J-REITs Strive to Sustain Earnings Stability—Market Safety Net Improves but Challenges Remain

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Amid the global financial crisis and deteriorating real estate market fundamentals, the J-REIT market is entering a grueling phase that will challenge the earnings stability of J-REITs. New policies to support cash flow and enhance the market safety net have improved the robustness of the J-REIT system against external shocks, but the development of a disciplined market will require further enhancements to shareholder protection and corporate governance.

1. Introduction

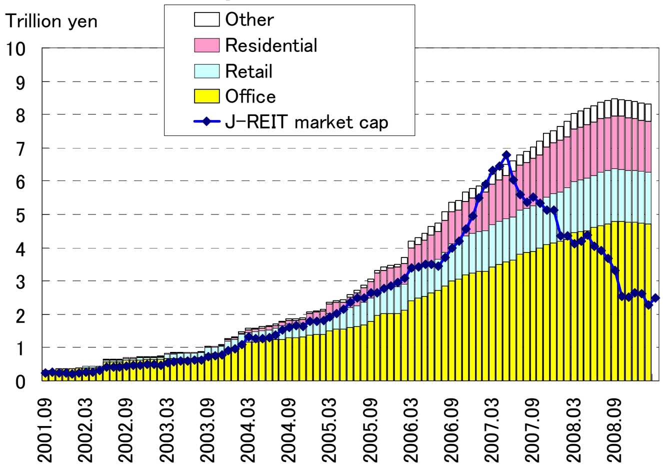
In the wake of the U.S. subprime mortgage meltdown and ensuing global financial crisis, Japan's faltering economy has dealt a sharp blow to the domestic real estate market, as seen by the prominent failures of emerging real estate companies and a steep slide in the office market.

The TSE J-REIT stock market has not been spared from the havoc. Following its September 2001 debut, the market grew vigorously as the scope of J-REIT properties expanded from office properties to commercial and residential properties. But while the total value of J-REIT properties still remains near the recent peak of slightly over 8 trillion yen, the TSE REIT index has plummeted approximately 70% since the May 2007 peak. As a result, the total market capitalization of J-REITs plunged from a high of 6.8 trillion yen in May 2007 down to 2.5 trillion yen in March 2009 (Exhibit 1).

J-REIT, or Japanese real estate investment trust, is an investment vehicle for operating a real estate leasing business. Funds are raised from investors and lenders, and the J-REIT enjoys a tax exempt status as long as it distributes at least 90% of earnings as dividends.

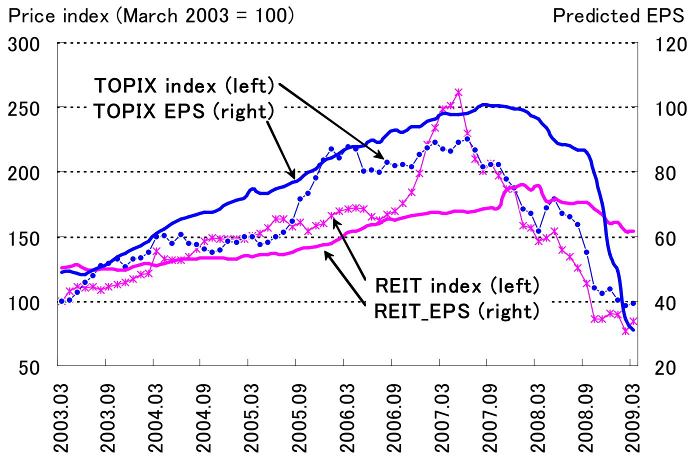
While the cash flow generated from income producing properties reflects real estate fundamentals such as rent and occupancy rate trends, it is essentially stable and defensive against business cycles. In fact, the predicted EPS of J-REITs dipped only slightly in the tumultuous second half of 2008, compared to the precipitous decline

Exhibit 1 Assets Under Management and Market Capitalization of J-REITs



Source: Compiled with materials from Investment Trusts Association, Japan.

