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Conditions at two hotel REITs

Differing views on RevPAR growth, based on differences in exposure to Tokyo, pricing, formats

Global Markets Research

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Japan REIT

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Invincible Investment and Japan Hotel REIT Investment announce results and guidance in week ending 26 August

Invincible Investment [8963] (Buy) announced 16/6 results and 16/12 guidance on 23 August, followed on 24 August by Japan Hotel REIT Investment [8985] (Buy), which announced 16/12 H1 results and 16/12 full year guidance. Below, we summarize conditions at these two major hotel REITs, and the differences between them.

Invincible Investment lowers RevPAR growth projection for 2016

Invincible Investment has lowered its 2016 RevPAR (average occupancy × average room rate) growth projection for existing hotels from 11–12% y-y to 6.5%, mainly because conditions at Tokyo hotels have been weaker than initially anticipated. The REIT has a portfolio of 48 hotels, 23 of which are in Tokyo. Although RevPAR rose 6.9% y-y in 16/6 at the 35 hotels for which y-y comparisons are available, hotels in Tokyo accounted for six of the eight hotels where it fell (the other two hotels were in Kawasaki and Yokohama).

Fiercer competition in Tokyo hotel market is main reason for downward revision to RevPAR growth projection

The reason why conditions at Tokyo hotels have been weaker than Invincible Investment had anticipated appears to be increased new supply of hotels. Increased choice also looks to have resulted in fiercer competition, in the form of hotel operators increasingly listing rooms on online booking sites, as well as the spread of private lettings. Growth in room rates at hotels owned by Invincible Investment has been slowing recently, partly because they are now much higher than they were around two years ago. However, there has yet to be any marked trend of guests avoiding Tokyo because of rising room rates and staying in the suburbs instead. Indeed, average occupancy at hotels in Tokyo owned by Invincible Investment has remained high.

Around one quarter of new hotels scheduled to open by around 2020 are in Tokyo

Invincible Investment said that Japan was likely to add around 72,000 hotel rooms by around 2020, equivalent to 4.8% of overall hotel stock of around 1.5mn rooms. Over the five-year period from 2016 to 2020, this represents a CAGR of almost 1%. Pressure on supply is therefore not that strong, sharp rises in land prices may cause the supply of new hotels to decline gradually, and inbound tourism to Japan is also likely to keep on rising, especially from the Asian middle classes. Accordingly, Invincible Investment thinks that supply-demand conditions for hotels in Japan can remain favorable provided there is steady growth in inbound demand. Nevertheless, we are somewhat concerned that around one quarter of the 72,000 or so new hotel rooms scheduled to become available by around 2020 are in Tokyo (text continues on next page).

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Invincible Investment still regards higher inbound demand as growth driver
Invincible Investment still thinks that higher inbound demand will drive RevPAR growth at portfolio hotels. It is pinning particular hopes on first-time visitors to Japan that tend to stay in Tokyo and appear to be less price sensitive. It thinks that the ratio of inbound guests at key hotel formats could rise from 34.9% in 16/6 to around 40% in future. The leisure/business travel breakdown at portfolio hotels appears to be 55–60:40–45.

Japan Hotel REIT Investment basically retains RevPAR growth projection for 2016
As of February, Japan Hotel REIT Investment projected RevPAR growth of 8.7% y-y in 2016 for its three main hotel formats, namely Hotel Management Japan, Accor, and The B. It now projects basically unchanged growth of 8.4%.

Differences in RevPAR outlook between two REITs reflect differences in regional mix, pricing, and formats
The main differences between Invincible Investment, which has lowered its 2016 RevPAR growth projection, and Japan Hotel REIT Investment, which has broadly retained its projection, revolve around the regional mix and pricing of their respective hotel portfolios. Hotels in Tokyo make up 15 of the 40 hotels in Japan Hotel REIT Investment's current portfolio, but account for only 18% of the portfolio on a purchase price basis. Meanwhile, average daily room rates for hotels in the Tokyo metropolis are around ¥10,000–15,000 for Japan Hotel REIT Investment versus around ¥8,000 for Invincible Investment, making the former less susceptible to price competition with private lettings. Moreover, whereas Japan Hotel REIT Investment's portfolio (including hotels outside of Tokyo) includes large numbers of city and resort hotels, Invincible Investment has mainly specialized in budget hotels where price tends to become the main differentiating factor for competitive purposes.

No signs of change in accommodation demand among Japanese business travelers
The leisure/business travel breakdown at hotels owned by Japan Hotel REIT Investment appears to be around 80:20. Leisure visitors thus account for a higher proportion of overall guests than at Invincible Investment, where the equivalent ratio is 55–60%. However, both REITs have said that there have been no changes in demand from Japanese business travelers, implying that Invincible Investment's higher exposure to business guests is unlikely to have dented RevPAR growth. Both REITs have said that Japanese companies have already been keeping business trips to a minimum for several years, and have increasingly responded to recent rises in room rates either by raising maximum accommodation budgets or by switching to a system whereby they reimburse expenses that have actually been incurred. They have seen no changes in accommodation demand among Japanese business travelers recently. Meanwhile, inbound visitors account for around 26% of guests at hotels owned by Japan Hotel REIT Investment. It regards inbound visitors and active seniors as promising customer segments.

