Japan - May 2020

SPOTLIGHT
Savills Research

J-REIT Volatility and Japan Property

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Volatility in J-REIT unit prices may be a sign of things to come

Summary

- Having had a fairly strong start to 2020, the COVID-19 outbreak has significantly weighed on global capital markets, and the J-REIT market was no exception.
- Over the course of a month, the TSE REIT Index experienced a decline of close to 50% as anxiety spread amongst investors. Though prices have somewhat stabilised since, many J-REITs remain at a discount to NAV.
- J-REITs, normally active deal makers, have seen their acquisition capacity weakened following the sudden drop in their value. As a result, opportunities have opened up for those with dry power at the ready.
- Consolidation within the J-REIT market may become more common, with smaller-scale entities becoming prime targets.
- Defensive sectors such as Residential and Logistics, as well as Office - all with somewhat solid fundamentals - have unsurprisingly fared better than the likes of Hospitality and Retail, and this can be seen in the respective J-REIT indices.
- Within each sector, the flight to safety has been apparent, with higher quality J-REITs coming out as winners.
- Looser monetary policy in the US, a boon to the J-REIT market under normal circumstances, has instead dragged given the current challenges. There may be further turbulence ahead as it would seem that a significant outbreak in Japan is yet to be priced into markets.

INTRODUCTION

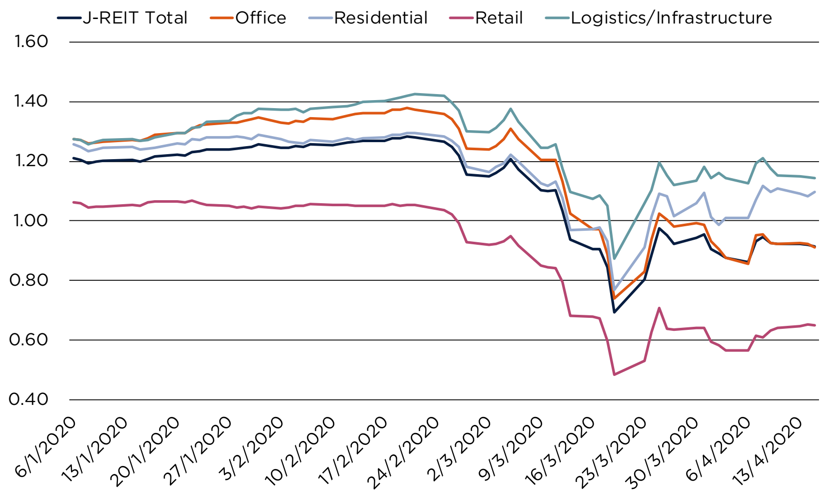
As COVID-19 continues to spread across the world without an end in sight, global capital markets have unsurprisingly been hit hard and the J-REIT market has suffered more than most. Yet, under the current circumstances, it is easy to forget that J-REITs had performed solidly up until 20 February – when the TSE REIT Index peaked at over 2,250 (Dividend: 3.5%, NAV: 1.28). Things swiftly changed thereafter, however, as the index lost around half of its value over the course of the following month, plummeting to 1,145 (Dividend: 6.8%, NAV: 0.69) by 19 March. A modest recovery to 1,640 (Dividend: 4.8%, NAV: 0.97) by 25 March notwithstanding, the index has hovered around the 1,500 mark (Dividend: 5.2%, NAV: 0.90) since the start of April – around 30% below its pre-COVID-19 high. J-REIT acquisition capacity has consequently been weakened. As such, given that they have accounted for over 30% of recent market transactions, this should pave the way for other investors previously struggling to acquire assets.

All things considered, therefore, J-REITs are likely to become rather active sellers of assets. Indeed, given the unprecedented levels of uncertainty, and with global interest rates moving even lower, defensive assets with stable incomes should remain popular for the time being. At the same time, deep discounts to NAV may facilitate consolidation within the J-REIT market. Cases of hostile takeovers – previously a rarity in Japan – have been on the up recently as attitudes within the market shift. For instance, real estate firm Unizo received multiple offers from major private equity players after travel agency HIS initially announced its hostile takeover bid. Meanwhile, Star Asia and Sakura REIT are currently in the process of merging after the former's proposed hostile bid was successful. This trend is likely to accelerate thanks to the ongoing price adjustments, especially for smaller, less financially endowed players whose unit prices are expected to remain supressed amid the uncertainty. To be sure, these smaller J-REITs with low NAV multiples face the prospect of being left behind without the ability to raise equity to fuel growth. As a countermeasure, therefore, they could start to seek out white knights before a hostile bid letter is delivered. Hence, the current scenario may provide larger sponsors or buyers with historically high levels of dry powder the opportunity to act.