Exhibit 2 Predicted EPS and Stock Price Performance of J-REITs and TOPIX



Sources: Predicted EPS for TOPIX is obtained from IBES TOPIX 12MTH FWD; for J-REITs, predicted EPS is aggregated from releases of individual J-REITs.

among domestic stocks tracked by the TSE TOPIX due in part to large losses at some companies (Exhibit 2). [1]

However, the earnings stability of J-REITs has failed to be reflected in their stock price performance. In fact, J-REIT shares have shown much greater volatility than the broad-based TOPIX. This contrast was heightened in October 2008, when New City Residence Investment Corporation shattered investor confidence in J-REITs by becoming the first J-REIT to file for bankruptcy under the Civil Rehabilitation Law. [2]

In response, the government began revising policies late last year to bolster the J-REIT system and inject public funds to sustain cash flows. As a result of the enhanced market safety net, the gloomy sentiment surrounding the NCRI failure has gradually started to lift.

As financial products, J-REITs excel in terms of disclosure transparency and earnings stability. However, for investors to better understand and appreciate these features, J-REITs need to fully demonstrate their robustness to external changes and exercise greater discipline to protect shareholder interests.

Drawing on individual J-REIT financial statements, below we analyze their aggregated balance sheet and predicted earnings per share, examine aspects of the recent market slump along with corresponding policy responses, and consider the challenges in promoting the development of a disciplined market.

2. Earnings Stability of J-REITs

1. J-REIT Balance Sheet

Based on the most recent disclosures of the 41 listed J-REITs, we first examine the condition of the aggregate balance sheet.

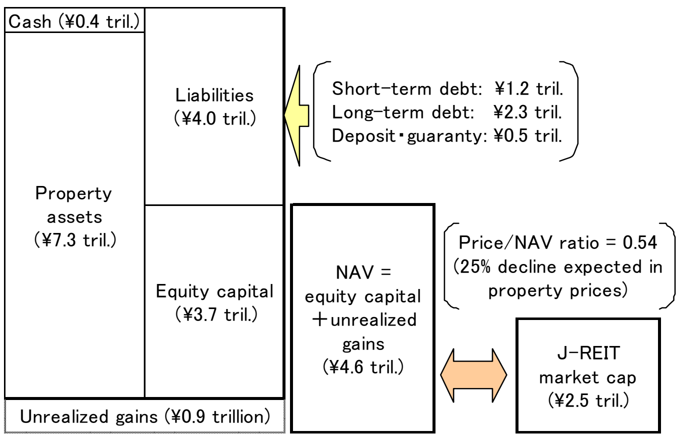
Liabilities and equity consist of 3.7 trillion yen of equity capital, and 4.0 trillion yen of liabilities in the form of loans and investment corporation bond issues, for a total of 7.7 trillion yen. Of this amount, 7.3 trillion yen is invested in income properties, and the remaining 0.4 trillion yen is held in cash (Exhibit 3).

Based on appraised property values disclosed in each six-month reporting period, unrealized gains (appraised value minus book value) amounted to 0.9 trillion yen in the second half of 2008. This amount is added to equity capital to obtain a net asset value (NAV) of 4.6 trillion yen. By comparison, the total market capitalization of J-REITs is only 2.5 trillion yen. Thus the ratio of market cap to NAV, or price-to-book ratio (PBR), is only 0.54, indicating that investors anticipate property prices will decline approximate 25%. [3]

Exhibit 4 shows how net operating income (NOI, or rental income minus management and operating expenses) is distributed across the following components: depreciation expense, which is largely proportional to outstanding assets (24%); other expenses (3%); compensation paid to asset manager (8%); interest expense (15%); and dividend distribution to investors (50%). For each component, the return on assets is shown in parentheses.

From the above, the financial structure of J-REITs can be described by the following characteristics: (1) the financial structure

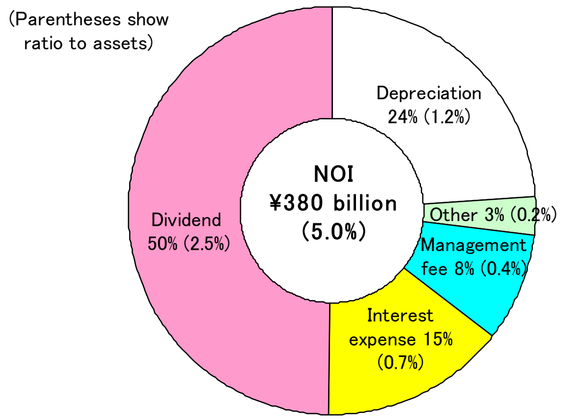
Exhibit 3 J-REIT Balance Sheet



Note: Shows results of 41 listed J-REITs from July to December 2008; cash is adjusted using parts of assets, liabilities, and retained earnings.
Source: Compiled from J-REIT disclosures.