Appendix A-1

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Issuer	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Invincible Investment	8963 JP	JPY 64,300	26-Aug-2016	Buy	N/A	A4,A5,A6,A7,A8,A11
Japan Hotel REIT Investment	8985 JP	JPY 86,800	26-Aug-2016	Buy	N/A	A4,A5,A6,A11

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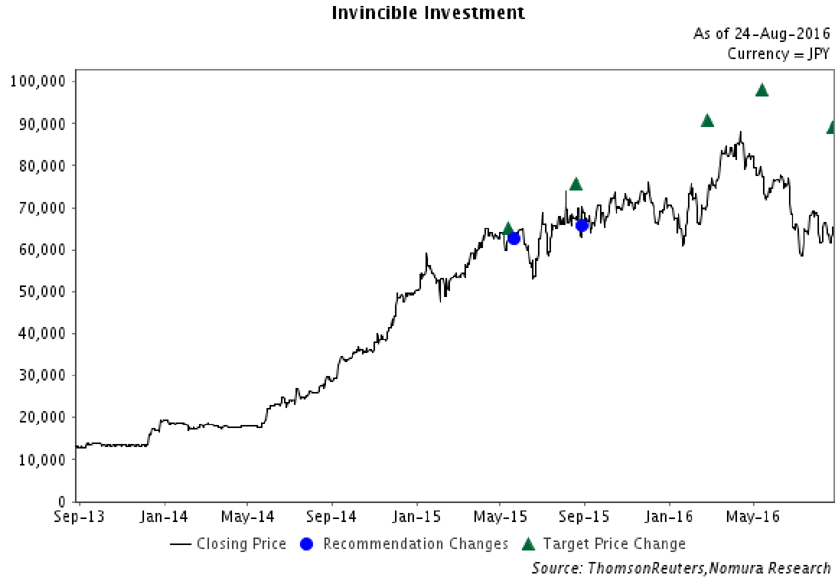
Invincible Investment (8963 JP) **JPY 64,300 (26-Aug-2016)** Buy (Sector rating: N/A)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
23-Aug-16		89,000	63,800
13-May-16		98,000	77,300
25-Feb-16		90,700	71,600
18-Aug-15	Buy		67,100
18-Aug-15		75,600	67,100
13-May-15	Neutral		63,900
13-May-15		65,000	63,900

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, ¥94,000 and ¥83,000, respectively). Our target price for this REIT is ¥89,000, 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 17/6. The discount rates we use are around 25bp lower than the weighted-average dividend yield of 3.55% and weighted-average implied cap rate of 4.19% (as of 23 August) for 38 REITs under our coverage. We apply a substantially lower risk premium for this REIT to reflect its strong expected EPU growth backed by its plentiful property purchase pipeline and anticipated rises in average room rates at portfolio hotels, owing partly to rising inbound demand.

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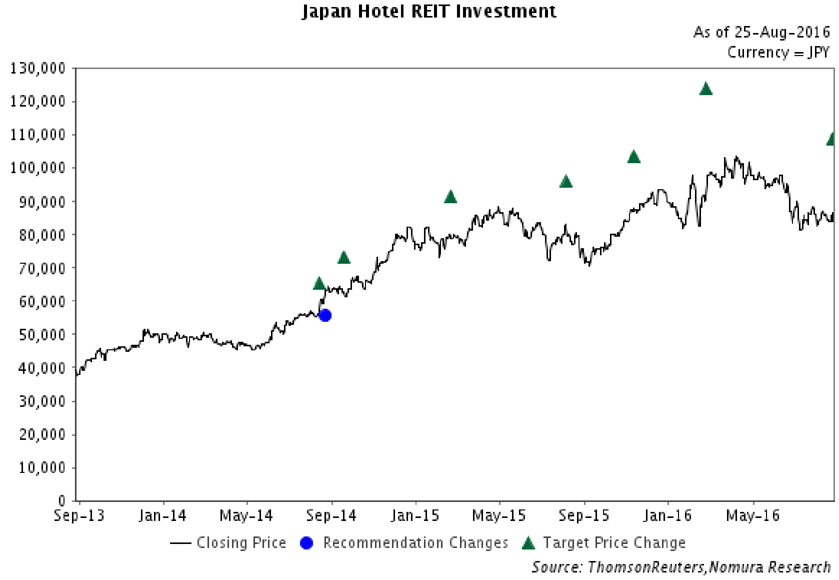
Japan Hotel REIT Investment (8985 JP) **JPY 86,800 (26-Aug-2016)** Buy (Sector rating: N/A)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
24-Aug-16		109,000	84,200
24-Feb-16		124,000	91,800
11-Nov-15		103,700	88,000
06-Aug-15		96,000	81,700
20-Feb-15		91,600	78,700
18-Sep-14		73,400	62,600
14-Aug-14	Buy		57,400
14-Aug-14		65,200	57,400

