Spring 2013

Linking Japan

Quarterly Investment Insights

The Art of Diversification

Generating Returns for Clients by Diversifying Locations, Financing and Timing

Publisher's Note

Somewhere between subprime and Lehman, a huge disappearing act took place. Most of the independent real estate firms that had made amazing strides over the previous ten years - Urban, PMC, Creed and many others - dropped like flies, often after posting amazing profits. Of course, the real estate firms that were members of major corporate groups also had a difficult run of it.

The biggest distinguishing factor over the years from then until about six months or so ago was that financing was easy for players related to major groups and REITs backed by household names but REITs with weaker sponsors and not necessarily weaker performance and independent real estate firms found the lending difficult and the interest rates high.

Most have since dug themselves out of that hole as banks discover they like lending money at very low interest rates and the spigots of the Bank of Japan continue to run powerfully. However, during the disappearing act and through the period of difficult lending terms, our two featured companies - Kenedix and RAYSUM - held fast. Kenedix negotiated with the banks and reduced its own portfolio through property sales and other measures while raising third-party and fund AUM, while RAYSUM bit the bullet and paid much of the debt down. Now though, we are witnessing the resurrection of the independents with Kenedix taking part in the acquisition of the former headquarters of Shinsei Bank and RAYSUM announcing a Medium-term Business Plan projecting major profits.

I am one that believes the independents are essential for keeping the market honest and interesting as they often are the ones that drive the cutting edge of the market - RAYSUM did so with NPLs and development securitization and Kenedix has been a trendsetter from its days as Kennedy-Wilson Japan to its REIT strategies. Hopefully, the resurrection of them and others means that the real estate market is once again on the verge of becoming healthy.

Additionally, we take a look at Abenomics, amazing what hearsay can do to consumer confidence. I don't know when Abe's measures will finally start but he does have the Bank of Japan opening the spigots and that is very evident on a daily basis. Maybe, just maybe, Japan will no longer be the headquarters for controlled negativity but rather the beacon for a soundly growing economy driving healthy economic relationships in the Asia-Pacific region.

J. Michael Owen
Chairman
Transpacific Enterprises

Linking Japan

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Taisuke Miyajima
CEO & President
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Waiting for Abenomics to Really Take Effect

Since late last year, the word Abenomics has been synonymous with the buzz surrounding Japan and a sharp rise in shares for many of the country's companies. The attention it is getting is appropriate. But pinning down what the term Abenomics means and assessing its impact is more difficult.

Photo: AP/AFRO

There can be little doubt that conditions in Japan have improved since Prime Minister Shinzo Abe of the Liberal Democratic Party prioritized the economy during campaigning for his December election win last year. The stock market is up around 45%. Sentiment has soared to five-and-a-half year highs. The Economy Watchers survey by the Cabinet Office shows that service sector sentiment in March was at its highest since records began. And business sentiment, as measured by the Bank of Japan, also posted its first rise in three quarters in the January-March Tankan survey. This has all happened as the new Governor of the Bank of Japan (BOJ), Haruhiko Kuroda, has unleashed the biggest monetary easing campaign the world has ever seen in a bid to achieve 2% inflation within two years.

"Abenomics is a set of policies Prime Minister Abe is implementing to stimulate the Japanese economy. It has three main components: fiscal stimulus, monetary easing and structural reform through policies such as the Trans-Pacific Partnership and lowering corporate tax," says Takuji Okubo, the chief economist at Japan Macro Advisers in Tokyo.

So is this the real deal? Perhaps. "When Mr. Abe initially took the PM's seat, many analysts were skeptical if the prime minister had really thought through these policies and if he had the political will to implement them," Okubo says. "But so far, he has positively surprised us."

While it is too early to break out the champagne, the signs of change are currently positive. With only a few months gone since the inception of Abenomics, it is too early to call the project a success. But since Abe took office, there has been a dramatic change in the Japanese economy and politics, mostly for the better.

The key difference between the early days of this LDP tenure and the governments of the five prime ministers that have resigned since Junichiro Koizumi left office in 2006 is leadership. A media-savvy team with a focus on the economy and a prime minister who appears to relish his job are running the country again for the first time in nearly seven years. Comments are carefully thought out (most of the time) and the determination to see business conditions improve is obvious. The rewards are clear: A few months into office, the cabinet still has approval ratings of around 70%. By contrast, most cabinets since 2006 have seen sharp drops to the 50% mark within months of taking office followed by approval ratings floating just above single digits before resignations. An upper house election in the summer, which would allow Abe to consolidate power, looks likely to go as smoothly as the LDP would hope.

One of the first things on the agenda of the Abe government was a stimulus package worth ¥113 trillion, confirmed January 11 by the cabinet. When it was unveiled, Abe delivered a

"Beating deflation and curbing the yen's appreciation are crucially important, so daring monetary policy is essential," Prime Minister Abe said.

speech expressing a determination not seen in Japanese politics for a long time. "Beating deflation and curbing the yen's appreciation are crucially important, so daring monetary policy is essential," he said. Over the next three months, as stocks rose, the appointment of the next BOJ Governor dominated the headlines. Perceptions of the new man for the job, Kuroda, are favorable across the board. A veteran of the Finance Ministry and former Asia Development Bank head, since taking the job, Kuroda has shown an awareness of media and market psychology that will be key to success in the early stages of the project.

Kuroda criticized the BOJ, particularly under the leadership of previous Governor Masaaki Shirakawa, for not doing enough to end deflation. He believes the BOJ needs to use monetary easing to tame deflation and real debt, and accept failure when policies are not working. Time will tell how willing Kuroda is to address failing policy, but the results of his first policy board meeting cannot be called conservative. In relative terms, it is an easing package about two and a half times bigger than the one being carried out in the U.S. It's consequences have only just begun to be felt: Stocks and the yen are back in territory not seen since the collapse of Lehman Brothers Holdings Inc., and bond markets appear to be factoring in inflation or collapse scenarios for Japan within the next decade.

The job for Kuroda, who has managed to win the overwhelming support of the nine BOJ board members for his actions, is to navigate the volatility that his massive easing has caused and convince the markets that his plan will work. But there are also critics. Investor George Soros has expressed his admiration for the ambition and scale of Kuroda's easing, but warned it could lead to the collapse of the yen. "If the Japanese yen starts to fall in value and the people of Japan lose faith and don't want to invest their money in the yen, they may put their money abroad, which could cause the yen's fall to become an avalanche," Soros said in an NBC interview. The currency was, as of April 24, floating around the psychologically important ¥99.86 to the dollar mark. That represents the midway point between the all-time high against the dollar of ¥75.56 in October 2011 and the ¥124.16 seen in June 2007, when the Japanese currency started to rise.

