Real estate investment

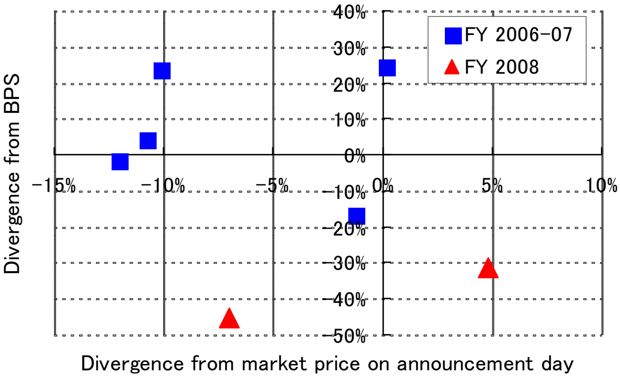
Discounted New Stock Issues of J-REITs

by Hiroto Iwasa
Real Estate Investment Analysis Team, Financial Research Group
hiwasa@nli-research.co.jp

Recently, new stock issues (capital increases) of J-REITs have occurred at prices well below book value per share, fueling concern that the interests of current investors are being diluted. To bolster investor confidence and improve market discipline, it is time to consider deregulatory measures to diversify equity financing methods and encourage M&A activity.

Currently, only two financing methods are available to J-REITs (Japan-style real estate investment trust)—borrowing, which includes the issuance of investment corporation bonds, and issuance of new investment units or stocks (capital increase). Due to conservative financial management, the amount that J-REITS can borrow is limited by the maximum loan-to-value (LTV) ratio in their operating guidelines. Considering that J-REIT growth is premised on making property acquisitions to improve portfolio returns and diversify risk, capital increases are an indispensable method of financing.

Exhibit 1 Divergence of Issue Price from BPS and Market Price



Source: Compiled by NLI Research Institute from financial disclosures.

Generally, when J-REITs raise funds through new stock issues, the issue price is set based not only on the current market price, but on the book value per share (BPS), which reflects the interest of current investors. However, entering fiscal 2008, several third-party allocations of new shares have been announced at significant discounts to BPS. As a result, concern is mounting that the conventional market consensus and trust between investors and asset managers may become irreparably damaged.

Until last fiscal year, new stock allocations had mainly targeted third parties who could provide operational backing or new channels for property acquisitions. However, entering this year, J-REITs have resorted to issuing new stocks amid difficulties with loan refinancing and obtaining loans for planned property acquisitions. Thus despite enjoying solid credit ratings based on high transparency and stable cash flows, even J-REITs are apparently not immune to the effects of global credit tightening.

The reason investors emphasize BPS when evaluating the issue price stems from the relationship between the issue price and distribution per share (DPS). Since J-REITs are required to distribute almost all profit to investors, DPS can be separated into three components: return on assets, book value per share (BPS), and leverage ratio.

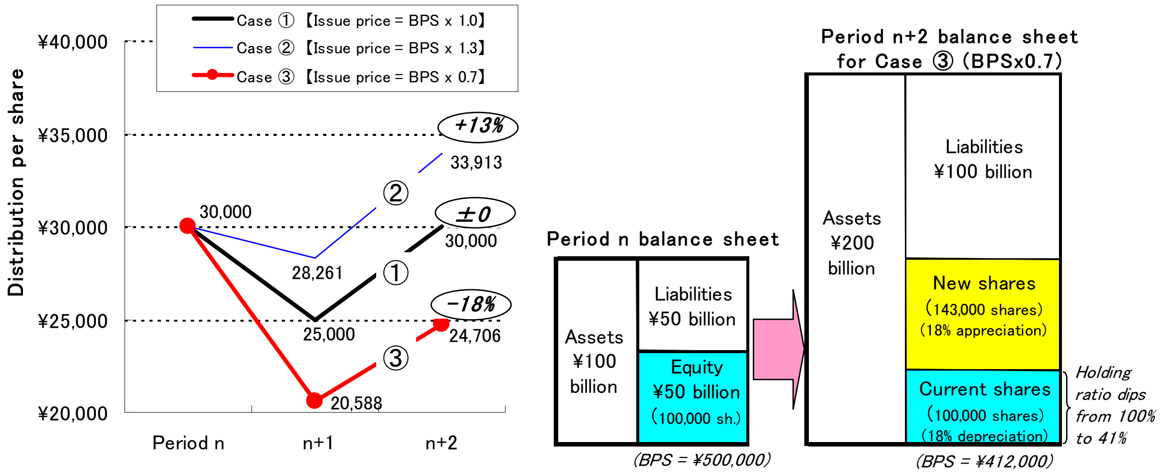
$$\boxed{\underset{\text{(distribution per share)}}{\mathrm{DPS}}} = \underset{\text{(return on assets)}}{\mathrm{ROA}} \times \boxed{\underset{\text{(book value per share)}}{\mathrm{BPS}}} \times \underset{\text{(leverage ratio)}}{\frac{1}{1-\mathrm{LTV}}}$$

