

## Japan Hotel REIT Investment

8985.T 8985.JP

EQUITY: JAPAN REIT

### New guidance: RevPAR growth target is 8.7% With no pullback apparent in lodging demand, next portfolio target is ¥500bn

#### Investment stance: reaffirming Buy rating while increasing risk premium in target price calculation

Japan Hotel REIT announced new 16/12 guidance on 24 August. Compared with February, rent income projections were raised for five of the six chains paying variable rent. The rent projection for the other is unchanged from February. The REIT's new overall projection for variable hotel rental income is ¥0.2bn higher than the most recent estimate (7 July). As of February, the RevPAR (average occupancy times average room rate) target for the three main chains (Hotel Management Japan, Accor, and The B) was +8.7% y-y. Concern about changing conditions in the hotel market has been rising in the stock market, but the business environment appears to be generally in line with what management expected at the start of 2016. Moreover, property acquisitions have been brisk. Since the start of 2016 the REIT has issued new shares twice and used the proceeds to acquire five properties (including Hilton Nagoya) for ¥61.1bn (5.1% weighted-average NOI yield). We use a fair-value dividend yield of 3.25% and fair-value cap rate of 4.0% to calculate our target price. Previously we valued Japan Hotel REIT 50bp lower than the weighted-average yield indicators of the 38 REITs we cover. We now change to 25bp lower based on the increased difficulty of forecasting conditions in the hotel market.

#### With no signs of general slowdown in lodging demand, next portfolio target is ¥500bn

The guest mix of the REIT's hotels is about 26% foreign visitors and the leisure to business ratio is roughly 7 to 3. Currently demand does not appear to be slowing in either category. We estimate the REIT's sensitivity to variable rent is a 14% increase in DPU in the event of a 10% rise in the average room rate of the 28 hotels under variable rent.

Following total acquisitions of ¥113.4bn in 2015 and 2016, the REIT's total assets under management has reached ¥286.8bn, nearing its long-targeted goal of ¥300bn. The REIT's next target for portfolio size is ¥500bn, though no deadline has been disclosed. Acquisitions currently under consideration are around the same scale as 2015. Target NOI yields are 4.2% for central Tokyo and 5-5.5% for major regional cities. We estimate LTV is 39.5%, already on par with the REIT's 40% target. The weighted-average residual maturity of its interest-bearing debt is 4.5 years and the weighted average cost is 1.3%, with some scope for reduction in our view

Parent	15/12		16/12E		17/12E		18/12E		
	Currency: JPY	Actual	Old	New	Co's	Old	New	Old	New
<b>Sales (mn)</b>		17,343	20,948	22,417	22,281	21,363	24,590	21,665	24,711
<b>Ope profits (mn)</b>		10,988	13,002	13,882	13,760	13,136	14,842	13,407	15,015
<b>EPS</b>		3,036.0	3,371.8	3,194.5	3,396.0	3,432.0	3,484.6	3,521.1	3,537.1
<b>P/E (x)</b>		27.7	25.0	26.4	N/A	24.5	24.2	23.9	23.8
<b>P/B (x)</b>		2.0	1.9	1.7	N/A	1.9	1.7	1.9	1.7
<b>Dividend yield (%)</b>		3.5	4.0	4.0	N/A	4.1	4.2	4.2	4.3

Source: Company data, Nomura estimates

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

### Global Markets Research

24 August 2016

<b>Rating</b> Remains	<b>Buy</b>
<b>Target Price</b> Reduced from 124,000	JPY 109,000
<b>Closing price</b> 24 August 2016	JPY 84,200
<b>Potential upside</b>	+29.5%

#### Anchor themes

Concern toward changes in hotel market conditions is on the rise with the yen strengthening, Japan and overseas economies volatile, and the number of new developments rising. This concern has recently extended to y-y declines in RevPAR. That said, we think skepticism could be eliminated by projections for continued growth in RevPAR by hotel REITs.

#### Catalyst

The REIT's three core chains have 2016 targets of +7.7% y-y for average room rate and +8.7% for RevPAR. Our focus is on what type of growth outlook the REIT indicates for 2017 once those targets are achieved. The stock of potential acquisitions is abundant.

