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J-REITs' true value lies in their income returns

Seijun Kim

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Nomura Research Institute, Ltd.

Executive Summary

J-REITs have been resurgent lately but many investors are uncomfortable with their price volatility. When investing in J-REITs, investors should not focus on temporary capital gains and losses. Instead, they should adopt a long-term investment horizon and focus on J-REITs' stable, high income returns.

Seijun Kim
Senior Consultant
Infrastructure & Energy Industry Consulting Department

Resurgent J-REITs

Japanese REITs have continued to perform well since autumn 2012. J-REIT equity offerings are booming, including both IPOs and seasoned offerings. The debt financing environment is also stable. J-REITs are starting to secure previously unavailable long-term loans with maturities in excess of 10 years. Armed with overwhelming firepower in terms of financing, investment corporations are acquiring prime assets in rapid succession. J-REITs' aggregate assets have recently surpassed ¥10 trillion. J-REIT investment-unit prices have of course also risen. The Tokyo Stock Exchange REIT Index gained 25% in the first six months of 2013.

However, more than a few investors are concerned that J-REITs may be in the midst of another bubble. From 2005 through mid-2007, the TSE REIT Index (excluding dividends) rose from 1,480 to 2,600. It subsequently plunged below 800. During the current recovery rally, the TSE REIT Index soared to 1,700 as of March 31, 2013, before precipitously falling back below 1,400. Anxieties about J-REIT volatility remain strong. J-REIT unit prices have undeniably been extremely volatile, fluctuating in response to exogenous changes such as the Bank of Japan's J-REIT purchasing policy, asset inflows to REIT investment trusts, and general capital market developments. Investors have deeply rooted suspicions that J-REIT unit prices do not reflect real estate market fundamentals.

J-REIT income returns cannot be overlooked

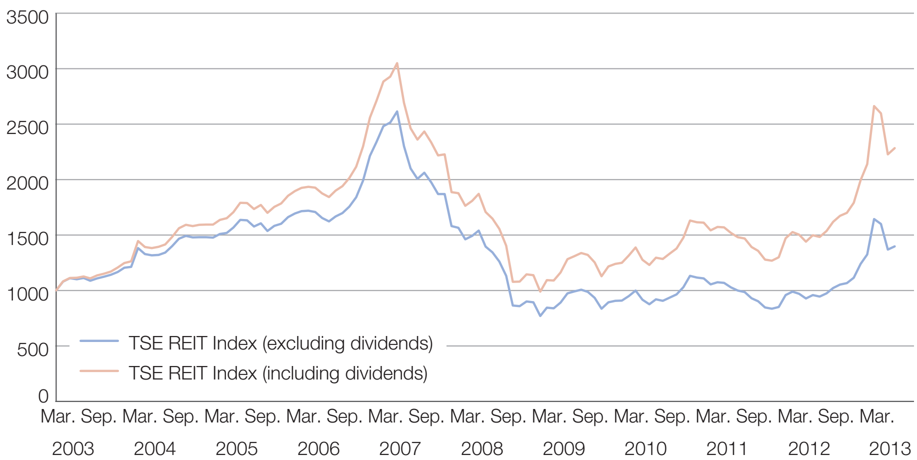
However, the story changes when the focus shifts to J-REITs' dividend power. First, J-REIT dividend yields are generally in the 4-5% range, much higher than yields available from other financial products. Even AA-rated J-REITs such as Nippon

Building Fund and Japan Real Estate Investment Corporation pay dividend yields of around 3%. Additionally, J-REIT dividends are mostly funded by rents from prime properties, making them more stable than equity dividends.

Inclusive of dividends, J-REITs have delivered solid returns (total returns, not just capital appreciation). As mentioned above, the TSE REIT Index exclusive of dividends has at times fallen below its inception level of 1,000. The TSE REIT Index inclusive of dividends, however, has never dipped appreciably below 1,000, even during the financial crisis. The performance gap between the index exclusive of dividends and the index inclusive of dividends has been widening year after year. Dividends and returns stemming from dividend reinvestment have started to constitute a major portion of J-REITs' shareholder value.