Exhibit 2 illustrates this relationship under three scenarios. Suppose a hypothetical J-REIT with 100 billion yen in assets raises 50 billion yen of capital, making property acquisitions worth 50 billion yen each year. For three issue price scenarios (BPS x 1.0, BPS x 1.3, and BPS x 0.7), we calculated the resulting DPS and effect on holdings of current investors. In Case 1, where the issue price = BPS (¥500,000), DPS is temporarily diluted but then recovers to 30,000 yen. However, in Case 3, where the issue price is discounted below BPS to ¥412,000, share dilution significantly decreases the future DPS. In other words, when J-REIT asset managers raise capital in this way, they are violating their mission of maximizing the interest of current investors, and actually cause severe damage to these interests.

Exhibit 2 Effect of Issue Price on DPS and Holdings of Current Investors

＜Issue price scenarios＞
Case ① 【Issue price ＝BPS x 1.0】
Case ② 【Issue price ＝BPS x 1.3】
Case ③ 【Issue price ＝BPS x 0.7】

＜Other assumptions＞
・NOI yield: 6% Interest rate: 2% Other investment expense: 2%
・Current shares: 100,000 Current BPS: ¥500,000 LTV: 50%



Source: Compiled by NLI Research Institute.

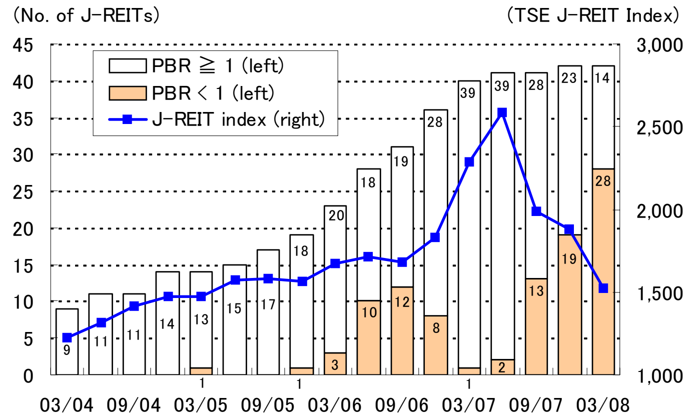
Of course, not all discounted stock issues are suspect. Changes in property prices and business conditions can cause BPS to fluctuate over time. Ultimately, however, as stipulated in the Investment Trust & Investment Corporation Law and articles of incorporation of J-REITs, the amount paid for new stock issues must reflect the fair asset value. Thus asset managers should be held accountable to investors to ensure that the issue price reflects both the market price and fair portfolio value, which managers themselves estimate and disclose.

The Tokyo Stock Exchange has taken note of the growing number of large new stock issues to third parties as a potential risk to the rights and interests of current investors. To avert the possible impact on market transparency and efficiency, the TSE plans to tighten the rules of corporate conduct as specified in the listing regulations.

Despite strong growth in the past, J-REIT market prices have softened since last year, and a growing number of J-REITs now have a price-to-book ratio (PBR) below 1. This reflects a growing risk premium (Exhibit 3).

In such circumstances, modifying the current system may not suffice to boost investor confidence and promote market discipline. We believe it is time for systemic reforms to diversify equity financing methods and facilitate M&A activity.

Exhibit 3 TSE J-REIT Index, and Number of J-REITs with PBR Below 1



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