NOMURA

MCUBS MidCity 3227.T 3227 JP

EQUITY: JAPAN REIT

16/6 results

Internal growth, lower funding costs ensure steady rise in DPU, potential for regular acquisitions?

Investment stance: reiterating Buy rating, no change to risk premium in our target price calculation

Occupancy remained high at the two flagship properties in Osaka Business Park, up 0.4ppt from 97.6% at end-15/12 to 98.0% at end-16/6 at Twin 21, and flat at 97.1% over the same period at the Matsushita IMP Building. Elsewhere at office buildings in the Honmachi area, occupancy rose from 87% to 100% at the MID Midosujikawaramachi Building, and rose by 2.2–3.0ppt at other office buildings, with no declines in occupancy at any buildings. This reflected a decline in the amount of office stock as a result of older office buildings being redeveloped as hotels in addition to improved economic sentiment, and suggested that conditions on the Osaka office market may now have bottomed out, having hitherto given cause for concern. Guidance for 16/12 calls for rental income from properties in the Osaka Business Park to rise as rent-free periods come to an end, but for only a minimal impact from properties in the Honmachi area, which account for a smaller portion of rental income.

In the Tokyo area, meanwhile, attention has been focusing on moves to attract tenants to G-Square Shibuya Dogenzaka and Cube Kawasaki, where there is still scope for occupancy to rise. However, guidance for 16/12 calls for occupancy at these properties to come in roughly flat because management has been looking to attract tenants prepared to pay above the going rate for the area, and because existing tenants have been expanding their footprint. That said, Tokyo office market conditions are buoyant, and we think that leasing out both properties at the going rate for the area in 16/12 (with rent-free periods of around three months) will contribute to earnings over the course of 17/6. We have factored management's calculations of full-term DPU boosts of around ¥200 apiece into our forecasts, and also generally concur with its projections about the management of other properties. We forecast interest savings in 16/12 and 17/6 following financial improvements in 16/6. We continue to value the REIT at discount rates 25bp higher than the weighted average for 38 REITs under our coverage.

Still looking to spend ¥40–50bn a year on properties, also starting to think about overseas investments

The REIT is currently looking closely at seven properties worth almost ¥50bn (of which three, worth ¥30bn, are in the Tokyo area) together with the complete ownership rights for Shibuya Sakuragaoka Square, which will cost around ¥10bn, at a yield yardstick of at least 3% after depreciation, in a bid to boost DPU by at least ¥200. It is also looking at properties in Sydney and Melbourne at NOI yields of 5–6% (and with depreciation costs of around 1%).

Parent	16/6	16/12E			17/6E		17/12E	
Currency: JPY	Actual	Old	New	Co's	Old	New	Old	New
Ope revenues (mn)	6,824	6,907	6,978	6,974	6,995	6,967	N/A	7,029
Ope profits (mn)	2,463	2,435	2,481	2,479	2,526	2,531	N/A	2,593
EPU	7,100.1	7,135.5	7,203.4	7,198.6	7,478.1	7,459.0	N/A	7,749.6
P/E (x)	24.5	24.4	24.2	N/A	23.3	23.4	N/A	22.5
P/B (x)	0.8	0.8	0.8	N/A	0.8	0.8	N/A	0.8
Dividend yield (%)	4.1	4.1	4.1	N/A	4.3	4.3	N/A	4.4

Source: Company data, Nomura estimates

Key company data: See next page for company data and detailed price/index chart.

Global Markets Research

22 August 2016

Rating Remains	**Buy**
Target Price Reduced from 419,000	JPY 401,000
Closing price 19 August 2016	JPY 348,500
Potential upside	+15.1%

Anchor themes

Smaller REITs can easily boost DPU via property acquisitions, but need to assess potential acquisitions more skilfully in terms of locations, yields, and quality. It is precisely at times of tough competition to acquire properties that the supply of high-quality properties from sponsors becomes even more crucial.

Catalyst

Potential catalysts include the speed at which the REIT finds new tenants for properties in Kawasaki and Shibuya, property acquisitions primarily from the pipeline supplied by the sponsor, the scale of reductions in funding costs when loans due in 17/12 are rolled over, and the start of overseas investments.

