The 10-second briefing

2014: the big unit-price drivers

- J-REITs: launch of NISAs could be a game changer; we estimate a potential annual inflow of JPY260-660bn into J-REITs
- H-REITs: building more market credibility for their ability to deliver DPU growth through acquisitions and AEI
- S-REITs: an office-rent recovery of at least 15% YoY could offset tapering fears, narrow the yield spread and support unit prices

Pan-Asia Real Estate Investment Trusts

- **Positive** (unchanged)
- Neutral
- Negative

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■ What's new

We identify the biggest unit-price drivers for 2014 in each key REIT market across our Pan Asia universe.

■ What's the impact

We believe inflows of new investment money from the introduction of individual retirement accounts (NISAs) in Japan will be positive for the **J-REIT** market. Using the take-up rates for individual savings accounts in the UK and the results of a NISA awareness survey by Nomura Asset Management, we estimate that the launch of NISAs from 1 January 2014 could result in annual fund inflows for the J-REIT market of JPY260-660bn (4-9% of the J-REIT market's end-November 2013 market cap), much larger than the BOJ's annual purchases of JPY30bn.

We believe the **H-REIT** sector could do well in 2014 if the H-REITS are able to build further market credibility in their ability to achieve DPU growth through acquisitions and asset-enhancement initiatives (AEI).

In the **S-REIT** sector, we believe the big driver could come from a stronger-than-expected rise in office rents (at least 15% YoY), which could trigger a sector-wide yield-spread compression and healthy positive returns for the S-REITs, similar to what occurred in the market from June 2006-June 2007. Although we remain cautious on the current office-market recovery, we acknowledge there is probably some upside risk to the market's (and our) forecasts for office rents and the broad consensus view that the sector yield spread of about 3.7% is unlikely to change much this year.

■ What we recommend

We are **Positive** on the **J-REITs** as the current yield spread (the average J-REIT dividend yield less the 10-year JGB yield) of 2.9% is still higher than the average of 2.2% during the property market's previous recovery in 2004-06, suggesting scope for contraction. We prefer the hotel, mid-cap office, and diversified REITs for their compelling valuations and prospects for dividend growth. Our **top pick** is **Japan Hotel REIT** (8985 JP, JPY49,050, Buy [1]) for its high exposure to variable-rent properties and as a play on Abenomics in the medium to long term.

We are also **Positive** on the **H-REITs**, with fundamentals supported by a commercial-property cycle still in their favour, their emergence as a niche segment in the property investor sector, and exposure to the suburban mall sector. Our **top pick** is **The Link REIT** (823 HK, HKD35.30, Buy [1]), as we think its AEI-driven DPU growth is in the early stages.

We remain **Positive** on the **S-REITs** and regard the sector as attractively valued on an absolute basis, trading, on our estimates, at a weighted-average 12-month forward dividend yield of 6.7% (as at 13 January 2014), a PBR of 0.98x, and FY14 DPU growth of 7%YoY. Our **top pick** is **Suntec REIT** (Suntec; SUN SP, SGD1.565, Buy [1]), which stands out for its wide discount to book value relative to its peers.

■ How we differ

As far as we know, Daiwa is the only broker to offer a Pan-Asia REIT-focused product.

Key stock calls

		New	Prev.
The Link REIT (823 HK)			
Rating		**Buy**	Buy
Target		**48.00**	48.00
Upside	▲	**36%**	
Suntec REIT (SUN SP)			
Rating		**Buy**	Buy
Target		**2.000**	2.000
Upside	▲	**27.8%**	
Japan Hotel REIT (8985 JP)			
Rating		**Buy**	Buy
Target		**56,000**	56,000
Upside	▲	**14.2%**	

Source: Daiwa forecasts.

Executive summary

2014: the big unit-price drivers

We see potential catalysts from NISAs in Japan, more evidence of DPU growth through acquisitions and AEI in Hong Kong, and a recovery in office rentals in Singapore.

■ J-REITs

We believe the inflows of new investment money from the introduction of NISAs could have a much bigger impact on the J-REIT market than on the stock market. Depending on the actual weighting for domestic REIT funds, we estimate that the NISAs could trigger an inflow of JPY260bn-660bn into the J-REITs this year, about 3.6-9.2% of the J-REIT market cap (as at end-November 2013). Our top pick is Japan Hotel REIT, the only Buy-rated name among the J-REITs we cover.

Our picks:
J-REITs – Japan Hotel REIT (introduction of NISAs and a play on variable rents)

■ H-REITs

In our view, the major reason for the strong performance of the H-REIT sector in recent years has not been yield compression, but the ability to achieve sustainable DPU growth through acquisitions and AEI. We expect this trend to continue in 2014. Our top pick is The Link REIT.

H-REITs – The Link REIT (AEI-driven DPU growth still in the early stages)

■ S-REITs

The big driver this year could come from a strong appreciation in office rents (by at least 15% YoY), leading to sector-wide yield-spread compression, in our view. We believe there is upside risk to the consensus (and our) view for rents to recover slowly and for the yield-spread to remain mostly stable. Our top pick is Suntec, which is the only Buy-rated name among the S-REITs under our coverage.

S-REITs – Suntec (recovery in office rentals in Singapore and attractive valuation)

Sector stocks: key indicators

								EPS (local curr.)					
		Share	Rating		Target price (local curr.)			FY1			FY2		
Company Name	Stock code	Price	New	Prev.	New	Prev.	% chg	New	Prev.	% chg	New	Prev.	% chg
Ascendas Real Estate Investment Trust	AREIT SP	2.17	Hold	Hold	2.23	2.23	0.0%	0.167	0.167	0.0%	0.185	0.185	0.0%
Ascott Residence Trust	ART SP	1.220	Hold	Hold	1.250	1.250	0.0%	0.100	0.100	0.0%	0.079	0.079	0.0%
CapitaCommercial Trust	CCT SP	1.460	Outperform	Outperform	1.650	1.650	0.0%	0.111	0.111	0.0%	0.176	0.176	0.0%
CapitaMall Trust	CT SP	1.865	Outperform	Outperform	2.180	2.180	0.0%	0.153	0.153	0.0%	0.150	0.150	0.0%
CapitaRetail China Trust	CRCT SP	1.300	Outperform	Outperform	1.480	1.480	0.0%	0.197	0.197	0.0%	0.157	0.157	0.0%
CDL Hospitality Trusts	CDREIT SP	1.650	Outperform	Outperform	1.800	1.800	0.0%	0.145	0.145	0.0%	0.186	0.186	0.0%
Champion REIT	2778 HK	3.40	Outperform	Outperform	3.80	3.80	0.0%	0.182	0.182	0.0%	0.161	0.161	0.0%
Fortune REIT	778 HK	6.13	Buy	Buy	8.20	8.20	0.0%	0.313	0.313	0.0%	0.362	0.362	0.0%
Frasers Centrepoint Trust	FCT SP	1.750	Outperform	Outperform	2.100	2.100	0.0%	0.169	0.169	0.0%	0.150	0.150	0.0%
Regal REIT	1881 HK	2.17	Outperform	Outperform	2.90	2.90	0.0%	0.143	0.143	0.0%	0.159	0.159	0.0%
Sunlight REIT	435 HK	2.95	Buy	Buy	4.00	4.00	0.0%	0.155	0.155	0.0%	0.183	0.183	0.0%
Suntec REIT	SUN SP	1.565	Buy	Buy	2.000	2.000	0.0%	0.107	0.107	0.0%	0.140	0.140	0.0%
The Link REIT	823 HK	35.30	Buy	Buy	48.00	48.00	0.0%	1.669	1.669	0.0%	1.893	1.893	0.0%
Japan Hotel REIT	8985 JP	49,050	Buy	Buy	56,000	56,000	0.0%	1,188	1,188	0.0%	1,995	1,995	0.0%

Source: Daiwa forecasts; note: prices as of close on 13 January 2014, except Japan Hotel REIT (10 January)

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Pan Asia Real Estate Investment Trusts: A few bright spots 7 October 2013	Pan Asia Real Estate Investment Trusts: Reinforcing our positive views 16 July 2013	Pan Asia Real Estate Investment Trusts: A disciplined way to chase yield 7 May 2013
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Comparison tables

■ J-REITs: ratings, valuations and key financial data

		Price (JPY)	Mkt cap (JPYbn)	Mkt cap (USDbn)	Daiwa rating	Current DPU (JPY)	Next DPU (JPY)	Current Yield (% p.a.)	Next Yield (% p.a.)	Gov't Yield (%)	Current Yd sprd (%)	Next Yd sprd (%)	Latest BVPS (JPY)	PBR (x)	Latest gearing (%)	Latest NAV (JPY)	P/NAV (x)
Office (large cap)																	
Nippon Building Fund	8951 JP	580,000	803	7.7	O/P	8,650	8,151	3.0	2.8	0.7	2.3	2.1	373,977	1.55	45.2	409,317	1.42
Japan Real Estate Inv	8952 JP	549,000	652	6.3	O/P	7,683	7,582	2.8	2.8	0.7	2.1	2.1	341,178	1.61	41.3	363,808	1.51
Office(mid cap)/div'd																	
Orix JREIT Inc	8954 JP	129,000	218	2.1	O/P	2,411	2,370	3.7	3.7	0.7	3.0	3.0	109,887	1.17	48.3	112,371	1.15
Japan Prime Realty Inv	8955 JP	335,000	276	2.7	O/P	5,933	5,939	3.5	3.5	0.7	2.8	2.8	238,929	1.40	45.7	213,629	1.57
Premier Investment Corp	8956 JP	399,500	87	0.8	O/P	10,000	9,693	5.0	4.9	0.7	4.3	4.1	445,694	0.90	53.2	389,038	1.03
Tokyu REIT Inc	8957 JP	629,000	123	1.2	Hold	12,019	12,402	3.8	3.9	0.7	3.1	3.2	590,716	1.06	44.2	601,583	1.05
Nomura RE Office Fund	8959 JP	465,000	173	1.7	Hold	10,000	10,000	4.3	4.3	0.7	3.6	3.6	578,188	0.80	40.7	439,523	1.06
United Urban Investment	8960 JP	147,600	351	3.4	O/P	2,750	2,750	3.7	3.7	0.7	3.0	3.0	98,958	1.49	49.6	104,213	1.42
Mori Trust Sogo REIT	8961 JP	820,000	216	2.1	Hold	17,830	17,212	4.3	4.2	0.7	3.6	3.5	582,735	1.41	53.7	529,129	1.55
Heiwa RE REIT Inc	8966 JP	79,300	70	0.7	O/P	1,659	1,673	4.2	4.2	0.7	3.5	3.5	96,146	0.82	44.2	88,429	0.90
Kenedix Realty Inv	8972 JP	495,000	165	1.6	O/P	9,302	9,367	3.8	3.8	0.7	3.1	3.1	526,195	0.94	47.5	446,316	1.11
Top REIT Inc	8982 JP	480,500	85	0.8	Hold	10,191	10,454	4.2	4.4	0.7	3.5	3.6	541,105	0.89	51.6	479,205	1.00
Japan Excellent Inc	8987 JP	116,300	131	1.3	O/P	2,462	2,444	4.2	4.2	0.7	3.5	3.5	107,298	1.08	48.7	95,580	1.22
Mori Hills REIT Inv	3234 JP	680,000	188	1.8	O/P	9,552	10,000	2.8	2.9	0.7	2.1	2.2	453,632	1.50	48.5	409,964	1.66
Activia Properties Inc	3279 JP	818,000	203	2.0	O/P	15,248	15,514	3.7	3.8	0.7	3.0	3.1	462,103	1.77	45.0	497,020	1.65
Commercial																	
Japan Retail Fund Inv	8953 JP	209,700	484	4.6	O/P	3,929	4,074	3.7	3.9	0.7	3.0	3.2	154,541	1.36	44.9	157,613	1.33
Frontier RE Investment	8964 JP	502,000	249	2.4	O/P	9,375	9,875	3.7	3.9	0.7	3.0	3.2	304,908	1.65	27.0	363,397	1.38
Residential																	
Sekisui House SI Inv	8973 JP	511,000	82	0.8	Hold	10,537	10,713	4.1	4.2	0.7	3.4	3.5	438,432	1.17	51.0	423,314	1.21
Daiwa House Residential	8984 JP	415,000	155	1.5	Hold	8,300	8,476	4.0	4.1	0.7	3.3	3.4	293,878	1.41	53.0	307,845	1.35
Japan Rental Housing	8986 JP	63,900	94	0.9	Hold	1,471	1,579	4.6	4.9	0.7	3.9	4.2	64,847	0.99	46.1	62,182	1.03
Nippon Accommodations	3226 JP	705,000	163	1.6	Hold	13,717	14,411	3.9	4.1	0.7	3.2	3.4	558,800	1.26	50.8	560,415	1.26
Nomura RE Residential	3240 JP	548,000	88	0.8	Hold	12,100	12,282	4.4	4.5	0.7	3.7	3.8	469,326	1.17	53.0	425,681	1.29
Hotel																	
Japan Hotel REIT Inv	8985 JP	49,050	129	1.2	Buy	1,621	1,897	3.3	3.9	0.7	2.6	3.2	32,686	1.50	46.7	34,053	1.44
Simple average			225	2.2				3.9	3.9	0.7	3.2	3.2		1.26	46.9		1.28
Weighted average			373	3.6				3.6	3.6	0.7	2.9	2.9		1.38	45.6		1.36