is simple due the fact that real estate properties comprise the majority of assets, resulting in highly transparent disclosure; (2) earnings are stable, which provides an adequate buffer against interest expense (NOI is six to seven times larger than interest expense) despite liquidity constraints such as a low cash-to-liabilities ratio; and (3) dividend distributions can be explained by fluctuations in NOI (excluding realized gains from property transactions) and interest expense.

Exhibit 4 Disbursement of NOI (2008)



Notes: Shows results of 41 listed J-REITs from January to December 2008.
Source: Compiled from J-REIT disclosures.

2. EPS Analysis

We next examine the historical performance of EPS. For consistency, one-time factors such as realized gains from transactions are excluded from current earnings, and necessary adjustments have been made including corrections to the number of outstanding shares of some J-REITs.

As seen in Exhibit 5, when scaled to 2003 1H = 100, the aggregated EPS has dipped only to 96 as of 2008 2H, indicating that EPS has remained extremely stable during this period.

EPS can be rewritten as a function of return on assets (ROA), book value per share (BPS), and leverage ratio as follows:

$$EPS = ROA + BPS + 1/1-LTV$$

where LTV is the loan-to-value ratio. When the three components rise (or fall), EPS also rises (or falls).

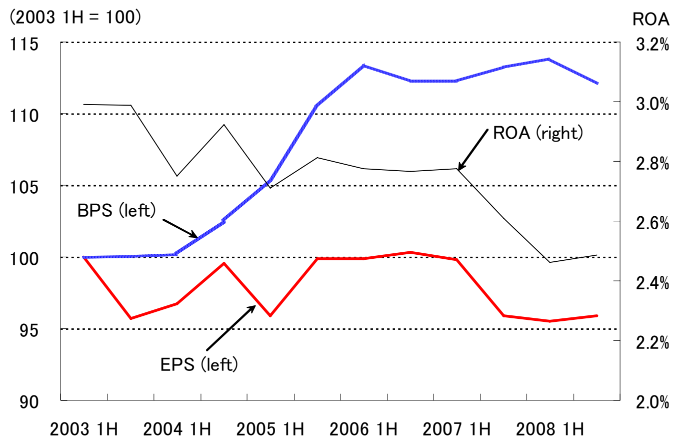
In the past, EPS was maintained by managing the leverage ratio at approximately 2.0 (LTV = 50%) and offsetting the falling ROA with a higher BPS. The falling ROA is attributed to the shrinking spread between NOI and interest payment (from 5.2% to 4.4%). Although the effect of the NOI decline was more pronounced at first, it has recently been overshadowed by the growing interest payment (Exhibit 6).

These trends reflect the following investment behaviors of J-REITs: (1) shares were issued at a price that exceeded BPS (causing BPS to rise); (2) debt financing was pursued (raising LTV to 50%); (3) properties were acquired in the real estate market recovery that

Exhibit 5 J-REIT Earnings Analysis

	EPS	2003 1H = 100	ROA (annual)	BPS	2003 1H = 100	Lev. ratio	LTV
2003 1H	15,341	100	3.0%	521,025	100	2.0	49%
2003 2H	14,678	96	3.0%	521,242	100	1.9	47%
2004 1H	14,834	97	2.8%	522,122	100	2.1	52%
2004 2H	15,268	100	2.9%	534,149	103	2.0	49%
2005 1H	14,708	96	2.7%	549,230	105	2.0	49%
2005 2H	15,318	100	2.8%	575,424	110	1.9	47%
2006 1H	15,316	100	2.8%	590,894	113	1.9	46%
2006 2H	15,387	100	2.8%	585,194	112	1.9	47%
2007 1H	15,307	100	2.8%	585,251	112	1.9	47%
2007 2H	14,716	96	2.6%	590,249	113	1.9	48%
2008 1H	14,653	96	2.5%	593,024	114	2.0	50%
2008 2H	14,709	96	2.5%	584,291	112	2.0	51%

EPS, ROA and BPS Trends



Note: Shows aggregated results of 41 listed J-REITs; excludes initial results after listing.
Source: Compiled from J-REIT disclosures.

