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Japan REIT sector

EQUITY: JAPAN REIT

Lowering TSE REIT Index range estimate

Factoring in rising interest rates, potential rise in equity market risk premiums

Global Markets Research

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Research analysts

Japan REIT

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Lowering TSE REIT Index range estimate on new interest rate assumptions, overhaul of REIT dividend outlook

We have trimmed our TSE REIT Index range estimate to reflect recent developments and future prospects on the financial/capital markets and within the REIT sector. In February 2016, we estimated a range for the TSE REIT Index over the subsequent 3-6 months of 1,715-1,995, and we stuck with this range the last time we revisited it in July. The TSE REIT Index has traded between 1,729.56 and 1,970.72 over the intervening period, and closed at 1,813.11 on 16 September. We have revised our range estimate because: (1) we have changed the 10-year JGB yield assumption we use in calculating our fair-value yield spread assumption for REITs from 0.2% to 0.3%; and (2) we have factored in recent dividends paid out by REITs. As a result, we have trimmed our range for the TSE REIT Index over the next 3-6 months from 1,715-1,995 to 1,700-1,950 (Figures 1 & 2).

Investors remain attracted to REITs for their high dividend yields and dividend reliability

The TSE REIT Index has outperformed the TOPIX by 18% on a year-to-date basis through 16 September. Yen appreciation and the uncertain outlook for the global economy have resulted in sustained concerns about corporate earnings. Investors have been particularly attracted to REITs for their high dividend yields and dividend reliability (specializing in rental properties, by law they have to return over 90% of profits to investors in the form of dividends) since the BOJ introduced its negative interest rate policy. With the Brexit vote still resonating and growing speculation about an interest rate hike in the US also contributing to a risk-off mood on global markets, we think that investors will remain attracted to REITs for their high dividend yields and dividend reliability, and expect them to continue to outperform equities as a whole.

Interest rates have been rising on expectations of BOJ policy moves and speculation that the Fed will hike rates

Meanwhile, interest rates have been on an upward trajectory for a while now. The last time we revisited our TSE REIT Index range estimate on 6 July, 10-year JGBs were yielding -0.270%. As of 16 September, this yield had improved to -0.04%. We do not assume negative interest rates for the purpose of calculating the appropriate yield spread for REITs. Indeed, negative interest rates can hardly be considered a natural state of affairs, given that the government and the BOJ are aiming to generate inflation and the consumption tax hike has been postponed despite ongoing concerns about a downturn in the state of Japanese public finances. Furthermore, speculation about a Fed rate hike is growing, while in Japan, speculation that the BOJ will move even further into negative interest territory may recede, and the BOJ may also signal that it is looking to steepen the yield curve. In response to these developments, we have raised the 10-year JGB yield assumption we use in calculating our fair-value yield spread assumption for REITs from 0.2% to 0.3%. While we retain our view that the fair-value yield spread is roughly equivalent to the risk premium, we have factored in developments on the equity markets (text continues on next page).

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REITs likely to keep on outperforming equities even if they fall in absolute terms
The REIT market has been stagnating recently, but performance has actually not been that bad. For example, the BOJ decided to roughly double its annual ETF purchasing program from around ¥3.3trn to around ¥6trn at its 29 July monetary policy meeting, while retaining its annual REIT purchasing program of around ¥90bn. The BOJ also refrained from taking interest rates even further into negative territory at this meeting, and interest rates subsequently rose, partly as a result of this. Despite less than favorable conditions for REITs, the TSE REIT Index still underperformed the TOPIX by only 2% between 29 July and 16 September, and it actually outperformed the TOPIX by 1.3% between 1 September and 16 September. We think this points to strong demand for REITs among investors under NIRP during risk-off phases.

