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Japan REIT sector

EQUITY: JAPAN REIT

REITs up despite ex-dividend date for 11 REITs

Stocks should benefit from BOJ buying, REITs seem also to be in favor

Global Markets Research

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Research analysts

Japan REIT

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Market participants apparently feeling safer in REITs than in stocks

TOPIX rose 2% on 29 August from the previous trading day. The main factor was likely the yen's retreat following the Fed chairwoman's lecture and comments by BOJ Governor Haruhiko Kuroda at the symposium at Jackson Hole, Wyoming, on 26 August. Amid these conditions the TSE REIT index rose 0.5% on 29 August despite it being the ex-dividend date for REITs with August-ending fiscal periods (ie, 11 of the 54 REITs). After nearly doubling its annual ETF buying target to roughly ¥6trn (from ¥3.3trn) at the 29 July Monetary Policy Meeting, the BOJ bought ¥71.9bn in ETFs on both 25 and 26 August, roughly double the daily amount of BOJ ETF buying up to 3 August. Even so, TOPIX continued to fall d-d on 25 and 26 August. On the other hand, the BOJ did not buy REITs on 25 or 26 August, but the TSE REIT index rose each day nonetheless. Judging from these market conditions, our view is that market participants feel safer in REITs than stocks.

BOJ's high volume of ETF buying likely to result in continued outperformance by stocks

However, leaving aside the matter of fundamental valuation of each asset class, REITs will likely continue to underperform stocks amid high-volume ETF buying by the BOJ (see our 18 August 2016 Nomura Global Research report Japan REIT sector - Change in REITs' strong performance vs equities?). Assuming the BOJ will buy ETFs at an annual pace of ¥6trn through the end of 2016, the central bank would need to purchase a monthly average of ¥920bn from September to December, which would equate to about 1.7% of the ¥52.6trn monthly average buying of TSE1 shares from January to July 2016. Meanwhile, the BOJ left its 2016 target for REIT buying unchanged at ¥90bn at the July Monetary Policy Meeting, which implies monthly average buying of ¥7.2bn from September to December, or 0.7% of the ¥1.1trn Jan-Jul 2016 monthly average. We think the BOJ's buying should provide a greater boost for stocks than REITs.

Even if the BOJ were to signal a change in course, impact on REIT market likely relatively small

That said, we think the stock market could currently reflect to some extent the potential for another round of major monetary easing given the BOJ's comments about undertaking a thorough review of qualitative and quantitative monetary easing with negative interest rates. On the other hand, we do not believe the REIT market currently prices in scope for additional easing by the BOJ, owing in part to the central bank increasing only its ETF buying target and leaving its REIT buying target unchanged at the July Monetary Policy Meeting. Even supposing that the BOJ does not take action on additional easing at the September Monetary Policy Meeting and signals a shift from major monetary easing, we would expect a smaller correction in the REIT market than in the stock market considering the groundwork that has been laid. (continues on next page)

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REITs can likely handle moderate rise in interest rates, but sharp increases would be a concern

One risk factor that should be noted is the potential that additional easing by the BOJ (including deeper negative interest rates) is already priced in to bond prices. Despite increased speculation that the US will soon increase interest rates, the yield of 10-year JGBs rose only 0.005% (to -0.07%) on 29 August from the previous trading day. This could be attributable to the effects of BOJ Governor Kuroda's comments in a lecture at Jackson Hole on 26 August that the current level of negative interest rates is still far from the lower limit, suggesting scope to push rates deeper into negative territory.

While we think the REIT market currently discounts some potential for interest rates to increase, we see a possibility of negative impact on the REIT sector if interest rates were to rise sharply over a short span amid speculation on the BOJ's next move as the September Monetary Policy Meeting approaches. Normally if interest rates rise and the yen strengthens too, we would expect a bigger correction in the stock market than in the REIT market. However, this could be offset by high-volume ETF buying by the BOJ. With the REIT sector unlikely to benefit as much as stocks from BOJ buying, we think a rapid rise in interest rates is a risk that should be noted in terms of relative performance versus stocks. That said, since the introduction of negative interest rate policy (NIRP), the gap between the average REIT yield and the 10-year JGB yield has widened. We think the REIT sector would be able to withstand a moderate rise in interest rates.