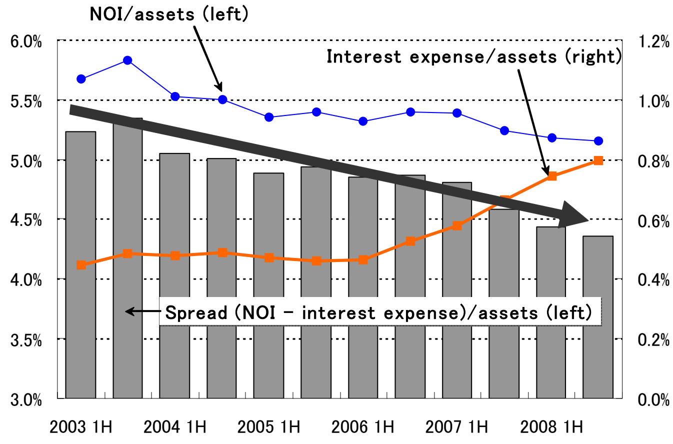
performed below the existing portfolio return (decline of NOI reduced ROA); (4) despite efforts to maintain NOI by raising rents, borrowing costs rose due to credit tightening by lenders (lower ROA).

In addition to the increasingly severe lending environment, with the real estate market turning downward—the office vacancy rate rose above 6% in central Tokyo and advertised rents have fallen 7% from the peak level—the question is whether EPS stability can be maintained going forward (Exhibit 7).

At present, it is difficult to boost EPS using financial controls to raise either BPS (with capital increases) or LTV (with increased debt). This leaves little choice but to accept the ROA decline and shrinking spread as NOI return decreases and interest payments increase.

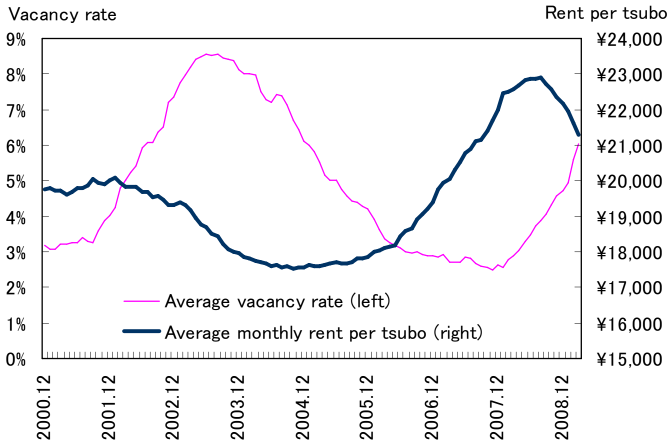
Looking ahead, difficult market conditions will test the property and financial management expertise of asset managers. Those who can minimize the EPS decline and gear up for an earnings recovery in the next cycle will stand out. Meanwhile, J-REITs will face market scrutiny as to whether their reputation for earnings stability remains intact.

Exhibit 6 Factors That Reduce ROA



Note: Assets = (Assets at end of last period + Assets at end of current period)÷2.
Source: Compiled from J-REIT disclosures.

Exhibit 7 Tokyo Central 5-Ku Office Market



Source: Compiled using data from Miki Shoji.