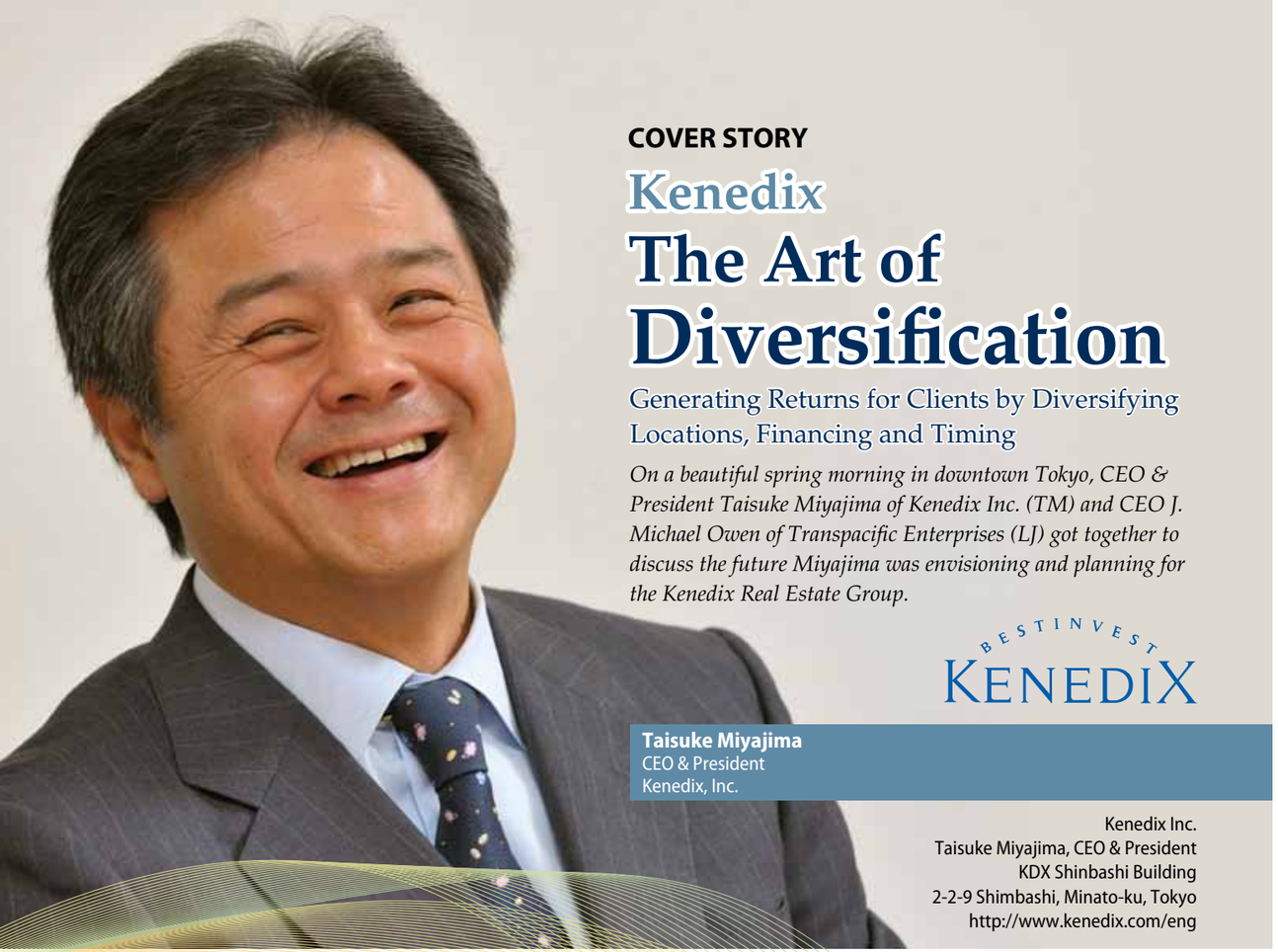
This is where the two other parts of the Abenomics strategy come in – structural and regulatory reform. And implementing these will take time. According to Yasuyuki Toda, a faculty fellow at the government affiliated Research Institute of Economy, Trade and Industry, joining TPP would eventually boost the economy by 1.5% per capita. But the measures in the TPP are not expected to be fully implemented until 2015 at the earliest, with Toda seeing the full effects of the agreement coming years later. Between now and then, wage increases are expected to provide an economic boost. In this year's annual wage negotiations with unions, while retailers such as Lawson Inc. and Seven & i Holdings Co. agreed to wage hikes, many electronics companies were not able to because of their precarious positions. In addition, other companies such as Toyota Motor Corp. decided to increase summer bonuses instead of base wages. Winter bonuses and next year's wage negotiations will be key weathervanes of the effectiveness of Abenomics.

"There are natural lags between the time certain growth enhancing policies are implemented and the time the real economy responds to these policies. It has only been five months since Abe took power," Okubo says.

This wait will be key. Luxury goods are seeing increases, with spending on watches up 34.9% at department stores, driving an overall on-the-year revenue boost of 6.6%. But low-cost restaurants are not. Beef-bowl chains such as Yoshinoya and Sukiya are slashing prices to try and attract customers. McDonald's sales declined by more than 3% in March, and President Eiko Harada has been pushed to increase menu prices by an average of around 20% in a bid to improve profit margins. Shoji Kuwabara, the owner of a yakitori chicken store in Tokyo's Meguro Ward, shares Harada's worries. "Abenomics is for the rich. Things are not improving for us," he said.

All people like Kuwabara can do is stay optimistic and wait for the effects of the recent stock bonanza and wage hikes to take effect. It is what the prime minister would want.

Richard Smart, Writer - Japan



COVER STORY

Kenedix
The Art of Diversification

Generating Returns for Clients by Diversifying Locations, Financing and Timing

On a beautiful spring morning in downtown Tokyo, CEO & President Taisuke Miyajima of Kenedix Inc. (TM) and CEO J. Michael Owen of Transpacific Enterprises (LJ) got together to discuss the future Miyajima was envisioning and planning for the Kenedix Real Estate Group.

BESTINVEST KENEDIX

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LJ: Congratulations on your promotion and thank you for selecting Linking Japan as a media to spread your message to investors. First, please reflect on the post-Lehman years and what they have meant to Kenedix.

TM: In the pre-Lehman years, our REIT and private funds were not so firmly established. Competition for properties was fierce. We acquired properties via our balance sheet, proposed development plans and made forward commitments. It was crucial for us to control our assets. As a result, our assets on the balance sheet in June 2008 reached 430 billion yen and our borrowings 310 billion yen. We implemented significant downsizing beginning from the subprime mortgage crisis that preceded the Lehman Shock and by 2012 we had reduced our balance sheet assets to 120 billion yen and our borrowings to 60 billion yen.

This was achieved through invaluable cooperation from the market here in Japan, particularly from equity investors and debt providers, and it was this cooperation and support that enabled us to survive the unprecedented, challenging conditions that were faced globally during this period.

During the post-Lehman period, our REITs (Kenedix Residential listed in 2012) have grown and evolved, and we have succeeded in increasing the AUM of our private funds to build a group-wide AUM of 1.1 trillion yen as of the end of calendar year 2012. Clearly we endured a comprehensive restructuring of our balance sheet, but with carefully timed real-estate transactions and the steady growth of our multiple private and public funds we successfully completed the first phase of restructuring at the end of last year.

