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EQUITY: JAPAN CONSTRUCTION & REAL ESTATE

Record gap for Mitsui Fudosan, Mitsubishi Estate

Mitsui Fudosan's implied cap rate at 6.5%

Global Markets Research

9 September 2016

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Spread between Mitsui Fudosan and Mitsubishi Estate's implied cap rates hits 1.9ppt, discount for Mitsui Fudosan is excessive in our view

Looking at the spread between the implied cap rates (based on our calculations) for Mitsui Fudosan [8801] and Mitsubishi Estate [8802] since 2003, we see that while the spread between the two companies' implied cap rates has narrowed from 2.6ppt in late August, it is still at an unprecedentedly high level of 1.9ppt based on 8 September closing prices. Except for the brief time when real estate stocks dropped sharply in the wake of the global financial crisis in 2008, Mitsui Fudosan's implied cap rate has been consistently higher than Mitsubishi Estate's, and the spread between the two companies cap rates has generally been around 0-1ppt. Even in September 2014, when Mitsui Fudosan's market cap was temporarily higher than Mitsubishi Estate's due to increased expectations for Mitsui Fudosan's profit growth following its capital increase in June 2014, the spread was still only 0.4-0.5ppt. We believe this is because real estate in the Marunouchi area (the focus of Mitsubishi Estate's portfolio) is valued higher than real estate in Nihonbashi (the focus of Mitsui Fudosan's portfolio), which results in a lower cap rate.

The spread between the two companies' implied cap rates started to widen significantly over the past range of 0-1ppt beginning in January 2016, and this picked up substantially from mid-June. In terms of fundamentals, at the beginning of 2016, the market became strongly aware of (1) the risk that Mitsui Fudosan's brand could be damaged when it came to light that there were construction problems involving the pilings for a large condominium building in Yokohama that the company had supplied and (2) the risk that the company might have to pay out compensation, including for rebuilding the condominium. Furthermore, around the time of the 23 June Brexit vote, the market appears to have priced in the risk that Mitsui Fudosan would be unable to sell off condominiums or find tenants for office buildings that it was developing in London. Like Mitsui Fudosan, Mitsubishi Estate also has real estate in London, so it faces risks from real estate prices in London and the possibility of asset values deteriorating due to a weakening in the pound sterling, but the company mainly rents out properties using long-term rental agreements and since it is not currently developing any properties in London, both we and the market consider its risks here to be relatively small. That said, it is our understanding that Mitsui Fudosan's brand has not been damaged by the condominium issue and that overall compensation for the issue amounts to around ¥40bn, of which a portion is expected to be charged to the construction company that was subcontracted to perform the work. It appears that Mitsui Fudosan's total investment for real estate under development in London amounts to around ¥180bn, but even if it ends up taking losses on half of this amount, its risk exposure, when combined with its portion of the compensation amount for the Yokohama condominium issue, looks to be around ¥100-120bn. We estimate that this equates to around 20-30bp in cap rate terms, so in our view, the recent gap in Mitsui Fudosan and Mitsubishi Estate's implied cap rates seems excessive.

Major projects this week (see page 2 for details)

- Obayashi [1802] joint venture handling central west zone of Nagoya Chuo Shinkansen station
- Obayashi joint venture chosen to construct New Shinagawa Station between Shinagawa Station and Tamachi Station
- Obayashi JV garners demolition contract for Marunouchi 1-3 project

Production Complete: 2016-09-09 08:58 UTC

Project details

Obayashi JV handling central west zone of Nagoya Chuo Shinkansen station
Central Japan Railway [9022] on 7 September announced that it had signed contracts with a joint venture of JR Tokai Construction, Maeda [1824], and JN Construction for the central east portion of construction on the Chuo Shinkansen Nagoya station and with a joint venture of Obayashi, JR Tokai construction, and Maeda for the central west portion. Work began on 6 September following the contract signing for both zones, and is scheduled for completion on 31 May 2019. The contract price has not been disclosed.

While JR Central had initially intended to sign contracts for the work on Nagoya Station itself before the end of March, the large scale and long duration of construction led the company to take a more cautious stance, and it had been putting off signing any contracts as it continued its talks with prospective contractors. The new Nagoya shinkansen station is scheduled to be constructed over roughly 1km intersecting the current conventional line station underground at a depth of 30m, and the portions on which work just began are the roughly 130m central east zone and the roughly 90m central west zone, which are within the site of the existing station. As the construction planned will use the cut-and-cover method, orders for the remaining zones will be made as the company makes progress on buying the necessary land. The company targets a start of construction for all portions of Nagoya Station by FY19. This construction mainly involves replacing the conventional line rails in the central east zone with construction girders and building the temporary piles and underground continuous walls for the foundations under the elevated shinkansen tracks in the central west zone. The company plans orders for various types of construction in these zones from here, but has not yet decided whether these will be separate or batch orders.

Construction has already begun on the New Shinagawa Station, the opposite terminus from Nagoya station on the new Chuo Shinkansen line. Construction for the north zone of the New Shinagawa Station (roughly 150m) will be handled by the Shimizu [1803]/Meiko Construction [1869]/Sumitomo Mitsui Construction [1821] JV, the south zone (roughly 300m) by the Obayashi/Kumagai Gumi [1861]/Toa [1865] JV, and the non-open cut zone (roughly 300m) by Hazama Ando [1719].

Obayashi joint venture chosen to construct New Shinagawa Station between Shinagawa Station and Tamachi Station
East Japan Railway [9020] on 6 September announced the overview of plans for the New Shinagawa Station (provisional name) to be constructed between Shinagawa and Tamachi stations on the Yamanote and Keihin Tohoku lines, and named the Obayashi/Tekken [1815] JV as the contractor. The JR East Consultants/JR East Design Corporation JV is responsible for the project design. Preparatory work will begin in September, while main construction is scheduled to begin at the beginning of 2017. A preliminary opening is planned for spring 2020, to be followed by a full opening around 2024. The plans call for a station 30m high with one underground floor, three floors above ground, and floor area of around 7,600m^2. The company also plans to invest roughly ¥500bn in redevelopment of the 130,000m^2 of land surrounding the new station. Construction is scheduled to begin after the 2020 Tokyo Olympics, with facilities scheduled to open as they are completed beginning in 2024.

Obayashi JV garners demolition contract for Marunouchi 1-3 project
The Obayashi/Taisei [1801]/Shimizu JV landed the contract for demolition work on the provisionally named Marunouchi 1-3 project, in which Mitsubishi Estate, the Japanese Bankers Association, and Mizuho Financial Group [8411] plan the combined redevelopment of the Ginko Kaikan, the Tokyo Bankers Association Building, and the former Mizuho Bank head office building. Obayashi was the original contractor for the former Mizuho Bank head office building. After demolition of these three existing buildings, the site will be used to construct a tower building with a height of around 150m, four floors below ground, and 29 floors above ground, with total floor area for the new buildings around 177,000m^2.Demolition work is scheduled to start in October 2016, with the main construction to start in December 2017, and completion targeted in FY20.

Appendix A-1

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

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