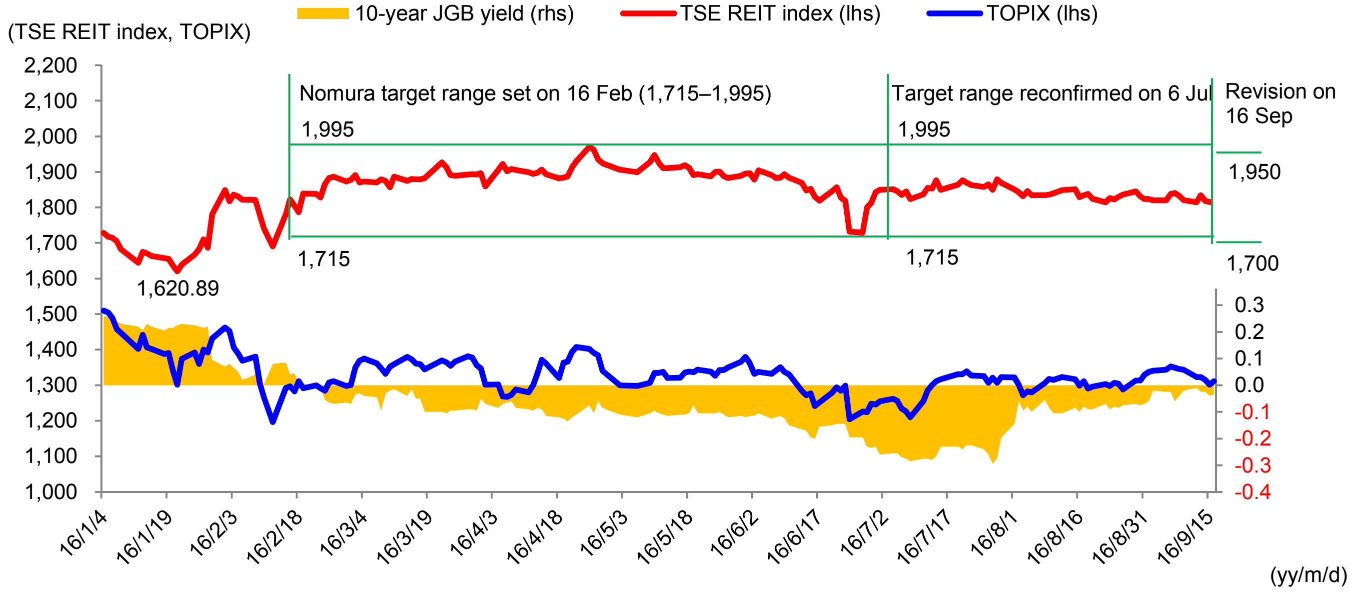
If anything, we think the equity market is in greater trouble, having become becalmed even though the BOJ has trebled annual ETF purchases. BOJ Governor Haruhiko Kuroda is scheduled to present the results of the BOJ's comprehensive assessment of monetary policy and indicate the direction of future policy at the next monetary policy meeting scheduled for 20-21 September. Depending on what he says, we could see an even stronger correction in the equity market (barring a bold program of additional monetary easing). The REIT market does not look to have factored in any additional easing by the BOJ, partly because it refrained from increasing its annual budget for REIT purchases at the July monetary policy meeting. As a result, we see little risk of a REIT sell-off prompted by disappointment at the failure of the BOJ to implement additional easing at the 20-21 September meeting. That said, REITs are a type of Japanese listed equity instrument, and a general correction in the Japanese equity market would almost certainly push up risk premiums. On the other hand, we do not think that the correction in the REIT market would be as large as the correction in the equity market because REITs have high dividend yields and pay out dividends reliably, and because expectations of additional monetary easing by the BOJ have not been factored in. Meanwhile, even if the BOJ were to implement additional monetary easing, we do not think that this would result in a sharp reduction in risk premiums for Japanese equities as a whole, nor do we believe that this would be enough to encourage a sustained market rally.

Dividend growth at REITs has been slowing, but no need to worry about falling dividends
Concerns have also arisen about changing operating conditions at REITs because of the uncertain outlook for the macro economy and for corporate earnings. However, portfolio occupancy has remained high to date throughout the REIT sector regardless of property type. Moreover, office REITs have generally managed to hike rents over the past few years (according to ARES, average rents at office buildings in the 23 wards of Tokyo owned by REITs and private funds rose 3.6% between end-May 2014 and end-May 2016). RevPAR (average occupancy × average room rate) has also continued to rise at hotel REITs. Invincible Investment [8963] (Buy) is projecting a 6.3% y-y rise in RevPAR at existing hotels in 16/12, while Japan Hotel REIT Investment [8985] (Buy) is projecting an 8.4% rise in RevPAR at hotels in its three main formats in 2016.

