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The Manhattan of Asia

Tokyo Experiences Stunning Urban Renaissance

Beyond the leafy red canna stalks lining his swimming pool, Koichi Mera looks out over the grounds of the Getty Villa from the back patio of his home in Malibu, California, in December 2005. Mera and his wife, who is an artist, looked forward to the January 2006 reopening of the museum, which is modeled after a first-century Roman house, the Villa dei Papiri, and home to a staggering 44,000 works of art.

They had been waiting a long time. Closed for renovations in 1997, the Getty Villa expansion had been mired in litigation for years—it was originally scheduled to be completed in 2002. Nearby homeowner associations had been able to delay the $275 million project, despite the Los Angeles City Council approving an extension to the villa's original conditional use permit back in 1999.

Such delays to construction projects are extremely rare in Japan, notes Mera, who is an adjunct professor at the Marshall School of Business at the University of Southern California. A prolific scholar, he co-wrote *The Asian Financial Crisis and the Role of Real Estate* and also contributed a chapter to *Unlocking Bureaucrat's Kingdom: Deregulation and the Japanese Economy.* Even in the relaxed setting of his Malibu home, his square jaw is set rigidly as he gazes intently at his questioner. Such focused attention is undoubtedly a legacy of spending decades discussing complex land policies across the globe. Only briefly, when noting the stubborn resistance of his neighbors to even small changes to his property, does he chuckle and allow a faint, tolerant smile to appear on his lips.

Mera wrote an influential paper that was widely circulated at the World Bank in the early 1970s and changed how international development theorists there viewed big cities. Before his analysis, Mera noticed a general perception among urban planners that big cities were inefficient and undesirable. Now most in policy-making circles agree with him and other experts who have concluded that large urban areas are engines of growth. He has taught urban economics at both Harvard and Tokyo University.

Land regulation is vastly different in Japan and the United States, and these differences partly explain the recent explosion of real estate investment in Tokyo, Mera points out. Developers in the United States must comply with both state and city regulations, as well as demands from the local community. The U.S. system is based on the assumption that contractors cannot be trusted. City inspectors come in at every stage and check their work.

"By comparison, the Japanese system is fairly simple," Mera explains. Japan has a national building code, but that is about it. Rules are largely the same for builders, from the southern island of Okinawa to the northern tip of Hokkaido. Municipal regulations are quite limited, he notes, and there are much less stringent inspections.

The Japanese approach does have some risks, of course. The lax regulatory code has been abused in the past. The Ministry of Land, Infrastructure, and Transport announced in November 2005 that 16 buildings were at risk of collapse in an earthquake because a privately run inspection firm authorized by the government did not detect false structural assessments. Large sections of Kobe were reduced to rubble during the Great Hanshin Earthquake of 1995. Some of the damages could have been avoided if the builders had strictly adhered to construction laws, observes Mera.

Recently, building codes in Japan have been liberalized to allow greater freedom in land use. This has been made possible by expanding the discretion of individual bureaucrats in approving proposed projects, but Mera notes that the system's previous virtue of treating all developers and builders equally has been sacrificed. Big developers, such as Mitsubishi or Mitsui, can now proceed more quickly with their plans. Smaller players, without connections in the ministries, may not be so lucky, he warns.

Despite such unfairness, the relatively permissive regulatory environment gives developers in Tokyo much more freedom to reshape the urban landscape than, say, the Getty Villa board of trustees have in Malibu. And it's not just major developments that must overcome obstacles in the United States that are largely unknown in Japan. U.S. homeowners as well face high hurdles even when remodeling their houses, Mera has discovered. An architectural review committee must approve any changes to homes in his neighborhood. Neighbors' comments have a great impact on the committee's decisions, he notes. "I think neighbors say no to any kind of change," he wryly observes.

In Seijogakuen-mae, a prestigious Tokyo suburb, his neighbors had no say on any changes he wanted to make on his house. Residential homes faced some city height and size regulations, but if houses complied with those, no one had the right to complain.

Use rules for land in Tokyo are also much less restrictive than in the United States, Mera points out. Real estate in the United States is classified by use into residential, commercial, and industrial zones. In Tokyo, as in many other Asian cities, such strict categories are not etched in stone. Owners of the small buildings that line many downtown Tokyo streets use their downstairs for stores or workshops and live upstairs. With exclusive use zoning designations relatively rare, it is easier for a developer to work in the Asian system, Mera says.

To be sure, a lenient regulatory code is just one factor supporting the current construction boom in Tokyo, albeit one that is often overlooked. Accelerating economic growth, rock-bottom prices, financial innovation, a flood of money from private and foreign funds, and a burgeoning real estate investment trust (REIT) market are supporting growth as well. Developers are radically transforming the Tokyo landscape at a pace that is shocking even to the most jaundiced observers.

The Renaissance of Tokyo's Business District

A snowman in the downtown Marunouchi district of Tokyo is as rare as it would be in Malibu, but one stood guard, white and rotund, in a blanket of snow outside the Tokyo Building in November 2005. Hundreds of people milled outside, some touching the snow in disbelief, to see if it was real. It was—shipped in for the skyscraper's grand opening.