As of mid-April, over half of listed J-REITs have NAV multiples of 0.8 or lower – suggesting that the majority of them are unable to raise equity capital for additional property acquisitions, and may instead become acquisition targets themselves. During the recent bull run, there were many J-REITs that were listed with a small initial AUM and without the property pipeline for further growth. These smaller entities may experience the most upheaval going forward.

The violent price swings we have witnessed thus far can be partly explained by the composition of the investor base. Specifically, it is made up of mainly domestic financial

GRAPH 1: NAV Multiple By Asset Class To Mid-April 2020



Source Savills Research and Consultancy institutions, particularly regional banks, who have historically held J-REITs due to their favourable accounting treatment. Therefore, with the end of the fiscal year approaching in March, many of these regional banks were forced to sell off these holdings in order to stem their annual losses. Given that regional banks tend to take cues from one another, those who had not sold by the fiscal year end may still feel pressure to offload J-REIT investments as soon as any sign of market uncertainty returns. Regional banks are also major investors in private REITs. As such, we may see these banks rush for an exit amid fears of further market turmoil. That said, this development may in fact be positive for long-term investors, presenting much-awaited opportunities to buy at a discount.

Capital markets around the world were hit hard by the COVID-19 outbreak, and the J-REIT markets have been no exception. This has, however, given rise to discounted opportunities, especially in the hospitality and retail sectors, and those with ample dry powder may be able to capitalise. Even so, further pain could lie ahead in the J-REIT markets.

TABLE 1: List of J-REITs at a NAV Discount and with a Market Cap of Less Than JPY100 Billion, as of 15 April 2020

REIT NAME	PRICE/NAV
Ichigo Hotel REIT	0.40
Ooedo Onsen REIT	0.53
MORI TRUST Hotel	0.60
Fukuoka REIT	0.61
XYMAX REIT	0.61
Kenedix Retail	0.64
Global One	0.65
Hoshino Resorts	0.65
Hankyu Hanshin REIT	0.67
SAKURA SOGO REIT	0.67
Star Asia	0.69
Marimo Regional Revitalization	0.70
HEIWA	0.71
Tosei REIT	0.73
Takara Leben REIT	0.78
SANKEI REAL ESTATE	0.79
ONE REIT	0.79
MIRAI Corporation	0.80
ESCON JAPAN REIT	0.80

Source JAPAN-REIT.com, Savills Research and Consultancy

TABLE 2: Dividend Yield Spreads of Each Sector Against The TSE REIT Index

YIELD SPREAD	OFFICE	RESIDENTIAL	RETAIL	LOGISTICS	HOTEL
Peak (Feb)	-0.5%	-0.2%	0.7%	0.0%	1.5%
Nadir (Mar)	-1.0%	-1.2%	2.6%	-1.1%	5.5%
Now (Apr)	-0.6%	-0.9%	2.6%	-0.9%	5.1%

Source Savills Research and Consultancy
Note: Feb, Mar, and Apr indicate 20 February, 19 March, and 1 April, respectively.

FLIGHT TO QUALITY

During times of uncertainty, the flight to safety is a well-trodden path, and this time is no exception. During the aforementioned decline of J-REIT prices from peak to trough between 20 February and 19 March, defensive sectors saw their premiums widen, whilst the hardest hit sectors, namely hospitality and retail, witnessed their discounts deepen. This trend can be seen in the table (Table 2), showing the dividend yield spreads of each respective sector against the TSE REIT index over time. The residential, logistics and office sectors are the clear winners of this flight to quality, whereas the hotel and retail sectors have significantly lagged. Recent property performance disclosures, which reflect the initial impacts of COVID-19, endorse this sector view.

To be sure, J-REITs are listed investment vehicles, and hence, in contrast to hard assets, exposure to instant trading activity can lead to an immediate and often exaggerated adjustment in prices – not to mention other non-property specific factors such as the sponsor's credit. Further, dividend yields (levered) are not equivalent to NOI yields. Given the absence of an actual benchmark that closely mimics the movement of hard asset prices, mainly due to the suspension of almost all transaction activity, Table 2 may shed some light on the scale of COVID-19's impact to these asset types.