#### Research analysts

##### Japan REIT

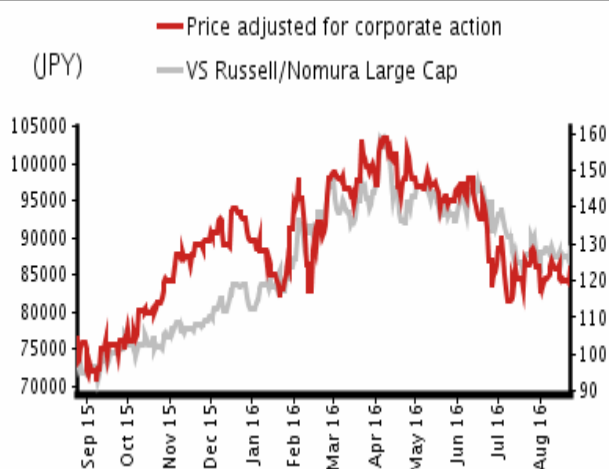
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# Key data on Japan Hotel REIT Investment

## Rating

Stock	Buy
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## Relative performance chart



Source: ThomsonReuters, Nomura research

## Performance

(%)	1M	3M	12M
Absolute	-2.5	-11.8	10.1
Relative to Russell/Nomura Large Cap	-1.3	-10.8	22.4

## Stock price data

Current stock price (JPY)	84,200
Market capitalization (JPY bn)	315.8
52-week low stock price (JPY)	70,100
52-week high stock price (JPY)	104,300
Shares out (mn)	3.8

Source: ThomsonReuters, Nomura research

## Valuation and ratio analysis

(JPY)	15/12	16/12E	17/12E	18/12E
EPS	3,036.0	3,194.5	3,484.6	3,537.1
BPS or NAV per share	41,318	48,362	48,457	48,440
DPS	2,975.0	3,390.2	3,553.7	3,606.2
Capital adequacy ratio (%)	54.1	57.2	57.2	57.2
ROE (%)	8.1	7.7	7.2	7.3

## Income statement

(JPY mn)	15/12	16/12E	17/12E	18/12E
Sales	17,343	22,417	24,590	24,711
Operating profits	10,988	13,882	14,842	15,015
Pretax profits	9,295	12,019	13,110	13,307
Minority interest	-	-	-	-
Net profits	9,294	12,018	13,109	13,306

## Balance sheet

(JPY mn)	15/12	16/12E	17/12E	18/12E
Total assets	240,356	318,023	318,651	318,604
Total liabilities	110,442	136,089	136,362	136,377
Net assets	129,914	181,934	182,289	182,227

Source: Company data, Nomura estimates

Fig. 1: Japan Hotel REIT Investment [8985]: financial data (1)