A choral group sang "Amazing Grace" as dozens of photographers fiddled with their cameras. Judging by their shouts when Natsumi Abe appeared, many were there to take pictures of the star, a former member of the girl pop group "Morning *Musume*," rather than the 32-story building. Staid-looking Mitsubishi Estate Co., Ltd. president Keiji Kimura received a much less enthusiastic response when he appeared. However, he did not seem to mind the clear favoritism of the crowd as he pushed a button, along with the celebrities Abe and Noriko Kato, lighting up the newest addition to the city's skyline.

If there is such a thing as a nerve center to corporate Japan, it is located in the Marunouchi District of Tokyo. About 240,000 people work in the 4,000 offices in the Marunouchi, Otemachi, and Yurakucho districts. During the Tokugawa Period, feudal lords made their homes in the Marunouchi District, just outside the fortifications of the imperial palace. After the Meiji Restoration, their estates were razed and much of the neighborhood was made into a military parade ground. When the government offered it for sale in 1890, there were few bidders, and Yanosuke Iwasaki, founder of the Mitsubishi trading house, was able to buy up much of the area. It was a far-sighted investment. Tokyo Station, the hub of the nation's transportation network, was within walking distance, so Marunouchi became the first business district in Japan. Red-brick buildings soon lined the streets, and the district became known as Londontown. The area retained its dominance through both the Great Kanto Earthquake of 1923 and the bombings of the city during World War II.

However, by the 1990s, the district suffered from several problems. With height restrictions of only 31 meters up through 1963, office ceilings were low because architects attempted to squeeze as many floors as possible in the squat buildings. That year new regulations limiting building size based on floor area ratios were introduced, but the rigid system still limited construction of new office buildings. Modern firms often need high ceilings to accommodate the cables and wiring strung beneath raised floors for their computer systems. By the age of the Internet, many offices in the Marunouchi area were hopelessly anachronistic. In addition, inspections following the Kobe earthquake of 1995 revealed that many needed renovations for earthquake protection. As a result, Mitsubishi Estate, the local landlord, decided many buildings should be demolished.

Deregulation assisted in the redevelopment of the region. Although city building codes were lenient, municipal authorities strictly controlled the volume size of local buildings. In principle, firms were allowed to have a total area 1000% of underlining floor space for offices. However, the government gave firms opportunities to increase the total area of newly constructed buildings from 2002. For example, if firms created common-use areas accessible to the public, such as retail shopping areas or hotels, a further 300% increase of the floor area ratio was allowed. In addition, such space in buildings was permitted to be exchanged—one building could have even more than 1000% of floor area devoted to office space if retail area replaced it in another Marunouchi building. For example, office space was increased in the Tokyo Building because the planned Peninsula Hotel took up more than 300% of the floor space in another building.

In addition, the government also permitted the exchange of air rights from the same year. In a system similar to some U.S. cities, air rights from historical buildings could be transferred to other buildings in the neighborhood, allowing taller buildings than before. Once again, buildings were no longer limited by the 1300% ceiling on floor area ratios. JR East, owner of Tokyo Station, is a part owner of Tokyo Building as well because it contributed its air rights to the new structure.

Mitsubishi, which owned and managed 31 of 98 buildings in the Marunouchi/Otemachi/Yurakucho area, took advantage of such deregulation by launching a massive two-stage reconstruction of the entire business district. Tokyo Building was the fourth building to open in a decade-long, ¥500 billion effort to create a new cityscape in front of Tokyo Station. Another seven or eight buildings will be built in a planned second stage, which is slated to cost another ¥450 billion.

Those investors who have watched Japan struggle through its "lost decade" may be scratching their heads and wondering, "Where will tenants come from to fill up these buildings?" Indeed, the Marunouchi Redevelopment Project comes in the wake of two other major construction schemes, both close by.

They are clearly visible from the thirty-first floor of the Marunouchi Building, completed in 2002 and a very short walk from Tokyo Station. From the windows facing west, the city appears to stretch endlessly into the gray mists of evening. Far below, the flat roofs of older buildings abruptly end in a chasm of glittering neon—the Ginza shopping district. A cluster of buildings just beyond appears to crowd the ribbon of railways cutting through the city. In 2003, the Shiodome area, which boasts 3.23 million square feet of office space, opened for business. Firms such as Dentsu, Inc.; Kyodo News; and Nippon Television Network Corp. have moved offices there, resulting in wags calling the area a "media *jokamachi,*" or media castle town. Even farther on, a tall metallic tower, its shape resembling a gun barrel, threatens the sky—the Roppongi Hills complex, which houses another 4 million square feet for offices and opened the same year. This deluge of office space hitting the market all at once was called the "2003 problem." Many worried that the long downward trend in Tokyo real estate prices would be further extended.