Tight supply-demand conditions for high-quality rental housing have also led to an increase in the proportion of rent rises at housing REITs. Data from the five housing REITs that have released FY16 H1 results to date reveal that on average, 50% of new tenants at existing properties paid higher rents than the previous tenants. This ratio has been on a consistent upward trajectory since coming in at 29% in FY12 H1. In addition, the opening of numerous large new distribution facilities has had hardly any impact on operating conditions at logistics REITs. According to JITA statistics, occupancy at the 236 logistics facilities owned by REITs averaged 99.0% at end-July 2016. Elsewhere, some commercial REITs have been affected recently by tenant departures, for example by a specific general merchandiser, but there has been no general increase in departures by major tenants or portfolio vacancies. Indeed, JITA statistics indicate that occupancy at the 398 commercial facilities owned by REITs averaged 99.3% at end-July 2016. Earnings also remain stable at healthcare REITs that lease out entire properties to operators. There are currently three healthcare REITs in Japan, Nippon Healthcare Investment [3308], which listed in November 2014, Healthcare & Medical Investment [3455], which listed in March 2015, and Japan Senior Living Investment [3460], which listed in July 2015. While none of them has an especially long track record, they have nevertheless maintained 100% occupancy since listing (in other words, there have been no vacancies as a result of operators ending tenancies). There have also been no signs of demands for rent reductions from tenants.

Growth in dividends generated by all listed Japanese REITs has slipped from 7.1% in FY15 to 4.7% in FY16 (data through 16 September). However, we see no need for concern about falling dividends, given portfolio conditions at REITs specializing in all different types of property and their ongoing commitment to avoiding capital increases that result in DPU dilution. We think that REITs will outperform equities. From the perspective of operations and valuations, we recommend REITs including Invincible Investment [8963] (Buy), LaSalle Logiport REIT [3466] (Buy), Japan Retail Fund Investment [8953] (Buy), Sekisui House SI Residential Investment [8973] (Buy), and Japan Hotel REIT Investment [8985] (Buy).

Fig. 1: TSE REIT Index performance, TOPIX, and 10-year JGB yield since setting of target range in February



Source: Nomura, based on TSE data

Fig. 2: TSE REIT Index target range

	TSE REIT index	Dividend yield %	10-year JGB yield %	Yield spread bp	P/NAV x		
	1,200	5.39	0.30	509	0.80		
	1,250	5.17	0.30	487	0.83		
	1,300	4.97	0.30	467	0.86		
	1,350	4.79	0.30	449	0.90		
	1,400	4.62	0.30	432	0.93		
	1,450	4.46	0.30	416	0.96		
	1,500	4.31	0.30	401	1.00		
	1,550	4.17	0.30	387	1.03		
	1,600	4.04	0.30	374	1.06		
	1,650	3.92	0.30	362	1.09		
	1,700	3.80	0.30	350	1.13	New downside support level	Yield spread of 350bp assuming 10-year JGB yield of 0.3%
	1,715	3.77	0.30	347	1.14	Previous downside support level	Yield spread of 350bp assuming 10-year JGB yield of 0.2%
	1,750	3.69	0.30	339	1.16		
16 Sep TSE REIT closing price 1,813.11→	1,800	3.59	0.30	329	1.19		
	1,850	3.50	0.30	320	1.23		
	1,900	3.40	0.30	310	1.26		
	1,950	3.30	0.30	300	1.29	New target	Yield spread of 300bp assuming 10-year JGB yield of 0.3%
	1,995	3.24	0.30	294	1.32	Previous target	Yield spread of 300bp assuming 10-year JGB yield of 0.2%
	2,000	3.23	0.30	293	1.33		
	2,050	3.15	0.30	285	1.36		
	2,100	3.08	0.30	278	1.39		
	2,150	3.01	0.30	271	1.43		
	2,200	2.94	0.30	264	1.46		
	2,250	2.87	0.30	257	1.49		
	2,300	2.81	0.30	251	1.53		