Expecting strong performances from hotel REITs on factors including attractive valuations

On 29 August the prices of hotel REITs rose as the yen weakened. Invincible Investment [8963] (Buy) rose 3.3% on the previous trading day, Japan Hotel REIT Investment [8985] (Buy) rose 2.6%, and Hoshino Resorts REIT [3287] (Buy) rose 1%. If the yen continues to weaken or at least does not re-strengthen amid speculation on near-term rate hikes in the US and additional monetary easing by the BOJ, we think hotel REITs will continue to perform well. Worry has emerged about changes in conditions in Japan's hotel market with the yen stronger than it was, domestic and overseas economies volatile, and new development on the rise. However, even without assuming sharp growth in the RevPAR (average occupancy times average room rate) at portfolio hotels, we think the valuations of Invincible Investment (16/12 dividend yield estimate is 4.8%) and Japan Hotel REIT (3.8%) are particularly attractive (Hoshino Resorts REIT's 16/10 dividend estimate is 3.5%).

Appendix A-1

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Materially mentioned issuers

Issuer	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Hoshino Resorts REIT	3287 JP	JPY 1,242,000	26-Aug-2016	Buy	N/A	A4,A5,A6,A7,A8,A11
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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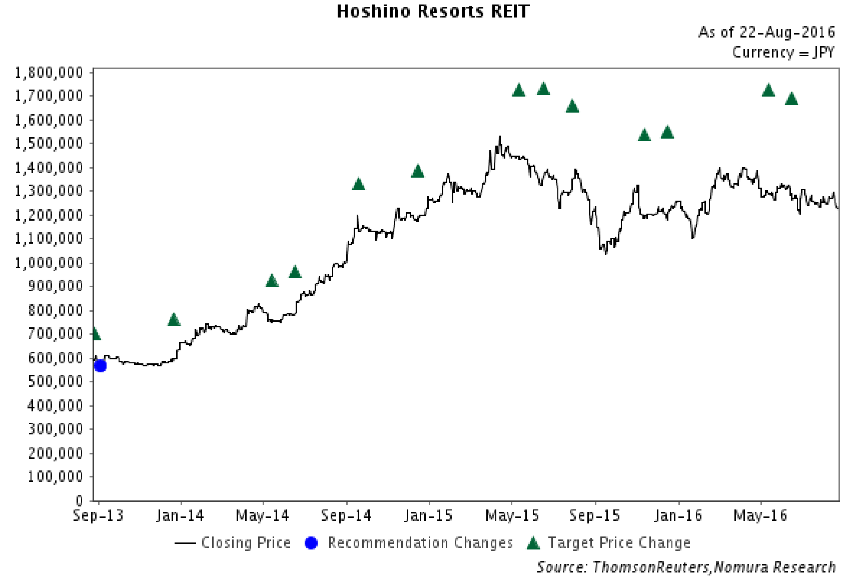
Hoshino Resorts REIT (3287 JP) **JPY 1,242,000 (26-Aug-2016)** Buy (Sector rating: N/A)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
15-Jun-16		1,692,000	1,290,000
12-May-16		1,725,000	1,289,000
15-Dec-15		1,553,000	1,181,000
12-Nov-15		1,535,000	1,189,000
30-Jul-15		1,661,000	1,350,000
17-Jun-15		1,732,000	1,365,000
11-May-15		1,725,000	1,447,000
15-Dec-14		1,388,000	1,184,000
18-Sep-14		1,334,000	1,154,000
16-Jun-14		963,000	785,000
13-May-14		923,000	752,000
20-Dec-13		759,000	598,000
27-Aug-13	Buy		591,000
27-Aug-13		700,000	591,000