3. The Enhanced Market Safety Net

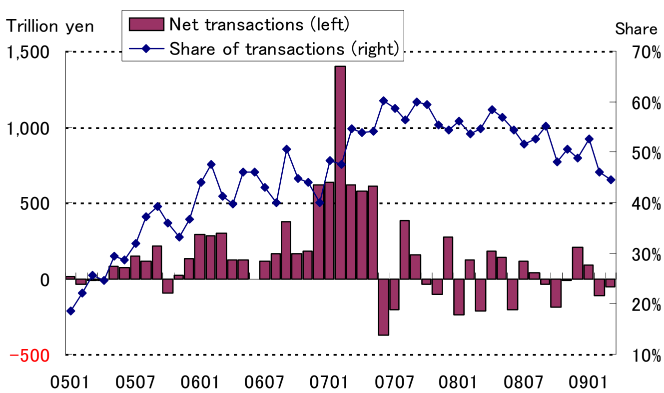
1. Growing Concerns About Refinancing

Below we examine why the market has overlooked the earnings stability of J-REITs, causing share prices to plunge far below the NAV since last year.

Major factors include the growing risk premium of real estate, and impact of large foreign capital flows amid the global excess liquidity situation. A particularly important factor was the Lehman Brothers shock in September 2008, which triggered serious concerns about cash flow (Exhibit 8).

J-REITs selectively invest in investment grade properties that have undergone due diligence, been securitized for trust

Exhibit 8 J-REIT Investment by Foreign Investors



Source: Tokyo Stock Exchange

beneficiary rights, and are professionally managed. Despite property-specific differences, J-REIT properties generated a cash flow exceeding a 5% return on average, while enjoying a high occupancy rate of 95% in the most recent period (Exhibit 9). In addition, since development activity is generally prohibited, J-REITs are distinct from real estate liquidization projects and funds, whose aims are development and short-term resale. J-REITs are also not exposed to exchange rate risk because they do not invest abroad.

However, a growing number of J-REITs such as NCRI have difficulty refinancing loans due to the inferior creditworthiness of their sponsors. NCRI's bankruptcy highlighted this problem, triggering strong concerns about the sustainability of the J-REIT system.

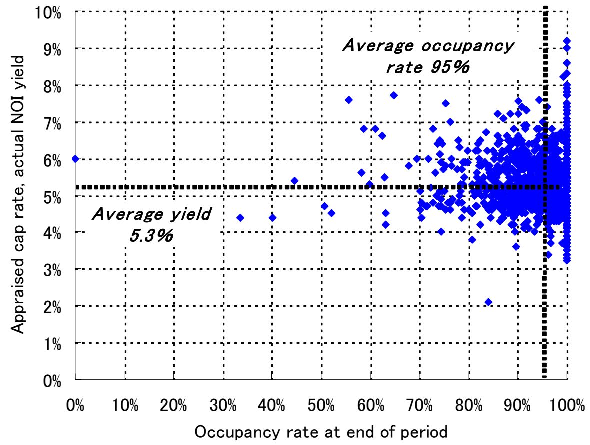
2. Announced Policy Reforms and Measures to Support Cash Flow

In the past, despite persistent demands for reforms to diversify financing methods and revise tax exemption requirements, regulatory authorities have not always been responsive.[4]

But on October 28, 2008, immediately after NCRI's bankruptcy filing, the Ministry of Land, Infrastructure and Transportation responded by organizing a "Forum to Establish a Real Estate Market That Earns the Confidence of Investors." The event discussed key issues confronting J-REITs such as the need for and potential impact of M&A activity, and enhancement of financing methods. The results of the event were disseminated widely to investors, and two types of policies were soon announced, including one measure still under study: (1) cash flow support for J-REITs; and (2) enhancement of the J-REIT infrastructure and creditworthiness. The new policies have brought about rapid progress in enhancing the safety net of the J-REIT market (Exhibit 10).

Moreover, in January 2009, when the Bank of Japan revised its collateral eligibility criteria to include J-REIT bonds, Governor Masaaki Shirakawa remarked that the J-REIT market was "a key component of the real estate securitization market that has reached a considerable size." This statement was significant in that it recognized the J-REIT market as a public institution that

Exhibit 9 J-REIT Properties (2008 2H)



Note: For 1,763 properties; excludes those acquired in current period.
Source: Compiled from J-REIT disclosures.