Research analysts

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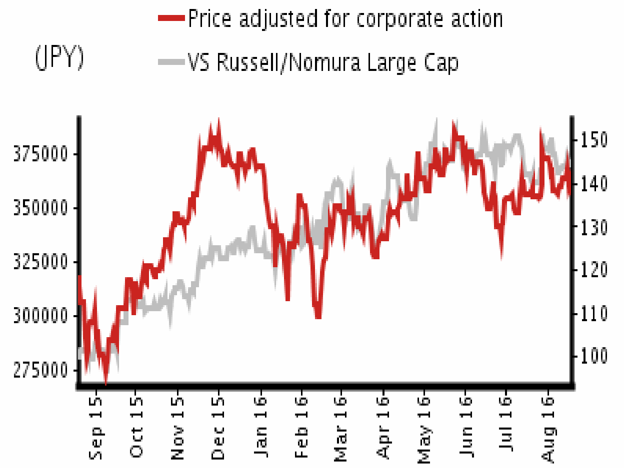
Key data on MCUBS MidCity

Rating

Stock	Buy

Relative performance chart



Source: ThomsonReuters, Nomura research

Performance

(%)	1M	3M	12M
Absolute	-2.4	-6.3	9.9
Relative to Russell/Nomura Large Cap	0.0	-3.6	31.8

Stock price data

Current stock price (JPY)	348,500
Market capitalization (JPY bn)	92.7
52-week low stock price (JPY)	271,800
52-week high stock price (JPY)	394,500
Shares out (mn)	0.3

Source: ThomsonReuters, Nomura research

Valuation and ratio analysis

(JPY)	16/6	16/12E	17/6E	17/12E
EPS	7,100.1	7,203.4	7,459.0	7,749.6
BPU or NAV per unit	440,304	440,407	440,663	440,954
DPU	7,100.1	7,203.4	7,459.0	7,749.6
Capital adequacy ratio (%)	51.4	51.9	51.9	3.5
ROE (%)	3.2	3.3	3.4	3.5

Income statement

(JPY mn)	16/6	16/12E	17/6E	17/12E
Operating revenues	6,824	6,978	6,967	7,029
Operating profits	2,463	2,481	2,531	2,593
Pretax profits	1,890	1,917	1,985	2,063
Minority interest	0	0	0	0
Net profits	1,889	1,916	1,984	2,062

Balance sheet

(JPY mn)	16/6	16/12E	17/6E	17/12E
Total assets	227,686	225,901	225,867	225,970
Total liabilities	110,554	108,742	108,639	108,665
Net assets	117,132	117,159	117,227	117,305

Source: Company data, Nomura estimates

Fig. 1: MCUBS MidCity Investment [3227]: financial data

(¥mn, except where noted)

	15/6	% vs prev term	15/12	% vs prev term	16/6	% vs prev term	16/12E	% vs prev term	17/6E	% vs prev term	17/12E	% vs prev term
No. of properties (term-end)	13		19		19		19		19		19	
Total acquisition price	165,130		217,104		217,104		217,104		217,104		217,104	
Total appraisal value (1)	129,180		188,505		192,615		N/A		N/A		N/A	
Total book value (2)	160,197		212,008		211,170		N/A		N/A		N/A	
Unrealized gains (1) - (2)	-31,017		-23,503		-18,555		N/A		N/A		N/A	
As % of book value	-19.4		-11.1		-8.8		N/A		N/A		N/A	
Income statement												
Operating revenue	5,266	2	6,580	25	6,824	4	6,978	2	6,967	-0	7,029	1
Leasing business income	5,266	2	6,580	25	6,824	4	6,978	2	6,967	-0	7,029	1
Profits on sale of real estate	-	-	-	-	-	-	-	-	-	-	-	-
Operating expenses	3,583	-1	4,072	14	4,361	7	4,496	3	4,436	-1	4,436	0
Leasing business expenses	3,123	-0	3,472	11	3,646	5	3,757	3	3,697	-2	3,697	0
Taxation	518	-2	509	-2	578	14	646	12	646	0	646	0
Other expenses	1,454	-1	1,711	18	1,787	4	1,822	2	1,799	-1	1,799	0
Depreciation	1,150	2	1,252	9	1,281	2	1,289	1	1,252	-3	1,252	0
Losses on sale of real estate	-	-	-	-	-	-	-	-	-	-	-	-
Asset management fees	318	-19	450	41	552	23	556	1	556	0	556	0
Other operating expenses	141	22	151	7	163	8	183	12	183	0	183	0
Leasing business profits	2,143	5	3,108	45	3,178	2	3,221	1	3,270	2	3,332	2
(Leasing business margin, %)	(40.7)		(47.2)		(46.6)		(46.2)		(46.9)		(47.4)	
Real estate NOI	3,293	3	4,360	32	4,459	2	4,510	1	4,522	0	4,584	1
Operating profits	1,683	9	2,507	49	2,463	-2	2,481	1	2,531	2	2,593	2
Nonoperating revenue	2	-4	3	28	2	-13	1	-48	1	0	1	0
Nonoperating expenses	447	-1	572	28	576	1	565	-2	547	-3	532	-3
Interest paid	354	-3	439	24	439	-0	407	-7	395	-3	380	-4
Loan-related cost	91	1	115	26	119	3	142	20	136	-4	136	0
Other	2	705	18	1,063	17	-7	16	-5	16	0	16	0
Recurring profits	1,239	14	1,938	56	1,890	-2	1,917	1	1,985	4	2,063	4
Extraordinary profits	-	-	-	-	-	-	-	-	-	-	-	-
Extraordinary losses	-	-	-	-	-	-	-	-	-	-	-	-
Net profits	1,237	13	1,937	57	1,889	-2	1,916	1	1,984	4	2,062	4
Total dividends	1,237		1,937		1,889		1,916		1,984		2,062	