Source: Bloomberg, Daiwa (prices as of close on 10 January 2014)

■ H-REITs: ratings, valuations, and key financial data

	Price (HKD)	Mkt cap (USDbn)	Daiwa rating	Daiwa target (HKD)	Target upside (%)	2013E DPU (HKD)	2014E DPU (HKD)	2013E Yd (%)	2014E Yd (%)	Gov't Yd (%)	2013E Yd sprd (%)	2014E Yd sprd (%)	Latest BVPS (HKD)	PBR (x)	Latest gearing (%)	DDM Value (HKD)	2013E FFO (HKD)	2014E FFO (HKD)	2013E P/FFO (x)	2014E P/FFO (x)
Retail																				
The Link REIT (823 HK)	35.30	10.52	Buy	48.00	36.0	1.66	1.87	4.7	5.3	2.3	2.4	3.0	38.04	0.93	11.6	48.00	1.67	1.89	21.2	18.6
Fortune REIT (778 HK)	6.13	1.47	Buy	8.20	33.8	0.36	0.42	5.9	6.8	2.3	3.7	4.5	9.73	0.63	20.1	8.20	0.31	0.36	19.6	17.0
Office																				
Champion REIT (2778 HK)	3.40	2.51	O/P	3.80	11.8	0.19	0.19	5.7	5.5	2.3	3.4	3.2	7.96	0.43	21.1	3.80	0.18	0.16	18.7	21.1
Sunlight REIT (435 HK)	2.95	0.62	Buy	4.00	35.6	0.20	0.22	6.8	7.6	2.3	4.5	5.3	6.52	0.45	25.9	4.00	0.18	0.21	16.1	14.1
Hotel																				
Regal (1881 HK)	2.17	0.91	O/P	2.90	33.6	0.16	0.17	7.1	7.9	2.3	4.9	5.6	4.90	0.44	29.2	2.90	0.14	0.16	15.2	13.6
Industrial/office																				
Prosperity REIT (808 HK)	2.27	0.41	Buy	3.00	32.2	0.15	0.17	6.8	7.7	2.3	4.5	5.4	4.55	0.50	20.9	3.00	0.12	0.13	19.1	17.1
Market cap weighted avg		**7.33**						**5.2**	**5.7**		**3.0**	**3.5**		**0.77**	**15.6**				**20.1**	**18.4**
Simple average		**2.74**						**6.2**	**6.8**		**3.9**	**4.5**		**0.56**	**21.5**				**18.3**	**16.9**

Source: Bloomberg, Daiwa forecasts

Note: prices as at the close on 13 January 2014; for The Link REIT 2013E/2014E = FY14E/FY15E (March year end) and Sunlight REIT 2013E/2014E = FY14E/FY15E (June year end)

■ S-REITs: ratings, valuations and key financial data

	Price (SGD)	Mkt cap (USDbn)	Daiwa rating	Daiwa target (SGD)	Target Upside (%)	FY13E DPS (SGD)	FY14E DPS (SGD)	FY13E Yield (%)	FY14E Yield (%)	10-yr bond yld (%)	FY13E Yd sprd (%)	FY14E Yd sprd (%)	Latest BVPS (SGD)	PBR (x)	Latest gearing (%)	FY13E FFO/shr (SGD)	FY14E FFO/shr (SGD)	FY13E P/FFO (x)	FY14E P/FFO (x)
Office																			
CCT SP	1.46	3.32	O/P	1.65	13.0	0.081	0.081	5.5	5.5	2.5	3.1	3.1	1.66	0.88	29.1	0.073	0.075	20.0	19.5
SUN SP	1.565	2.80	Buy	2.00	27.8	0.091	0.106	5.8	6.8	2.5	3.3	4.3	2.05	0.76	38.6	0.050	0.088	31.4	17.7
KREIT SP	1.155	2.45	Hold	1.29	11.7	0.080	0.085	6.9	7.4	2.5	4.5	4.9	1.29	0.90	44.2	0.055	0.060	21.0	19.1
Retail																			
CT SP	1.865	5.10	O/P	2.18	16.9	0.101	0.113	5.4	6.0	2.5	3.0	3.6	1.71	1.09	33.4	0.105	0.113	17.8	16.6
FCT SP	1.75	1.14	O/P	2.10	20.0	0.109	0.110	6.2	6.3	2.5	3.8	3.8	1.77	0.99	27.6	0.107	0.107	16.4	16.4
SGREIT SP	0.76	1.29	O/P	0.90	18.4	0.050	0.051	6.6	6.7	2.5	4.2	4.3	0.86	0.88	30.3	0.052	0.051	14.7	14.8
CRCT SP	1.3	0.78	O/P	1.48	13.8	0.090	0.106	6.9	8.2	2.5	4.4	5.7	1.47	0.88	25.9	0.056	0.062	23.3	20.9
Industrial																			
AREIT SP	2.17	4.12	Hold	2.23	2.8	0.143	0.161	6.6	7.4	2.5	4.2	5.0	1.97	1.10	29.7	0.154	0.157	14.1	13.8
MLT SP	1.035	1.99	Hold	1.09	5.3	0.075	0.077	7.3	7.4	2.5	4.8	5.0	0.93	1.11	34.3	0.077	0.075	13.5	13.9
CREIT SP	0.695	0.68	Hold	0.71	2.2	0.051	0.054	7.3	7.8	2.5	4.9	5.3	0.67	1.04	35.8	0.030	0.049	23.0	14.3
Hospitality																			
CDREIT SP	1.65	1.27	O/P	1.80	9.1	0.110	0.117	6.6	7.1	2.5	4.2	4.6	1.60	1.03	29.7	0.108	0.116	15.3	14.3
ART SP	1.22	1.22	Hold	1.25	2.5	0.094	0.079	7.7	6.5	2.5	5.3	4.0	1.38	0.89	40.3	0.049	0.058	25.0	21.1
Simple average		2.18						6.6	6.9		4.1	4.5		0.96	33.2			19.6	16.9
Market-cap wtd avg		**3.02**						**6.3**	**6.7**		**3.8**	**4.3**		**0.98**	**33.5**			**19.2**	**16.7**

Source: Bloomberg, Daiwa forecasts; note: prices as at the close on 13 January 2014

■ Major A-REITs: valuations and key financial data

Name		Price (AUD)	Mkt cap (USDbn)	FY14E DPS (AUD)	FY15E DPS (AUD)	FY14E Yield (%)	FY15E Yield (%)	10-yr bond yld (%)	FY14E Yld sprd (%)	FY15E Yld sprd (%)	Latest NTA (AUD)	P/NTA (x)	Latest gearing (%)	FY14E FFO/shr (AUD)	FY15E FFO/shr (AUD)	FY14E P/FFO (x)	FY15E P/FFO (x)
Westfield Group	WDC AU	10.13	18.8	0.51	0.525	5.0	5.2	4.2	0.8	1.0	6.99	1.45	36.2	0.669	0.7	15.1	14.5
Stockland	SGP AU	3.78	7.8	0.24	0.242	6.3	6.4	4.2	2.1	2.2	3.50	1.08	22.7	0.237	0.257	15.9	14.7
Westfield Retail Trust	WRT AU	3.05	8.2	0.199	0.204	6.5	6.7	4.2	2.3	2.5	3.47	0.88	22.1	0.198	0.204	15.4	15.0
Goodman Group	GMG AU	4.77	7.3	0.209	0.223	4.4	4.7	4.2	0.2	0.4	2.69	1.77	18.5	0.346	0.371	13.8	12.9
Mirvac Group	MGR AU	1.73	5.7	0.09	0.095	5.2	5.5	4.2	1.0	1.3	1.62	1.06	23.6	0.12	0.126	14.4	13.7
GPT Group	GPT AU	3.60	5.5	0.204	0.21	5.7	5.8	4.2	1.4	1.6	3.76	0.96	19.9	0.25	0.253	14.4	14.2
CFS Retail Trust	CFX AU	1.99	5.3	0.137	0.139	6.9	7.0	4.2	2.7	2.8	2.04	0.97	28.8	0.139	0.14	14.3	14.2
Dexus Property Group	DXS AU	1.04	4.3	0.061	0.063	5.9	6.1	4.2	1.6	1.8	1.05	0.99	29.0	0.08	0.083	13.0	12.5
Commonwealth Property Office	CPA AU	1.24	2.6	0.067	0.069	5.4	5.6	4.2	1.2	1.3	1.15	1.08	25.2	0.085	0.088	14.6	14.1
Australand Property Group	ALZ AU	3.88	2.0	0.217	0.222	5.6	5.7	4.2	1.4	1.5	3.57	1.09	33.0	0.255	0.269	15.2	14.4
Market cap weighted avg						**5.6**	**5.8**		**1.4**	**1.5**		**1.2**	**27.1**			**14.8**	**14.1**
Simple average						**5.7**	**5.9**		**1.5**	**1.6**		**1.1**	**25.9**			**14.6**	**14.0**

Source: Bloomberg (prices as of close on 13 January 2014)

J-REITs

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The big driver for 2014: NISAs

NISA introduction could have a big impact

Japan's version of the UK's individual savings accounts (NISAs) was officially introduced from 1 January 2014. We believe the inflows of new investment money from the introduction of NISAs will have a much bigger impact on the J-REIT market than on the stock market. The main reasons for this are: 1) REITs have features that are suitable for NISAs, and 2) investment trusts have a greater presence in the J-REIT market than the Japan stock market.

REITs suited for NISAs

Through NISAs, annual investments of up to JPY1m are exempt from taxes on dividends and capital gains for five years. However, once stocks or other assets held in a NISA are sold, the proceeds cannot be reinvested in the NISA. As such, NISAs encourage the holding of investments over a long period as opposed to frequent, short-term trading. We think J-REITs are well suited for NISAs as they aim to provide investors with steady dividend income from their rental revenue. Naturally, NISAs can invest in J-REITs or investment trusts with J-REIT holdings. Investment trusts investing in different J-REITs can be purchased for as little as JPY10,000, so these products would be ideal for NISAs.

Investment trusts have a greater presence in the J-REIT market than the stock market

According to the Tokyo Stock Exchange (TSE), in FY12 investment trusts accounted for around only 2% of overall stock market turnover, but roughly 12% of the J-REIT market turnover. In terms of holding ratios, investment trusts accounted for only 4.5% of shares held (TSE data for FY12), but held on average 33.7% of the four J-REITs that disclose information on investment trust holding ratios (Japan Real Estate Investment [8952], Global One Real Estate [8958], Mori Hills REIT [3234], and Frontier Real Estate Investment, based on their most recent results announcements). So their J-REIT holding ratio is roughly 7 times that for stocks, suggesting investment trusts carry greater importance for J-REITs than stocks. Looking at the J-REIT market net buying/selling by investor category, the inflow of funds from investment trusts gained steam from the start of 2013 on the back of Japan Government and Bank of Japan (BOJ) measures to bring the Japanese economy out of deflation, as well as Tokyo being selected to host the 2020 Summer Olympics. Money from individual investors via investment trusts is one factor behind the recent rally in the J-REIT market. From 2014, we expect more new money to flow into the J-REIT market via NISA accounts.

Calculating new funds invested through NISAs

The actual amount of new funds that will flow into J-REITs through NISAs is still highly uncertain, but we have formulated a rough calculation using a top-down approach and assuming several conditions based on the precedent set by individual savings accounts (ISAs) in the UK and a survey by Nomura Asset Management regarding awareness of NISAs. Under our conservative scenario (Scenario 1), we estimate an annual inflow of JPY260bn, which would be almost 9 times as much as annual BOJ purchases (JPY30bn). We therefore think NISAs could have a disproportionately greater impact on the J-REIT market than on the stock market.

Assumptions based on UK ISAs

We assume that 6% of those eligible to open a NISA (residents aged 20 or over, about 100m people) will subscribe, representing 6m new accounts. The 6% is based on a survey of UK ISAs that shows around 6% of those eligible invest through such accounts. A survey by Nomura Asset Management suggests that each account holder will invest an average of JPY780,000 in the first year, which would result in an annual aggregate of JPY4.7tn. The survey expects around 70% of funds held in NISAs to be invested in investment trusts, which implies that JPY3.3tn could flow into investment trusts eligible for NISAs (domestic/overseas equity funds and domestic REIT funds). According to Morningstar, domestic REIT funds accounted for 8% of the net asset balance of all NISA-eligible investment trusts (end-Nov 2013). We therefore extrapolate that 8% of JPY3.3tn, or an estimated JPY260bn (3.6% of the total J-REIT market cap) in new funds could be invested in the J-REIT market through NISAs (scenario 1).