	(¥mn, except where noted)											
	13/12		14/12		15/12		16/12E		17/12E		18/12E	
		% vs prev term		% vs prev term		% vs prev term		% vs prev term		% vs prev term		% vs prev term
No. of properties (term-end)	28		30		36		41		41		41	
Total acquisition price	158,902		173,429		225,723		286,800		286,800		286,800	
Total appraisal value (1)	166,237		205,408		302,110		N/A		N/A		N/A	
Total book value (2)	156,350		170,576		223,372		N/A		N/A		N/A	
Unrealized gains (1) - (2)	9,887		34,832		78,738		N/A		N/A		N/A	
As % of book value	(6.3)		(20.4)		(35.2)		N/A		N/A		N/A	
<b>Income statement</b>												
<b>Operating revenue</b>	11,472	-	12,760	11	17,343	36	22,417	29	24,590	10	24,711	0
Variable rent	2,811	-	3,693	31	6,722	82	9,681	44	10,812	12	10,933	1
Fixed rent	8,661	-	9,066	5	10,311	14	12,736	24	13,778	8	13,778	0
Profits on sale of real estate	-	-	-	-	306	-	-	-	-	-	-	-
Operating expenses	6,105	-	5,215	-15	6,355	22	8,535	34	9,747	14	9,696	-1
Leasing business expenses	3,871	-	4,163	8	5,002	20	6,840	37	7,666	12	7,587	-1
Taxation	721	-	835	16	941	13	1,216	29	1,525	25	1,525	0
Other expenses	852	-	927	9	1,289	39	2,266	76	2,622	16	2,543	-3
Depreciation	2,297	-	2,400	4	2,772	15	3,358	21	3,519	5	3,519	0
Loss on sale of real estate	1,189	-	-	-	-	-	-	-	-	-	-	-
Asset management fees	739	-	809	10	1,046	29	1,117	7	1,448	30	1,473	2
Other operating expenses	307	-	242	-21	306	26	577	88	633	10	636	0
Leasing business profits	7,602	-	8,597	13	12,031	40	15,577	29	16,924	9	17,124	1
Leasing business margin (%)	(66.3)		(67.4)		(69.4)		(69.5)		(68.8)		(69.3)	
Real estate NOI	9,900	-	10,997	11	14,803	35	18,935	28	20,443	8	20,643	1
<b>Operating profits</b>	5,367	-	7,545	41	10,988	46	13,882	26	14,842	7	15,015	1
Nonoperating revenue	7	-	5	-30	19	-	5	-73	5	0	5	0
Nonoperating expenses	1,634	-	1,774	9	1,712	-4	1,779	4	1,738	-2	1,713	-1
Interest paid, loan-related cost	1,544	-	1,629	5	1,550	-5	1,554	0	1,550	-0	1,530	-1
Interest on REIT bonds	44	-	37	-15	63	69	131	108	131	0	131	0
Other	46	-	108	-	98	-9	94	-4	58	-39	53	-9
<b>Recurring profits</b>	3,740	-	5,776	54	9,295	61	12,109	30	13,110	8	13,307	2
Extraordinary gains	36	-	-	-	-	-	-	-	-	-	-	-
Other	36	-	-	-	-	-	-	-	-	-	-	-
Extraordinary losses	542	-	-	-	-	-	90	-	-	-	-	-
Loss on reduction of fixed assets	25	-	-	-	-	-	-	-	-	-	-	-
Impairment losses etc.	517	-	-	-	-	-	90	-	-	-	-	-
Pretax net profits	3,234	-	5,776	79	9,295	61	12,019	29	13,110	9	13,307	2
<b>Net profits</b>	3,233	-	5,774	79	9,294	61	12,018	29	13,109	9	13,306	2
Total dividends	5,082	-	6,015	18	9,355	56	12,754	36	13,369	5	13,566	1
of which, drawdowns of internal reserves	(1,849)		(241)		(61)		(736)		(260)		(260)	

Note: NOI (net operating income) = leasing business profits + depreciation expenses.

Source: Company data, Nomura estimates

Fig. 2: Japan Hotel REIT Investment [8985]: financial data (2)

(¥mn, except where noted)