Note: NOI (net operating income) = leasing business profits + depreciation; NOI yield = NOI ÷ real estate acquisition price

Source: Company data, Nomura estimates

Fig. 2: MCUBS MidCity Investment [3227]: financial data

(¥mn, except where noted)

Balance sheet	15/6	15/12	16/6	16/12E	17/6E	17/12E
Current assets	13,585	13,386	15,881	15,445	16,692	18,076
Cash & deposits	13,304	12,892	15,648	15,207	16,453	17,836
Other	281	495	233	238	239	240
Long-term assets	160,518	212,640	211,715	210,412	209,145	207,879
Property, plant & equipment	160,202	206,928	206,090	204,801	203,549	202,297
Intangible long-term assets	1	1	5	5	5	5
Other intangible fixed assets in trust	1	1	5	5	5	5
Investments, other assets	315	5,712	5,621	5,606	5,592	5,577
Investment securities	0	5,085	5,085	5,085	5,085	5,085
Long-term prepaid expenses	305	617	526	511	497	482
Security deposits	10	10	10	10	10	10
Other assets	0	0	0	0	0	0
Deferred assets	15	73	90	44	30	15
Unit issuance costs	15	73	59	44	30	15
Total assets	174,118	226,100	227,686	225,901	225,867	225,970
Current liabilities	20,031	27,323	23,365	16,567	16,416	18,011
Short-term borrowings	2,500	4,300	0	0	0	0
L-T borrowings due within 1 year	15,250	20,150	20,150	13,800	13,675	15,300
Other	2,281	2,873	3,215	2,767	2,741	2,711
Long-term liabilities	60,041	81,597	87,189	92,174	92,224	90,654
Long-term borrowings	49,925	69,900	72,575	77,300	77,300	75,675
Deposits & guarantees	10,116	11,697	11,614	11,874	11,924	11,979
Other	0	0	3,000	3,000	3,000	3,000
Total liabilities	80,072	108,920	110,554	108,742	108,639	108,665
Unitholders' equity	92,808	115,243	115,243	115,243	115,243	115,243
Retained earnings	1,237	1,937	1,889	1,916	1,984	2,062
Profits available for disposal	1,237	1,937	1,889	1,916	1,984	2,062
Accumulated other comprehensive income	0	0	0	0	0	0
Net assets	94,046	117,180	117,132	117,159	117,227	117,305
Total liabilities and net assets	174,118	226,100	227,686	225,901	225,867	225,970