Significant potential market impact

Similarly, based on the fact that domestic equity funds account for 31% of the net asset balance of all NISA-eligible investment trusts, we calculate that about JPY1tn (of the aforementioned JPY3.3tn) is likely to flow into the Japanese stock market. As this is only 0.3% of the total market cap of Japanese stocks (TOPIX constituents, as at the end of November 2013) compared with the 3.6% for J-REITs, NISAs look set to impact the J-REIT market more than the equity market.

This assumption does not take into account the aforementioned fact that REITs are suited for NISAs. We have assumed that domestic REIT funds will account for 8% of new money invested in investment trusts through NISAs, but Morningstar suggests that they accounted for 18% of funds invested in January-November 2013. Our more aggressive scenario (scenario 2) therefore assumes that domestic REIT investment trusts will account for 20% of total funds invested in investment trusts through NISAs. Applying this to the JPY3.3tn raises the figure to JPY660bn (9.2% of the total J-REIT market cap). We therefore envisage a significant market impact.

■ J-REIT market: estimated impact of NISAs (2014)

Expected number of NISA accounts: 6m	
Those at least 20 years old (100m people)	
x 6% (based on ISA take-up in the UK)	
Assumed average annual investment per account:	
JPY780,000	
(from Nomura Asset Management NISA survey)	
Aggregate annual investment in NISAs	
JPY4.7tn	
JPY780,000 x 6m accounts	
Scenario 1	**Scenario 2**
J-REIT market inflow	J-REIT market inflow
About JPY260bn	**About JPY660bn**
JPY4.7tn x	JPY4.7tn x
Investment trust weight (70%) x	Investment trust weight (70%) x
Domestic REIT fund weight (8%)	Domestic REIT fund weight (20%)

Source: Nomura Asset Management, Morningstar, compiled by Daiwa

J-REIT sector view: Positive

Retain Positive stance on the sector

We maintain our Positive stance on the J-REIT sector for the next six months.

For the J-REITs under our coverage, we estimate a weighted average dividend yield of 3.6%, a price-to-NAV ratio of 1.3x, and an implied cap rate of 4.2% (all as at 10 January and based on current/next-period estimates). Whereas the J-REIT yield spread – calculated as the difference between the average J-REIT dividend yield and the 10-year JGB yield – averaged 2.2% during the property market's recovery in 2004-06, it is currently at 2.9%, suggesting significant scope for contraction (ie, REIT unit-price gains).

Among the valuation metrics for the J-REIT market, our focus is on dividend yields. We also use price-to-NAV ratios (PBRs adjusted to reflect unrealised gains/losses on real-estate holdings) as an indicator for property values, as well as implied cap rates, which can be adjusted to reflect disparities among current market rents and the REITs' degrees of leverage.

Top pick: Japan Hotel REIT (8985)

We recommend hotel, mid-cap office, and diversified REITs in view of: 1) the potential for per-unit dividends to increase on the back of internal growth (such as revenue increases or cost savings) and external growth (such as property acquisitions), and 2) their compelling valuations. Among the hotel REITs, we continue to focus on Japan Hotel REIT. Although the excessive discount (in the middle of 2013) previously afforded to this REIT has been gradually fading, we continue to favour the stock as: 1) profits from variable rent properties have recently been strong, and 2) this is one name we view as well positioned to reap benefits from Abenomics over the medium/long term.

Focusing on mid-cap office REITs, diversified REITs

Along with the hotel REITs, we are also focusing on the mid-cap office REITs and diversified REITs, which are yielding an average of 3.9% (as at 10 January, based on current/next-period estimates), vs. 2.8% for the large-cap office REITs (same basis). Comparing this spread of 1.1pp with the average spread of 0.2pp in 2004-06, we believe the mid-cap office REITs and diversified REITs currently look very attractive.

If we consider the average cap rate at the time of property acquisition versus the average net operating income (NOI) yield on existing properties, we note a gap of around 80bps for office and diversified REITs, while these two metrics (the acquisition cap rate and the NOI yield) are already at similar levels for REITs focusing on other asset types. Given this disparity, we expect office and diversified REITs to continue to acquire properties from 2014. We also note that diversified REITs are better positioned to acquire properties such as hotels and data centres, segments where competition is less intense, in our opinion.

We caution that those REITs with office properties that are inferior to those of the large-cap office REITs, or whose average rental agreements are longer, may struggle to benefit as much when office rents rise. Nevertheless, we expect such REITs to still experience internal growth (from factors such as rental increases) over the medium to long term. Among the individual stocks, we recommend Orix JREIT (8954 JP, JPY129,000, Outperform [2]), United Urban Investment (8960 JP, JPY147,600, Outperform [2]), and Japan Excellent (8987 JP, JPY116,300, Outperform [2]).

2013 property acquisition amount at record high

2013 was a record year for J-REIT property acquisitions. The amount spent to acquire logistics facilities surged YoY with the listing of a few new logistics-property REITs. One example is Nippon Prologis REIT, which increased capital with two public offerings after going public. Including its IPO, this REIT raised a total of JPY359.5bn for property acquisitions. Office-building acquisitions also increased YoY, with the biggest splash in 2013 made by Nippon Building Fund, which purchased the NBF Osaki Building for JPY66.6bn.

Deals involving commercial facilities were also abundant. Prominent examples include Yodobashi Camera Multimedia Kichijoji, purchased by United Urban Investment for JPY28bn, Shibuya Flag Building, acquired by Mori Trust Sogo REIT (8961) for JPY32bn, and Kawasaki Le Front, bought by Japan Retail Fund Investment (8953) for JPY30bn. In addition to logistics centres, office buildings, and commercial facilities, there were also major deals involving hotels, data centres, and infrastructure facilities. For example, Japan Hotel REIT purchased Hilton Tokyo Bay Hotel for JPY26bn, Industrial & Infrastructure Fund Investment (3249) bought the IIF Osaka Toyonaka Data Center for JPY5.6bn, and United Urban Investment acquired the *KDDI* Fuchu Building for JPY4.9bn.

Most REITs acquire properties viewed as safe investments

Even though the real-estate market has picked up significantly, most REITs still remember the bitter lessons following the Lehman crisis, so have focused on "safe" properties, with cap rates at the time of purchase equivalent to or higher than the average NOI yield of their existing properties.

Since mid-2012, cap rates have been clearly declining, so we believe the pace of property acquisitions could slow in 2014. According to the Japan Real Estate Institute's Real Estate Investor Survey, yields expected by investors on property as at 1 October 2013 have declined across the board versus the previous survey on 1 April 2013, by 0.1pp to 4.2% for office buildings (in Marunouchi/Otemachi), by 0.2pp to 5.2% for rental housing (one-room; in Meguro/Setagaya), by 0.1pp to 4.4% for commercial facilities (upscale urban specialty retail facilities, in Ginza), and by 0.2pp to 5.6% for logistics/warehousing facilities (single tenant; in the Tokyo Bay area). Cap rates are clearly declining for all asset types.

In all cases except for office buildings, the average cap rate at the time of property acquisition has been roughly in line with the average NOI yield for existing properties. We foresee that property acquisitions could become more difficult in 2014 as long as REIT managers are unwilling to tolerate lower cap rates than those for their existing portfolios at the time of purchase. Based on this consideration, we assume the amount spent by J-REITs to acquire properties in 2014 will decline YoY.

Selling properties is one effective strategy

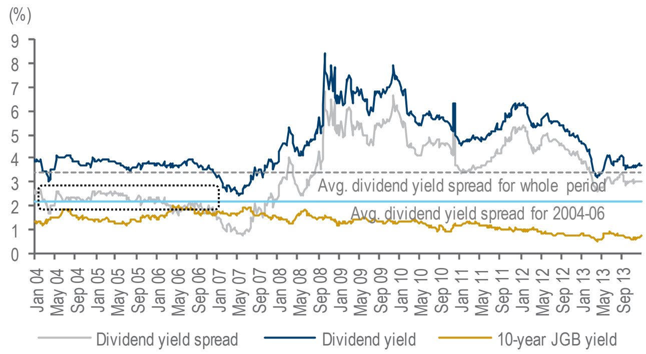
Prior to the Lehman crisis, some REITs drove down cap rates at the time of purchase to as low as their implied cap rate, aggressively acquiring properties even as prices were climbing. Indeed, in 2007-08 the average cap rate at the time of purchase for all J-REIT properties declined to around 5%. There were even cases of some REITs buying properties with cap rates of less than 4%. As a result, properties purchased in 2007-08 were the main reasons for unrealised losses held by the various J-REIT companies.

In contrast, some REITs today are taking advantage of the current strong real-estate market conditions to sell properties. For example, Nippon Building Fund sold its NBF Nihonbashi Muromachi Center Building for JPY28.2bn, and Frontier Real Estate Investment (8964) sold WV Sakae and AEON Hadano Shopping Center for JPY17bn combined. Considering past developments, we believe that an effective business strategy when cap rates are declining is not to continue acquiring properties, but rather to take advantage of market conditions and dispose of properties.

Next-generation asset class properties also warrant attention

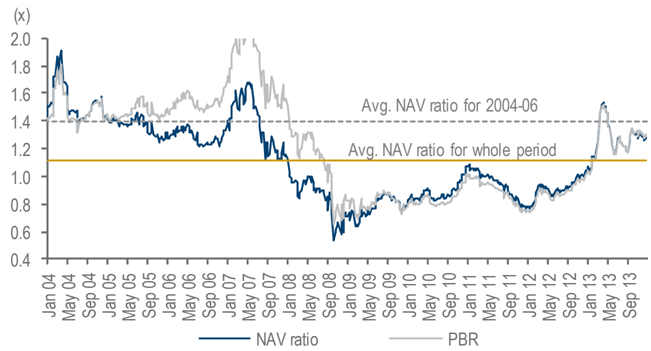
Healthcare facilities, data centres, and infrastructure-related facilities look set to become the next-generation assets for the J-REIT market. There are examples of some listed REITs already dealing in such facilities. In most cases, the cap rate at the time of purchase has been from 6% to around 7%, higher than those for office buildings, housing, commercial facilities, and logistics facilities. We are particularly interested in healthcare facilities following media reports in Japan about the establishment of REITs specialising in this field. Reports covered the establishment of healthcare facility REITs by Ship Healthcare Holdings (3360), Daiwa Securities Group (8601), Kenedix (4321), and Shinsei Bank (8303). Operator risk is a unique characteristic of a healthcare asset. Examples of such risks include nursing care accidents and improper nursing care insurance billing. The operator's business scale, management principles, organisational management system, and compliance will all need to be carefully examined in order to minimise such risks.

▪ J-REIT: dividend yield, 10-year JGB yield, yield spread (%)



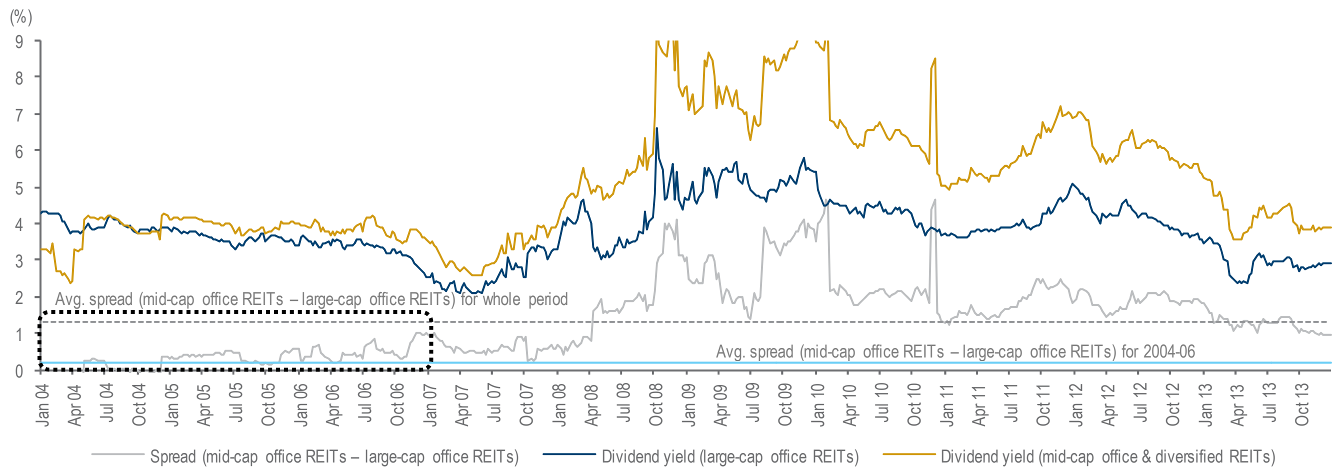
Source: Daiwa

▪ J-REIT: price-to-NAV, PBR ratios (x)