For further reading on the impact of COVID-19 on Japan property, please read our spotlight report "COVID-19 and Japan Property".

SECTOR VIEW

When looking closer within each sector, a stark difference in the required dividend yield by investor emerges, demonstrating the winners and losers among each asset type (Table 3).

Office

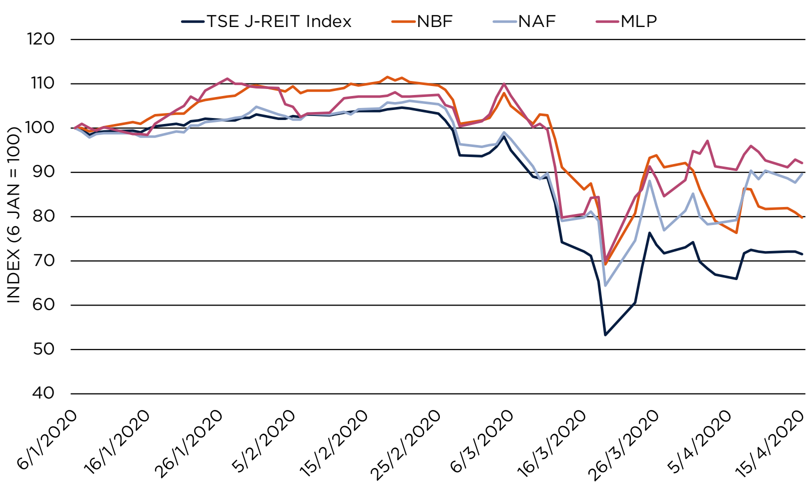
The table compares Nippon Building Fund (NBF), a holder of Grade A Tokyo office assets, and Ichigo Office REIT (Ichigo), an investor of Grade B/C offices. The spread between these two tends to be tight during upbeat periods, though this trend has historically reversed when markets are under stress. For instance, the gap between these two was 120 basis points (bps) at the recent peak in February but widened by almost 300bps at the nadir. Thereafter, the spread has stabilised at around 300bps. Unsurprisingly, Grade A offices, typically with cash-rich creditable tenants, should be able to weather this crisis with relative ease, whilst lower grade offices may not be as fortunate.

TABLE 3: Dividend Yield by Sector of Select J-REIT

YIELD SPREAD	PEAK (FEB)	NADIR (MAR)	NOW (APR)
Office: Grade A vs Lower Grade			
NBF	2.4%	3.9%	3.1%
Ichigo	3.6%	8.0%	6.3%
Premium	-1.2%	-4.1%	-3.2%
Residential: Tokyo vs Nationwide			
NAF	2.7%	4.5%	3.6%
Samty	4.9%	7.8%	6.5%
Premium	-2.1%	-3.3%	-2.8%
Retail: High street vs Shopping Centres			
JRF	3.8%	9.4%	8.2%
Frontier	4.8%	8.9%	7.6%
Premium	-1.0%	0.6%	0.6%
Logistics: Grade A vs Lower Grade			
MLP	2.7%	4.1%	3.1%
CRE	4.2%	7.2%	4.9%
Premium	-1.5%	-3.0%	-1.9%
Hotel: Unique vs Budget			
Hoshino	5.0%	10.1%	8.2%
Invincible	6.5%	17.7%	15.1%
Premium	-1.5%	-7.6%	-6.9%

Source Savills Research and Consultancy

GRAPH 2: Year-to-date Performance of High Quality J-REITs in the Three Most Defensive Sectors* vs TSE REIT Index as of 15 April 2020



Source JPX, Savills Research and Consultancy
*The three most defensive sectors, in no particular order, are Office, Residential and Logistics

Residential

Here we compare Nippon Accommodation Fund (NAF), representing a middle-market residential portfolio tilted towards Tokyo, and Samty Residential REIT (Samty), which has a greater exposure to nationwide assets. This time, the spread was 210 bps at the index peak but widened by over 100bps on the bottom day, stabilising at 280bps since. Residential assets in Tokyo are renowned for their defensive nature, though it would appear that quality mid-market residential assets across the nation are also exhibiting stability, as long as the overall quality is sound.

