Real estate investment

# Low Valuation of Residential J-REITs Overlooks a Key Factor—Stability of Rental Income

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*J-REITs specializing in residential properties are now extremely undervalued. However, residential rents tend to be far less volatile than office rents, and thus likely to offer greater cash flow stability even in economic downturns. In particular, residential J-REITs enjoy lower vacancy rates than the private sector average due to their newer properties and superior management and leasing capabilities. Thus despite concerns about the long-term effect of population decline on housing demand, we predict residential J-REITs can continue to earn a relatively stable rental income.*

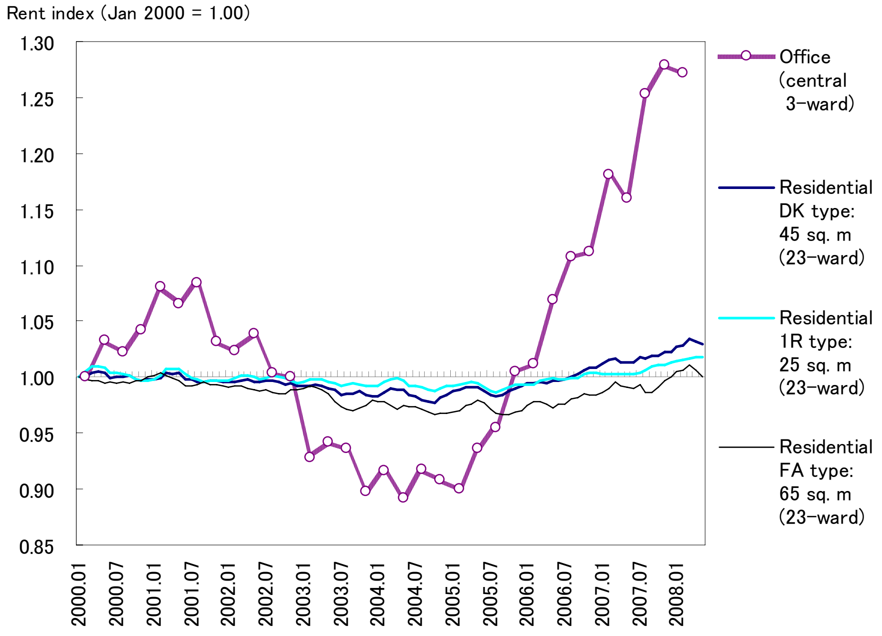
While the J-REIT index of the Tokyo Stock Exchange has plummeted since June 2007, J-REITs that specialize in residential properties have been hit particularly hard. As of July 16, 2008, none has an investment unit price above the original listing price. In fact, valuations are down by between 14% to 64% from their original listing prices in the second half of 2004.

Leaving aside issue-specific factors, the overall low valuations of residential J-REITs can be explained by: (1) concern that the population decline will reduce housing demand and thus rental income; and (2) lack of reliable data on rental housing market trends (such as rent and vacancy rate) to enable accurate property appraisals and help offset the above concern.

According to the residential rent index compiled and calculated by Recruit Co., apartment rents in Tokyo's 23 wards have been relatively stable at least since 2000, particularly in comparison to office rents in Tokyo's central 3-ward business district (Exhibit 1).

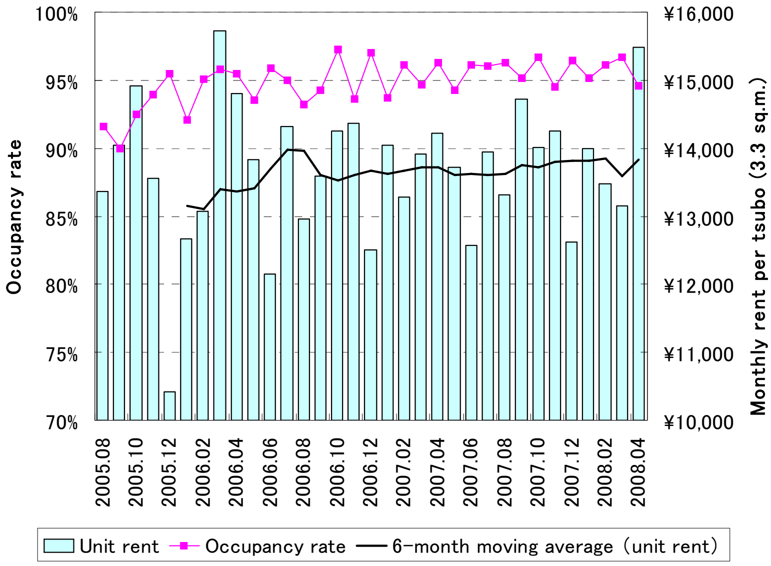
As Exhibit 1 clearly illustrates, apartment rents are far less cyclical than office rents, thus offering greater cash flow stability.