Source: Nomura

Appendix A-1

Analyst Certification

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Materially mentioned issuers

Issuer	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
LaSalle LOGIPORT REIT	3466 JP	JPY 106,900	16-Sep-2016	Buy	N/A	A4,A5,A6,A7,A8,A11
Japan Retail Fund Investment	8953 JP	JPY 245,800	16-Sep-2016	Buy	N/A	A4,A5,A6,A11
Invincible Investment	8963 JP	JPY 56,400	16-Sep-2016	Buy	N/A	A4,A5,A6,A7,A8,A11
Sekisui House SI Residential Investment	8973 JP	JPY 121,700	16-Sep-2016	Buy	N/A	A6,A11
Japan Hotel REIT Investment	8985 JP	JPY 85,500	16-Sep-2016	Buy	N/A	A4,A5,A6,A11

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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.

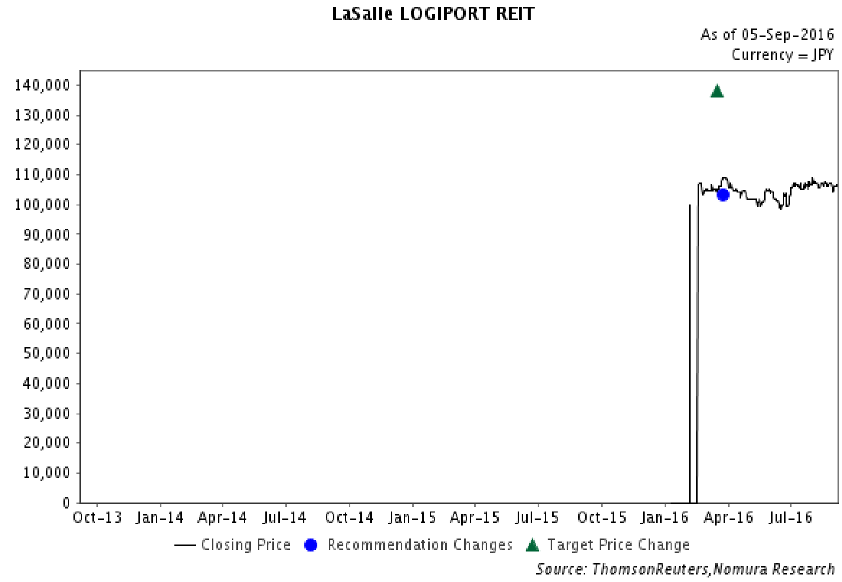
A7 The Nomura Group has managed or co-managed a public or Rule 144A offering of the issuer's securities in the past 12 months.

A8 Nomura Securities Co., Ltd., has lead managed a public offering of equity or equity linked securities of the issuer in the past 12 months.

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

LaSalle LOGIPORT REIT (3466 JP) **JPY 106,900 (16-Sep-2016)** Buy (Sector rating: N/A)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
16-Mar-16	Buy		105,300
16-Mar-16		138,000	105,300

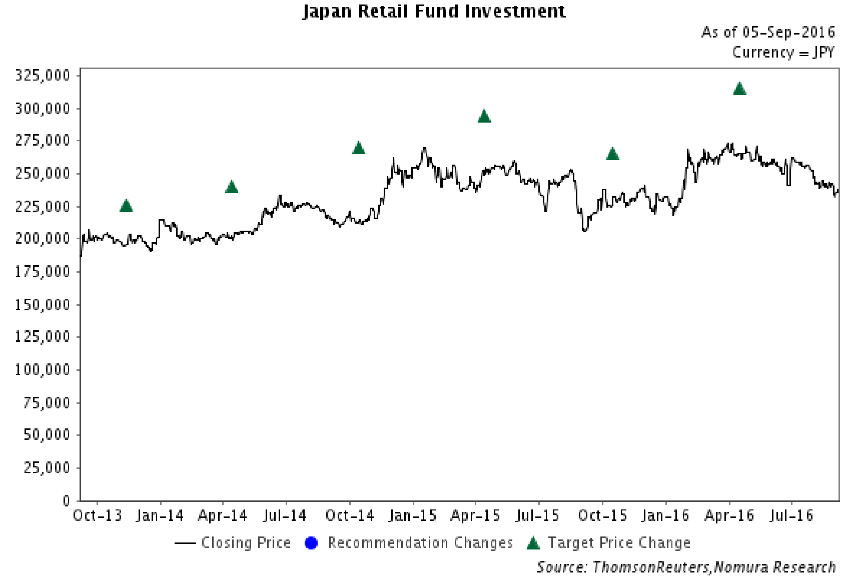
For explanation of ratings refer to the stock rating keys located after chart(s)