However, the Shiodome and Roppongi Hills developments are full and demand for office space is continuing to increase, notes Masahiro Kobayashi, Deputy General Manager at Mitsubishi Estate. In addition to economic growth, Kobayashi cites structural changes in the corporate sector as underpinning demand for high-quality offices. Companies are getting larger because of increasing M&A transactions, so they need more office space. For example, one of the main tenants of the newly built Marunouchi Building is Mitsubishi UFJ Securities Co., Ltd. This was formed in 2005 through a merger of Mitsubishi Securities Co., Ltd. and UFJ Tsubasa Securities Co., Ltd., members of the Mitsubishi and UFJ banking groups whose merger was discussed in the last chapter.

Meanwhile, Mitsubishi Securities was created in 2002 from a merger of Kokusai Securities Co., Ltd.; Tokyo-Mitsubishi Securities Co., Ltd.; Tokyo-Mitsubishi Personal Securities Co., Ltd.; and Isse Securities Co., Ltd. UFJ Tsubasa Securities Co., Ltd. was formed in 2000 from a merger of four firms … well, let's stop there. It is clear that as companies take over related business, they will need constantly bigger offices in which to house the newly created firms.

Second, the M&A boom is also fueling consolidation among professional firms, which are demanding bigger and better offices as well. Traditionally, law offices in Japan have been small, with firms having only a couple of senior partners. They are now exploding in size, boosting capacity to handle the complex M&A transactions that are now a big business. "We have little choice but to rely on the services of large law firms in handling cases that require vast expertise," Kazuhiko Toyama, COO of the Industrial Revitalization Corp. of Japan, told Nihon Keizai Shimbun, Inc. Mori, Hamada & Matsumoto, one of the most prestigious law firms in Japan, has 199 lawyers and now requires six floors in the Marunouchi Kitaguchi Building, which is part of the OAZO complex, which opened in September 2004.

As demand for high-quality office space heats up throughout the city, the Marunouchi area is in a commanding position to reassert its dominance as a financial center because of its advanced telecommunications network. From a low-tech holdout, the district is rocketing to the forefront of the information age through a fluke of industrial design.

The air in Marunouchi was not always as clean as it is today; clouds of toxic gases engulfed Tokyo in the 1970s. Buildings sent plumes of smoke into the sky, threatening even the rows of elegant, neatly pruned pine trees in the Outer Garden of the Imperial Palace. Local authorities decided drastic measures were needed and ordered the extensive drilling of tunnels throughout the Marunouchi area to create a massive district heating and cooling (DHC) system.

More than 3 decades later, Syuichi Nomura of Marunouchi Heating Supply Co. climbed down a ladder leading to Marubeni Dai-ichi tunnel. We had entered the company's underground Otemachi center via stairs next to Karugamo Pond, across the street from the Imperial Palace. After putting on hard hats, we walked through a cavernous room housing massive freezers that chilled water for circulation in nearby buildings. The headquarters of firms such as Mizuho Bank, The Japan Development Bank, and the financial newspaper, *Nihon Keizai Shimbun*, were all cooled in the summer by these machines. Ducking and crawling through some tunnels, we then edged down a catwalk to a ladder. At the bottom was the tunnel that Nomura now peered down.

We were about 75 feet underground. When engineers built the tunnel in 1996, they had to contend with a maze of underground infrastructure, including five subway tunnels as well as all the gas, electricity, water, and sewer lines that served the business district. However, the builders of the first ducts decades ago did not even anticipate one of the tunnels' most valuable uses.

In the space between yellow steam pipes on the left side of the tunnel, two fiber optic lines were tightly wedged, part of a 14,000-kilometer network of single-mode cables that linked the whole business district.

These dark fibers, or fiber optic cables, were installed by Marunouchi Direct Access, Ltd. "By chance, Marunouchi Heating had all these ducts," says Toru Okusa, director of the joint venture between Mitsubishi Estate Co., Ltd., and Marubeni Corp.

However, the tunnel system alone was not enough. If Mitsubishi did not own 30 buildings in the area, there would be no incentive to invest in an extensive fiber optic network. Most buildings in the

Marunouchi area, which spans more than 100 hectares, have access to the network. The system of fiber optic cables is also linked to the Marunouchi Data Center, where building tenants or telecommunications firms can lease space to install equipment or servers.

"In a new building, if you have to put your own servers in; then it takes up space and requires expensive generators and air-conditioning," Okusa notes, adding that servers can be provided to new tenants in as quickly as 2 weeks. Numerous telecommunication firms, such as KDDI and Cable & Wireless, use Marunouchi Direct Access optical fibers, meaning competition between such companies is fierce, driving down telecommunication costs. Even Roppongi Hills has tried to cut network costs to compete with this area, says Okusa. The Marunouchi Direct Access network can also link users to Internet exchange points directly, which reduces costs for tenants as well.