**Exhibit 1 Office and Residential Rents in Tokyo (2000–2008)**




Note: Residential rent data covers the Tokyo 23-ku area; office rent data covers the Tokyo central 3-ward area.
Sources: *Recruit Residential Price Index*; NLI Research Institute

**Exhibit 2 Occupancy Rate and Monthly Rent of J-REIT Residential Properties (Tokyo 23 wards)**




Source: J-REIT financial statements.

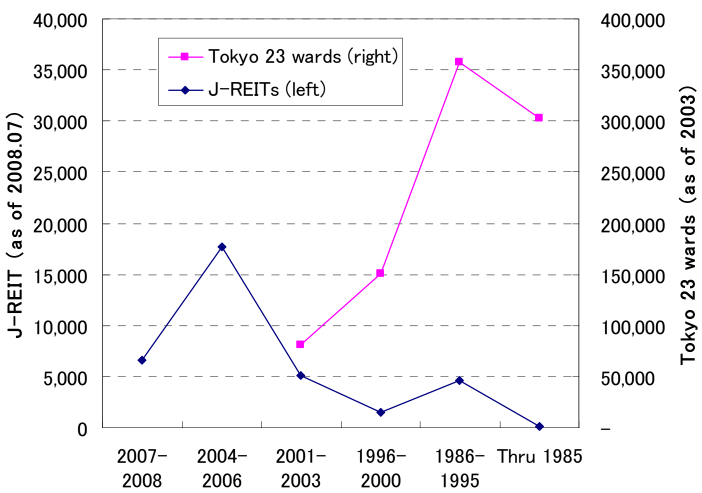
Next we examine the competitive position of residential J-REITs within the private rental market of Tokyo's 23 wards. Our data was obtained from J-REIT financial statements, and the *2003 Housing and Land Survey*, the latest 5-year survey of the Ministry of Internal Affairs and Communications.

Three things come to light. First, the average vacancy rate of private rental apartments (apartments in non-wooden buildings that are rented by the private sector) was 15.4% in 2003, compared to only 4.7% for J-REITs from August 2005 to April 2008 (Exhibit 2).

Second, J-REIT residential properties tend to be newer than the average private sector property. In the MIC survey, the stock of private rental apartments amounted to approximately one million dwellings (since then, housing starts of rental apartments have averaged from 50,000 to 60,000 units per year). Of the dwellings whose construction year is known, 74% (660,000 units) were built in 1995 or earlier, making them at least 8 years old as of 2003 (Exhibit 3). By comparison, the J-REIT data shows that 68% (24,000 units) of J-REIT residential properties were built since 2004, and thus currently less than four years old.

Third, the MIC survey found that 80% of private rental apartments in the 23 wards are owned by individuals, with the proportion rising as the age of property increases. Generally, properties owned by individuals tend to compare unfavorably with J-REIT properties in terms of equipment and fixtures, building management, and condition of repair and renovation. In particular, housing stock constructed during the bubble era is known for being of low quality.

**Exhibit 3 Annual Construction of Apartments (Tokyo 23 wards)**




Note: For Tokyo 23 wards, rental apartments include all privately managed rental apartments located in non-wooden buildings and used exclusively for living.
Sources: MIC, *2003 Housing and Land Survey* for private sector data; J-REIT materials.

Thus compared to the private sector average, J-REIT residential properties tend to be much newer, higher in quality, and under better management and security on a daily basis—which are significant advantages in the leasing market.

Even with demand for rental housing predicted to ebb as the younger population declines, J-REITs seem capable of expanding market share and stabilizing rental income by emphasizing superior quality, expert management, and corporate leasing, while adapting property portfolios to shifts in demand.