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, ¥156,000 and ¥121,000, respectively). Our target price for this REIT is ¥138,000, based on a fair-value dividend yield of 3.25%, a fair-value cap rate of 4.0%, and earnings forecasts for 17/8. We apply discount rates close to the weighted average dividend yield of 3.32% and the weighted average implied cap rate of 4.04% (as of 14 March) for the 35 REITs under our regular 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 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.

Japan Retail Fund Investment (8953 JP) **JPY 245,800 (16-Sep-2016)** Buy (Sector rating: N/A)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
15-Apr-16		315,000	265,900
15-Oct-15		265,000	225,500
13-Apr-15		294,000	248,600
14-Oct-14		270,000	213,700
14-Apr-14		240,000	202,000
12-Nov-13		226,000	196,400

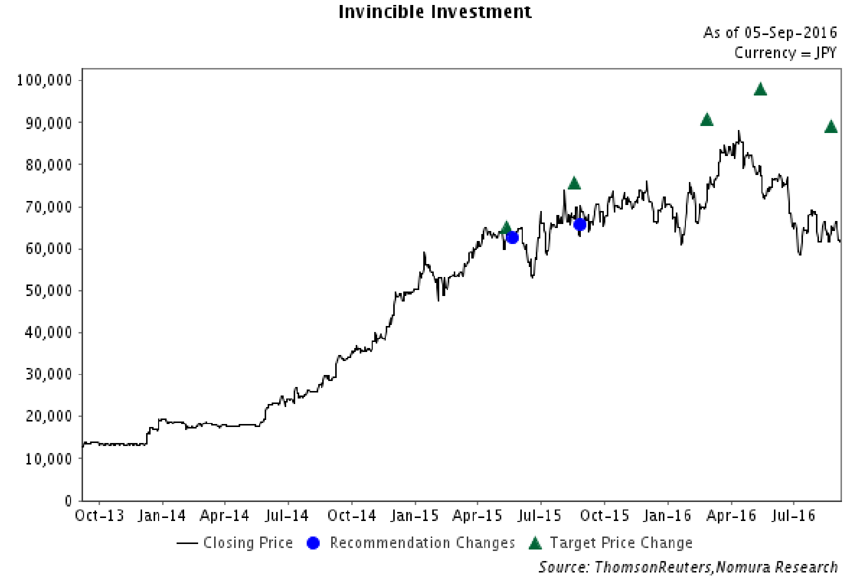
For explanation of ratings refer to the stock rating keys located after chart(s)

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, ¥310,000 and ¥320,000, respectively). Our target price for this REIT is ¥315,000, based on a fair-value dividend yield of 2.75%, a fair-value cap rate of 3.5%, and earnings forecasts for 16/8 and 17/2. The discount rates we use are around 50bp lower than the weighted-average dividend yield of 3.30% and weighted-average implied cap rate of 4.01% (as of 14 April) for 36 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 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.

Invincible Investment (8963 JP) **JPY 56,400 (16-Sep-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