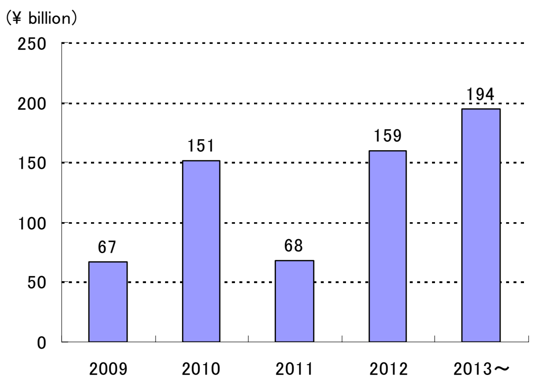
Exhibit 10 New Policies for J-REITs

① Cash flow support
Development Bank of Japan provides loans from Crisis Response Operations of the Japan Finance Corporation
Enhanced monitoring by FSA of J-REIT cash flows
Under study
Establishment of joint public-private investment fund for funds of DBJ & Japan Post Bank

② Infrastructure and creditworthiness
Regarding the requirement to distribute 90% of earnings, profit is defined as account book profit, not taxable income
BOJ revised collateral eligibility criteria to include J-REIT bonds (AA rating or better)
Removal of barriers to J-REIT M&A activity ・Adjustments for negative good will (out of dividends) ・Rules for handling of fractional shares (M&A cash-out)
Partial revision of Comprehensive Guidelines for Superivision of Financial Instruments Business Operators ・Stricter stance on conflict of interest in transactions ・New rules concerning forward commitments
Under study
Addition of J-REITs to eligibility list of Banks' Shareholdings Purchase Corporation

Source: Compiled from publicly available materials.

Exhibit 11 Redemption of J-REIT Bonds



Source: Compiled from publicly available materials.

can influence the financial system.

However, it remains to be seen whether these measures will have more than an announcement effect, and actually help prevent further business failures and revitalize the market. Given the difficulty of issuing new bonds to refinance those coming due, much is riding on the new policy loans from the Development Bank of Japan (funded by the Crisis Response Operations of the Japan Finance Corporation) and the prospects for M&A activity to consolidate the industry (Exhibit 11).

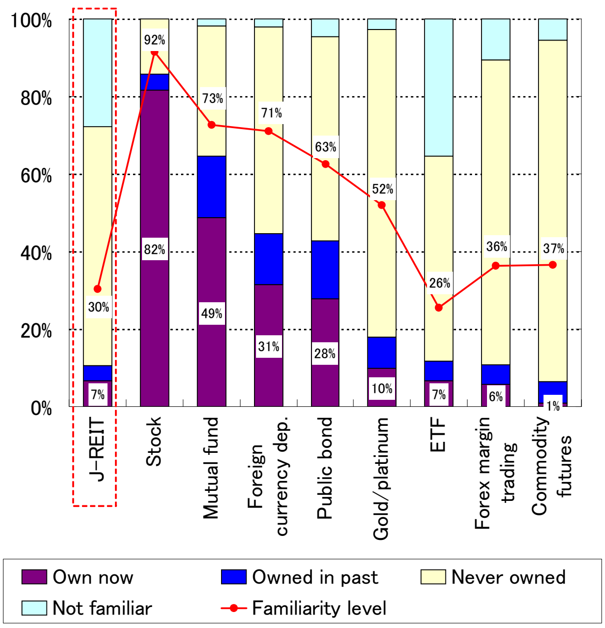
4. Further Enhancement of Investor Confidence

1. Market Growth and Discipline

The J-REIT market grew vigorously until the first half of 2007 as new sponsors flooded into the J-REIT market, but at some point the market began to lose discipline. Participants should ask themselves whether they compromised the spirit of fiduciary duty by not putting shareholder interests first and foremost.

Cases of improper conduct have been reported at some J-REITS, including the administrative reprimand of asset managers for inappropriately influencing property appraisers when making acquisitions, sudden change of operating guidelines to acquire specific properties, and share dilution due to new share issuance at discounted prices. [5] To improve investor confidence and ensure the development of a disciplined market, a thoroughgoing approach is needed to protect shareholder interests and enhance shareholder participation in governance.

