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Forerunners of Nippon

A new strategy to invest abroad is Diamond Realty's latest effort to innovate ahead of others

The DREAM team: early movers

Diamond Realty Management (DREAM), the real estate investment management arm of Japanese conglomerate Mitsubishi Corporation, is not one of the first names that spring to mind when thinking about private real estate investment in Japan. And yet, since its founding in 2004, the firm has grown its asset base to approximately \$4 billion, making it one of the more established firms in the Japanese market.

DREAM manages an open-ended private REIT, private equity real estate funds and mezzanine finance real estate funds, the latest of which is expected to be launched this quarter. Whether the firm is able to keep to its growth trajectory, however, has much to do with how it navigates one of the hardest private real estate investment markets in Japan in years. Indeed, with fierce competition for core real estate and free-lending banks with which to contend, DREAM's business faces challenges aplenty.

President and chief executive Takashi Tsuji acknowledges as much. "Everyone is crowding to the same assets," he says. He admits that leverage is starting to return to pre-crisis levels of about 75 percent on a loan-to-value basis and, in such a liquid market, it would be reasonable to suppose there would be little place for a mezzanine finance-focused strategy.

Knack for moving first

For those reasons, executives at DREAM today are spending time looking at a new niche strategy currently neglected by its rivals in a bid to adapt to these challenging conditions.

Finding a niche in a market as clearly defined as private real estate sounds like an oxymoron. However, manager William Hsu says that is precisely what his firm has done in its past, and he has faith that history will repeat itself. In fact, he notes that DREAM has been an "early mover" in a number of specialized strategies that have become popular since.

The prime example of this strategy is logistics real estate, which Hsu says was a favorite of DREAM before large, international companies like Global Logistic Properties and Goodman Group legitimized the asset class for institutional investors. DREAM has acquired \$1.5 billion of industrial real estate since it first uncovered the opportunity a decade ago, and today it has four funds dedicated solely to the property type.

Another example is data centers, which still is a nascent sector region-wide, with only a handful of firms like Singapore-listed Keppel Land operating vehicles dedicated to the property type. DREAM closed its first data center fund in 2011 with JPY9.5 billion (€67 million; \$92 million) in capital commitments. Today, the firm is preparing to launch a second fund for the same strategy.

It is not only property types where DREAM executives feel they have been first movers. The firm also lays claim to being among the pioneers in Japan's embryonic private REIT universe. In October 2012, DREAM launched a private REIT in Japan to cater to institutional investors with long-term investment horizons, such as pension plans. To date, the DREAM Private REIT has \$1 billion in assets and about

\$650 million of equity. DREAM anticipates it will grow the REIT to \$2.5 billion in assets in the next three years, according to director Masanobu Fujita.

DREAM's leadership add that they have been first to react to market cycles as well. In support of that claim, they say the firm was the first to return to offering mezzanine finance to private real estate borrowers following the global financial crisis. In that space, DREAM filled a hole left by international lenders, which had departed from the marketplace in the wake of collapsing valuations.

Fujita remembers how it was the domestic managers that first saw that opportunity. DREAM raised its first mezzanine finance fund in 2011, collecting JPY10.2 billion of equity. To date, it has closed on \$700 million of mezzanine loans.

"We have two strengths [as a mezzanine finance lender]," Tsuji says. "One, we can evaluate the underlying asset because we are an asset manager; and two, we can handle the asset in case a takeover is necessary."

DREAM's connections to Mitsubishi also give it the capacity to tackle hefty deals in the Japanese market, Tsuji adds. The largest one to date was \$200 million.

One more step out

Nonetheless, Tsuji iterates the importance of accepting when the first mover advantage is over. He points out that there are increasing numbers of mezzanine finance lenders these days, making the market increasingly liquid. To illustrate, he notes that good assets are now finding competitive senior lending terms up to 60 percent on a loan-to-value basis, as compared to a maximum of 50 percent three years ago.