Such a network, located in the heart of the nation's business district, could have major implications. Because most buildings in the area are included in the same network, tenants in various buildings can be linked in local area networks (LANs) with little effort. This could reduce costs associated with mergers and acquisitions; if one firm bought out or merged with another in the same area, their individual networks could be linked rapidly, speeding integration of operations. The Marunouchi Direct Access system is better, more secure, and cheaper than the virtual private networks (VPNs) that companies often use to link LAN systems between buildings, says the company. Because hundreds of firms are headquartered in Marunouchi, such business tie-ups are likely to become increasingly frequent. The existence of such a network may help ease such activity.

With so many corporate headquarters located in the area, investment banks and funds are likely to increasingly concentrate in the district—rather than spend valuable minutes in long transits between potential investment targets and fund managers, analysts and bankers can jump in a taxi for a short ride or even walk. JP Morgan has seven floors in newly opened Tokyo Building. Law firms, consulting businesses, and auditors will likely find it convenient to set up shop near their clients as well.

Although it has always been the business center of Tokyo, its spacious streets have seemed somehow lacking in vitality in the past—only depressingly dark coffee shops, bookstores lined with monotonous texts, or dull bank branches greeted pedestrians who had the temerity to go for a stroll in the neighborhood. Although one of the most glamorous department store streets in the world, Ginza-dori, was only a short stroll from nearby Yurakucho Station, few shoppers wandered under the tracks into the dreary maze of financial company headquarters on the other side. On weekends, much of the district was a ghost town.

Now the Otemachi region has taken on new life. Swank shops such as Kate Spade and Tiffany & Co. line Nakadori, a broad, tree-lined avenue that lures shoppers to a further 140 stores in the Marunouchi Building. The juxtaposition of trendy retailers and other residents in the previously staid neighborhood can be jarring; Brooks Brothers shares a building with the Ministry of Education, Culture, Sports, Science, and Technology. Still, it appears that planners here have taken to heart some of the admonishments of Jane Jacobs, author of *The Death and Life of Great American Cities*, and are trying to revitalize the area by encouraging various uses.

Real Estate Investors Zero In on Hot Neighborhoods

Not all of Tokyo looks as good as Marunouchi. Indeed, vast swaths of the city remain low-rise older buildings. Akira Mori, one of the largest landlords in Tokyo, says that much of the city's building stock is outdated. Indeed, widespread demolitions triggered alarms during summer 2005 about a possible increase in asbestos-related deaths in the city. The razing of aging buildings with high concentrations of the cancer-causing material is rapidly spreading.

However, health worries about the demolition of older buildings are not stemming the rush of businesses and residents to newly developed areas. Many are flocking to areas such as Shiodome and Roppongi Hills, where residences, offices, and entertainment facilities are integrated into the same complexes, Mori points out.

Akira Mori is the third son of the late Taikichiro Mori, a real estate investor who was the richest man in the world in the early 1990s, according to *Forbes* magazine. Akira Mori and his brother, Minoru, both inherited fortunes from their father. Minoru Mori took over Mori Building, and Akira Mori presides over Mori Trust, which expects record sales and profits in the fiscal period ending March 2006.

Population has increased in the three central wards of Tokyo because of the attractiveness of the new developments. With more young people moving into the city, "Schools are in short supply," says Mori, sitting behind a sprawling wooden conference table at his firm's headquarters in Toranomon in March 2006. Mori, who is in his sixties with ruffled gray hair, carries himself with the quiet, understated dignity of a medical doctor with a thriving practice, and is graciously attentive to his visitor. Despite overseeing a multibillion-dollar empire, he patiently answers questions, never conspicuously checking his watch.

"Overall demographic trends are irrelevant [to the Tokyo market]," Mori observes. "As long as business activities are centered in Tokyo, the property market will continue to develop."

In fact, real estate prices are being supported by unprecedented factors, Mori notes. "Usually when the economy gets better, interest rates rise, and then rents go up. Now the opposite is occurring, and rents are rising even though interest rates remain low."

Money is also coming in from overseas, as foreign institutions buy up shares in real estate investment trusts (REITs). "It's an extremely benign environment for real estate investing," Mori adds.

Although upward pressure on long-term interest rates is limited, they are unlikely to stay at current levels forever, Mori says. As interest rates rise over the long term, REITs will face rising cost of capital, and margins will be squeezed. "If interest rates rise by 100 basis points, that could have a dramatic impact on the market," Mori notes.

Good and bad locations will become more differentiated, and REITs that do not own attractive properties likely will face problems, Mori warns. Mori Trust is concentrating its holdings on high-growth areas. It owns Marunouchi Trust Tower North near Tokyo Station, Tokyo Shiodome Building, and Shiroyama Trust Tower near Roppongi. Such locations, where demand for office space is intensifying, will not be hurt by interest-rate increases, he argues.

In addition, funds heavily dependent on rents from residential properties, which are extremely sensitive to changes in the economy, will be exposed if interest rates rise, Mori warns. In addition to extensive office holdings, Mori Trust has diversified into hotel operations to avoid such dependency; Conrad Tokyo opened in the upper levels of Tokyo Shiodome Building in summer 2005.