Exhibit 12 J-REIT Awareness Survey (Individuals)



Note: Familiarity level shows percent of respondents who are aware of the product and its contents.
Source: Compiled using data from Association for Real Estate Securitization

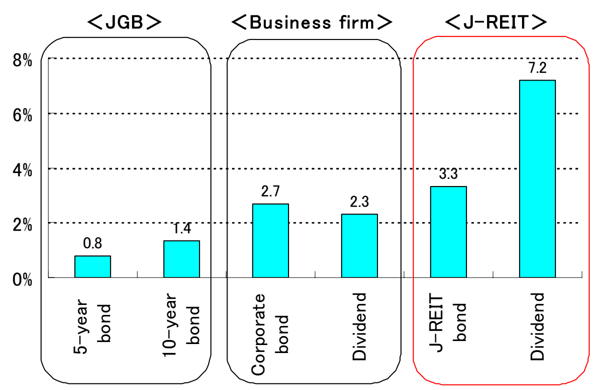
2. Guidelines to Protect Shareholder Interests

Protection of shareholder interests is a particularly urgent issue. To ensure the market's stability and growth, it is important to expand the range of investors by educating individual investors, whose knowledge of J-REITs is limited compared to other financial products (Exhibit 12). [6] The high dividend yield of J-REITs should be an appealing feature for them (Exhibit 13).

However, since last year, a number of cases have been announced in which EPS plummeted due to factors such as third-party stock issues at prices below book value, and property sales at prices far below appraised values (Exhibit 14).

Asset managers, who bear fiduciary duty toward investors, need to possess a spirit of legal compliance as well as high ethical standards. However, a considerable disparity

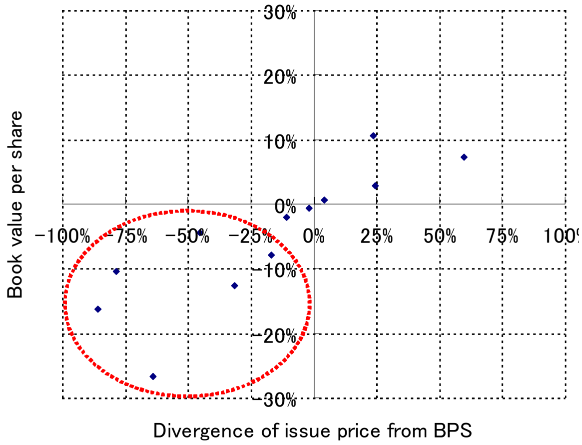
Exhibit 13 Comparison of Yield (March 2009)



Note: Corporate bonds are rated A by R&I, with 5 years to maturity. J-REIT bonds are rated A or better, with market quotations available. (4.2 years to maturity)
Source: Compiled using data from Association for Real Estate Securitization.

now exists among asset managers. It is time for the industry to draft common guidelines to protect shareholder interests on issues such as share dilution through third-party stock issues, enhanced disclosure and accountability of property transactions, and bankruptcy filing under the Civil Rehabilitation Law.

Exhibit 14 Third-Party Stock Issues



Source: Compiled from disclosures.

3. Creating a New Asset Manager Category

Since J-REITs outsource the management of properties to asset managers, conflicts of interest are always likely to arise. For this reason, shareholders must build mutual trust with and the asset manager at the same time keep a watchful eye. In principle, they lose the confidence of shareholders, asset managers are supposedly dismissed and weeded out of the market. However, as the NCRI case showed, it is difficult in practice for shareholders to dismiss or replace the asset manager due to a breakdown in the corporate governance system. [7]

To enhance the market's cleansing effect and empower shareholders to say "No" to disagreeable asset managers, one possibility is for the public and private sector to jointly create a new category of asset manager whose creditworthiness is backed by the government. Thus if an existing asset manager shows a lack of fiduciary duty, or is incapacitated by loss of creditworthiness due to the sponsor's bankruptcy, shareholders could submit a proposal at the annual shareholders' meeting to install the new asset manager. In addition, the new asset manager could step in to replace asset managers who wish to withdraw from J-REIT operation, thereby acting as a catalyst for industry consolidation.