As such, DREAM has re-thought the strategy for its incoming mezzanine finance fund, with a view to finding that niche once more. Today, the firm is willing to extend loans to developments, previously an area no one considered given the inherent risk.

While there is finance in abundance for Japan's standing assets, with lenders and investors alike feeling comfortable about committing to established assets, the same cannot be said for development. That, by DREAM's reckoning, represents an opportunity for the firm.

"We're always focusing on the gap between demand and supply," says Tsuji. "Right now, the greatest gap we see is in the development stage projects."

However, in a sign of the times, DREAM will be committing capital to a strategy that brings with it greater risk than before, even though it should produce similar core to value-added style returns. Tsuji points to DREAM's Mitsubishi relationship as a mitigating factor, allowing it to evaluate projects with the same efficiency that it has evaluated assets in the past. In addition – and where appropriate – DREAM also will be able to secure senior debt from major Japanese banks for the developments, thanks to its connection with its parent.

The incoming mezzanine finance fund – the firm's third

– will likely be launched sometime in the second quarter this year, and DREAM hopes to corral about \$150 million for it from investors. The firm declined to comment on its fund-raising plans, but it generally launches a fund after it already has closed the vast majority of its deals using capital from Mitsubishi's balance sheet. Once the fund is constructed, the loans are transferred over.

"What's important is how to adapt to the change of market conditions," Tsuji sums up. "We don't want to compete with others [for the big deals], which means we have to gain a first-mover advantage and differentiate ourselves."

So far, DREAM's trailblazing has paid off. The firm declined to comment on returns, but *PERE* understands most of the funds it raised since the crisis have been posting net returns of more than 10 percent – and some vehicles are tracking the 30 percent range.

Outside its home turf

DREAM shares one last strategy where again it hopes to be out of the starting blocks before others catch on: exporting Japanese institutional capital to international, private real estate markets.

Japanese institutions are notorious for moving at a glacial pace when it comes to investing in new asset classes or sectors. Japan's Government Pension Investment Fund (GPIF), for example, has batted around investing in alternative assets for years, but it only just made its first ever concrete allocation to alternative assets in February.

As other Japanese pensions seek to diversify their investment base, Tsuji believes they will be "forced to allocate to real estate" and already have started domestically with

investments in listed J-REITs, private REITs and closed-ended funds. Going abroad, however, currently is outside their comfort zone, and that is where DREAM as a domestic manager hopes to bridge another gap.

"What investors really lack [in overseas real estate] is a sense of trust," Hsu explains. "And a co-investment with Mitsubishi gives them that sense of trust." With a well-respected brand name domestically, the hope is that Japanese institutions should feel comfortable allowing DREAM to select assets or managers abroad.

DREAM already has assumed an advisory role within Japan since 2004, assisting international investors seeking to break into the Japanese property market. Tsuji hopes that experience will serve as a precursor to taking them abroad.

Tsuji describes the island nation as "relationship-driven" and, to that end, DREAM has brokered a few introductions in the past. "In the same way, we hope to challenge Japanese investors to go outbound and invest overseas, even if they are cautious," he says.

By Tsuji's reckoning, DREAM has fostered a reputation for being a first mover in Japan. It is hoping it has done enough to encourage Japanese capital to take its first steps abroad with the firm. □

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The Forerunner of Japan

Diamond Realty Management Inc. (DREAM) is one of the leading private equity real estate asset managers in Japan. Established by Mitsubishi Corporation in 2004, DREAM manages about US\$4 billion across various asset types.

Always keeping an eye on the gaps of supply and demand, DREAM has been a pioneer in the logistics, data center, mezzanine, and private REIT sectors. DREAM combines its parent company's resources with professional expertise to help institutional investors seize the opportunities that Japan has to offer.



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<http://www.mc-dream.com/> tel. +81-3-5212-4811 e-mail : info@mc-dream.com