Financial indicators	15/6	% vs prev term	15/12	% vs prev term	16/6	% vs prev term	16/12E	% vs prev term	17/6E	% vs prev term	17/12E	% vs prev term
Investment units out (units)	192,025		266,025		266,025		266,025		266,025		266,025	
EPU (¥)	6,622		7,615		7,100		7,203		7,459		7,750	
DPU (¥)	6,444	8	7,281	13	7,100	-2	7,203	1	7,459	4	7,750	4
BPU (¥)	489,757		440,485		440,304		440,407		440,663		440,954	
NAV (BPU + unrealized property gain/ unit, ¥)	328,232	1	352,136	7	370,555	5	N/A		N/A		N/A	
FFO	2,388		3,189		3,170		3,205		3,236		3,314	
AFFO	1,994		2,945		2,730		2,405		2,586		2,589	
Capital expenditures	394		244		440		800		650		725	
FFO/unit (¥)	12,435	-1	11,987	-4	11,917	-1	12,049	1	12,165	1	12,456	2
AFFO/unit (¥)	10,383	7	11,069	7	10,263	-7	9,042	-12	9,722	8	9,731	0
Payout ratio (AFFO basis) (%)	62.1		65.8		69.2		79.7		76.7		79.6	
EBITDA	2,834		3,759		3,744		3,770		3,783		3,845	
NOI	3,293	3	4,360	32	4,459	2	4,510	1	4,522	0	4,584	1
NCF	2,899	9	4,116	42	4,019	-2	3,710	-8	3,872	4	3,859	-0
NOI acquisition price yield (%)	4.1		4.0		4.1		4.2		4.2		4.2	
NOI acquisition price yield after depreciation (%)	2.7		2.9		2.9		3.0		3.0		3.1	
NOI yield (%)	4.2		4.1		4.2		4.3		4.3		4.4	
ROA (%)	1.4		1.9		1.7		1.7		1.8		1.8	
ROE (%)	2.7		3.7		3.2		3.3		3.4		3.5	
Cost of borrowing (%)	1.3		1.4		1.2		1.2		1.1		1.1	
Interest-bearing debt	67,675		94,350		95,725		94,100		93,975		93,975	
LTV (1) (%)	38.9		41.7		42.0		41.7		41.6		41.6	
LTV (2) (%)	44.7		46.9		47.1		46.9		46.9		46.9	
LTV (3) (%)	47.3		46.6		45.8		45.3		45.1		45.0	

Note: (1) NOI (net operating income) = leasing business profits + depreciation; NOI yield = NOI ÷ real estate acquisition price. (2) NOI after depreciation = NOI - depreciation costs = leasing business profits, NOI yield after depreciation = leasing business profits ÷ real estate acquisition price. (3) FFO (funds from operations) = net profits + depreciation – profits on sale of real estate + losses on sale of real estate; AFFO = FFO – capital expenditure. (4) Cost of borrowing = (interest paid + finance-related costs) ÷ ((term-initial interest-bearing debt + term-end interest-bearing debt) ÷ 2) × 2. (5) LTV (loan to value) (1) = total interest-bearing debt ÷ total assets. (6) LTV (2) = (total interest-bearing debt + deposits & guarantees) ÷ total assets. (7) LTV (3) = total interest-bearing debt ÷ (total assets + unrealized gains/losses on real estate holdings based on appraised values). (8) EPU and DPU calculated based on no. of units out at end of each fiscal period.

Source: Company data, Nomura estimates

Appendix A-1

Analyst Certification

We, Ryo Takatsu and Tomohiro Araki, hereby certify (1) that the views expressed in this Research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this Research report, (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Research report and (3) no part of our compensation is tied to any specific investment banking transactions performed by Nomura Securities International, Inc., Nomura International plc or any other Nomura Group company.

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Materially mentioned issuers

Issuer	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
MCUBS MidCity	3227 JP	JPY 348,500	19-Aug-2016	Buy	N/A	A4,A5,A6,A11

A4 The Nomura Group had an investment banking services client relationship with the issuer during the past 12 months.

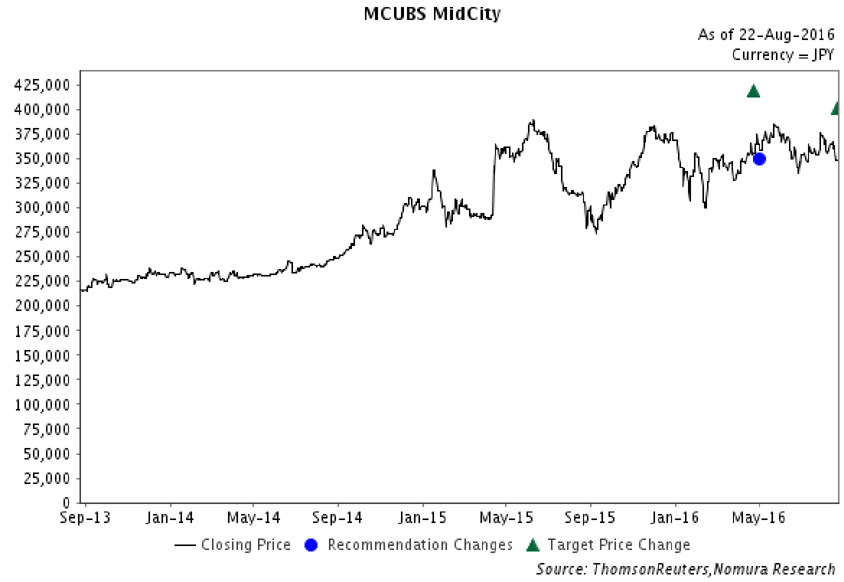
A5 The Nomura Group has received compensation for investment banking services from the issuer in the past 12 months.