5. Conclusion

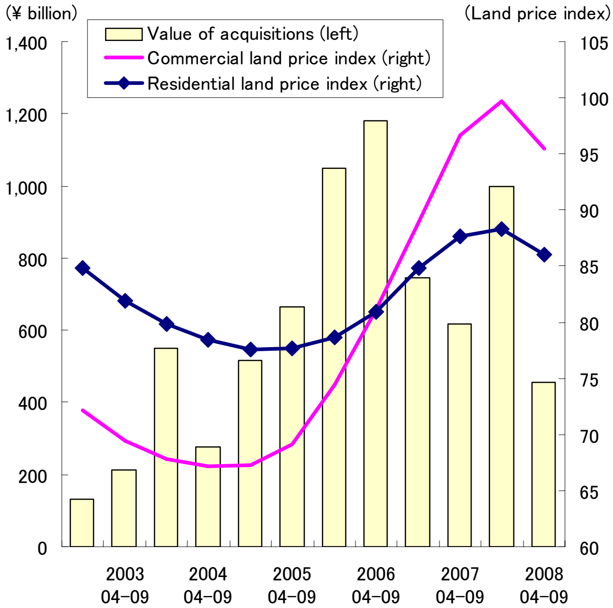
Despite progress in enhancing the market safety net and making the J-REIT system more robust, the J-REIT market's return to normalcy will be detained until the global financial crisis abates and Japan's economy recovers, which will likely take time.

Meanwhile, in the medium term, we must note the risk of pro-cyclicality due to financing restrictions imposed on J-REITs.

The real estate market cycle is known to be volatile. When the market expands, J-REITs raise capital through public subscriptions and aggressively acquire new properties. But when the market contracts, financing restrictions (the restriction on retaining earnings is also a factor) constrict cash flow, and properties are dumped on the market even as liquidity dries up (Exhibit 15).

Since individual property prices are essentially determined by the income they produce, the recent mini-bubble in 2006 and 2007 cannot be directly attributed to J-REITs. However, one problem is that some

Exhibit 15 J-REIT Property Acquisitions and Urban Land Price Trends



Note: Acquisitions of new listed J-REITs are counted at the time of listing. Urban land price indexes cover six large city areas (Tokyo, Yokohama, Nagoya, Kyoto, Osaka, and Kobe).
Source: Compiled from JREI, *Urban Land Price Index.*

sponsors have an exit strategy of dumping properties on J-REITs, some sponsors have put themselves in a crisis by pursuing ill-advised real estate developments.

As an anchor of the real estate market, it is imperative for J-REITs manage to preserve their 8 trillion yen in accumulated assets and adequately prepare for the next market expansion. In envisioning the future J-REIT market, among the top issues that must be addressed are ensuring the stability of financing and constructing a more productive relationship with sponsors.

Endnotes

1. However, a growing number of J-REITs have downgraded their dividend outlook due to one-time factors such as paying a penalty to the seller for canceling a purchase, or selling properties at a capital loss for financial restructuring purposes.

2. For a detailed analysis of the NCRI failure in Japanese, see Hiroto Iwasa, "On the First J-REIT Failure: Can the Market Avert a Chain Reaction in Loss of Confidence?" in *Researcher's Eye*, NLI Research Institute, November 21, 2008. (http://www.nli-research.co.jp/report/researchers_eye/2008/eye081121.html)

3. If the value of J-REIT properties, currently valued at 8.2 trillion yen (7.3 trillion yen + 0.9 trillion yen), decreases by 25%, NAV would decline from 4.6 trillion yen to 2.5 trillion yen.

4. In June 2008, the Japan Securities Dealers Association requested to the Council for the Promotion of Regulatory Reform of the Cabinet Office that the ban on share repurchases be lifted, and that financing methods be diversified. The Financial Services Agency replied that "since these involve a high level of judgment from the perspective of capital adequacy policy, and significantly affect the interests of shareholders including minority shareholders, approval is difficult from the perspective of shareholder protection."

5. The Investment Trust and Investment Corporation Act, Article 82.6 requires that an investment trust issues new shares at a fair price that reflects asset holdings. Thus the asset manager is accountable to shareholders for setting the issue price at a fair value based not only on the current market price, but on the asset manager's own evaluation of the property portfolio.

6. The Association for Real Estate Securitization cites "the study and implementation of a dissemination policy for individual investors" as a priority in its fiscal 2009 business plan.

7. See the Investment Trust and Investment Corporation Act, Article 206 regarding termination of the asset manager's contract.