LJ: You alluded to the successful significant reduction of borrowings during the post-Lehman era. Have you reached what you feel is the optimal level?

TM: No, we still have a distance to travel in that regard. We currently have 90 billion yen in assets on the balance sheet, but our new medium-term plan calls for reducing this figure further to 40 billion yen.

LJ: In December 2012, Kenedix succeeded in acquiring the former headquarters of Shinsei Bank from a Morgan Stanley-operated fund. What's the significance of this transaction, and what is your future intent regarding the asset?

TM: For us, the Shinsei acquisition served as a beacon signaling our recovery. In February 1999, Kennedy-Wilson, our parent company, was involved in its first large-scale deal in Japan, acquiring a data center building in Kawasaki. This was really the deal that launched Kenedix, and we grew from there. Through strategic planning and implementation, we have managed to navigate the subprime and Lehman crises and restructure our balance sheet, and the Shinsei acquisition was really both the culmination of our reorganizational efforts and the start of the next leg of our corporate journey. It was a momentous achievement for Kenedix, and it also conveyed an unequivocal message to the market. We were back, and everyone knew it.

Also, as you know we are heavily involved in real estate, and the operative phrase of that industry is "location, location, location." The location of Shinsei's former headquarters is ideal given its proximity to government offices and the financial district. Another phrase that is now in vogue in the real estate industry is "timing, timing, timing" and we were confident that this was an ideal time both for us to make the acquisition and to do so in tandem with our partners – Development Bank of Japan and Tokyu Real Estate. It also fit with my own philosophy of being "a half-step ahead" – maintaining an ability to anticipate, read trends and act quickly – and these qualities enabled us to successfully close this deal.

LJ: Market activity has become increasingly brisk over the past twelve months. What trends are market activities – including those of Kenedix – over that period indicating?

TM: One trend of the past several years is the growth of securitized real estate as a market. The time between market fluctuations has shortened, and the fluctuations themselves are less severe. As is widely recognized, economic recovery is heralded by a recovery in equity markets. J-REITs became active buyers from last year and property prices have begun climbing. There is no doubt that equity is presently driving market activity. This has clearly had an impact on property prices since the advent of Abenomics. These signs tell us we are experiencing economic cycles as we normally would. The next aspect in which effects are reflected is in rents – class A office building rents are recovering. As far as medium-sized buildings are concerned, while a rent gap does remain, we are seeing a gradual shortening of free rent periods awarded to tenants. There are also more frequent requests by tenants for more floor space in their present buildings. These developments, the abundant equity, good liquidity and other factors have convinced us that an improvement in rents is near and hence that very strong market conditions will continue.

In Japan, when things appear to be improving, the word "bubble" begins to resurface. Today, compared with the early 1990s and the time directly after the Lehman bankruptcy, J-REITs account for a large proportion of the market. There have been significant improvements in both liquidity and transparency. Pricing, cash flow and cap rate disclosure has progressed, as well as that of loan terms. There is no longer the sense of urgency among investors that we once saw with regard to individual deals taking place; the market is showing signs of steady growth going forward. Also, currently real estate in Japan is inexpensive relative to global standards – particularly given the recent weakening of the yen – making the real estate environment here very favorable for investment from overseas.

LJ: You have announced a One Kenedix policy. What is your aspiration for this?

TM: Following the subprime crisis, Kenedix companies were decentralized and adopted a rather defensive stance. At the end of the day, Kenedix is an asset management company, meaning that there is no conflict of interest between Kenedix and the funds it manages. We decided that in the interest of providing the best possible service to our clients, we needed to have all Kenedix companies working in harmony, and that meant a closer relationship in all respects.

Office Building in Uchisaiwaicho, Chiyoda-ku
(Shinsei Bank's Former Headquarters Building)

- This property was purchased through an SPC in December 2012 as a joint project of Kenedix, Tokyu Land Corporation and Development Bank of Japan.
- The property occupies one of the few sites adjacent to Hibiya Park and is also near the Kasumigaseki area.
- The aims are to help revitalize this district of central Tokyo as well as increase the value of the property.

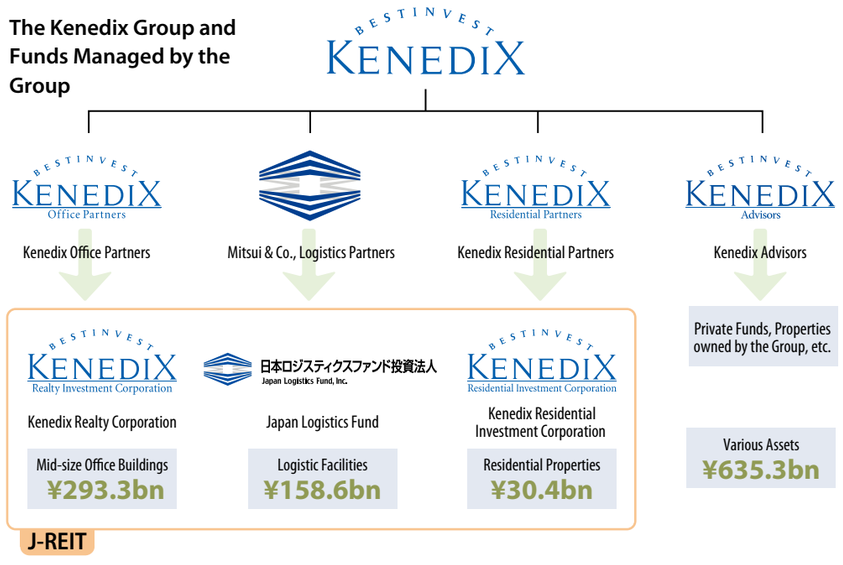
KENEDIX Financial Information (mm yen)

	Dec. 2008	Dec. 2009	Dec. 2010	Dec. 2011	Dec. 2012	Dec. 2013
Revenue	137,431	77,831	38,589	19,486	20,957	16,800
Operating income	16,267	8,433	7,331	6,931	5,837	4,550
Ordinary income	5,316	225	2,202	2,464	2,328	2,900
Net income	-10,850	-18,438	-2,452	1,313	-10,128	1,000

Furthermore, in addition to the office REIT, residential REIT and private funds we are presently managing, we intend to expand by entering and incorporating new asset classes. In doing so, it is necessary for us to standardize our organizational structure into a form more suited to this kind of growth.

LJ: You noted that the financing environment is favorable. At present, most of your corporate loans are secured. Is changing this so a greater proportion of the loans are unsecured a part of your strategy going forward?