Ultimately, the emergence of new city centers will tax the city's existing infrastructure, Mori warns. "As activity concentrates in the heart of Tokyo, more work on the city's arteries and veins are necessary," Mori observes. Desire to increase such investment may be behind Tokyo Mayor Shintaro Ishihara's call for future Olympic games, Mori adds.

The background of John Tofflemire, an Italian American from Detroit, could hardly be more different from the regal past of Akira Mori. Tofflemire spent a year as a young man driving a cab through dangerous New York City neighborhoods, much like Robert De

Niro's character Travis Bickle in the movie Taxi Driver. Though he, too, dodged muggings and shady characters, Tofflemire found the metropolis fascinating, and his passion for urban landscapes ultimately led him to acquire a Ph.D. in urban and regional economics at the University of Pennsylvania. His enthusiasm, coupled with aging matinee-idol looks and a light-gray pompadour, previously made him a popular commenter for financial TV news channels. He rarely appears on TV nowadays; he is too busy providing confidential investment advice to heavy-hitters in the Tokyo market.

Tofflemire wholeheartedly agrees with the real estate mogul that only parts of Tokyo are growing. He has long been convinced that communications and communication technology are the nervous systems of urban environments—the reasons that people come together. Now running Sapient Real Estate Consulting in Tokyo, he believes the convergence of transportation and communication linkages in Tokyo will lead to the building of a new high-rise corridor stretching from the Imperial Place, through Otemachi and Kasumigaseki, to Shinagawa. Central Tokyo, he gushes, will become the new Manhattan of Asia.

"People mistakenly believe that telecommunications causes cities to disperse," he observes. "That's completely wrong. What [it does] is cause people with certain skills to come together and market those skills to a larger market and in greater depth." He notes that George J. Stigler's 1951 paper *The Division of Labor is Limited by the Extent of the Market* showed that the extent of markets is determined by the ability to have control through good communications. Stigler won the Nobel Prize in Economics in 1982.

Fascinated by the wealth and power that urban areas represent, Tofflemire continues to study the old imperial capitals of Europe. Venice is one of his favorites. His wife attended university in nearby Padova, and he first saw the city when they visited her friend's parents, who lived near the Rialto Bridge in an old villa—so old, in fact, that the house appears in a sixteenth-century painting. He was completely floored by the city's grandeur. "The thing that struck me was, 'My God, this was one of the greatest empires that ever existed in history,'" he remembers.

"Cities are places where people make money. They make money for two reasons—one, because of greed, and two, because of fear." Tofflemire says. The fear that drove Venetians was the fear of being subjugated. Indeed, the brutal struggle of medieval Italian principalities for survival inspired Machiavelli to write his famous amoral treatise on the exercise of power.

Japan, like Venice, is probably more motivated by fear than greed, reflects Tofflemire. Japan's industrialization during the late nineteenth century was motivated by a fear of domination by the West, while the restructuring of Japan in the late twentieth and early twenty-first centuries is, to a significant extent, driven by fears of being eclipsed, both politically and economically, by China, he says.

Tofflemire arrived in Japan in June 1992, near the peak of the Tokyo real estate bubble, to develop an econometric model for China's Fujian province for Mitsubishi Research Institute (MRI). After working on a number of international consulting projects at MRI, he left to join Richard Ellis, the British real estate brokerage firm, in 1996. The firm became CB Richard Ellis in 1998 and then merged with Ikoma Shoji, a Japanese real estate brokerage firm, in 1999.

Tofflemire, seeing opportunities in the Tokyo commercial real estate market finally emerging after a decade of stagnation, decided to strike out on his own in 2004. Land prices in Tokyo are starting to go up, he notes, while acknowledging that widespread declines continue outside city centers. Commercial land prices in Tokyo rose 0.6% in the year that ended July 2005, the first such increase since 1990, according to the Ministry of Land, Infrastructure, and Transport. After years of being off the radar screen, Tokyo is once again attracting the attention of global real estate investors. Tokyo was cited in a 2004 survey by the Association of Foreign Investors in Real Estate as one of the top three cities for real estate investment, the first time the city made the cut since the survey started asking the question in 2001.

Some market watchers attribute the price increases to purchases by REITs , flush with funds, and worry about the sustainability of the recovery. The first two Japanese REITs, Nippon Building Fund, Inc., and Japan Real Estate Investment, were launched in September 2001. Twenty-six such trusts were listed on the Tokyo Stock Exchange by December 2005 with a combined capitalization of ¥1.8 trillion. The Tokyo Stock Exchange REIT Index, launched at the end of March 2003, climbed from 1,000 to 1,768.87 by May 8, 2006, according to the exchange.

Tofflemire sees no cause for alarm. “I don’t think it’s a bubble; it’s rational,” he reflects. “If it was, no intelligent investor could do deals. And I know they are doing deals. There are arbitrage plays out there where you can make money.”