Source: Daiwa

▪ J-REIT dividend yields (mid-cap office REITS vs. large-cap office REITS)



Source: J-REITs, Daiwa

Notable market movements

■ J-REITs: performance as at 30 December 2013

	Bloomberg	Price JPY	Dec (MOM) % chg	4Q13 (QoQ) % chg	2013 (YoY) % chg
Nippon Building Fund	8951 JP	612,000	1.7	0.3	37.1
Japan Real Estate Inv	8952 JP	564,000	4.3	(1.7)	32.7
Orix JREIT Inc	8954 JP	131,700	3.1	5.4	54.8
Japan Prime Realty Inv	8955 JP	337,000	(1.7)	(2.3)	35.2
Premier Investment Corp	8956 JP	407,000	2.0	(9.2)	27.8
Tokyu REIT Inc	8957 JP	649,000	6.0	4.0	37.9
Nomura RE Office Fund	8959 JP	489,000	0.7	(3.2)	(1.6)
United Urban Investment	8960 JP	151,300	3.0	0.9	52.5
Mori Turst Sogo REIT	8961 JP	838,000	(2.3)	(10.8)	15.3
Heiwa RE REIT Inc	8966 JP	81,000	5.5	2.0	41.1
Kenedix Realty Inv	8972 JP	499,500	4.7	3.4	65.9
Top REIT Inc	8982 JP	494,000	9.3	(0.1)	33.0
Japan Excellent Inc	8987 JP	123,300	1.7	(3.5)	27.1
Mori Hills REIT Inv	3234 JP	698,000	(0.3)	2.8	50.8
Activia Properties Inc	3279 JP	829,000	4.5	(2.6)	53.0
Japan Retail Fund Inv	8953 JP	214,200	6.0	5.9	35.1
Frontier RE Investment	8964 JP	520,000	8.6	2.7	37.7
Sekisui House SI Inv	8973 JP	512,000	3.0	0.8	29.3
Daiwa House Residential	8984 JP	419,500	3.5	(1.8)	24.1
Japan Rental Housing	8986 JP	64,500	0.5	(11.6)	14.0
Nippon Accommodations	3226 JP	708,000	1.3	(1.5)	18.0
Nomura RE Residential	3240 JP	545,000	1.1	(4.4)	14.0
Advance Residence Inv	3269 JP	227,000	2.2	(1.0)	28.2
Japan Hotel REIT	8985 JP	50,400	4.6	10.0	111.1
	TSE REIT	1515.01	3.2	0.3	35.9
	TOPIX	1302.29	3.5	9.1	51.5

Source: Bloomberg

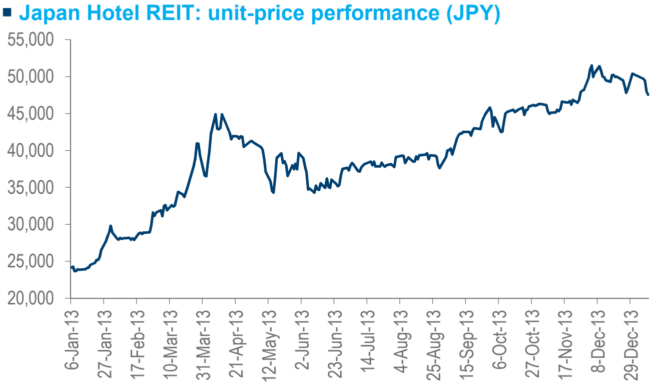
J-REIT top pick

Japan Hotel REIT (8985)

(8985 JP, JPY49,050, Buy [1])

Target Price: JPY56,000

■ Japan Hotel REIT: unit-price performance (JPY)



Source: Bloomberg

■ Japan Hotel REIT: investment indicators

12-month range (JPY)	23,860-51,500
Market cap (USDm)	1,243
Shares outstanding (m)	2,621.28
Foreign ownership (%)	21.9%

Source: Daiwa

Japan Hotel REIT: high weighting of variable rent properties

Japan Hotel REIT's portfolio is made up entirely of hotels, an asset class with earnings characteristics that differ from those of office buildings or residential properties. The portfolio also has a higher weighting of properties with variable rents than other J-REITs. The REIT aims for earnings stability from fixed rent revenue as well as upside from variable rent revenue.

In April 2013, it acquired Hilton Tokyo Bay Hotel, defined as a trophy asset by the REIT, for JPY26bn. At the same time, it announced plans to increase capital through a public offering in April 2013, the second one since its formation through a merger between Nippon Hotel Fund and Japan Hotel and Resort in April 2012. Funds raised through the two public offerings have helped the REIT to reinforce its property-acquisition network. We assume external growth (acquisitions) will continue, helped in part by its access to hotel trading information from a wide range of sources.

Positioned to benefit from Abenomics

We recommend the REIT as a name positioned to greatly benefit from the impact of Abenomics. Variable rents account for a high 28% (period ended December 2012) of rent revenue, and improvement in hotel earnings are directly reflected in the per-share dividend. Even if hotel occupancy is sluggish, we see limited downside risk to dividends, as we think bargain purchase gains would probably be used to offset the impact.

Valuation and investment opinion

Over the past six months, the REIT has outperformed the TSE REIT Index by 22.2% (as at 10 January 2014), and its previously excessive discount has steadily diminished. We continue to like the REIT as recent profit levels at variable rent properties have been high, and from a medium/long-term perspective we view it as one of the names in an excellent position to benefit from Abenomics.

Risk factors

Risk factors would include a hit to rent revenue from sluggish hotel occupancy at properties with variable rents, the withdrawal of major tenants, or sharp rent reductions.

There is also risk of an impact from dilution to NAV and dividend per share if the REIT were to issue new shares and acquire properties with yields lower than the NOI yield of existing properties or its implied cap rate. Additionally, risk premiums in the wider J-REIT market could expand on events such as major investors withdrawing funds or a rapid deterioration in the lending stance of banks.

■ J-REITs: ratings, valuations, and key financial data

		Price (JPY)	Mkt cap (JPYbn)	Mkt cap (USDbn)	Daiwa rating	Current DPU (JPY)	Next DPU (JPY)	Current Yield (% p.a.)	Next Yield (% p.a.)	Gov't Yield (%)	Current Yd sprd (%)	Next Yd sprd (%)	Latest BVPS (JPY)	PBR (x)	Latest gearing (%)	Latest NAV (JPY)	P/NAV (x)
Office (large cap)																	
Nippon Building Fund	8951 JP	580,000	803	7.7	O/P	8,650	8,151	3.0	2.8	0.7	2.3	2.1	373,977	1.55	45.2	409,317	1.42
Japan Real Estate Inv	8952 JP	549,000	652	6.3	O/P	7,683	7,582	2.8	2.8	0.7	2.1	2.1	341,178	1.61	41.3	363,808	1.51
Office (mid cap)/div'd																	
Orix JREIT Inc	8954 JP	129,000	218	2.1	O/P	2,411	2,370	3.7	3.7	0.7	3.0	3.0	109,887	1.17	48.3	112,371	1.15
Japan Prime Realty Inv	8955 JP	335,000	276	2.7	O/P	5,933	5,939	3.5	3.5	0.7	2.8	2.8	238,929	1.40	45.7	213,629	1.57
Premier Investment Corp	8956 JP	399,500	87	0.8	O/P	10,000	9,693	5.0	4.9	0.7	4.3	4.1	445,694	0.90	53.2	389,038	1.03
Tokyu REIT Inc	8957 JP	629,000	123	1.2	Hold	12,019	12,402	3.8	3.9	0.7	3.1	3.2	590,716	1.06	44.2	601,583	1.05
Nomura RE Office Fund	8959 JP	465,000	173	1.7	Hold	10,000	10,000	4.3	4.3	0.7	3.6	3.6	578,188	0.80	40.7	439,523	1.06
United Urban Investment	8960 JP	147,600	351	3.4	O/P	2,750	2,750	3.7	3.7	0.7	3.0	3.0	98,958	1.49	49.6	104,213	1.42
Mori Trust Sogo REIT	8961 JP	820,000	216	2.1	Hold	17,830	17,212	4.3	4.2	0.7	3.6	3.5	582,735	1.41	53.7	529,129	1.55
Heiwa RE REIT Inc	8966 JP	79,300	70	0.7	O/P	1,659	1,673	4.2	4.2	0.7	3.5	3.5	96,146	0.82	44.2	88,429	0.90
Kenedix Realty Inv	8972 JP	495,000	165	1.6	O/P	9,302	9,367	3.8	3.8	0.7	3.1	3.1	526,195	0.94	47.5	446,316	1.11
Top REIT Inc	8982 JP	480,500	85	0.8	Hold	10,191	10,454	4.2	4.4	0.7	3.5	3.6	541,105	0.89	51.6	479,205	1.00
Japan Excellent Inc	8987 JP	116,300	131	1.3	O/P	2,462	2,444	4.2	4.2	0.7	3.5	3.5	107,298	1.08	48.7	95,580	1.22
Mori Hills REIT Inv	3234 JP	680,000	188	1.8	O/P	9,552	10,000	2.8	2.9	0.7	2.1	2.2	453,632	1.50	48.5	409,964	1.66
Activia Properties Inc	3279 JP	818,000	203	2.0	O/P	15,248	15,514	3.7	3.8	0.7	3.0	3.1	462,103	1.77	45.0	497,020	1.65
Commercial																	
Japan Retail Fund Inv	8953 JP	209,700	484	4.6	O/P	3,929	4,074	3.7	3.9	0.7	3.0	3.2	154,541	1.36	44.9	157,613	1.33
Frontier RE Investment	8964 JP	502,000	249	2.4	O/P	9,375	9,875	3.7	3.9	0.7	3.0	3.2	304,908	1.65	27.0	363,397	1.38
Residential																	
Sekisui House SI Inv	8973 JP	511,000	82	0.8	Hold	10,537	10,713	4.1	4.2	0.7	3.4	3.5	438,432	1.17	51.0	423,314	1.21
Daiwa House Residential	8984 JP	415,000	155	1.5	Hold	8,300	8,476	4.0	4.1	0.7	3.3	3.4	293,878	1.41	53.0	307,845	1.35
Japan Rental Housing	8986 JP	63,900	94	0.9	Hold	1,471	1,579	4.6	4.9	0.7	3.9	4.2	64,847	0.99	46.1	62,182	1.03
Nippon Accommodations	3226 JP	705,000	163	1.6	Hold	13,717	14,411	3.9	4.1	0.7	3.2	3.4	558,800	1.26	50.8	560,415	1.26
Nomura RE Residential	3240 JP	548,000	88	0.8	Hold	12,100	12,282	4.4	4.5	0.7	3.7	3.8	469,326	1.17	53.0	425,681	1.29
Hotel																	
Japan Hotel REIT Inv	8985 JP	49,050	129	1.2	Buy	1,621	1,897	3.3	3.9	0.7	2.6	3.2	32,686	1.50	46.7	34,053	1.44
Simple average			225	2.2				3.9	3.9	0.7	3.2	3.2		1.26	46.9		1.28
Weighted average			373	3.6				3.6	3.6	0.7	2.9	2.9		1.38	45.6		1.36

Source: Bloomberg, Daiwa (prices as of close on 10 January 2014)

H-REITs

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The big driver for 2014: gaining more credibility

Building up credibility to deliver sustained DPU growth

We believe that gaining more credibility (and convincing the market that they can still deliver sustainable DPU growth) will be the main unit-price driver for the H-REITs in 2014, as we believe the yield compression phase for the H-REITs is over. That said, unlike some of their counterparts overseas, the H-REITs' unit price outperformance over the past few years was not driven primarily by yield compression, in our view.

Instead, we believe one main contributing factor was that the H-REITs showed that asset enhancement initiatives (AEI) are an effective way to upgrade and boost the achieved rents of their portfolios; and that they have been able to achieve sustained DPU growth from underlying operations over the past few years. In retrospect, the magnitude of yield compression experienced by the H-REITs appears modest compared with many other overseas counterparts.

In our opinion, there are three factors that could increase the credentials of the H-REITs to deliver sustained DPU growth in the next few years.

1) Number of properties having completed AEI is reaching critical mass

There seems to be a perception in the stock market that the impact of AEI is over once the project is completed. The REIT's ability to deliver DPU growth, so the argument goes, will weaken as it completes AEI on more of its upgradable properties. We can see the logic of this argument but think it is a misguided one.

Apart from the conventional wisdom in the retail property industry that it typically takes 2-3 leasing cycles for the full effects of changes to come through, we think another important aspect to bear in mind is that a landlord's number of upgraded properties need to reach a critical mass before they can catch the attention and gain the confidence of higher-grade tenants.

Take The Link REIT as an example. While it has now completed AEI on over 30 of its top properties, our observation is that it is still in the early stage of attracting higher-grade retail tenants. As a matter of fact, many retailers that would previously have opened stores only in the malls of private developers have started coming to The Link's portfolio in the past 3-4 years, usually starting with just 1 or 2 stores. This is natural, as many would want to test the waters first, and be convinced about The Link REIT's commitment and ability to upgrade its malls.