The Kenedix Group and Funds Managed by the Group



Note: AUM as of the end of December 2012

TM: 'Simplicity' is the word that best characterizes Kenedix's financial strategy. Going forward we are looking to move away from being an owner of assets to almost exclusively being a manager of assets. We will proactively pursue corporate loans within our three asset management firms related to the REITs and private funds but there are no particular monetary targets for these loans. Kenedix itself is not interested in debt to buy assets with. On the other hand, we currently have 50 billion yen in equity, and will invest that in funds and take out loans against that equity at the fund level. We intend to exercise full disclosure to our clients. As an asset management firm, naturally the importance of sound financial standing, leverage control and disclosure cannot be overemphasized.

With regard to joint equity investment, we need to time such activity strategically. We are in essence not a company that pursues returns from equity investments – we offer asset management services. We intend to effectively disperse our equity investments, and diversify our products and leverage. This implementation of co-investment will enable us to withstand severe fluctuations in prevailing conditions.

LJ: You mentioned earlier that as of the end of last year you had 1.1 trillion yen in AUM. Are you aiming for a specific AUM presently?

TM: Yes, by the end of 2015 we hope to have reached 1.4 trillion yen in AUM, which represents an increase of 300 billion yen. Our primary focus will be on doing this through the REITs, as the current capital raising environment is extremely favorable, and we also plan to leverage our experience in directly raising capital from the market. The timing is also optimal for the application of creative equity financing.

With regard to our private funds, most will have durations of three to five years. We will actively originate new funds. However, we will also sell off properties quickly as legacy funds approach maturity and property prices increase. It is not our intent to require private funds to maintain high balances. Our interest is more in returns and performance track records. The key to this area of business is maximizing the quality of our investments.

LJ: You mentioned joint equity investment, or co-investment, earlier, and it's a key strategy outlined in your medium-term business plan. Can you share the monetary size and how you intend to manage the exposure that will result from this?

TM: The first and most important point is spreading such investments among a variety of investors. As for controlling risk, our policy will be to invest within our equity capabilities – we will not use debt to fund equity. Here again, disclosure is crucial. We will disclose our co-investment portfolio, expected return and actual return so that Kenedix investors can readily ascertain how we are applying our equity.

LJ: Given that the scale of the listing of your residential REIT was relatively small, could you tell us what your goals are in terms of expanding the REIT's scale of operation?

TM: The source of support for the REIT really depends upon the stage of development it happens to be in. Our office REIT's property sourcing, acquisition and equity financing are all conducted independently of us. The residential REIT obviously has a long way to go. We manage a REIT bridge fund for the purpose of selling properties to the REIT, and it is rather large. We also have a private fund that offers properties to the residential REIT at market prices. By utilizing these, we hope to raise the REIT's AUM to 100 billion yen.

LJ: Kenedix as a listed company has a responsibility to its investors, and the REITs also have investors they are responsible to. While it's likely impossible to completely overcome the possibility of conflict of interest, how do you plan to assuage investors' concerns in this regard?

TM: As a REIT sponsor, we intend to steadily reduce the volume of proprietary trading and transition away from being an owner of assets. The original REITs were devised to purchase assets from their sponsors, but our REITs are the first that were not originated for that purpose. I am convinced that we are on the verge of realizing the model of an asset management firm optimally managing "funds" for the profits of our investors.

A REIT, however, is a vessel that is somewhat lacking in flexibility, and the way we can most effectively support our REITs is through transparency. For instance, in cases where equity financing is difficult, we can establish a bridge fund – this is funded by Kenedix and the REIT, and is comprehensively disclosed to investors, from acquisition to sales. And in the event capital gains are earned, the REIT investors can enjoy this benefit as well. If there are no capital gains derived, then the sale is at market price.

LJ: What about conflicts of interest arising between funds and the two REITs?

TM: Naturally conflicts of interest are an area of great concern to an asset management company. By clarifying the concept of the fund and providing comprehensive disclosure, we are able to avoid such conflicts. In the case of the transaction involving Shinsei's former headquarters, it qualifies as not only a class A property but also as a development project, and as such no conflicts arise with our office REIT, which specializes in mid-sized office properties.

LJ: You often speak, as you did earlier, about being half a step ahead. While president of the REIT, you shifted your focus from mixed office and residential to office-centered, and from having a regionally diversified portfolio to a Tokyo-centric portfolio. The changes usually preceded market lulls. Do you intend to strictly observe these strategies today?

TM: When I was appointed president of Kenedix, I spoke to all employees and reminded them that there isn't really a listed firm in Japan yet that practices "pure" asset management. For this reason I think that it's necessary for our company to re-invent itself. There are a number of issues we need to deal with, but in the medium term it is vital that we again establish financial control with a simple financial structure for our accounts, that we support the growth of our REITs and that we heighten the returns of our private funds through a co-investment strategy. We would also like to look at expanding the asset classes handled by our REITs or establish new REITs that own assets like retail, senior housing and healthcare.

LJ: There are rumors that a Japanese REIT may finally invest overseas. Would Kenedix consider investing overseas if investors in its funds voiced interest in doing so?

TM: Well, we already have a platform established in the U.S. – it's an apartment investment platform with the Kennedy-Wilson Group. We have used limited equity there to invest in multi-family properties particularly on the West Coast. In the short term, given the weakening of the yen and other factors, the timing right now is not optimal, and we have put the originating of new funds on hold.

As we all know, the market is cyclical, and when it reaches a favorable point in the cycle, and exchange rates are also favorable, we want to be prepared to move quickly and decisively.

LJ: What do you think is the often overlooked strength of Kenedix?

TM: Asset management firms are known for having frequent changes in their personnel. Reflecting on the history of Kenedix, Ryosuke Homma, our corporate advisor, initially led Kenedix. He was followed by Atsushi Kawashima, our chairman, and I had the privilege of assuming the post of president this year. All of us, as well as Taiji Yoshikawa, our current CFO, have been together here since 1998. The stability in upper management here at Kenedix is very likely our single biggest selling point. It is also a prime factor for the market support we received during the tough post-Lehman years that played a significant role in Kenedix surviving the severe conditions of the past few years and begin the next phase of our evolution. Stability is key to delivering reliability and consistency.

LJ: Thank you for your time.

BESTINVEST KENEDIX Office Partners

Naokatsu Uchida

CEO and President,
Kenedix Office Partners (KOP)
Executive Director, Kenedix Realty Investment Corporation (KRI)

LJ: Can you give us a background on the history of the REIT since its IPO in 2005?

NU: Yes, we were listed on the Tokyo Stock Exchange in July 2005 and have grown subsequently. Even after the Lehman Shock, we were able to raise equity through two public offerings and re-started acquiring properties relatively quickly. We intend to continue growing our assets and seek to achieve AUM of 400 billion yen in the medium-to-long term.

LJ: You mentioned that KRI's medium-to-long term target is AUM of 400 billion yen, comprised of 100 properties. Is this correct?

NU: Yes, these are general guidelines, particularly with regard to average property value, and please bear in mind that asset size of each property may of course vary. Besides these numerical targets, what I would like to emphasize is our goal to become the No. 1 J-REIT that specializes in mid-sized office buildings. We are already the largest owner of mid-sized office properties with nearly 80 properties in our portfolio, but we recognize that there is still a sizable share in this market within our reach.