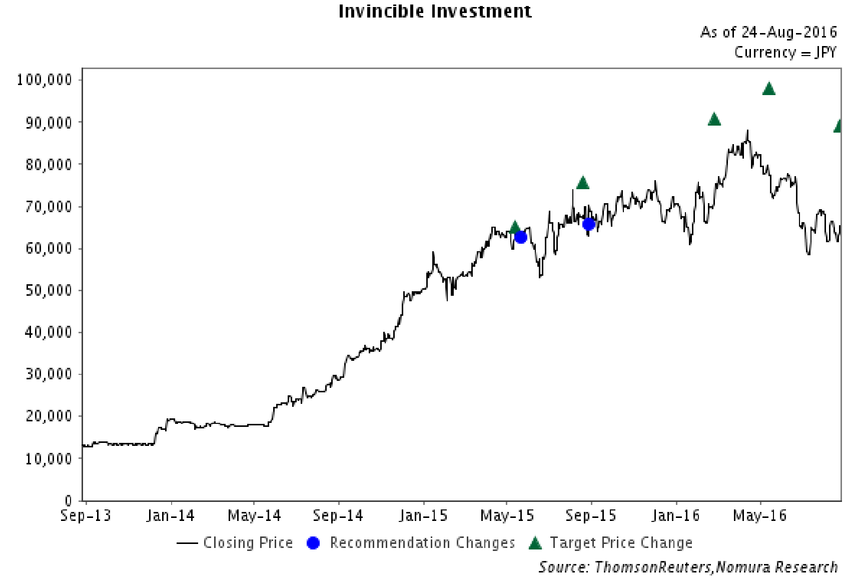
For explanation of ratings refer to the stock rating keys located after chart(s)

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, ¥1,408,000 and ¥1,977,000, respectively). Our target price for this REIT is ¥1,692,000, based on a fair-value dividend yield of 3.25%, a fair-value cap rate of 3.75%, and earnings forecasts for 16/10 and 17/4. The discount rates we use are around 25bp lower than the weighted-average dividend yield of 3.40% and weighted-average implied cap rate of 4.10% (as of 15 June) for 37 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 as a result of the departure of major tenants or substantial reductions in rents. We should 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 stock market participants. Factors that could cause the unit price to substantially outperform our target price include a major improvement in rental income, a large and effective reshuffling of assets with the sponsor, and a lower risk premium generally on real estate assets, including REITs, as a result of more aggressive monetary easing by the BOJ.

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

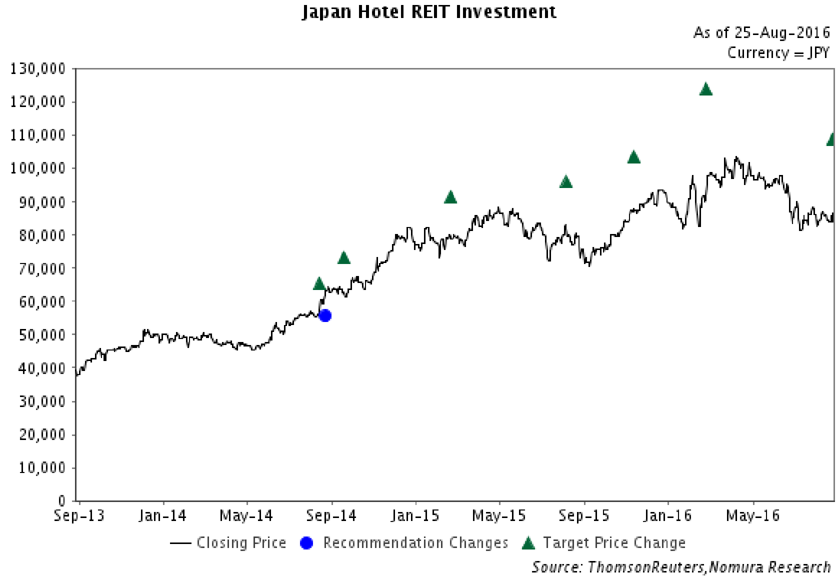
For explanation of ratings refer to the stock rating keys located after chart(s)

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.

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 as a result of the departure of major tenants or substantial reductions in rents. We should also note the possibility of capital losses or writeoffs 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, a large and effective reshuffling of assets with the sponsor, and lower risk premiums generally on real estate assets, including REITs, as the BOJ steps up its monetary easing policies.

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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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.

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