However, as they start to see more and more examples of The Link REIT's upgraded malls, their confidence to open more stores in The Link's portfolio would increase; and this could well gradually develop into a virtuous cycle, allowing the portfolio to attract tenants with higher and higher rent-paying capacity over time.

■ The Link REIT: status of AEI work

	No. of projects	Estimated cost (HKDm)
Completed since IPO in November 2005	30	2,678
Under way	8	1,121
Pending statutory approval	5	774
Others under planning	>13	>1,200
Total	>56	>5,773

Source: Company

■ The Link REIT: AEI summary

	No. of projects	Cumulative no. of completed AEI work	Capex (HKDm)	Cumulative capex (HKDm)	IFA ('000 sq ft)	Cumulative IFA ('000 sq ft)
FY08	5	5	126	126	608	608
FY09	5	10	222	348	638	1,246
FY10	6	16	484	832	829	2,076
FY11	5	21	776	1,608	939	3,015
FY12	4	25	587	2,195	336	3,351
FY13	5	30	483	2,678	516	3,867

Source: Company

2) Strengthened acquisition capability

In retrospect, 2013 was an important year for the H-REITs in that three REITs made acquisitions, financed mainly through debt, which helped ensure that the acquisitions were yield-accretive. We think this new development was possible because the H-REITs have been able to upgrade their assets over the past few years.

This, coupled with a generally favourable industry environment, has allowed the H-REITs' asset value to continue to grow and the H-REITS to pursue acquisitions through the use of debt while maintaining a cushion against the regulatory limit of a 45% debt/asset ratio. We believe that upgrading newly acquired properties and potential further new acquisitions should open another potential venue for growth for the H-REITs.

■ Acquisitions done by the H-REITs in 2013

	Prosperity REIT	Fortune REIT	Regal REIT	
Announced	15-Dec-13	30-Jul-13	28-Jun-13	28-Jun-13
Property	9 Chong Yip Street	Kingswood Ginza	A hotel in Sheung Wan	A hotel in North Point
Location	Kwun Tong, Kowloon	Tin Shui Wai, New Territories	Sheung Wan, Hong Kong	North Point, Hong Kong
Property type	Office	Retail	Hotel	Hotel
Year of completion	2004	1998	2013	2014E
Gross rentable area (sq ft)	136,595	665,244	77,440 (GFA)	73,700 (GFA)
No. of car park spaces	64	622	na	na
No. of tenants	41*	206^	248 rooms	338 rooms
Appraised value (HKD)	1,064m* (7,789/sq ft)*	Avg. 5,854m** (8,800/sq ft)	1,580m^	1,650m^
Consideration (HKD)	1,010m (7,394/sq ft)	5,849m (8,792/sq ft)	1,580m	1,650m^^
Developer	Hutchison Whampoa	Cheung Kong	Regal Hotels & Paliburg	Regal Hotels & Paliburg
Occupancy rate	94.1%*	65.5%**	na	na
Passing rent (HKD/sq ft)	~16.0*	27.4**	na	na

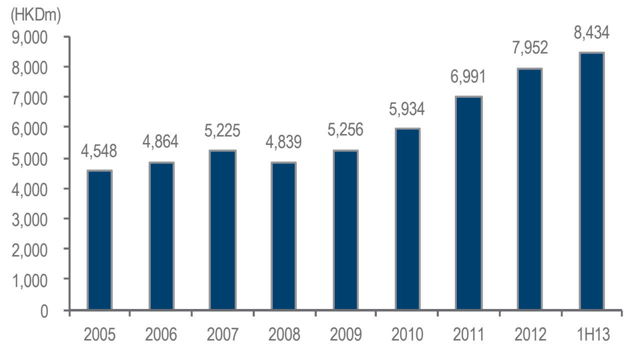
Source: Companies, Daiwa
*Note: *as at 30 Sep 2013*
***as at 30 Jun 2013*
^on an as-completed basis
^^subject to final adjustment based on an updated appraised value

Note that so far, the acquisitions made by the H-REITs have not been purely financial deals. Instead, we believe these acquisitions can bring strategic value to their portfolios. For example, we think Fortune REIT's acquisition of the Kingswood Ginza Mall will strengthen its exposure to the fast growth of suburban malls in Hong Kong, given that Kingswood Ginza Mall has been poorly managed for years, but is the second largest mall in Northwest New Territories in terms of GFA.

Similarly, we also believe Prosperity REIT's acquisition of 9 Chong Yip Street will strengthen its exposure to the Kowloon East area, where we believe its portfolio occupies a favourable position in that it is one of the few players in the segment below the large-floor plate multinational type grade-A office buildings.

Meanwhile, Regal REIT's acquisition of boutique hotels in urban areas should strengthen its overall competitiveness as a hotel operator. Moreover, we believe The Link REIT will start looking at potential acquisition opportunities in the Pearl River Delta area, which would notably expand the basket of acquisition opportunities it can access.

■ Prosperity REIT: changes in property valuation since IPO



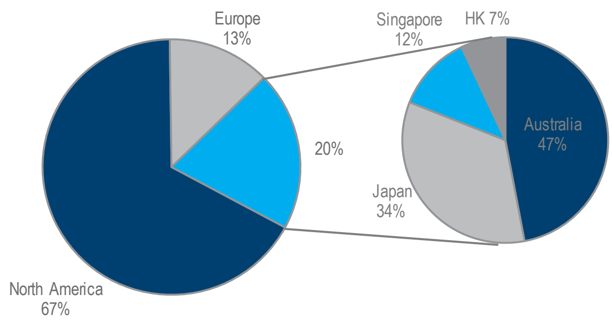
Source: Company

Overall, if more H-REITs can demonstrate that they can pull off yield-accretive acquisitions and enhance the potential of the acquired assets, this should help to strengthen investor perception about their potential to deliver sustained DPU growth, in our view.

3) Policy support from regulators

We think one feature of the regulatory framework for the H-REITs is that there seems to be no special advantages in being a REIT, as the REIT code in Hong Kong does not accord any tax or other advantages to the H-REITs. Instead, H-REITs are subject to more restrictions, and this has been a factor which has hindered the development of the H-REITs, in our view.

■ Structure of the global REIT market capitalisation



Source: Government of the HKSAR

Note that recently, the Financial Services Development Council put out a report titled "Developing Hong Kong as a Capital Formation Centre for Real Estate Investment Trusts", in which it highlighted that Hong Kong has been lagging behind in the development of its REIT market. According to the report, "compared to the size and liquidity of its capital market, Hong Kong's REIT market has fewer listings, smaller REIT sizes and less diversity in asset type" and it recommends making amendments to the Inland Revenue Ordinance, the REIT Code, the Mandatory Provident Fund Schemes

(MPFS) Regulation and Companies Ordinance to facilitate the development of the H-REITs.

Overall, we see the potential for changes in Hong Kong's regulatory framework for the REIT sector. Potential areas of change could include lowering the H-REITs' income tax or exempting them from having to pay income tax at all, waiving the stamp duty on the transfer of property related to H-REITs, eliminating the government rates for their non-residential properties, allowing H-REITs a certain degree of involvement in development activities, and changing the categorisation of REITs so that MPF funds can invest more than 10% of the portfolio in the H-REITs.

Overall, we see potentially favourable regulatory changes as another factor that could strengthen the credibility of H-REITs to deliver sustainable DPU growth over the next few years.

Sector view: Positive

We are Positive on the H-REITs, and believe that the concerns related to US tapering have been played out – even though the H-REITs' unit price performances have not been driven primarily by yield compression in the past. Instead, we believe the performance has been backed by a solid record in AEI and DPU growth, which we think has steadily bolstered their reputation, and should improve further over the next year (through more evidence of DPU growth, aided by AEI).

Overall, we believe the outlook for the H-REITs is still supported by the following factors: 1) the commercial property cycle is still in their favour, 2) the H-REITs have been moving from a neglected sector in the past towards a niche segment in the Property Investor sector, and 3) the suburban malls in Hong Kong are moving along a promising track and this should underpin the rental income and DPU outlook for many H-REITs. Moreover, we see the aforementioned factors strengthening the H-REITs' credibility in the market to deliver sustained DPU growth over the next few years.

After the recent unit price correction, we think the valuations of the H-REITs have adjusted to attractive levels, and would advise investors to focus on REITs that can deliver sustained DPU growth over the next few years.

The main risk would be a sharp rise in US interest rates and a deterioration in the outlook for the Hong Kong economy, which could significantly affect the DPU growth prospects for the H-REITs.

Notable market movements

Unit prices of the H-REITs were adversely affected by the tapering concerns and fell by 1.2% to 5.4% QoQ in 4Q13 (with the exception of Hui Xian REIT which rose by 0.8% QoQ).

■ H-REITs: unit-price performance in 2013

Name	BBG code	December (MoM)	4Q13 (QoQ)	2013 (YoY)
The Link REIT	823 HK	-1.1%	-1.2%	-2.8%
Champion REIT	2778 HK	-1.4%	-3.1%	-7.5%
Regal REIT	1881 HK	-1.3%	-1.8%	0.5%
Fortune REIT	778 HK	-4.0%	-3.4%	-3.1%
Yuexiu REIT	405 HK	-1.6%	-1.6%	2.7%
Sunlight REIT	435 HK	-1.0%	-1.3%	-9.1%
Prosperity REIT	808 HK	-2.2%	-5.4%	-3.8%
Hui Xi'an REIT	87001 HK	-0.8%	0.8%	-7.0%
Hang Seng Index		-2.4%	2.0%	2.9%

Source: Bloomberg
Note: as at 31 December 2013

Daiwa H-REIT ideas

Prosperity REIT: increasing exposure to the Kowloon East area

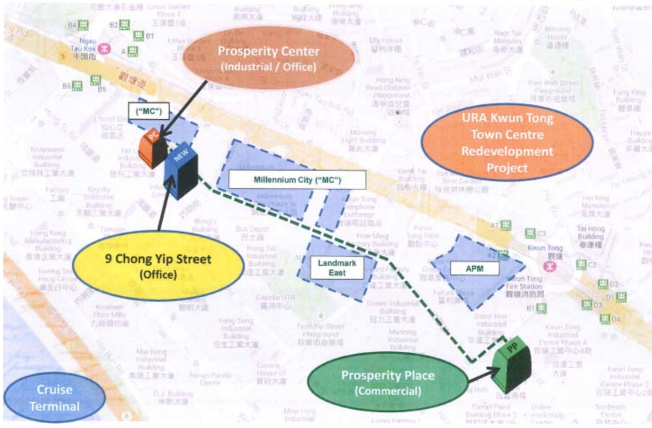
We see the Prosperity REIT's latest acquisition (announced on 16 December) of 9 Chong Yip Street, an office building owned by Hutchison Whampoa (Not rated) for HKD1,010m as an important step in its development. While the price represents an initial NPI yield of only 2.5%, based on the property's passing net property income of HKD12.7m in 1H13, we think this needs to be seen in the context that office rents in the Kowloon East area have appreciated greatly in recent years and the current passing rent in this property, at HKD16/sq ft, looks rather low.

Based on a spot rent of about HKD21/sq ft (which will be protected by rental support from the vendor for two years), we expect its NPI yield to rise to 3.2%. Given the proper AEI, we see room for the achieved rent in this building to rise further to HKD25/sq ft or more, given that currently the most prime grade-A office buildings in the area are commanding rents of over HKD35/sq ft. In any case, the deal will be yield-accretive in the near term given it is funded by two new loans the group has secured, which have a low effective interest rate of 1.74%. As such, we recently raised our FY14 and FY15 DPU forecasts by 1.5% and 1.2%, respectively.

Overall, we see this as a market price deal which does bring some strategic value to Prosperity REIT given it would strengthen its exposure to the Kowloon East area. We see Kowloon East as a sub-market where Prosperity REIT occupies a favourable position, in that it is one of the few players in the segment below the large-floor plate multinational type grade-A office buildings. This acquisition should also help facilitate Prosperity REIT's transformation into a more retail-oriented portfolio, where the room for rental expansion is much higher.