A6 The Nomura Group expects to receive or intends to seek compensation for investment banking services from the issuer in the next three months.

A11 The Nomura Group holds 1% or more of any class of common equity securities of the issuer.

MCUBS MidCity (3227 JP) **JPY 348,500 (19-Aug-2016)** Buy (Sector rating: N/A)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
22-Aug-16		401,000	349,000
22-Apr-16	Buy		356,000
22-Apr-16		419,000	356,000

For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology For REITs, our target price is the simple average of two theoretical prices derived from the fair-value dividend yield and the fair-value cap rate (in this case, ¥391,000 and ¥413,000, respectively). Our target price for this REIT is ¥401,000, based on a fair-value dividend yield of 3.75%, a fair-value cap rate of 4.5%, and our earnings forecasts for 16/12 and 17/6. The discount rates we use are around 25bp higher than the weighted-average dividend yield of 3.53% and weighted-average implied cap rate of 4.17% (as of 19 August) for 38 REITs under our coverage. This reflects the quality of the portfolio, the current state of portfolio management, the REIT's track record up to now including capital increases, property acquisitions, and internal growth, as well as its scope for future internal and external growth, its market capitalization, and its credit rating.

Risks that may impede the achievement of the target price We think the unit price could substantially undershoot our target price in the event of deterioration in rental income from the existing portfolio caused by the departure of major tenants, sharp rent reductions, or a decline in occupancy. In our view investors also need to be aware of liquidity risk owing to the special nature of land ownership interests. We also note the possibility of capital losses or write-offs on properties that are sold or rebuilt. In addition, DPU and NAV could be diluted if the REIT uses future equity financing to acquire properties with cap rates that are lower than the implied cap rate and NOI yield on the existing portfolio. The REIT's unit price is also likely to be sensitive to changes in monetary policy. There is also the possibility of the loss or destruction of properties as a result of earthquakes or other natural disasters. Factors that could cause the unit price to substantially outperform our target price include major improvement in rental income, property acquisitions that lead to dividend increases, equity financing that results in an increase in DPU, a lower risk premium generally on real estate assets, including REITs (for example, as a result of deregulation), M&As, a reduction or elimination of unrealized losses, and a credit rating upgrade.

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As at 30 June 2016. **The Nomura Group as defined in the Disclaimer section at the end of this report.*

Explanation of Nomura's equity research rating system in Europe, Middle East and Africa, US and Latin America, and Japan and Asia ex-Japan from 21 October 2013

The rating system is a relative system, indicating expected performance against a specific benchmark identified for each individual stock, subject to limited management discretion. An analyst’s target price is an assessment of the current intrinsic fair value of the stock based on an appropriate valuation methodology determined by the analyst. Valuation methodologies include, but are not limited to, discounted cash flow analysis, expected return on equity and multiple analysis. Analysts may also indicate expected absolute upside/downside relative to the stated target price, defined as (target price - current price)/current price.

STOCKS

A rating of **'Buy'**, indicates that the analyst expects the stock to outperform the Benchmark over the next 12 months. A rating of **'Neutral'**, indicates that the analyst expects the stock to perform in line with the Benchmark over the next 12 months. A rating of **'Reduce'**, indicates that the analyst expects the stock to underperform the Benchmark over the next 12 months. A rating of **'Suspended'**, indicates that the rating, target price and estimates have been suspended temporarily to comply with applicable regulations and/or firm policies. Securities and/or companies that are labelled as **'Not rated'** or shown as **'No rating'** are not in regular research coverage. Investors should not expect continuing or additional information from Nomura relating to such securities and/or companies. Benchmarks are as follows: **United States/Europe/Asia ex-Japan**: please see valuation methodologies for explanations of relevant benchmarks for stocks, which can be accessed at: http://go.nomuranow.com/research/globalresearchportal/pages/disclosures/disclosures.aspx; **Global Emerging Markets (ex-Asia)**: MSCI Emerging Markets ex-Asia, unless otherwise stated in the valuation methodology; **Japan:** Russell/Nomura Large Cap.