LJ: Tell us a bit about your strategy for achieving your goals.

NU: Our strategy is fairly simple, that is, we seek to obtain the most efficient fund raising, whether through bank borrowings or issuances of bonds and equity, whenever we seek to acquire properties. We'll try to effectively time our capital-raising around when properties become available.

LJ: How has the recent economic shift affected your growth strategy?

NU: It appears that economic environments and market sentiments are clearly shifting and active trading of properties has increased with the advent of Abenomics. When the market becomes more active, how we source and execute external growth becomes critical. Our track record of acquiring properties directly from the market has provided us with a critical information network of acquisition opportunities, which puts us in relatively advantageous positions when negotiating deals. It's important to acquire properties that have a characteristic fit with our portfolio. Additionally, the size of AUM makes a difference when it comes to portfolio management, as increased AUM generally enables us to decrease costs such as construction expense, building management fees, etc. through economies of scale, and to serve to strengthen our market competitiveness.

We will pursue external growth by utilizing the strength of the Kenedix Group to source opportunities. Occasionally, we may co-invest with our sponsor in funds that own properties we would like to add to our portfolio when such funds decide to exit in the future.

It's more our style to use the resources of the group as a whole to take advantage of opportunities as they arise. Kenedix, Inc. as a provider of information really serves a role similar to that of a broker for us.

KDX Ginza 1-chome Building

LJ: Another aspect of KRI that sets you apart would be the fact that you are conducting property management internally.

NU: True. Looking at mid-sized office buildings, there is a high level of risk attached to the return when investing. One reason is that buildings in this class are typically 8 to 10 stories with a single tenant on each floor. Let's think about an example of an 8-story building with about 100 tsubo per floor. If one floor becomes vacant, the occupancy of this property instantly drops by about 12.5%. This kind of volatility or susceptibility to fluctuation would often result in a difference of about +1% in the cap rate when evaluating acquisition price. In other words, when the cap rate for a larger building commands 4%, this mid-sized office building may require 5% for this potential cash flow volatility. Fortunately, because we already have nearly 80 properties and more than 850 tenants in our portfolio, we may be able to mitigate such volatility through diversification and thus optimize returns from our investments.

We are securing new leases with about 100 tenants per year. We make sure to maintain good relationships with leasing agents so that they may be incentivized to work with us and find appropriate tenants whenever there is a vacant floor. This is another scale merit as the agents are happy to work with us because of our business volume. One critical point about our in-house property management function – this will allow us to be well versed in our portfolio, to be aware of current issues, and to be able to respond swiftly and precisely when any issues arise. This is a critical difference from typical mid-sized office owners who only own one to a few office buildings. Owners of large office buildings naturally have considerable buying power, and in terms of bringing that power to the 'inefficient' mid-sized office building market, KRI is leading the way.

Focus Investing in the Mid-sized Office Buildings in the Tokyo Metropolitan Area

Prime business area which sustains the Japanese economy

Large number of tenants and tenant diversification by industry

Broad-based stock and superior properties

Total No. of Properties (End of April 2013)	Acquisition Value (End of April 2013)	Occupancy Rate (End of March 2013)
83	292,553 million yen	92.6%

BESTINVEST KENEDIX Residential Partners

Akira Tanaka

President, Kenedix Residential Partners, Inc. (KRP)
Executive Director, Kenedix Residential Investment Corporation (KDR)

LJ: Kenedix Residential Investment Corporation was listed in 2012, the first J-REIT listed after a long hiatus in IPOs. Could you talk about your medium-term goals and the strategies you will employ to achieve them?

AT: We listed on April 26, 2012 with assets of about 30 billion yen. There were several objectives with our listing: Providing a new opportunity for J-REIT investors in a stagnant market, attracting new investors to assets managed by the Kenedix Group through the very stable residential property asset class, and expansion of AUM under our Group.

Currently our portfolio scale is the smallest among J-REITs, but naturally we are committed to achieving future external growth. We listed in a very difficult market environment that had a distinct "risk off" characteristic where investors were more cautious. Investors were and now are more proactive in assessing portfolio assets and REIT characteristics, but an IPO road show generally is over in two weeks. We were convinced this was too short for investors to become familiar with the characteristics and quality of a large portfolio – especially for residential properties – so we figured this was a good size to launch with.

Our next numerical target is a portfolio of about 100 billion yen in the near future. This is the second step in our development following the IPO and has been planned since the outset. We do face challenges reaching this target, but we are continuing to work toward this immediate goal.

LJ: What are the typical characteristics of a residential property in your portfolio?

AT: The foundation of our investment philosophy is placing priority on the land over the building. Factors such as the location and characteristics of a plot of land are crucial – this may sound harsh, but a building will eventually disappear while the land will remain. We believe that a focus on site location and optimal utilization of land characteristics is a better approach to evaluating targets for acquisition.

We have some properties that are more than a ten-minute walk from the nearest train station and more than twenty years old. In most cases, a property like this that targets singles is not attractive. When a property targets families, the preference tends to be for a quieter, nicer environment near a shopping center and school possibly distant from mass transit. Excessive consideration of proximity to the train station and building age can thus exclude a lot of properties that are actually quite attractive.

Presently, about 64% of our portfolio is in the Tokyo Metropolitan area and the remainder in other regional areas. This will likely be the nominal balance going forward, though it is dictated more by circumstances than philosophy.

LJ: Are so-called shared housing and senior housing possible candidates for the portfolio?

AT: We will consider adding such properties and our investment policy allows for up to 20% of our portfolio to fall into such categories. Our portfolio, however, is presently too small for us to immediately consider them. Another thing to remember is that senior housing is a rather different asset class from the standard single and family-type residences.

Senior housing is an operational asset, and given our portfolio size we can't yet afford to have even one out of twenty assets taking operator's risk. We certainly do see senior housing as a growing area, and I'm probably one of the few people in this industry with real experience in senior housing asset management. Kenedix Advisors, Inc. is handling asset management duties for senior housing assets in Japan for a Singapore-based investor. I was the head of Kenedix Advisors just before my current position, so I'm familiar with the ins and outs of managing senior housing. Once our portfolio becomes large enough, we will actively consider acquiring senior housing.

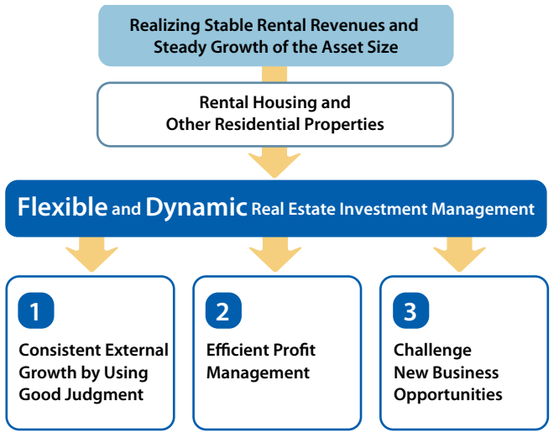
KDX Yoyogi Residence

LJ: As a newly established residential REIT, can you explain your approach to differentiating yourselves from other REITs specializing in residential properties?