Overall, we believe Prosperity REIT occupies a special niche in the office market, as its current achieved rent (HKD18.5/sq ft for 1H13) is among the cheapest for a single landlord office portfolio. We see considerable room for an improvement in its achieved rent and believe that its current FY14 DPU yield of 7.7% is attractive (for more details, see our note *The Property REIT: Growing Kwoloon East exposure*)]

■ **Prosperity REIT: location of its properties in Kwun Tong**



Source: Company

■ **Prosperity REIT: financing of the acquisition**

Financing	Consideration	Indicative terms	Maturity
The New Facility	HKD784m	i) HKD404m secured term loan at 1.45% pa over HIBOR	5 years expiring Dec 2018
		ii) HKD380m unsecured term loan at 1.50% pa over HIBOR	3 years expiring Dec 2016
The Existing Revolving Credit Facility	HKD226m	HKD226m from existing revolving credit facility at 0.81% pa over HIBOR	5 years expiring Aug 2015
Total	HKD1,010m	Estimated weighted average cash financing cost = 1.74% pa	

Source: Company

H-REIT top pick

The Link REIT

(823 HK, HKD35.30, Buy [1])
Target price (DDM-based): HKD48.00

Far from exhausting the benefits of AEIs

■ **The Link REIT: unit-price performance (HKD)**

Source: Bloomberg

■ **The Link REIT: investment indicators**

12-month range (HKD)	33.95-46.30
Market cap (USDbn)	10.52
Average daily turnover (USDm)	19.44
Shares outstanding (m)	2,303
Major shareholder (%)	The Capital Group (12.0%)

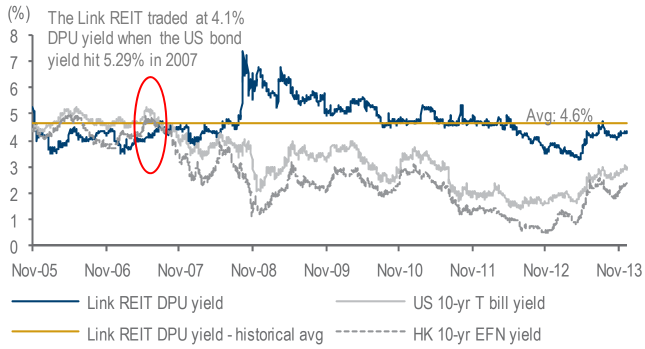
Source: Daiwa

Investment thesis

We believe The Link REIT is still operating in a virtuous cycle. We do not subscribe to the view that the benefits it derives from AEIs, and hence its DPU-growth prospects, have peaked. In our opinion, now is more like the "end of the beginning" of the revitalisation of The Link REIT's vast retail portfolio in Hong Kong, which we think is on track to become a higher-grade retail-property portfolio in the years to come.

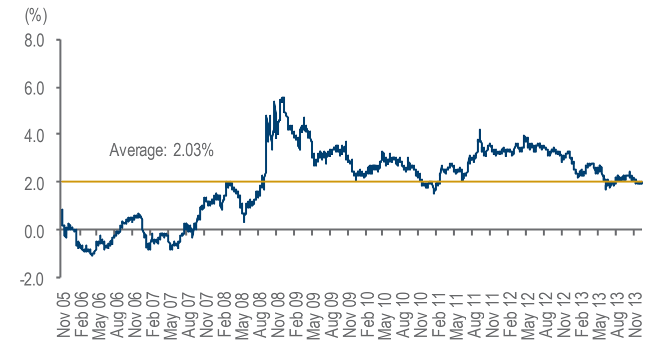
Following the recent unit-price correction, The Link REIT's one-year forward DPU yield has risen to 4.7%, which is close to its average DPU yield of 4.4% since the listing in November 2005 (after excluding the abnormal period of April-2008 to December 2009). In terms of PBR, it is trading currently at about 1SD below its average of 1.25x since its IPO. We think the recent unit-price correction provides a good opportunity to accumulate the units, especially as the H-REITs could benefit from potential favourable regulatory changes in 2014.

■ The Link REIT: DPU yield vs. US 10-year T-bill yield



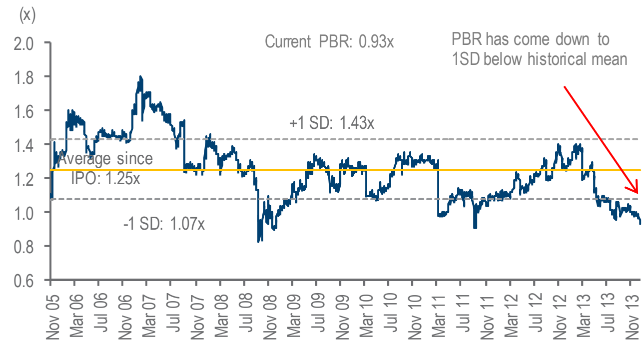
Source: Bloomberg, Datastream, Daiwa

■ The Link REIT: DPU yield spread against Hong Kong 10-year EFN history



Source: Datastream, Company, Daiwa

■ The Link REIT: historical PBR since listing in 2005



Source: Company, Bloomberg, Daiwa

Still in the early phase of upgrading its vast portfolio

We think now is still an early phase, when tenants with higher rent-paying capacity start to gain confidence in renting space in a property in The Link REIT's portfolio. While most of the new tenants that have come to its portfolio in recent years have been expanding, many still have fewer than 10 shops in The Link REIT's portfolio, and we expect their expansion to continue. Reinforcing this trend would be the growing prominence of suburban malls in the New Territories and the coming of a new group of consumers to the Hong Kong retail property market, which allows The Link REIT to have improved access to retailers with higher rent-paying capability.

■ The Link REIT: magnitude of expansion of some tenants

Tenant	Category	Year joined The Link REIT's properties	No. of stores as at the end of Mar 2013
Baleno	Apparel	2005	21
Tao Heung Group	Chinese restaurant	2005	9
Café 100%, Café de Itamomo	Specialty restaurant	2007	23
Bao Dim Sin Seng / Qun Qun Pan	Bakery /cake shop	2008	11
O Farm	Personal care	2010	5
Sasa	Personal care	2010	7
Cottex	Home decoration	2010	13
Colourmix	Personal care	2011	3
Wanko / Veeko	Apparel	2011	6
759 Store	Food	2011	43

Source: Company

While its starting to pursue opportunities in southern China may result in increased perceived risk, we think this needs to be balanced by its strengthened longer-term business growth prospects, as this could significantly expand the basket of assets it is able to acquire. We note that many of The Link REIT's major tenants have already expanded their operations significantly in southern China, and so it would be against the long-term interests of The Link REIT to exclude itself entirely from the Mainland market.

In addition, we believe that suburban malls are now very well-positioned in the Hong Kong commercial property market, given that many international retailers are now looking to expand their presence in the suburban malls and that for some Mainland consumers, suburban malls are more convenient for them. With some 60% of its portfolio located in the New Territories, The Link REIT should benefit from the expansion of suburban malls in Hong Kong, especially as it has now formulated a strategy to focus especially on districts where there is high retail-sales growth potential and where it has the potential to become a more important player.

■ **Distribution of retail property assets by area**

		IFA ('000 sq ft)	Car park spaces	Income (HKDm pa)	Value (HKDm)
Hong Kong Island	Eastern	529.0	3,639	182.2	2,982.6
	Southern	316.8	2,549	129.6	2,281.4
Kowloon	Wong Tai Sin	1,414.5	8,981	697.3	12,392.5
	Kwun Tong	1,524.9	11,107	620.2	9,962.8
	Sham Shui Po	305.5	2,502	93.2	1,592.7
	Kowloon City	246.3	1,152	73.5	1,447.3
	Yau Tsim Mong	34.9	225	22.3	323.7
New Territories	Sha Tin	1,329.7	10,968	550.7	8,791.0
	Sai Kung	853.9	6,547	475.4	8,109.7
	Yuen Long	738.9	6,332	401.5	6,551.1
	Tuen Mun	1,082.7	6,572	364.2	6,330.4
	Kwai Tsing	1,013.0	7,181	363.4	5,936.2
	Tai Po	695.3	5,710	270.3	4,408.1
	NT North	475.8	2,959	205.5	3,344.1
	Islands	297.3	2,437	109.8	1,811.7
	Tsuen Wan	78.8	609	24.7	406.8

Source: Company, Daiwa

Valuation

While The Link REIT trades at a premium to other H-REITs, we think this is supported by the distributable-income growth it has achieved and its stronger DPU-growth prospects. Moreover, following the recent unit-price correction, its current DPU yield and yield spread compared with 10-year Government EFNs are in line with its DPU yield since it was listed in November 2005.

Overall, we believe The Link REIT is still in a growth phase. Our target price of HKD48 is pegged to our 10-year DDM valuation. Our target price corresponds to an FY15 DPU yield of 3.9%.

Risks to our call

The main risks to our call are regulatory and social factors that could adversely affect The Link REIT's ability to improve its achieved rent. Potential new acquisitions outside Hong Kong could also expose it to risks it has not faced before.

■ **The Link REIT: financial summary (HKDm)**

	2014E	2015E	2016E
Revenue	7,107	7,814	8,557
Net-property income	5,205	5,814	6,495
Distribution	3,843	4,388	4,962
DPU (HKD)	1.656	1.872	2.098
DPU growth % chg YoY	13.2	13.0	12.1
DPU yield (%)	4.7	5.3	5.9
Book value per unit (HKD)	35.64	35.58	35.58
PBR (x)	1.0	1.0	1.0
EPU (HKD)	1.669	1.893	2.127
ROE (%)	4.7	5.3	6.0
Gearing (%)	13.6	13.6	13.5
FFO/unit (HKD)	1.67	1.89	2.13
P/FFO (x)	21.2	18.6	16.6

Source: Daiwa forecasts

■ **H-REITs: ratings, valuations, and key financial data**

	Price (HKD)	Mkt cap (USDbn)	Daiwa rating	Daiwa target (HKD)	Target upside (%)	2013E DPU (HKD)	2014E DPU (HKD)	2013E Yd (%)	2014E Yd (%)	Gov't Yd (%)	2013E Yd sprd (%)	2014E Yd sprd (%)	Latest BVPS (HKD)	PBR (x)	Latest gearing (%)	DDM Value (HKD)	2013E FFO (HKD)	2014E FFO (HKD)	2013E P/FFO (x)	2014E P/FFO (x)
Retail																				
Link REIT (823 HK)	35.30	10.52	Buy	48.00	36.0	1.66	1.87	4.7	5.3	2.3	2.4	3.0	38.04	0.93	11.6	48.00	1.67	1.89	21.2	18.6
Fortune REIT (778 HK)	6.13	1.47	Buy	8.20	33.8	0.36	0.42	5.9	6.8	2.3	3.7	4.5	9.73	0.63	20.1	8.20	0.31	0.36	19.6	17.0
Office																				
Champion REIT (2778 HK)	3.40	2.51	O/P	3.80	11.8	0.19	0.19	5.7	5.5	2.3	3.4	3.2	7.96	0.43	21.1	3.80	0.18	0.16	18.7	21.1
Sunlight REIT (435 HK)	2.95	0.62	Buy	4.00	35.6	0.20	0.22	6.8	7.6	2.3	4.5	5.3	6.52	0.45	25.9	4.00	0.18	0.21	16.1	14.1
Hotel																				
Regal REIT (1881 HK)	2.17	0.91	O/P	2.90	33.6	0.16	0.17	7.1	7.9	2.3	4.9	5.6	4.90	0.44	29.2	2.90	0.14	0.16	15.2	13.6
Industrial/office																				
Prosperity REIT (808 HK)	2.27	0.41	Buy	3.00	32.2	0.15	0.17	6.8	7.7	2.3	4.5	5.4	4.55	0.50	20.9	3.00	0.12	0.13	19.1	17.1
Market cap weighted avg		**7.33**						**5.2**	**5.7**		**3.0**	**3.5**		**0.77**	**15.6**				**20.1**	**18.4**
Simple average		**2.74**						**6.2**	**6.8**		**3.9**	**4.5**		**0.56**	**21.5**				**18.3**	**16.9**

Source: Bloomberg, Daiwa forecasts

Note: prices as of close on 13 Jan 2014; for The Link REIT 2013E/2014E = FY14E/FY15E (March) and Sunlight REIT 2013E/2014E = FY14E/FY15E (June)

S-REITs

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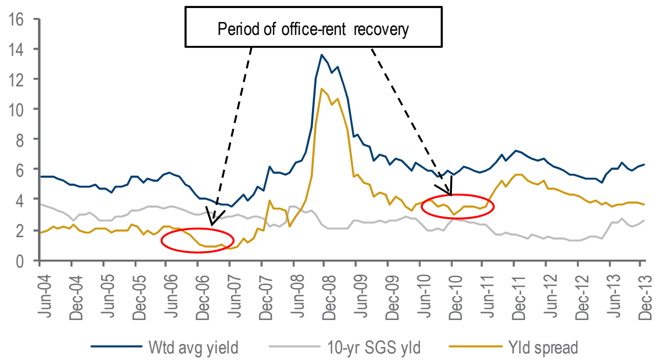
The big 2014 driver: a robust office-market recovery

Positive catalyst

We believe that a robust office-market rental recovery, should it materialise, would have highly positive repercussions for the returns of S-REITs in 2014.