The spread between lending and capitalization rates in Tokyo was one of the world’s largest in 2005. Capitalization rates, or cap rates, are calculated by dividing the net income generated by a property over its purchase price and are a standard measure of return used in real estate investment. Although cap rates have fallen in recent years, they remain higher than lending rates. “You can invest, buy buildings, and sell them into the REIT market,” Tofflemire observes.

A very active mezzanine debt market is another new development helping to support commercial real estate prices, Tofflemire says. Debt on buildings can be sliced into various tranches based on risk. Loans amounting to the first 70% or so of a building’s value are deemed relatively low risk—and termed vanilla. Such loans are exposed to only low-probability dangers such as earthquakes and terrorist attacks—otherwise, borrowers are almost certain to get their money back. Japanese lenders will do vanilla lending at very competitive rates, Tofflemire says.

Mezzanine debt is that which is typically above the amount vanilla lenders will comfortably extend. As debt approaches 100% of the value of the building, lenders must get more sophisticated at assessing risks to the building's cash flow and their ability to get repaid. Mezzanine debt, as a result, is much more expensive.

Tofflemire notes that the mezzanine debt market is becoming much broader and deeper; most foreign investment banks are very sophisticated lenders in this segment. Domestic banks are coming up to speed as well. With banks slicing the various levels of debt according to risk levels more closely and pricing them accordingly, the loan market has ballooned, Tofflemire adds. The explosion of the REIT market, which started in 2001, has increased market transparency and helped the banks make such strides. Meanwhile, as lending rates have fallen, borrowers can bid on more properties

That is not to say the market is without risk. Because cap rates can be a function of debt, investors boost their exposure through leverage. If an investor buys and cap rates fall, the property's price goes down, potentially wiping out the initial equity. Falling rents are bad news.

A law establishing fixed-term leases in 2000 also modestly increased the attractiveness of securitized property in the city. Previously, business leases lasted only 2 years. Traditional 2-year leases in Japan are more secure than they appear because relocation costs are high and this increases inertia of Japanese firms, notes Tofflemire. As a result, the risk on such cash flows is considerably less than it appears to Western minds unfamiliar with Japan, he argues. Nonetheless, fixed-term leases now last up to 20 years, formally locking in returns for a much longer period. Although this is still a small percentage of the market, many new buildings offer only such leases.

These new leases have created some uncertainty regarding condominium units. "One of the dirty secrets of the market is whether these fixed-term leases … would, in fact, stand a legal challenge," Tofflemire warns. Market players are uncertain whether the new law regarding fixed-term leases or an old law safeguarding tenant rights, The Landlord and Tenant Act, will prove dominant in condominium rental developments. The old act makes it easy for tenants to leave. "At some point, if somebody wants to get out of a long-term lease and the landlord says, 'No,' if they take them to court to test the law, then we'll find out." However, the sophisticated lenders in the mezzanine debt market are fully aware of this ambiguity.

Aside from the continued spread between cap rates and borrowing costs, which ensures positive cash flow for real estate investors, they can also book gains on properties by selling them into the REIT market. A huge spread still exists between lower- and higher-grade property in the city. With the new liquidity in the land market, people can now arbitrage between the two classes. Such opportunities are attracting some of the largest real estate funds in the world.

One such investor is Morgan Stanley Real Estate Fund (MSREF) . It is one of the biggest players in the real estate market, with more than $10 billion under management in Japan. Sonny Kalsi, a managing director at Morgan Stanley who came to Japan in 1997 expecting to stay only 2 or 3 years, says the fund has vastly exceeded expectations. Kalsi cut his teeth in the distressed debt market buying properties put up for sale during the savings and loan crises in the United States. MSREF saw an opportunity in Japan during the banking sector crisis in the late 1990s; it acquired its first property in 1998.

Eight years later, Morgan Stanley has a staff of 200 accountants, lawyers, leasing specialists, and architects in the property asset-management business. All major aspects of a real estate deal can be handled in-house. The fund looks for good properties with clear inefficiency in management, which can be addressed by this team. Kalsi points to the redevelopment of the Ebisu Prime property as an example of how his firm operates. They acquired the property from failed Chiyoda Mutual Life Insurance in 2001. The property's image had been tarnished by its owner, who did not invest or maintain it properly. Morgan Stanley brought in new retail tenants, installed an ATM in the lobby, and renovated the building's common areas. In addition, it ran ads on FM radio and posted posters at the nearest JR station. After sprucing up the property and improving its reputation in the market, Morgan Stanley sold it for a substantial profit to an insurance company in 2005.

Kalsi is upbeat regarding the prospects for further growth of Japanese real estate. Although acknowledging that an economic slowdown could hurt business, he points to a number of factors that suggest that demand for grade-A office space will continue to rise. As long as the economy grows, Japanese firms will grow with it, demanding more office space to house their operations. Japanese companies are also increasing their office space per worker, from 10 to 15 square meters a decade or so ago to 25 square meters today. Office workers get 35 square meters in the United States, so there is still room for growth, he adds.

