to develop projects on their own.

<u>Syndication</u>

Both Mitsui Real Estate Sales and Haseko are reported to have syndicated portions of their U.S. portfolios. Shuwa is also rumored to be trying to sell a partial interest in its Arco Plaza property to individual Japanese investors.

Many Japanese individuals are interested in investing in U.S. real estate because they can obtain higher returns than are available in Japan. However, the average person in Tokyo has no knowledge of U.S. markets and lacks the funds and management ability needed to acquire property themselves. Thus, syndication of U.S. projects by Japanese institutions is a natural response to this demand. One syndication currently being marketed in Japan by three trust banks even has an American company as one of its general partners. We expect to see more syndication activity as the Japanese become more experienced with this technique.

Property Management

In general, previous foreign investors did not acquire a sufficiently large portfolio of properties to cost-justify the addition of property management functions to their operations. The Japanese are different. Companies with substantial portfolios will become actively involved in the operation and leasing of their property.

An executive of Nomura Real Estate International indicated that "We intend to manage our own property to save on fees. Your fees are very expensive." In fact, certain firms such as LaSolana, Mitsui and Shuwa, have already begun property management operations. At this time, however, it is too early to determine how well they will manage their properties.

Adoption of American Practices

Over time it will become more difficult to distinguish Japanese investors from domestic companies. Many Japanese firms already have more than one office in the U.S. These offices will be increasingly staffed with Americans to take advantage of their knowledge of local market conditions and government procedures and of their professional real estate contacts. Further, American staffs will be vested with increasing discretion to purchase and develop property.

With greater experience, the time needed to make investment decisions should also be shortened. However, U.S. operations will continue to be closely managed by home-office personnel temporarily stationed in the U.S.

Internationalization of the U.S. Real Estate Market

Like earlier hyperbolies which accompanied large Canadian and Arab investments before them, grandiose expectations regarding the eventual scope of Japanese investment activity will probably be exaggerated. Rather, the U.S. is participating in the evolution of an international real estate market in which the Japanese are presently the leading players.

The U.S. real estate market offers Japanese and other foreign investors a wide array of investment options and structures that is unmatched in its size, scope and openness by any other market in the world. Fearful of economic or political backlash, Japanese firms may try to diversify away from U.S. investments, but the huge volume of funds they have to invest will make it almost impossible for them to do so. Due to the fundamental attractiveness of the U.S. market, we expect that Japanese investment will continue to grow for the foreseeable future.

Steady growth is anticipated for two reasons. First,

Japanese investors will become even more widespread in the U.S. market as scores of cash-rich industrial companies and high net worth individuals from Japan purchase U.S. property. For example, New York City's Tower 49 was purchased as a corporate investment by the world's largest producer of corn syrup, Japan's Kato Kagaku Company, for $303.5 million. As this type of Japanese investor moves more agressively into the United States, they may create additional opportunities for domestic advisors.

Secondly, heavily regulated Japanese pension funds and trust banks may also receive permission from the MOF to invest in U.S. property. According to Russell Linder, Director of Bear Saint Properties in Washington, D.C., "there is more than $100 billion in pension money in Japan, if just 1% of that comes here, thats $1 billion, which is enormous." (30)

Our expectation for Japan's continued prominence in U.S. real estate investment is based on certain assumptioms, i.e. that the Japanese economy will not experience a significant downturn, that Japanese farmland adjacent to urban centers will remain unavailable for development and that U.S. investments continue to provide superior yields. A change in any one of these items could negatively impact Japanese investment in the U.S. In addition, investment could decrease if the MOF were to adopt more restrictive policies.

It is important to remember too that the Japanese are used to constant appreciation in property value and near 100% occupancy rates. These conditions are rare in U.S. markets. It is impossible to know how the Japanese will react to a downturn in the U.S. real estate market. Note however, that European investors became more conservative and pulled back from the U.S. marketplace after previously blue-chip southwestern markets soured in the mid-1980's.

A change in American political and social attitudes represents the greatest possible detriment to continued investment activity by any foreign investor. Thusfar, real estate investment by foreign investors has not captured widespread public attention. We do not expect that it will. After all, the most prominent foreign investors, the Japanese, own less than one percent of the value of real property in the U.S. (31). If a public outcry were to develop, more foreign investors would enter into joint ventures with American firms to mitigate potential criticism.

Foreign investment in the U.S. is not a fad. Today the Japanese are the most prominent and consistent investors in our marketplace. They will not disappear, but, in time their rate of U.S. acquisitions may level-off. Indeed, there are signs that the Japanese may only be the leading wave of additional Pacific Rim investment. Behind them may follow

other significant Asian investors from Hong Kong, Singapore and South Korea. Astute intermediaries are already cultivating relationships with this potential group of foreign investors.

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