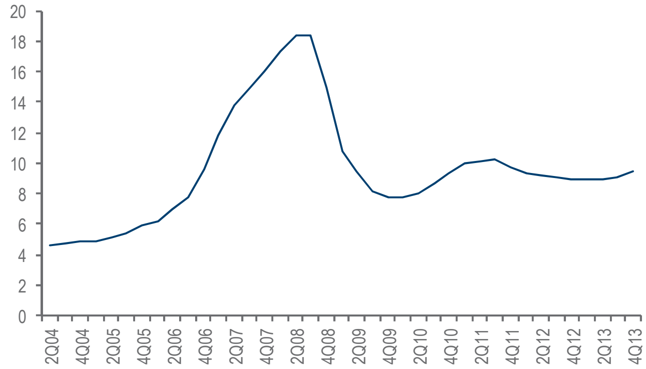
As shown in the following chart, which highlights the weighted-average S-REIT yield spread (the yellow line), the 2 most recent periods of office-rent recovery (most notably from 2Q06 to 2Q07 and, to a lesser extent, from 2Q10 to 2Q11) correspond to periods of S-REIT sector yield-spread compression.

■ S-REIT sector: weighted-average sector DPU yield, 10-year SGS yield and yield spread (%)



Source: Bloomberg, Daiwa

■ Singapore office: JLL prime grade-A rents (old series) SGD/sq ft



Source: Jones Lang LaSalle, Daiwa

Of course, there have been other periods of yield-spread compression in recent memory, such as from December 2008 to June 2010 and from December 2011 to May 2012. We would characterise these periods differently, as a gradual return to normalcy and diminishing market-risk premiums following global shocks (the global financial crisis in late 2008 and Eurozone debt crisis in late 2011). A yield-spread compression triggered by an office-market recovery would be confined to the Singapore market.

Stagnant yield spread reflects uncertainty

Since Bernanke's remarks on 22 May 2013 suggesting an eventual tapering of bond purchases by the Fed, the S-REIT yield spread has remained largely stagnant, which has been bad news for S-REIT unit prices, because their DPU yields have risen (with unit prices correspondingly falling) in line with the increase in the 10-year Singapore government securities (SGS) yield.

Although the absolute level of the S-REIT sector's weighted-average yield spread, of about 3.8% (based on our estimates), looks attractive (relative to its median value of 3.5% since June 2004) and is one of the highest among REIT markets globally, investors have been hesitant to enter the market on concerns that interest rates will rise further eventually as the Fed transitions from QE to a more normal but less accommodative monetary policy.

If the sector yield spread remains stagnant for 2014 as it did for 2H13, S-REIT dividend yields (and returns) would closely track the 10-year SGS yield, and the implication for S-REIT unit prices and returns would be negative in a rising interest-rate environment. To expect the sector yield spread to remain unchanged for 2014 is hardly a vote of confidence for the S-REIT market, but we reckon that it is probably the consensus view in the market.

Yield spread could narrow on a strong office-market recovery

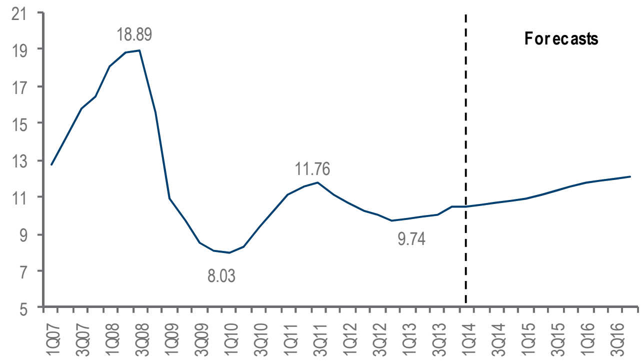
We believe a sharp and decisive recovery in the office-rental market (with spot rents rising by more than 15% YoY) could be a catalyst for a compression in the yield spread of S-REITs. Moreover, if the 10-year SGS yield remains stable for 2014, S-REIT unit prices could appreciate and possibly outperform the FSSTI, as they did from June 2006 to June 2007 when the S-REIT sector yield-spread compression was driven by a sharp recovery in office rents. We even believe that a strong office-rental recovery could overcome jitters of rising interest rates and 10-year SGS yields, assuming, of course, that global interest rates and bond yields do not spike up suddenly.

Office-rent recovery could be better than we expect

We assume muted growth in the current office-rental recovery compared with previous recoveries. Since the late 1980s, Singapore has experienced five periods of office-rent recovery, excluding the current one. The most recent office-rental cycle bottomed out in 4Q12, according to Jones Lang LaSalle's CBD prime grade-A data series (although other widely available rental series, including those from Singapore's Urban Redevelopment Authority [URA] indicate a bottom in 1Q13 instead).

Our office-rent forecast assumes QoQ increases of less than 2% for all quarters from 1Q14 to the end of 2016. In particular, we assume overall rental growth of 11% for 4Q14 (compared with the cyclical bottom in 4Q12), considerably slower than the median rental increase of 22%, measured from 2 years after the bottom of a typical rental cycle.

■ Singapore offices: CBD prime grade-A rents and Daiwa forecasts (SGD/sq ft/mth)



Source: Jones Lang LaSalle, Daiwa forecasts from 1Q14

Overall, we forecast annual average (CBD prime grade-A) rents to increase by 5.4% YoY for 2014 and 6% YoY for 2015, after having declined by 0.7% YoY for 2013.

■ Singapore office: rentals and Daiwa forecast

		2009	2010	2011	2012	2013	2014E	2015E	2016E
CBD prime grade-A rents (4Q)	SGD/sq ft/mth	8.08	10.21	11.14	9.74	10.51	10.77	11.61	12.08
YoY change	%	*(48.0)*	*26.3*	*9.1*	*(12.5)*	*7.9*	*2.5*	*7.7*	*4.1*
CBD prime grade-A rents (annual avg)	SGD/sq ft/mth	9.30	8.97	11.41	10.16	10.09	10.63	11.27	11.90
YoY change	%	*(47.9)*	*(3.5)*	*27.2*	*(10.9)*	*(0.7)*	*5.4*	*6.0*	*5.6*

Source: Jones Lang LaSalle; Daiwa forecasts from 1Q14

Reasons for caution for this recovery

The reasons for our more cautious view on rental growth and demand for this cycle have not changed much since our report of 31 January 2013: *Singapore Office REITs, A mild recovery is in the price*.

We believe the following factors will dampen rental growth compared with those in previous recoveries: 1) the availability of quality decentralised office space in Jurong East, Paya Lebar, and one-North as viable, price-competitive alternatives to traditional CBD office space, 2) the considerable amount of vacant stock in the CBD downtown core, and 3) a significant increase in new supply from 2016.

These risk factors have not improved much from a year ago.

First, the market appears to have absorbed new office space in one-North (from The Metropolis and Nexus) reasonably well in 2013, but major anchor tenants are still being sought for the major decentralised office spaces in Jurong East (Westgate) and Paya Lebar (Paya Lebar Square) that are scheduled to open in 2014.

Second, as at the end of 3Q13, the CBD vacancy rate was 6.1% – compared with 4.9% at the end of 2Q13 and 7.3% at the end 4Q12 – so the overall vacancy rate improved slightly. However, the improvement in the committed occupancy rates for the recently opened prime grade-A office towers has been achieved mostly by attracting existing occupiers in the CBD. These spaces will have to be leased to other tenants once the occupiers move out of their existing premises, though it would create a temporary tightening of supply during the tenancy transition.

Third, visibility has improved greatly for new supply over 2016-17, and large office occupiers with leases that expire by then will have many options to consider. It appears to be full steam ahead for the M&S developments (DUO in Bugis and Marina One in the new downtown), which will add a combined 2.37m sq ft of office space. Details have also been released for Guoco Tower in Tanjong Pagar.

■ **Singapore office: projected supply from 2014**

Scheduled completion	Market	Office development	NLA (sq ft)
2014	A	CapitaGreen	720,000
	A	South Beach Tower	501,943
	B	Orchard Gateway	37,354
	D	Westgate Tower	316,857
	D	MND Building (JEM)	312,153
	D	Paya Lebar Square	458,106
	D	Fusionopolis Phase 2A	54,000
		2014 subtotal	2,400,413
2015	D	Galaxis (Fusionopolis 5)	49,762
		2015 subtotal	49,762
2016	A	Guoco Tower	900,000
	A	Robinson Tower	128,000
	A	5 Shenton Way	285,000
	A	EON Shenton	103,021
	A	Robinson Square (P)	35,355
	C	DUO	570,000
		2016 subtotal	2,021,376
2017 and after	A	Marina One	1,800,000
	A	Oxley Tower (P)	111,713
	A	SBF Centre (P)	235,400
		2017 and after subtotal	2,147,113
		Grand total	**6,618,664**

Source: Jones Lang LaSalle, Daiwa
Note: A=CBD (shaded in blue), B=Orchard Road, C=CBD fringe, D=decentralised areas

Economic uncertainty looms again

One factor that was not mentioned in our previous report was the state of the economy. Singapore achieved GDP growth of 3.7% YoY (advance estimate) for 2013 after experiencing sluggish growth for most of 1H13. Following some short-term export-related euphoria in 3Q13, and a sobering 4Q13 performance (the sharp MoM dip in manufacturing PMI for December 2013 to 49.7 from 50.8 for November was not encouraging), we are again facing economic uncertainty at the start of 2014. The Singapore economy remains highly dependent on external demand conditions, which have an immediate impact on demand for office space.

Upside potential

Despite all of these reasons for us to expect a muted recovery, we acknowledge that there is a possibility that office rentals might exceed our forecast for 2014 and recover more strongly than we expect (rising, we reckon, by at least 15% YoY to beat current market expectations), and exhibiting growth rates similar to previous recoveries (a median increase of 22% over a 2-year period from the low).

We believe this bullish outcome would require office-space demand from large occupiers new to Singapore (and not from tenant relocations from one CBD address to another). Still, the perception of vacancy rates tightening considerably with the announcement of more leasing deals in the coming quarters could swing sentiment from a renter's market to a landlord's market, leading to a stronger-than-expected increase in spot rents. A strong office-rental recovery also implicitly assumes a clear improvement in the external demand and GDP-growth outlooks to encourage large occupiers to make these office-space commitments.

We reiterate that although we expect a muted office-rent recovery (it remains the base scenario in our DPU forecasts), we cannot rule out the possibility (our subjective probability for this outcome is 25-30%) that the office-rent recovery could accelerate, leading to an upward revision to our DPU forecasts for the office S-REITs and a sector-wide yield-spread compression, led possibly by the outperformance of the office S-REIT sector (against the FSSTI and FSTREI).

Sector view: Positive

We remain Positive on the S-REITs, and believe the sector is attractively valued on an absolute basis, trading, by our estimates, at a weighted-average 12-month forward dividend yield of 6.7% (as at 13 January 2014), a PBR of 0.98x, and forecast FY14 DPU growth of 7% YoY.

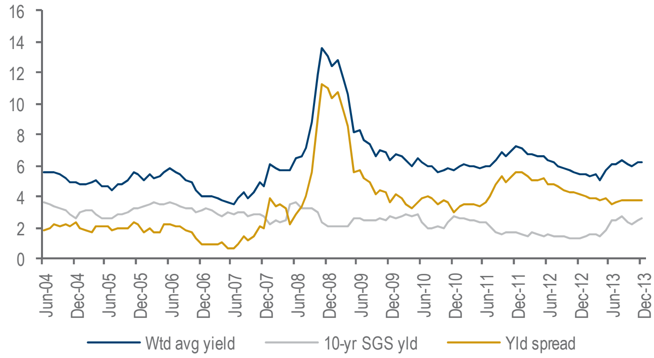
Solid and highly visible DPU growth

Moreover, we believe there is strong visibility on DPU growth over the next 6-12 months and see little risk of DPU-growth disappointment. For the office, retail, and industrial-property sectors, rental growth for 3Q13 was either flat or slightly positive QoQ, and we expect the trend to continue for at least a few more quarters.

Yield spread remains undemanding

The sector's yield spread (the DPU yield less the 10-year SGS yield), based on our FY13 and FY14 DPU forecasts, is 3.8% and 4.3% respectively. Compared with other REIT markets, these yield spreads are among the highest globally.

■ **S-REITs: weighted-average yield, 10-year government bond yield, and yield spread (%)**



Source: Bloomberg, Monetary Authority of Singapore, Daiwa

The yield spread could narrow

The relatively stable yield spread that we have observed since late May 2013 may have lulled investors into believing that it could persist indefinitely as long as there was a risk of further tightening by the Fed. We reckon that the expectation for the yield spread to remain stable in 2014 is the consensus view, implying that S-REIT returns for this year will be highly dependent on 10-year SGS yields. However, we believe the yield spread would narrow and that the S-REIT sector would outperform the FSSTI if the recovery of the office-rental market gained pace, even in an environment of rising interest rates, as long as the increase was gradual.

We prefer office and retail S-REITs

Office and retail are our top S-REIT subsectors. We expect a modest recovery in office rents over the next several years, but a decisive shift from a renter's market to a landlord's market could fuel a strong recovery and lead us to raise our DPU forecasts. Meanwhile, office S-REITs still trade at the largest discounts to NAV in the S-REIT sector even though office rents have clearly bottomed out in 4Q12-1Q13. With the worst of the domestic cyclical slowdown probably over, we expect the retail property sector's fundamentals to improve gradually in 2014. The valuations of retail S-REITs are also undemanding relative to their long-term (from the time of our coverage) price-to-Daiwa NAV ratios.