Kalsi also points to fair and transparent zoning, empowering developers and giving them more freedom to do what they want with properties. Morgan Stanley headquarters in Tokyo is basically in a residential district, he notes. Its Yebisu Garden Place offices were formerly the site of a Sapporo brewery. Liberal zoning laws enabled the property to be developed commercially.

Tokyo Mid-town: A New Gateway for the Nation

Cities are not merely locations; they often act as incubators for new ideas and ways of seeing the world. As nexuses for gatherings of creative and ambitious people, as well as sources of wealth for financing architectural and artistic endeavors, urban areas have often acted as fertile breeding grounds for new intellectual movements. Encircled with the resplendent Ringstrasse, *fin de siècle* Vienna was home to many innovators in architecture, psychology, art, and music. The central European capital "with its acutely felt tremors of social and political disintegration, proved one of the most fertile breeding grounds of our century's a-historical culture," wrote Carl E. Schorske in the twentieth century. Perhaps *commencement du siècle* Tokyo will be viewed as a similarly fecund period by later historians.

Property developers, no less than high-tech firms, are focusing on how to develop their holdings of the intellectual assets discussed in Chapter 2, "Intellectual Property Wars." Not merely content to construct buildings, they are engaged in an intensive cultural introspection, attempting to ascertain how Tokyo can best compete with cosmopolitan centers across the globe. Indeed, when developers brainstormed about how to develop the former site of the Self-Defense Forces Building in the Roppongi district in Tokyo, they compared the city with New York, London, and Paris, remembers Takashi Nakayama, project manager of the planning group for the Tokyo Mid-town Development Department at Mitsui Fudosan Co., Ltd . He and others on his team strove to look beyond the aftereffects of the collapse of the bubble economy and debated how the city should evolve into the twenty-first century. The development is scheduled to open in spring 2007.

Nakayama, echoing Tofflemire, observes that all cities are places where people come together, collect information, and create new things. His group envisioned making Tokyo Mid-town a base for such activity. To be sure, the Roppongi neighborhood is much different from the central business district. It is farther west on the Shuto Expressway No. 3, away from Tokyo Station and the amazing transportation links that bind Marunouchi with the rest of the country.

Roppongi has always been primarily a residential community. In addition, the area is home to many embassies and foreigners. Up to 1 out of every 6 of the 10,000 people living within a mile from Roppongi crossing is from overseas, notes Nakayama. Foreign brokers and financial journalists hang out in the many bars on the strip.

Reporters gazed down on the district from a conference hall in Roppongi Hills, where Mitsui held a press conference in November 2005. The skeleton of the Tokyo Mid-town Tower, which was already almost fully leased, loomed over Roppongi crossing. Fuji Photo Film. Co., Ltd.; Fuji Xerox Co., Ltd.; and Yahoo Japan Corp. had signed contracts. Four TV cameras rolled and about a hundred journalists listened intently as Koichi Omuro, the executive vice president for Mitsui Fudosan, introduced the participants in the project. Ritz-Carlton will run a five-star hotel in the top floors of the skyscraper. Oakwood Worldwide will manage luxury-service apartments for executives visiting the city, while John Hopkins will operate a clinic for such residents, along with the Japanese firm High Technology. Slides showed a park where pampered residents could stroll. Ensconced in such surroundings, whiny expats would have to relinquish their complaint, dating back to the *o-yatoi-gaijin,* that Japan was a "hardship post."

However, Nakayama is anticipating that Tokyo Mid-town will not just be a collection of office and apartment buildings that provide a steady stream of rents to project investors, (including the National Mutual Insurance Federation of Agricultural Cooperatives; Yasuda Mutual Life Insurance Company; Sekisui House, Ltd.; Fukoku Mutual Life Insurance Company; and Daido Life Insurance Company). In their internal discussions, the developers commented on the shift of factories to the low-cost Chinese mainland and acknowledged that Japan had to move away from its reliance on manufacturing to prosper in the new century. They hit upon the concept of "Japan Value" as a focus of the Tokyo Mid-town project. "Japan

Value" would be the added value that Japan creates and transmits to the rest of the world in the future. Reflecting on the success Japan has had with industrial and product design in the past, the developers decided to create a base for design and art activities in the city.

Art from across the city is converging on the Roppongi district. The National Art Center will open here in 2007. Meanwhile, the Mori Art Museum opened in summer 2003 in Roppongi Hills. The complex, Japan's answer to the radiant cities envisioned by architect Le Corbusier, also boosts nine movie screens and more than 2,000 seats, and is now home to the Tokyo International Film Festival, which was previously held in Shibuya.

In the nearby Tokyo Mid-town Tower, the Japan Industrial Design Association has already signed a lease on the fifth floor, along with the Nihon Graphic Kyokai. Suntory Museum of Art, with its collection of rare lacquer ware, will also move to the complex. Meanwhile, a sleek building with slanting roofs suggestive of *origami* folds will be built to house 21/21 Design Site, a think tank devoted to disseminate Japanese design concepts to the rest of the world. The center will house the offices of the Japan Industrial Design Promotion Organization.