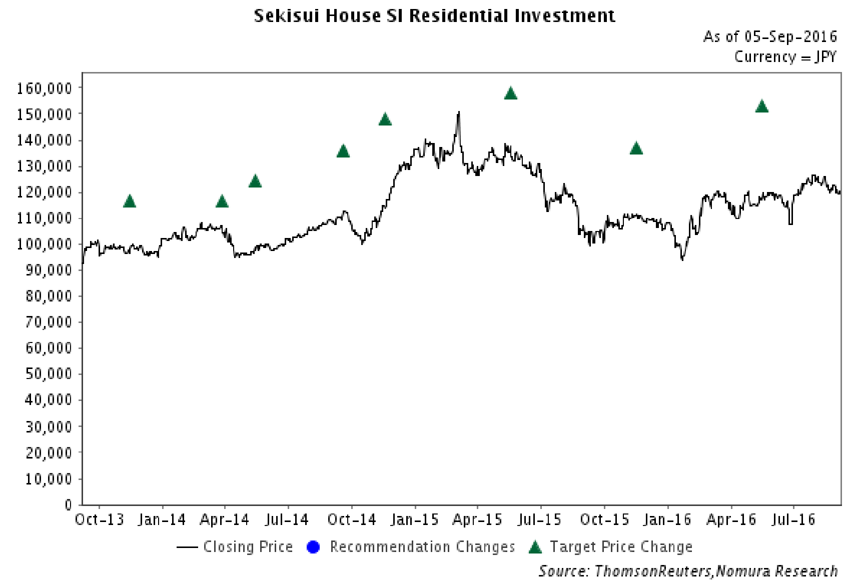
For explanation of ratings refer to the stock rating keys located after chart(s)

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.

Sekisui House SI Residential Investment (8973 JP) **JPY 121,700 (16-Sep-2016)** Buy (Sector rating: N/A)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
16-May-16		153,000	117,000
16-Nov-15		137,000	111,400
18-May-15		158,000	137,300
17-Nov-14		148,000	113,600
18-Sep-14		136,000	111,900
14-May-14		124,000	98,600
27-Mar-14		116,400	107,300
14-Nov-13		116,400	98,000

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

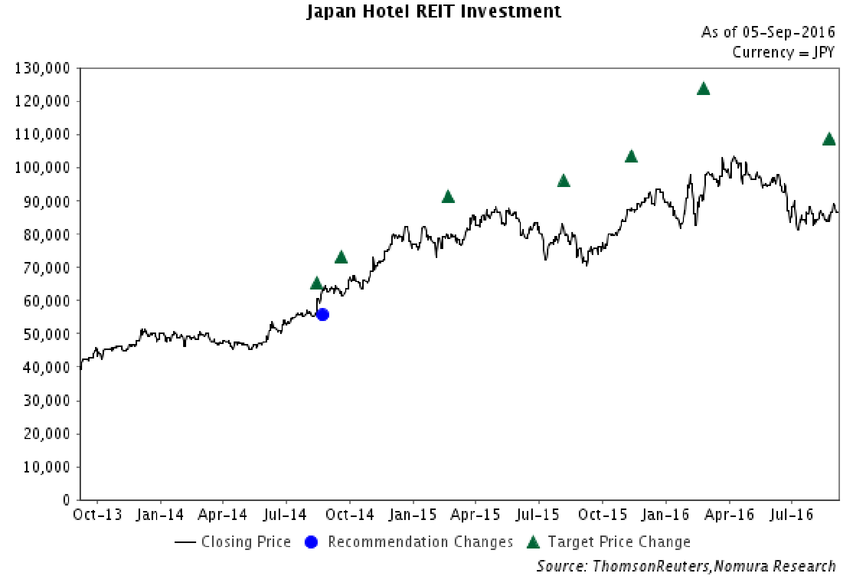
Valuation Methodology For REITs, our target price is the simple average of two theoretical prices derived from the fair-value dividend yield and the fair-value cap rate (in this case, ¥143,000 and ¥163,000, respectively). Our target price for this REIT is

¥153,000, based on a fair-value dividend yield of 3.0%, a fair-value cap rate of 3.75%, and earnings forecasts for 16/9 and 17/3. The discount rates we use are around 25bp lower than the weighted-average dividend yield of 3.35% and weighted-average implied cap rate of 4.07% (as of 16 May) for the 37 REITs under our coverage.

Risks that may impede the achievement of the target price Risk factors 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 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 the yields demanded by REIT 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 lower risk premiums generally on real estate assets, including REITs, as a result of more aggressive monetary easing by the BOJ.

Japan Hotel REIT Investment (8985 JP) **JPY 85,500 (16-Sep-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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STOCKS

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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

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