AT: It is difficult to differentiate REITs specializing in residential properties by property characteristics. Rather, differentiation must be done in the quality of management, whether or not they are paying dividends as promised, and then whether or not the REIT appears to have potential for further growth. At the end of our second fiscal period we had total assets of 33.2 billion yen, and as mentioned we are targeting a 100 billion yen portfolio in the near future.

The Kenedix Group currently has 131.5 billion yen of residential properties excluding KDR's portfolio. This will serve as a potential pipeline for us, and we will proactively utilize this pipeline. This is a distinct advantage in today's fierce acquisition climate.

Basic strategy



Total No. of Properties (End of April 2013)	Acquisition Value (End of April 2013)	Occupancy Rate (End of March 2013)
20	30,474 million yen	95.5%

RAYSUM
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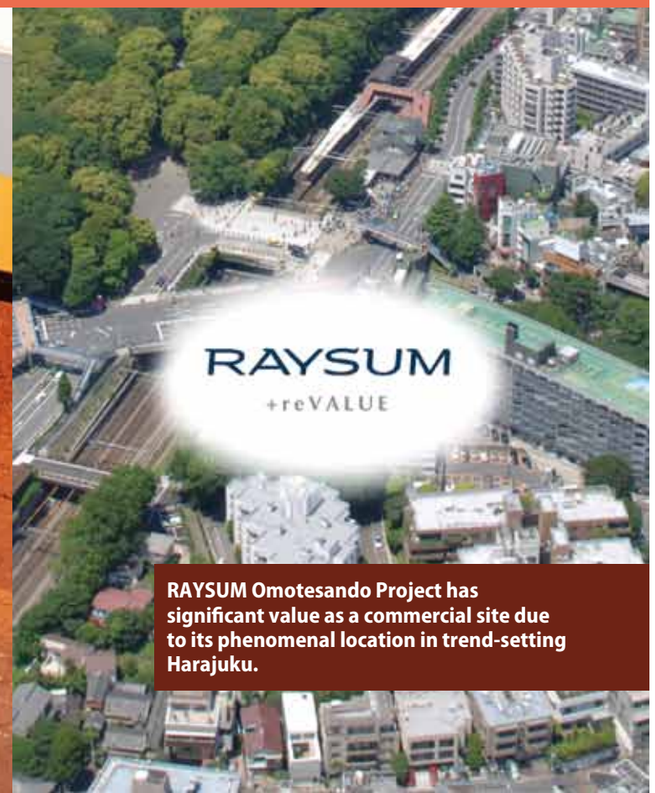
FEATURE

RAYSUM Resurrects

Daring as Ever, Daring Us to Share in Its Dream



RAYSUM Omotesando Project has significant value as a commercial site due to its phenomenal location in trend-setting Harajuku.

Tatsuya Iizuka – Managing Director **Tsuyoshi Komachi** – Managing Director **Takeshi Tanaka** – President and **Nobuyuki Matsukura** – Director (left to right)

RAYSUM rode a wave that many in the real estate industry rode in 2006-07. A wave of successful transactions and easy money. A wave that at its peak led many real estate asset managers and others to list on the stock market and at its trough to delist or desist.

RAYSUM was one of the leaders among the independents. It along with Kenedix and others constantly filled the pages of the Nihon Keizai Shimbun, RAYSUM pursuing profits through the addition and creation of unique value in their properties, which are their products. Today, RAYSUM is a survivor and not just a survivor but a bold, daring business that survived the bloodbath of post subprime and Lehman in Japan. RAYSUM reduced its exposure to banks using cash on hand and refocused on what makes it special to emerge now with its first medium-term business plan calling for robust growth based on solid experience and the unique values that make RAYSUM special.

RAYSUM was founded in 1992 with a mission to correct inconsistencies in how Japanese real estate was valued at the time. The industry then valued empty lots more highly than operating buildings with tenants. The Japanese legal system had provided tenants with strong positions in their leasing contracts and as such the tendency was to view tenants as trouble when developing. Consequently, developers preferred trouble-free, tenant-free lots over operating buildings. President Tanaka of RAYSUM felt this was illogical and sought to create a viable real estate investment market for buying and selling existing office and residential buildings, etc.

Having navigated the post-Lehman waters, RAYSUM is once again on the road to expansion and, following operating income of 2.2 billion yen and 2.0 billion yen of net profit in the fiscal year ended in March 2013, projects net profit of 7 billion yen or even much higher as of the end of the Medium-term Business Plan in March 2016.

President Tanaka initially led RAYSUM to stake out a strong position in NPLs by proactively investing in and gaining returns in the handling of NPLs. Today the NPL market is smaller, so the company has sought and found sourcing opportunities elsewhere.

Japan is often mentioned in passing as an aging population that is rapidly shrinking, but the actual fact is that the population of the 23 wards of Tokyo has risen to over 9 million. Combined with the Japanese government announcing it will make Tokyo the easiest place to work in the world with 24/7 subways and easing FAR and other requirements to enable optimal developments and the building of a non-stop global city, Tokyo provides excellent opportunities for developers with a mission.

It is not as if RAYSUM has no experience developing representative projects in Tokyo. RAYSUM to date has performed admirably in these large projects by being a "chance maker" for investors and focusing on its concept of +reVALUE, that is optimized when its "air leasing" (the ability to discern the potential profitability of a property by attracting new tenants after existing tenants have moved out), purchasing, sales and other teams collaborate to determine the best investment and structuring approach for the properties they are optimizing for their investor clients. RAYSUM uses scientific methods to ensure that they properly analyze and understand not just market practices in the general vicinity but demographics and emerging trends that can dramatically impact the property. President Tanaka can often be heard talking about the importance of focusing on the future and avoiding the trap of focusing on the past that afflicts appraisers and real estate professionals.

Once it has conceptualized these different values, the tax, accounting, appraisal, construction, finance and real estate experts of RAYSUM analyze projects to make sure that RAYSUM proposes the optimal asset form for its customer's benefit. A dedicated unyielding spirit that puts the customer first

and is committed to realizing additional value for them and itself is what drives RAYSUM. The company is committed to delivering great product to market. This commitment drives its Medium-term Business Plan.

First, understand that RAYSUM has already proven itself previously in Central Tokyo deals such as the Shinjuku Sky Building near Shinjuku Station bought for 20.2 billion yen and sold the next year for 37.0 billion yen and the Jingumae RAYSUM Building that was acquired for 7.2 billion yen in March 2006 and sold for 13.0 billion yen in May 2007 after the buyer agreed to do 1.0 billion yen conversion work.

In the case of the Shinjuku Sky Building, after RAYSUM acquired this 33 year-old building next to the busiest station in the world (Shinjuku Station), agreement was reached with all of its 23 tenants to leave and then the site was sold to the top big box store in Japan.