In Japanese homes, the *genkan,* or front entryway, often welcomes visitors with an alcove for pottery, *ikebana,* or art displays. Mitsui Fudosan appears to be building a new *genkan* for the entire nation.

Tokyo as a Cultural Beacon in Asia

Motohisa Furukawa, a lawmaker in the Diet, says Tokyo could become the Manhattan of Asia, much like Tofflemire is forecasting. However, Furukawa is not talking about just a dramatic new skyline. He envisions Tokyo becoming a cultural beacon and center for business activity for the entire region.

"New York City is not typical America," observes Furukawa, who studied at Columbia University on the Upper West Side of Manhattan. The still-youthful-looking Diet man, in his early forties, frequently grins while discussing his views about the Japanese capital. "Average America is more like … Texas," he jokingly speculates. "However, if you want to understand America, you must understand New York. If foreigners go to America, they want to see the city. People visit from all over the world. So finance, fashion, entertainment thrive."

Japan is part of Asia, of that there is no doubt. Every spring, paddies in the countryside turn emerald green with rice shoots, as they have for centuries. Some of first irrigation channels in the country's flat agricultural plains were initially carved out by Korean engineers using Chinese technology more than 1,000 years ago. Elegant Chinese characters grace even mundane signs along city streets in Tokyo, as they do in Beijing, Hong Kong, Singapore, and Taipei.

However, Japan is also different from the rest of the region, maintains Furukawa. Having adopted Western technology and institutions much faster than the rest of the region, Japan has separated itself from its neighbors. He points to the parallel situation across the Pacific Ocean.

Japan in Asia could take the same role as New York City in the United States, he argues. "Asian young people like Japanese pop culture," he notes, and adds that designers such as Louis Vuitton display their goods in Japan because they know if they are popular in Tokyo, then they will succeed in other Asia markets. This is similar to how New York leads the U.S. fashion industry, he observes.

"Japan should encourage other Asians to visit, as well as Westerners who want to understand this region. If many people come, that could stimulate activity," he proposes.

Hurdles remain to such plans, not the least of which is a daunting linguistic barrier for foreigners. Nonetheless, Tokyo does have one advantage that may prove decisive: financial clout. Its vitality is also impressive—any visitor to the city can feel its energy, which stems from the excitement of ambitious people working hard and believing their efforts will be rewarded. Meanwhile, internationalization efforts are proceeding. The Tokyo Stock Exchange plans to open an office in Beijing in 2006 to recruit candidates for listing. Hong Kong–based Zinhua Finance listed on TSE's Mothers market in 2004, while South Korean steelmaker POSCO joined the TSE First Section in 2005.

Nonetheless, discussions of Tokyo's future are always clouded by worries about Japan's dwindling population. In the next chapter, some suggest that concern about dwindling numbers of Japanese is overwrought. Others even see signs that some demographic trends bode well for certain investment strategies.

Investment Implications

Skeptics of the recovery in the Tokyo real estate market often point out that land price gains have not spread out evenly throughout the entire Japanese archipelago. Such a cavalier dismissal of the city's urban renaissance, conspicuously visible to anyone walking the streets of Marunouchi or Roppongi, reveals a disregard of the first rule of real estate investment: Location largely dictates price. To be sure, real estate market gains have been centered in areas with strong transportation and communication links to the rest of the nation, and central Tokyo is a prime beneficiary of the recent boom. Indeed, many towns in the distant countryside could well continue their descent into relative penury. Even in the capital, some properties that are badly located, poorly designed, or backed with ill-conceived financing plans, could lose money in the years ahead. However, just because the whole country is not sharing equally in the recovery of real estate values does not mean that rebounding areas are being mispriced. Indeed, as the effects of deregulation ripple through the economy and constraints on capital flows ease, such disparities between investments in many asset classes are likely to widen, not narrow.

A relatively lenient regulatory code, accelerating economic growth, rock-bottom prices, cheap financing, corporate restructuring, and financial innovation have all supported the rebound in Tokyo commercial property. Any slowing of economic growth going forward could well weigh on prices. In addition, rising interest rates may squeeze margins, especially those at REITs whose holdings are not narrowly focused on prime areas of the city. Desirable properties are often located in the arc stretching from Marunouchi to Shinagawa. However, some developers are already positioning themselves for rising capital costs, striving to add value to the properties they hold. Tokyo Mid-town, with its lofty ambitions of becoming an international showcase of Japanese design, is one such example. Tokyo's real estate market should be considered as a regional play, capable of attracting businesses from across Asia and likely to benefit from the rapid growth of China. Needless to say, the attractions of Tokyo real estate are magnified, in relative terms, by the dramatic run-up of prices in the United States.

Investors should carefully examine the holdings of REITs listed on the TSE. Spatial diversity among trust property holdings is not necessarily desirable. Indeed, the greater concentration of holdings in hot neighborhoods, the better.

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