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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Transactions involving Japanese equities (including Japanese REITs, Japanese ETFs, and Japanese ETNs) are subject to a sales commission of up to 1.404% of the transaction amount (or a commission of ¥2,808 for transactions of ¥200,000 or less). When Japanese equities are purchased via OTC transactions (including offerings), only the purchase price shall be paid, with no sales commission charged. However, Nomura Securities may charge a separate fee for OTC transactions, as agreed with the customer. Japanese equities carry the risk of losses owing to price fluctuations. Japanese REITs carry the risk of losses owing to fluctuations in price and/or earnings of underlying real estate. Japanese ETFs carry the risk of losses owing to fluctuations in the underlying indexes or other benchmarks.
Transactions involving foreign equities are subject to a domestic sales commission of up to 1.026% of the transaction amount (which equals the local transaction amount plus local fees and taxes in the case of a purchase or the local transaction amount minus local fees and taxes in the case of a sale) (for transaction amounts of ¥750,000 and below, maximum domestic sales commission is ¥7,668). Local fees and taxes in foreign financial instruments markets vary by country/territory. When foreign equities are purchased via OTC transactions (including offerings), only the purchase price shall be paid, with no sales commission charged. However, Nomura Securities may charge a separate fee for OTC transactions, as agreed with the customer. Foreign equities carry the risk of losses owing to factors such as price fluctuations and foreign exchange rate fluctuations.
Margin transactions are subject to a sales commission of up to 1.404% of the transaction amount (or a commission of ¥2,808 for transactions of ¥200,000 or less), as well as management fees and rights handling fees. In addition, long margin transactions are subject to interest on the purchase amount, while short margin transactions are subject to fees for the lending of the shares borrowed. A margin equal to at least 30% of the transaction amount and at least ¥300,000 is required. With margin transactions, an amount up to roughly 3.3x the margin may be traded. Margin transactions therefore carry the risk of losses in excess of the margin owing to share price fluctuations. For details, please thoroughly read the written materials provided, such as listed securities documents or documents delivered before making a contract.
Transactions involving convertible bonds are subject to a sales commission of up to 1.08% of the transaction amount (or a commission of ¥4,320 if this would be less than ¥4,320). When convertible bonds are purchased via OTC transactions (including offerings), only the purchase price shall be paid, with no sales commission charged. However, Nomura Securities may charge a separate fee for OTC transactions, as agreed with the customer. Convertible bonds carry the risk of losses owing to factors such as interest rate fluctuations and price fluctuations in the underlying stock. In addition, convertible bonds denominated in foreign currencies also carry the risk of losses owing to factors such as foreign exchange rate fluctuations.
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.
Purchases of investment trusts (and sales of some investment trusts) are subject to a purchase or sales fee of up to 5.4% of the transaction amount. Also, a direct cost that may be incurred when selling investment trusts is a fee of up to 2.0% of the unit price at the time of redemption. Indirect costs that may be incurred during the course of holding investment trusts include, for domestic investment trusts, an asset management fee (trust fee) of up to 5.4% (annualized basis) of the net assets in trust, as well as fees based on investment performance. Other indirect costs may also be incurred. For foreign investment trusts, indirect fees may be incurred during the course of holding such as investment company compensation.
Investment trusts invest mainly in securities such as Japanese and foreign equities and bonds, whose prices fluctuate. Investment trust unit prices fluctuate owing to price fluctuations in the underlying assets and to foreign exchange rate fluctuations. As such, investment trusts carry the risk of losses. Fees and risks vary by investment trust. Maximum applicable fees are subject to change; please thoroughly read the written materials provided, such as prospectuses or documents delivered before making a contract.
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.
In OTC transactions of credit default swaps (CDS), no sales commission will be charged. When entering into CDS transactions, the protection buyer will be required to pledge or entrust an agreed amount of margin collateral. In some of these cases, the transaction payments may exceed the amount of margin collateral. There shall be no advance notification of required collateral value or collateral ratios as they vary depending on the financial position of the protection buyer. CDS transactions carry the risk of losses owing to changes in the credit position of some or all of the referenced entities, and/or fluctuations of the interest rate market. The amount the protection buyer receives in the event that the CDS is triggered by a credit event may undercut the total amount of premiums that he/she has paid in the course of the transaction. Similarly, the amount the protection seller pays in the event of a credit event may exceed the total amount of premiums that he/she has received in the transaction. All other conditions being equal, the amount of premiums that the protection buyer pays and that received by the protection seller shall differ. In principle, CDS transactions will be limited to financial instruments business operators and qualified institutional investors.
No account fee will be charged for marketable securities or monies deposited. Transfers of equities to another securities company via the Japan Securities Depository Center are subject to a transfer fee of up to ¥10,800 per issue transferred depending on volume.

Nomura Securities Co., Ltd.

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