Additionally, the hefty dividends that J-REITs have been continually paying are contributing to recoupment of capital losses incurred in the aftermath of the financial crisis. Exhibit 2 tabulates by holding period the TSE J-REIT Index's cumulative total returns inclusive of dividends. For example, investors who bought the index in the first half of 2007, when J-REITs were soaring, would have incurred a 44-47% loss if they had sold during the period from 2009 through mid-2010. However, if they had continued to hold the index for a longer period, accumulation of hefty dividends would have reduced their capital losses. If they had waited to sell until the first half of 2013, for example, their losses would have been reduced to a mere 1%. Such analysis suggests that even if J-REIT investors temporarily incur capital losses due to a mistimed entry, income returns increasingly mitigate the capital losses if the investors

Exhibit 1. TSE REIT Index (including and excluding dividends)



Source: NRI, based on TSE data

Exhibit 2. TSE REIT Index's total returns (including dividends) by holding period

'03H2		8%	25%	43%	61%	60%	68%	106%	142%	100%	53%	3%	15%	9%	10%	46%	36%	14%	34%	61%	105%
'04H1			15%	32%	48%	48%	55%	90%	123%	85%	41%	-5%	6%	1%	2%	35%	26%	5%	24%	48%	89%
'04H2	Uptrend			14%	29%	28%	35%	65%	93%	60%	23%	-18%	-8%	-13%	-12%	17%	9%	-9%	8%	28%	64%
'05H1					13%	12%	18%	44%	69%	40%	7%	-28%	-19%	-24%	-23%	2%	-5%	-20%	-6%	12%	44%
'05H2						0%	5%	28%	50%	24%	-5%	-36%	-28%	-32%	-31%	-9%	-15%	-29%	-16%	0%	28%
'06H1							5%	29%	51%	25%	-4%	-36%	-28%	-32%	-31%	-9%	-15%	-29%	-16%	0%	28%
'06H2								23%	44%	19%	-9%	-39%	-32%	-35%	-34%	-13%	-19%	-32%	-20%	-5%	22%
'07H1	Upsurge								17%	-3%	-26%	-50%	-44%	-47%	-46%	-29%	-34%	-45%	-35%	-22%	-1%
'07H2										-17%	-37%	-57%	-52%	-55%	-54%	-39%	-44%	-53%	-44%	-34%	-15%
'08H1											-23%	-49%	-42%	-45%	-45%	-27%	-32%	-43%	-33%	-20%	3%
'08H2	Crash											-33%	-25%	-29%	-28%	-4%	-11%	-26%	-12%	5%	34%
'09H1													12%	6%	7%	42%	33%	11%	31%	56%	100%
'09H2														-5%	-4%	27%	18%	-1%	17%	40%	78%
'10H1															1%	34%	25%	4%	23%	47%	88%
'10H2	Stagnation															33%	24%	3%	22%	45%	86%
'11H1																	-7%	-22%	-8%	10%	40%
'11H2																		-16%	-1%	18%	50%
'12H1																			18%	41%	80%
'12H2	Recovery																			19%	52%
'13H1																					28%
Entry		Uptrend						Upsurge			Crash			Stagnation						Recovery	
Exit		'03 H2	'04 H1	'04 H2	'05 H1	'05 H2	'06 H1	'06 H2	'07 H1	'07 H2	'08 H1	'08 H2	'09 H1	'09 H2	'10 H1	'10 H2	'11 H1	'11 H2	'12 H1	'12 H2	'13 H1

Note: H1 means January 1 if an entry date or June 30 if an exit date. H2 means July 1 if an entry date or December 31 if an exit date.
Source: NRI, based on TSE data

have a long-term investment horizon. The same holds true for equities and other asset classes, but to a lesser extent than for investors in J-REITs with generous dividends.

J-REITs' role in investors' portfolios

J-REITs' high income returns are thus not only a source of substantial interest income, they also contribute greatly to enhancing total returns. If investors focused on this point, J-REITs' position in many investors' portfolios would change and J-REITs would play a bigger role. In particular, mature pension funds facing a big challenge from pension-reserve drawdowns should place more value on J-REITs' income returns.

If investors evaluate investments based on long-term total returns without being swayed by short-term volatility stemming from capital market noise, the short-term volatility may eventually subside. In such an event, long-term investors would be more likely to invest in J-REITs. While such a change in the environment is unlikely to happen overnight, future changes in investor behavior should lead to further improvement in J-REITs' return profiles.

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Inquiries to : Financial Technology and Market Research Department
Nomura Research Institute, Ltd.
Marunouchi Kitaguchi Bldg.
1-6-5 Marunouchi, Chiyoda-ku, Tokyo 100-0005, Japan
E-mail : kyara@nri.co.jp

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