Balance sheet	13/12	14/12	15/12	16/12E	17/12E	18/12E
Current assets	13,643	15,836	15,633	32,690	34,547	35,455
Cash & deposits	12,553	14,425	13,698	30,189	31,803	32,698
Other	1,089	1,411	1,935	2,501	2,743	2,757
Long-term assets	157,006	172,161	224,588	285,192	284,021	283,118
Property, plant & equipment	136,530	150,736	203,489	264,093	262,921	262,018
Intangible long-term assets	19,824	19,842	19,885	19,885	19,885	19,885
Leaseholds	19,774	19,774	19,774	19,774	19,774	19,774
Other	50	68	111	111	111	111
Investments, other assets	652	1,582	1,215	1,215	1,215	1,215
Investments in securities	-	603	-	-	-	-
Long-term prepaid expenses	445	804	993	993	993	993
Guarantee deposits	171	171	171	171	171	171
Other	36	5	50	50	50	50
Deferred assets	80	95	135	141	83	31
Investment unit issuance costs	62	56	67	85	40	-
REIT bond issuance costs	17	39	68	56	43	31
<b>Total assets</b>	<b>170,727</b>	<b>188,091</b>	<b>240,356</b>	<b>318,023</b>	<b>318,651</b>	<b>318,604</b>
Current liabilities	17,887	13,475	25,073	21,053	25,376	25,023
Short-term borrowings	2,669	-	9,000	8,700	8,700	8,700
Corporate bonds maturing within 1 year	-	-	2,500	-	-	2,000
L-T borrowings due within 1 year	13,702	11,825	11,394	9,536	13,585	11,217
Other	1,516	1,650	2,180	2,817	3,090	3,106
Long-term liabilities	63,085	74,274	85,369	115,036	110,986	111,355
Corporate bonds	2,500	6,000	9,500	15,000	15,000	13,000
Long-term borrowings	55,913	63,265	70,379	92,243	88,194	90,562
Deposits & guarantees	4,626	4,651	4,956	7,259	7,259	7,259
Other	46	359	534	534	534	534
<b>Total liabilities</b>	<b>80,972</b>	<b>87,749</b>	<b>110,442</b>	<b>136,089</b>	<b>136,362</b>	<b>136,377</b>
Unitholders' equity	48,845	59,025	85,471	134,829	134,829	134,829
Retained earnings	40,999	41,691	44,971	47,631	47,986	47,924
Earnings surplus	21,746	21,746	21,746	21,746	21,746	21,746
Reserve for distribution	16,017	14,169	13,928	13,867	13,131	12,871
Unappropriated retained earnings	3,235	5,776	9,296	12,018	13,109	13,306
Valuation, translation adjustments and others	-88	-373	-527	-527	-527	-527
Net assets	89,756	100,342	129,914	181,934	182,289	182,227
<b>Total liabilities and net assets</b>	<b>170,727</b>	<b>188,091</b>	<b>240,356</b>	<b>318,023</b>	<b>318,651</b>	<b>318,604</b>
<b>Financial indicators</b>						
Investment units out (units)	2,621,281	2,791,281	3,144,227	3,761,907	3,761,907	3,761,907
EPU (¥)	1,307	2,159	3,036	3,195	3,485	3,537
DPU (¥)	1,939	2,155	2,975	3,390	3,554	3,606
of which, drawdowns of internal reserves	(705)	(86)	(19)	(196)	(69)	(69)
BPU (¥)	34,241	35,948	41,318	48,362	48,457	48,440
NAV (BPU + unrealized property gain/ unit, ¥)	38,013	48,427	66,360	N/A	N/A	N/A
FFO	7,225	8,174	11,761	15,466	16,628	16,826
AFFO	6,371	6,868	9,950	12,581	14,280	14,209
Capital expenditures	854	1,306	1,811	2,885	2,348	2,617
FFO/unit (¥)	2,756	2,929	3,740	4,111	4,420	4,473
AFFO/unit (¥)	2,431	2,461	3,164	3,344	3,796	3,777
Payout ratio (AFFO basis) (%)	79.8	87.6	94.0	101.4	93.6	95.5
EBITDA	7,664	9,946	13,761	17,240	18,362	18,534
NOI	9,900	10,997	14,803	18,935	20,443	20,643
NCF	9,046	9,691	12,992	16,050	18,095	18,027
NOI yield (%)	6.3	6.4	6.6	6.7	7.2	7.3
NOI yield after depreciation (%)	4.9	5.0	5.4	5.5	6.0	6.1
NCF yield (%)	5.8	5.7	5.8	5.7	6.4	6.4
ROA (%)	2.4	3.1	3.9	3.8	4.1	4.2
ROE (%)	3.6	5.8	8.1	7.7	7.2	7.3
Interest-bearing debt	74,784	81,090	102,773	125,479	125,479	125,479
LTV (i) (%)	43.8	43.1	42.8	39.5	39.4	39.4
LTV (ii) (%)	46.5	45.6	44.8	41.7	41.7	41.7
LTV (iii) (%)	45.0	39.5	34.0	34.3	34.3	34.3

Note: (1) NOI (net operating income) = leasing business profits + depreciation expenses; NOI yield = NOI ÷ real estate book value. (2) NCF (net cash flow) = NOI - capital expenditures; NCF yield = NCF ÷ real estate book value. (3) FFO (funds from operation) = net profits + depreciation expenses ± one-time profits/losses; AFFO = FFO - capital expenditures. (4) LTV (loan to value) (i) = total interest-bearing debt ÷ total assets. (5) LTV (ii) = (total interest-bearing debt + deposits & guarantees) ÷ total assets. (6) LTV (iii) = total interest-bearing debt ÷ total appraisal value of real estate holdings.