Major S-REIT risks

The downside risk to our Positive view would come either from a sudden and sharp increase in the 10-year SGS yield (triggered by renewed fears of aggressive tapering by the Fed) or more negative economic news and cuts to the market’s GDP-growth forecast for 2014, which would inevitably dampen demand for office space.

Notable market movements

Hot then cold

The FSSTI ended the year flat YoY, while the S-REIT sector, using the FSTREI as the proxy, declined by 8.9% YoY. Last year was one of two distinct markets. Up to late May and before Fed tapering fears emerged, the S-REIT sector outperformed the FSSTI as the overall stock market searched aggressively for yield plays. Afterwards, the S-REIT sector sharply underperformed the FSSTI, undermined by a rise in the 10-year SGS yield and the pullout of short-term funds shortly after the yield-compression play theme ended abruptly. Unit-price performance (mostly down for the year) appeared to be macro-related, with no clear biases by property sub-sectors or market-cap size.

■ S-REIT performance

	Bloomberg code	Price (SGD)	Dec (MOM) (%)	4Q13 (QoQ) (%)	2013 (YoY) (%)
Office					
CapitaCommercial Trust	CCT SP	1.45	(2.4)	0.0	(13.9)
Suntec REIT	SUN SP	1.54	(1.3)	(5.8)	(8.1)
Keppel REIT	KREIT SP	1.185	0.0	(3.7)	(8.5)
Retail					
CapitaMall Trust	CT SP	1.905	(2.1)	(2.8)	(10.6)
Frasers Centrepoint Trust	FCT SP	1.76	(0.6)	(4.6)	(12.0)
Starhill Global REIT	SGREIT SP	0.785	0.6	(1.3)	0.0
CapitaRetail China Trust	CRCT SP	1.33	(5.7)	(3.3)	(19.1)
Industrial					
Ascendas REIT	AREIT SP	2.2	(0.9)	(3.5)	(7.2)
Mapletree Logistics Trust	MLT SP	1.055	(3.2)	(1.4)	(7.9)
Cambridge Industrial Trust	CREIT SP	0.69	(1.4)	3.0	2.2
Hospitality					
CDL Hospitality Trusts	CDREIT SP	1.64	0.9	0.6	(12.8)
Ascott Residence Trust	ART SP	1.205	1.3	(4.4)	(11.4)
Index					
FTSE Singapore REIT	FSTREI	714	(1.3)	(2.8)	(8.9)
FTSE Straits Times	FSSTI	3167.43	(0.3)	(0.3)	0.0

Source: Bloomberg
Note Prices as at 31 December 2013

Daiwa’s S-REIT ideas

Retail S-REITs: gradually improving

In our report *Singapore Retail REITs: Gradually improving*, we reiterated our positive view and Outperform (2) ratings for all our retail S-REITs. Our outlook for FY14-15 did not change following the 3Q13 results announcements. We believe industry fundamentals will strengthen gradually over the next 12 months, even though interest-rate and yield-spread erosion risks remain.

Ascott Residence Trust: a major rights issuance

In our note *Ascott Residence Trust: a major rights issuance*, we downgraded our rating to Hold (3) from Outperform (2) on the back of a significant loss in DPU-growth momentum and dilution following the company’s 1-for-5 rights issue (announced on 4 November) to fund future acquisition opportunities.

S-REITs: top pick for 2014

Suntec REIT

(SUN SP, SGD1.565, Buy [1])
Target price (DDM-based): SGD2.00

Risks appear fully discounted

■ Suntec: unit-price performance (SGD)

Source: Bloomberg

■ Investment indicators

12-month range (SGD)	1.465-2.00
Market cap (USDm)	2.80
Average daily turnover (USDm)	9.89
Shares outstanding (m)	2,266
Major shareholder (%)	Suntec City Development (6.2%)

Source: Suntec, Daiwa

Investment thesis

We reaffirm our Buy (1) rating for Suntec, which is the only Buy-rated name among the S-REITs we cover. As one of the largest S-REITs (by asset size, market cap, and daily turnover), Suntec stands out for its wide discount to book value. A closer analysis of the NAV discount suggests to us that it is overdone.

We note that Suntec's current discount to NAV (pegged to Daiwa DDM valuations) relative to its peers and its trading history (since 31 December 2007) looks highly attractive now. The units are trading nearly 1SD below its median price-to-Daiwa NAV, while CapitaCommercial Trust (CCT) and Keppel REIT (KREIT) are trading at or close to their median price-to-Daiwa NAVs. Furthermore, Suntec's 10pp discount to CCT's price-to-Daiwa NAV appears excessive given that over the period from 31 December 2007 to 31 December 2013 their median price-to-Daiwa NAVs have been nearly identical (0.88x for CCT and 0.89x for Suntec).

■ Office S-REITs: price-to-Daiwa NAV (x)

	CCT	KREIT	SUN
Current	0.88	0.90	0.78
Median*	0.88	0.94	0.89
Mean*	0.86	0.95	0.88
Std dev*	0.16	0.19	0.14

Source: Daiwa

Note: *From 31 December 2007 to 31 December 2013

■ Office S-REITs: price-to-Daiwa NAV (x)

Source: Daiwa

The preceding table and chart reveal that Suntec has not always traded at a discount to its peers. For instance, during the period of the global financial crisis, it was one of the few large-cap S-REITs to refrain from a defensive and highly dilutive equity-fundraising exercise (although it did proceed with a SGD152m private placement in December 2009), and its premium valuation (relative to its peers) during that period was justified, in our opinion.

Not about the asset or management

One widely cited reason for Suntec's NAV discount has been the perceived quality and long-term competitiveness of its core Suntec City asset. However, we note that for most of its trading history (any time before about mid-2012), Suntec rarely traded at a discount to its peers, so citing Suntec City to explain the current discount is probably off the mark, in our view.

A similar argument can be made by blaming management for the current NAV discount. We believe this would be equally inappropriate, since the management team (CEO Yeo See Kiat, and Suntec's REIT manager, ARA, an affiliate of Cheung Kong) has changed little over the years.

Ongoing refurbishment

The ongoing refurbishment is probably a better explanation for Suntec's current valuation discount, because the start of the AEI (with the visible physical closure of major parts of the mall) in June 2012 corresponded roughly to when Suntec started to trade at a noticeable discount to its peers (on a price-to-Daiwa NAV basis), a situation which has persisted up to now.

Although we accept the premise that lingering refurbishment risks could have led to Suntec's current discount relative to its peers, we believe it still does not satisfactorily explain the size of the discount, which we regard as excessive.

Instead of trading at its median price-to-Daiwa NAV of 0.89x, in line with its two closest office S-REIT peers, the market, in effect, is assuming value destruction of about SGD450m (at Suntec's current price-to-Daiwa NAV of 0.78x, based on our estimates). This amount would easily exceed the entire capital expenditure budget of SGD410m for refurbishment. No doubt, the major refurbishment poses execution risks, but to assume that the entire programme would lead to a net destruction of the property's income-producing ability relative its pre-refurbishment status is cynicism at its most extreme, in our view.

Australia acquisition could backfire

Another recent development that has not helped Suntec's unit-price performance was the acquisition of 177-199 Pacific Highway, a 31-storey office tower under development in the North Sydney CBD for AUD413.9m (SGD470m), announced on 15 November 2013 (as discussed in our note: *Suntec REIT – still our top pick*.

After negative feedback on the deal from some seasoned real-estate securities investors, we accept that the acquisition could backfire if the 4-year rental guarantee (for 24% of the building's net-lettable area on the upper floors) rolls off and reveals that the space was grossly over-rented. This negative development would also render the initial net-property income (NPI) yield of 6.9% that was announced as unsustainable, and cast doubt on management's ability to create long-term value for unitholders.

The appropriateness of this acquisition for Suntec's portfolio is a longer-term issue, and will depend on future market conditions. Over the next several years, we estimate that it will be marginally DPU-accretive, based on the deal's structure and the guaranteed income. But to make judgement now and to assume that this acquisition will destroy value in the order of SGD450m is highly cynical and excessive, in our view.

Valuation

We maintain our DDM-derived six-month target price of SGD2.00. Suntec's book value per unit was SGD2.069 as at the end of September 2013. At 0.78x, Suntec is trading almost 1SD below its median price-to-Daiwa NAV of 0.89x (since August 2004).

Risk to our call

The key risk to our call would be an unforeseen downturn in the office market over the next 6 months, an outcome that could occur if the Singapore economy lost traction and slipped into recession in the coming quarters. Another risk would be a sudden equity fund-raising exercise, which, we believe, would undermine management's credibility.

■ **Suntec: financial summary**

	2013E	2014E	2015E
Revenue	221	300	369
Net-property income	139	206	271
Distribution	205	241	307
DPU (SGD)	0.091	0.106	0.134
DPU growth (% chg YoY)	(4.4)	16.9	25.9
DPU yield (%)	5.8	6.8	8.5
Book value per unit (SGD)	2.085	2.051	2.214
PBR (x)	0.8	0.8	0.7
EPU (SGD)	0.107	0.140	0.409
ROE (%)	5.1	6.7	19.2
Gearing (%)	38.3	39.4	38.4
FFO/unit (SGD)	0.050	0.088	0.117
P/FFO (x)	31.3	17.8	13.4

Source: Daiwa forecasts

■ S-REITs: ratings, valuations and key financial data

	Price (SGD)	Mkt cap (USDbn)	Daiwa rating	Daiwa target (SGD)	Target upside (%)	FY13E DPS (SGD)	FY14E DPS (SGD)	FY13E yield (%)	FY14E yield (%)	10-yr bond yld (%)	FY13E yld sprd (%)	FY14E yld sprd (%)	Latest BVPS (SGD)	PBR (x)	Latest gearing (%)	FY13E FFO/unit (SGD)	FY14E FFO/unit (SGD)	FY13E P/FFO (x)	FY14E P/FFO (x)
Office																			
CCT SP	1.46	3.32	O/P	1.65	13.0	0.081	0.081	5.5	5.5	2.5	3.1	3.1	1.66	0.88	29.1	0.073	0.075	20.0	19.5
SUN SP	1.565	2.80	Buy	2.00	27.8	0.091	0.106	5.8	6.8	2.5	3.3	4.3	2.05	0.76	38.6	0.050	0.088	31.4	17.7
KREIT SP	1.155	2.45	Hold	1.29	11.7	0.080	0.085	6.9	7.4	2.5	4.5	4.9	1.29	0.90	44.2	0.055	0.060	21.0	19.1
Retail																			
CT SP	1.865	5.10	O/P	2.18	16.9	0.101	0.113	5.4	6.0	2.5	3.0	3.6	1.71	1.09	33.4	0.105	0.113	17.8	16.6
FCT SP	1.75	1.14	O/P	2.10	20.0	0.109	0.110	6.2	6.3	2.5	3.8	3.8	1.77	0.99	27.6	0.107	0.107	16.4	16.4
SGREIT SP	0.76	1.29	O/P	0.90	18.4	0.050	0.051	6.6	6.7	2.5	4.2	4.3	0.86	0.88	30.3	0.052	0.051	14.7	14.8
CRCT SP	1.3	0.78	O/P	1.48	13.8	0.090	0.106	6.9	8.2	2.5	4.4	5.7	1.47	0.88	25.9	0.056	0.062	23.3	20.9
Industrial																			
AREIT SP	2.17	4.12	Hold	2.23	2.8	0.143	0.161	6.6	7.4	2.5	4.2	5.0	1.97	1.10	29.7	0.154	0.157	14.1	13.8
MLT SP	1.035	1.99	Hold	1.09	5.3	0.075	0.077	7.3	7.4	2.5	4.8	5.0	0.93	1.11	34.3	0.077	0.075	13.5	13.9
CREIT SP	0.695	0.68	Hold	0.71	2.2	0.051	0.054	7.3	7.8	2.5	4.9	5.3	0.67	1.04	35.8	0.030	0.049	23.0	14.3
Hospitality																			
CDREIT SP	1.65	1.27	O/P	1.80	9.1	0.110	0.117	6.6	7.1	2.5	4.2	4.6	1.60	1.03	29.7	0.108	0.116	15.3	14.3
ART SP	1.22	1.22	Hold	1.25	2.5	0.094	0.079	7.7	6.5	2.5	5.3	4.0	1.38	0.89	40.3	0.049	0.058	25.0	21.1
Simple average		2.18						6.6	6.9		4.1	4.5		0.96	33.2			19.6	16.9
Wtd average		**3.02**						**6.3**	**6.7**		**3.8**	**4.3**		**0.98**	**33.5**			**19.2**	**16.7**

Source: Bloomberg, Daiwa forecasts
Note: Prices as at the close on 13 January 2014

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