Retail

The spread between Japan Retail Fund (JRF), made up of high street retail assets, and Frontier REIT (Frontier), an investor of shopping centres, including supermarkets, stood at 100 bps on 20 February. Interestingly, come 19 March, Frontier's discount had swung to a premium following a 150bps adjustment, stabilising at around a 60bps premium since. Indeed, high street retail has emerged from the current uncertainty as a clear loser, whilst supermarkets are one of a few winners. This reversal in fortunes during the drawdown may give food for thought for the prospects of the rapidly changing retail sector. Now, market participants have to contend with not only the rise of e-commerce, but also how the COVID-19 outbreak will transform consumer behaviour going forward.

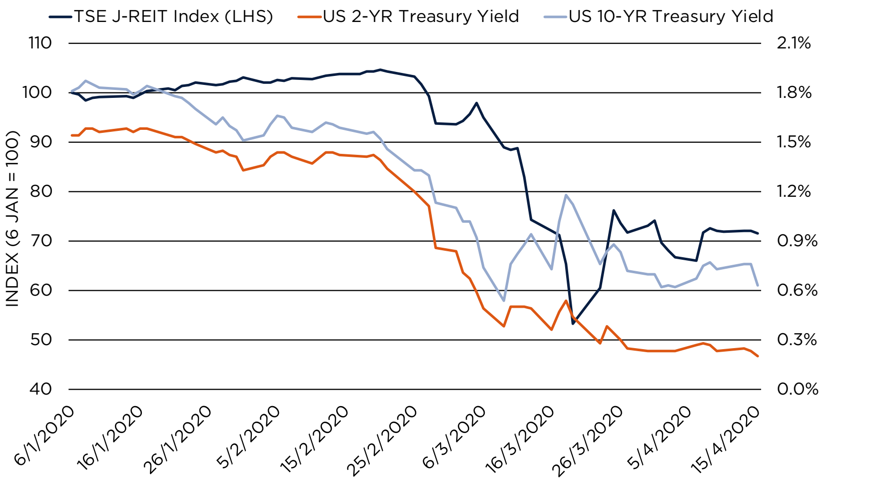
Logistics

We now turn our attention to the logistics sector. The table compares Mitsui Fudosan Logistics Park (MPL), a good indicator of the Grade A logistics sector and CRE Logistics Fund (CRE), which represents mid-scale logistics facilities. At the index peak, the spread between the former and the latter was 150 bps. This expanded by 150bps over the ensuing month, before tightening to 190 bps, where it has remained since. With robust demand for logistics assets, the impact from COVID-19 certainly looks more manageable. Given the lingering labour shortage, mid-scale facilities also have sound demand.

Hotel

Hotels continue to bear the brunt of the COVID-19 outbreak, and this can be seen in the table. The spread between Hoshino Resorts REIT, who invests in unique hotels with a strong brand appeal, and Invincible, an investor in budget hotels, was 150 bps

GRAPH 3: The Relationship Between US Treasuries and the TSE REIT Index Year-to-date as of 15 April 2020