SECTORS

A **'Bullish'** stance, indicates that the analyst expects the sector to outperform the Benchmark during the next 12 months. A **'Neutral'** stance, indicates that the analyst expects the sector to perform in line with the Benchmark during the next 12 months. A **'Bearish'** stance, indicates that the analyst expects the sector to underperform the Benchmark during the next 12 months. Sectors that are labelled as **'Not rated'** or shown as **'N/A'** are not assigned ratings. Benchmarks are as follows: **United States:** S&P 500; **Europe:** Dow Jones STOXX 600; **Global Emerging Markets (ex-Asia):** MSCI Emerging Markets ex-Asia. **Japan/Asia ex-Japan:** Sector ratings are not assigned.

Explanation of Nomura's equity research rating system in Japan and Asia ex-Japan prior to 21 October 2013

STOCKS

Stock recommendations are based on absolute valuation upside (downside), which is defined as (Target Price - Current Price) / Current Price, subject to limited management discretion. In most cases, the Target Price will equal the analyst's 12-month intrinsic valuation of the stock, based on an appropriate valuation methodology such as discounted cash flow, multiple analysis, etc. A **'Buy'** recommendation indicates that potential upside is 15% or more. A **'Neutral'** recommendation indicates that potential upside is less than 15% or downside is less than 5%. A **'Reduce'** recommendation indicates that potential downside is 5% or more. A rating of **'Suspended'** indicates that the rating and target price have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including when Nomura is acting in an advisory capacity in a merger or strategic transaction involving the subject company. Securities and/or companies that are labelled as **'Not rated'** or shown as **'No rating'** are not in regular research coverage of the Nomura entity identified in the top banner. Investors should not expect continuing or additional information from Nomura relating to such securities and/or companies.

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Target Price

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When bonds are purchased via public offerings, secondary distributions, or other OTC transactions with Nomura Securities, only the purchase price shall be paid, with no sales commission charged. Bonds carry the risk of losses, as prices fluctuate in line with changes in market interest rates. Bond prices may also fall below the invested principal as a result of such factors as changes in the management and financial circumstances of the issuer, or changes in third-party valuations of the bond in question. In addition, foreign currency-denominated bonds also carry the risk of losses owing to factors such as foreign exchange rate fluctuations.
When Japanese government bonds (JGBs) for individual investors are purchased via public offerings, only the purchase price shall be paid, with no sales commission charged. As a rule, JGBs for individual investors may not be sold in the first 12 months after issuance. When JGBs for individual investors are sold before maturity, an amount calculated via the following formula will be subtracted from the par value of the bond plus accrued interest: (1) for 10-year variable rate bonds, an amount equal to the two preceding coupon payments (before tax) x 0.79685 will be used, (2) for 5-year and 3-year fixed rate bonds, an amount equal to the two preceding coupon payments (before tax) x 0.79685 will be used.
When inflation-indexed JGBs are purchased via public offerings, secondary distributions (uridashi deals), or other OTC transactions with Nomura Securities, only the purchase price shall be paid, with no sales commission charged. Inflation-indexed JGBs carry the risk of losses, as prices fluctuate in line with changes in market interest rates and fluctuations in the nationwide consumer price index.The notional principal of inflation-indexed JGBs changes in line with the rate of change in nationwide CPI inflation from the time of its issuance. The amount of the coupon payment is calculated by multiplying the coupon rate by the notional principal at the time of payment. The maturity value is the amount of the notional principal when the issue becomes due. For JI17 and subsequent issues, the maturity value shall not undercut the face amount.
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In interest rate swap transactions and USD/JPY basis swap transactions ("interest rate swap transactions, etc."), only the agreed transaction payments shall be made on the settlement dates. Some interest rate swap transactions, etc. may require pledging of margin collateral. In some of these cases, transaction payments may exceed the amount of collateral. There shall be no advance notification of required collateral value or collateral ratios as they vary depending on the transaction. Interest rate swap transactions, etc. carry the risk of losses owing to fluctuations in market prices in the interest rate, currency and other markets, as well as reference indices. Losses incurred as such may exceed the value of margin collateral, in which case margin calls may be triggered. In the event that both parties agree to enter a replacement (or termination) transaction, the interest rates received (paid) under the new arrangement may differ from those in the original arrangement, even if terms other than the interest rates are identical to those in the original transaction. Risks vary by transaction. Please thoroughly read the written materials provided, such as documents delivered before making a contract and disclosure statements.
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