There were 23 tenants renting the 6,000m² of leasable floor area initially, but RAYSUM readied an alternative property and got all tenants to vacate in about 14 months, far quicker than budgeted, so that it could be sold to a major electronics retail firm in Japan.

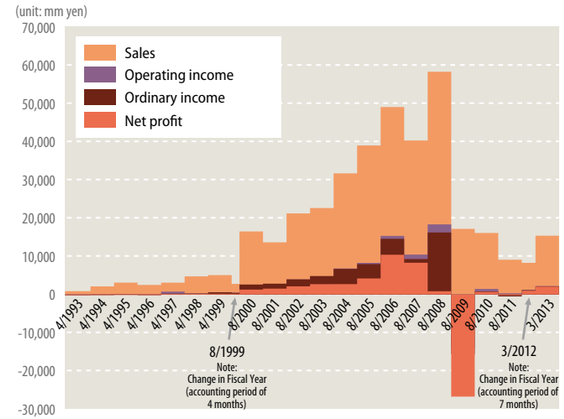
In the case of the Jingumae RAYSUM Building, RAYSUM obtained this building formerly housing a bankrupt sports club that had a unique design by a famous architect. Rather than leasing it to another sports club, RAYSUM converted the roughly 5,000m² of leasable floor space into office space with a higher rent and longer contract.

The timing was perfect for a major entertainment firm needing to centralize its offices and have a studio, and RAYSUM converted the building to meet its specifications.

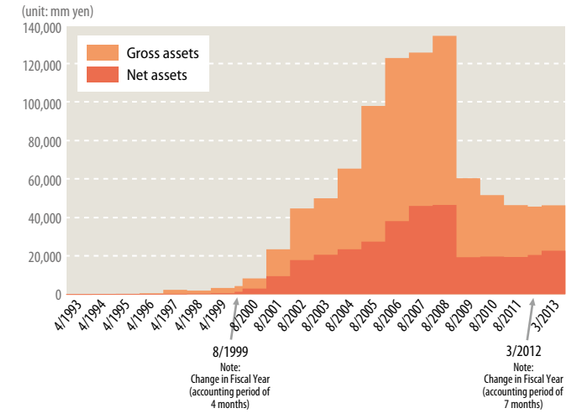
Specifically, the pool was converted into an office and the squash court into a studio. These and other steps cost 1.0 billion yen. RAYSUM secured the new tenant and sold the property to an institutional investor in May 2007. Again the project was completed far earlier than budgeted, a sign of a professional team that understands the value of time.

These are just two examples of a wealth of redevelopment and reposition projects that RAYSUM has delivered to the market. Now RAYSUM is going to fulfill its medium-term growth goals through the fast delivery of inventory products in the favorable Japanese market and investment in emerging ASEAN countries. RAYSUM perceives the growing wealth of the newly emergent ASEAN countries and the opportunities of collaboration with dominant local players as a great way to diversify its strategies and income.

Trends in Business Results since Foundation



Property Situation Transition since Foundation



RAYSUM is focused on gaining success through four core strategies that will raise the value of the products delivered to the market by improving their fundamentals via a reinforcement of the air leasing team, augmenting and nurturing of personnel on the purchasing team, hiring and cultivating young sales personnel and, most importantly, providing customers with optimal properties through close internal collaboration across its organization. Thus, a favorable cycle is being created where the diverse teams within RAYSUM originate deals based on mutually perceived opportunities to ensure customers can differentiate RAYSUM from competitors and RAYSUM can truly improve the fundamentals of the products it delivers to market. RAYSUM has evolved from making CHANCES provided by opportunities to delivering market-innovating CHANGES that give its investors unique opportunities that others rarely offer.

RAYSUM OMOTESANDO PROJECT

RAYSUM possesses the RAYSUM Omotesando Project, and one possible upside of its next Medium-term Business Plan is the redevelopment of the site. The property is linked to extraordinary profit in the plan and thus doesn't impact projected operating income; however, the projected story increases in brightness when the site is sold. This site is located in the immediate vicinity of Yoyogi National Gymnasium (1964 Olympics), Meiji Shrine, where Emperor Meiji is enshrined; and the ever-popular Harajuku Station, home to diverse fashion tastes and one of the top brand avenues of Tokyo. RAYSUM has secured a phenomenal location for train access, tourist access and advertising access to train passengers – a unique opportunity that RAYSUM's diligence and adherence to its philosophy of +reVALUE has made possible.

Site Overview

Address: 6-chome Jingumae, Shibuya Ward, Tokyo

Area: 3,008.10m² (includes 148.48m² planned to be supplied to Shibuya Ward for road expansion)

Access: 2-minute walk from Harajuku Station on the JR Yamanote Line
1-minute walk from Meiji Jingumae Station on the Chiyoda Subway Line (Tokyo Metro)

Appraisal: Over 30 billion yen

Views from the RAYSUM Omotesando Project from a height of around five floors. The lush green carpet of Meiji Shrine seen during the day and the lights of Shinjuku skyscrapers at night.

Signs of Life

Japan's Real Estate Industry No Longer Reeling

Over the past year, Japan's real estate market and the financing environment surrounding it have begun to bounce off the ropes like a punch-drunk but determined fighter whose vision is slowly coming back into alignment. The new sentiment brought on by discussion of Abenomics and the spigots of the Bank of Japan was recently summed up at the APREA Property Leaders Forum in Hong Kong where Mitsui Fudosan Senior Executive Managing Director Hitoshi Saito noted that, "The (Japanese) government has succeeded in changing market sentiment – and it has created high expectations."

Spigots Open Fully

The Bank of Japan, under new leadership, is buying Japanese Government Bonds (JGBs) at a rate of 1 trillion yen a month, and is expected to pick up the pace as it plans to increase its total holdings by about 40% to 140 trillion yen by the end of this year. "The recent changes in policy have driven yields on the June 10-year JGB to 60 basis points as of April 10th," says Jon Tanaka, Managing Director of the Tokyo office of Angelo, Gordon International, which manages over $25 billion of equity. "Japanese financial institutions and pensions collectively own over 60% of JGBs, and with yields so low they may be tempted to liquidate a sizable amount. In our view, they may allocate a portion for investment in J-REITs and real estate assets because of attractive yields."

Like many others, however, Tanaka is convinced it's a bit early to begin celebrating. "The question is really what will happen to fundamentals," he says, noting recovery will depend in large part on "whether or not the measures enacted under Abenomics – to include Japan's participation in the Trans-Pacific Partnership – gain traction and become effective long-term reforms. It seems that corporate Japan has generally been responsive to this point."

The BOJ's quantitative easing program has been a boon to the J-REIT market as well, inspiring numerous public offerings and two IPOs earlier this year alone. Prologis set up an industrial REIT, Nippon Prologis REIT, and officially listed on the TSE on January 10. The REIT's portfolio will consist initially of 12 properties acquired from the sponsor and valued at 173 billion yen. Tokyu Land has also established a REIT, Comforia Residential REIT, and it was listed on the TSE J-REIT Index on February 6. It currently has 53 residential properties located inside the Tokyo Metropolitan area, with a total acquisition price of about 71.2 billion yen. Comforia Residential REIT is the second REIT formed by Tokyu Land in less than a year, following Activia Properties REIT – with a portfolio comprised of commercial properties in Central Tokyo – which was listed in June 2012.