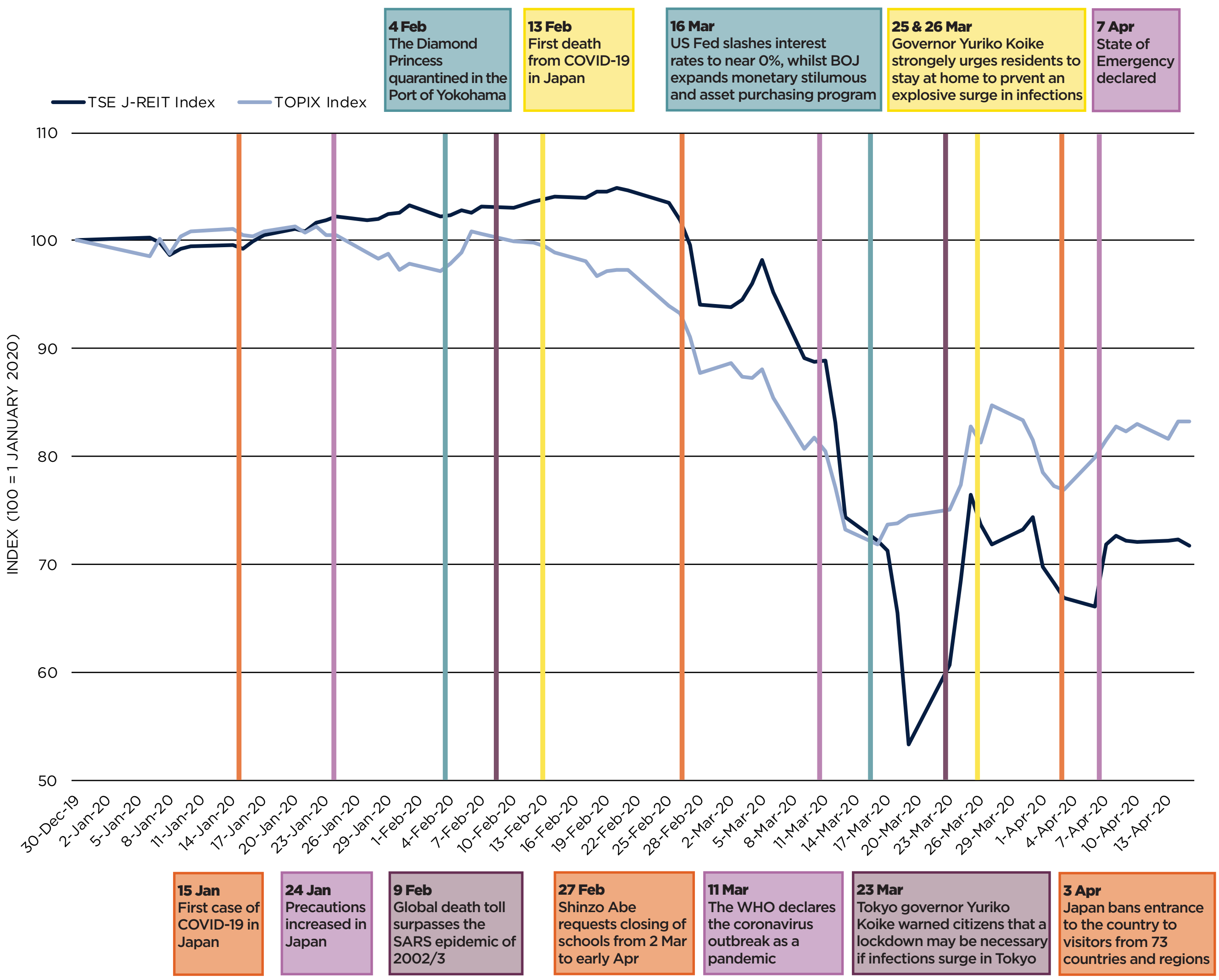
Source US Department of the Treasury, JPX, Savills Research and Consultancy

at the broader market peak. Subsequently, this increased by over 600bps by the time the index had reached its lowest point. The spread has now found firmer footing at around 690 bps. The hotel sector has not been helped by the large supply of mostly of budget hotels, and as a consequence, this has significantly adjusted required dividend yield, with concerns mounting for these assets.

IMPACT FROM ABROAD

Under normal circumstances, the reduction of global interest rates, especially in the US, has been a tailwind for the J-REIT market. The compression of government bond yields that followed the Global Financial Crisis further enhanced the attraction of the wider yield spreads found amongst J-REITs and, in doing so, had recently pushed unit prices to historic highs.

GRAPH 4: COVID-19 Timeline of Events in 2020 as of 15 April 2020



Source Savills Research and Consultancy

The current situation is far from normal, however. In an attempt to cushion the blow caused by the COVID-19 outbreak, the Fed Funds Rate was initially cut by 50bps on 3 March. As the global situation deteriorated, a larger-than-expected cut in rates on 15 March saw US interest rates languish close to zero – a level not seen since 2015 – and the fallout from these extensive measures has been clear amongst both credit and capital markets. For instance, a major listed credit default swap index in Japan has skyrocketed, implying extreme uncertainty in the credit markets. Meanwhile, acknowledging the severity of the global pandemic, J-REIT unit prices plummeted soon after the latest Fed rate cut, and despite some recovery since, unit prices remain far below previous highs (Graph 4).

Looking further ahead, however, there may be a sense that if market stabilisation can be achieved, the potential for significant upside remains for J-REITs. That said, with the full scale of the COVID-19 pandemic in Japan still unclear, this optimism may be short-lived. Indeed, it would seem that the Japanese markets have priced in the severe outbreak in the West, but is yet to price in a full-blown epidemic in Japan. As such, if the domestic situation were to significantly worsen, the J-REIT market could very well take another dive. Alternatively, global capital makets may have become accustomed to the grim news related to COVID-19, including the significant deteroration of major ecomonic indicators, keeping the market strangely calm during the pandemic.

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