Source: Company data, Nomura estimates

# Appendix A-1

## Analyst Certification

I, Tomohiro Araki, hereby certify (1) that the views expressed in this Research report accurately reflect my personal views about any or all of the subject securities or issuers referred to in this Research report, (2) no part of my 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 my 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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Issuer	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Japan Hotel REIT Investment	8985 JP	JPY 84,200	24-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.

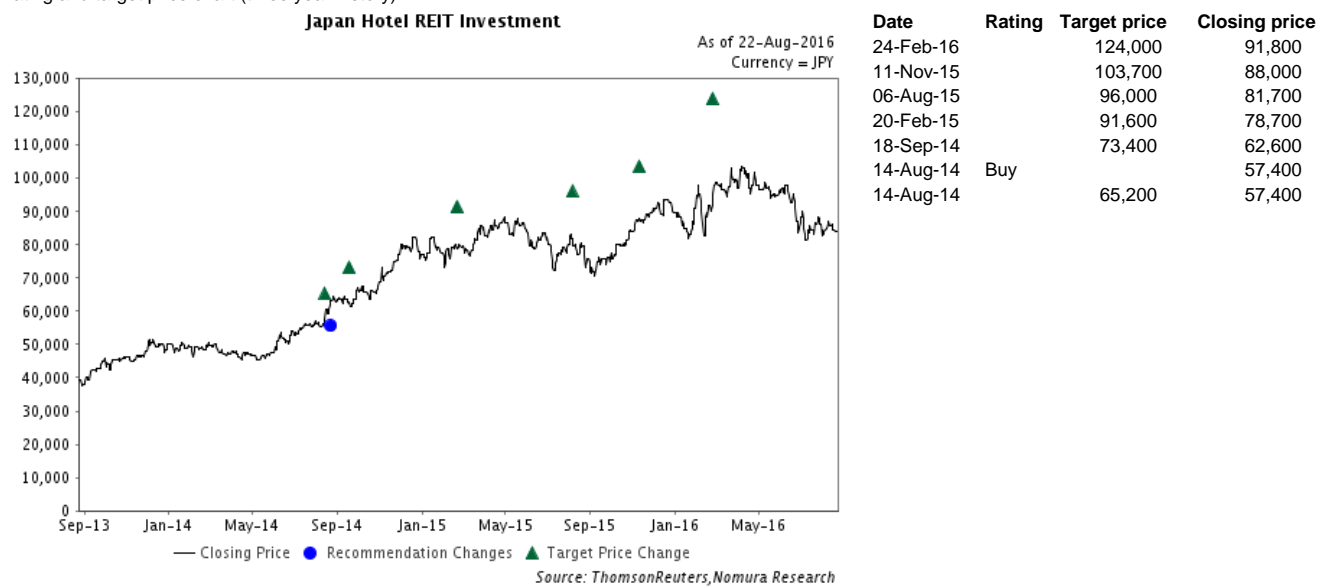
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A11 The Nomura Group holds 1% or more of any class of common equity securities of the issuer.

### Japan Hotel REIT Investment (8985 JP)

JPY 84,200 (24-Aug-2016) Buy (Sector rating: N/A)

Rating and target price chart (three year history)



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, ¥109,000 and ¥109,000, respectively). Our target price for Japan Hotel REIT is ¥109,000, based on a fair-value dividend yield of 3.25%, a fair-value cap rate of 4.0%, and earnings forecasts for 16/12 and 17/12. The discount rates we use are around 25bp lower than the weighted-average dividend yield of 3.54% and weighted-average implied cap rate of 4.18% (as of 24 August) for the 38 REITs under our coverage.

**Risks that may impede the achievement of the target price** Risks that could cause the unit price to come in well below our target price include a worsening in rental income on the portfolio, for example as a result of the departure of major tenants, or substantial reductions in rents. We also note the possibility of capital losses or write-offs on properties that are sold or rebuilt. Other risks include higher financing costs as a result of rising interest rates and a rise in yield demanded by REIT market

participants. As factors that could cause the unit price to substantially outperform our target price, we note the possibility of major improvements in rental income, large and effective reshuffling of assets with the sponsor and others, and a lower risk premium generally on real estate assets, including REITs.

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

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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

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### 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

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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.

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