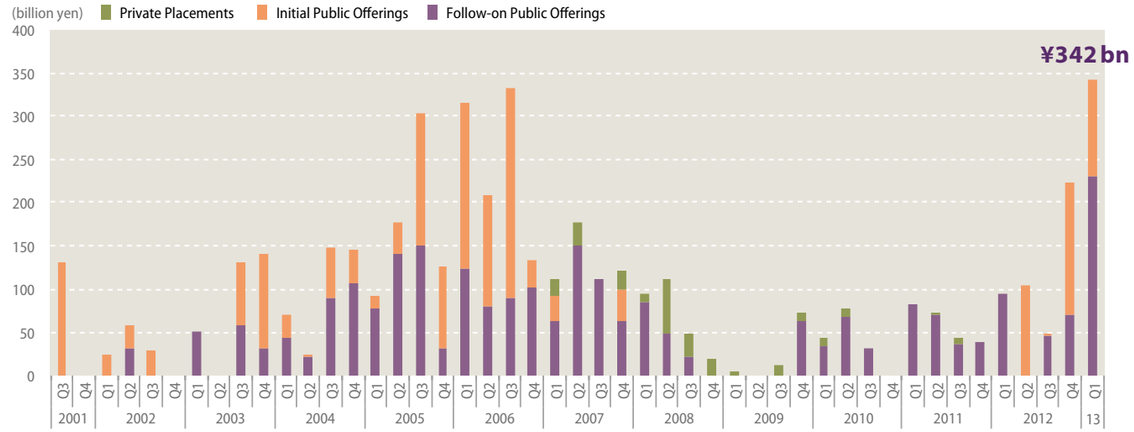
The J-REIT market saw a new record for fund procurement established in Q1 2013, with a total of over 340 billion yen raised through thirteen POs. Nippon Building Fund was the single largest beneficiary, netting just under 70 billion yen.

End of an Era?

According to an article by Pacifica Capital CEO Seth Sulkin in the April edition of the ACCJ Journal, the expiration of the Act on Temporary Measures to Facilitate Financing for Small and Medium-Sized Enterprises – a law that went into effect post-Lehman enacted for the purpose of offering some measure of protection for small companies and to help prevent a host of bad loans from further impacting an already reeling economy – may actually not signify the end of the 'extend and pretend' era.

While noting that banks could naturally begin to disregard requests for extensions, Sulkin wrote, "At the moment, I think Japanese banks are unlikely to change their behavior much as they still have bitter memories of 15 years ago when selling NPLs at deep discounts created huge holes in their balance sheets that ultimately had to be filled by government capital injections." He added that the current rising trend in real estate prices is beginning to make banks and borrowers alike optimistic about the prospect of recouping all or part of their investments.

J-REIT Equity Offerings



Note: Net proceeds Source: Compiled by Association for Real Estate Securitization based on publicly disclosed J-REIT data

What's Happening

In early April, AXA REIM and Sumitomo Mitsui Trust REIM announced the acquisition of an office property in Shinjuku via their joint Tokyo Office Property Fund, which closed at 10 billion yen last September, with a second closing possible within 2013.

Grosvenor has recently begun shifting its investment and development focus towards Asia due to perceived potential for future growth. Asian assets presently account for 8% of Grosvenor's total assets, and it aims to increase that to 15% with an eventual total investment of 100 billion yen.

In December 2012, Fortress closed its Japan Opportunity Fund II at 130 billion yen. It focuses on real estate and real estate-related debt, and it expects the fund to be fully invested within two years.

Richwood Capital Partners Asia has just acquired multiple assets – offices and residences - in downtown Tokyo and expects to invest 20 to 30 billion yen in total.

According to the Nikkei Real Estate Market Report of April 26, GreenOak Real Estate, an asset management firm based in the U.S. that manages assets in Japan valued at around 60 billion yen, purchased three Tokyo office buildings in March, and is believed to have spent up to 7 billion yen.

Diamond Realty Management (DREAM) revealed in Cannes in March that it plans to launch Dream Logistics Fund III, with the goal of achieving 300 billion yen in assets using funds raised from foreign investors.

Perspective

Japan, More than Tokyo?

Sumitomo Mitsui Trust Research Institute Co., Ltd.

Scale of Japanese Cities

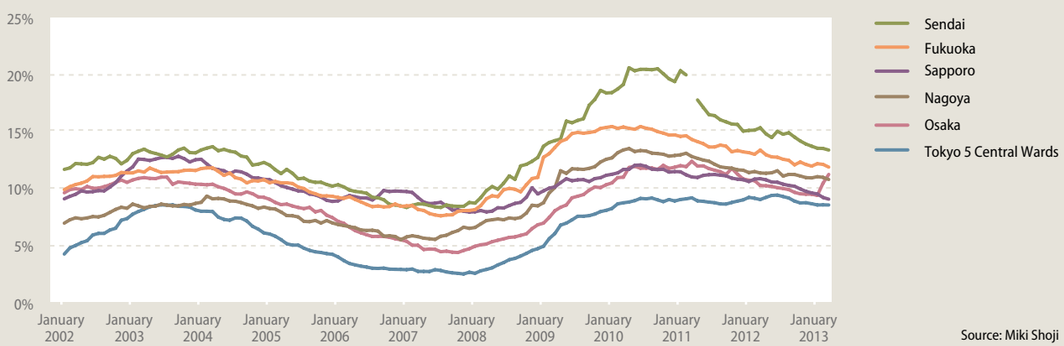
How many cities in Japan can you name? The fact is that there are more cities in Japan with populations exceeding 1 million (12) than can be said of other industrialized countries such as the U.S. (9), Australia (5), Germany (3) and France (2). Central cities outside of Tokyo's 23 wards (population 8.59 million) include Osaka (2.54 million), Nagoya (2.18 million), Sapporo (1.9 million), Fukuoka (1.42 million) and Sendai (1.02 million). (By contrast, the population of Paris is 2.25 million).

Office Market Trends in Regional Cities

The average vacancy rates for office buildings in the aforementioned regional cities are higher than Tokyo. However, control of new supply following the Lehman Shock took effect more quickly there than in Tokyo, and rapidly revealed itself in the rebound from the drop in occupancy that helped to narrow the gap with Tokyo. And today, like in Tokyo, there are clearer signs that rents have bottomed out.

The scale of these cities and an analysis of their office market cycles would seem to clearly indicate that Japan has a great deal to offer investors outside of the Tokyo Metropolitan Area. We are convinced that we will see a gradual expansion in real estate investment activity from Tokyo to these other areas.

Office Vacancy Rates of Major Japanese Cities



Source: Miki Shoji