Daiwa Capital Markets

Sector

Construction & real estate / Pan Asia
4 July 2012

The 10-second briefing

A new spin on valuing REITs

- REITs: structured property entities - regulations mandate high dividend payouts, though entities are inherently cyclical
- H-REITs and S-REITs trade at discounts to NAVs, suggesting cyclical value, specifically in the office sector
- Cash-flow surety underpins value in selected office and residential J-REITs trading at NAV multiples of 1.01x and 0.99x, respectively

Pan Asia Real Estate Investment Trusts

- **Positive** (initiation)
- Neutral
- Negative

How do we justify our view?

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Important disclosures, including any required research certifications, are provided on the last two pages of this report.

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The 10-second briefing

A new spin on valuing REITs

- REITs: structured property entities - regulations mandate high dividend payouts, though entities are inherently cyclical
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Pan Asia Real Estate Investment Trusts

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and the Pan Asia REITs team

What's new

Pan Asia property is cyclical. Thus, if real estate investment trusts (REITs) are invested in Pan Asia property, they are by definition cyclical. Why are landlords, such as Hongkong Land or indeed Hysan Development, valued on a premium/ discount to NAV, and other landlords with similar business models, such as CapitaCommercial Trust (CCT), assessed on the basis of dividend per unit (in essence a backward-looking measure)?

In this report we provide a comprehensive analysis of the REIT sectors of Hong Kong, Singapore and Japan, and offer a fresh take on cross-border valuation and comparison.

What's the impact

The appropriate valuation methodology for REITs, in our view, needs to reflect: 1) the variability of underlying cash flow, which is determined by length of lease and structure of rental reviews, and 2) the inherent volatility of underlying capital values in the physical real estate market. While REIT valuations tend to focus on static measures – DPU yield spreads and cash-flow multiples (eg, funds from operations) – it is the directional outlook of a REIT's underlying asset value, in our view, which delivers the opportunity for leveraged growth during an upward trend in the asset cycle, though this potentially exposes the REIT to highly dilutive defensive capital raisings to offset rising gearing in a downcycle.

What we recommend

We believe the Pan Asia property markets have unique characteristics within the global real estate space and are not suited to one specific valuation norm. Our Pan Asia REITs team favours a multi-year income/ dividend approach for highly cyclical markets, and a cash-flow multiple or income capitalisation approach for more stable asset markets.

Office market cyclicality

Major markets	Period	Rent % chg pa	Std dev (%)	Capital value % chg pa	Std dev (%)
Tokyo	1995-11	(2.2)	3.6	n.a.	n.a.
Hong Kong	1999-11	4.8	8.2	9.0	17.4
Singapore	2003-11	7.7	20.6	10.8	17.8

Source: Jones Lang LaSalle (JLL), CBRE, CEIC, Miki Shoji

The contraction in financial-services sector demand and new completions led to higher vacancies in Singapore and Tokyo in 1Q12. But, a turnaround in rental growth prospects looks likely in 2013/14. Supply constraints in Hong Kong's Central district augur well for a swifter rental recovery in 1H13. While declining rents should place downward pressure on capital values, we expect lower interest rates to support modest compression in capitalisation rates (cap rates) in the near term, mitigating balance-sheet risks for the REITs due to asset revaluations.

Applying our newly standardised valuation approach across our Pan Asia REITs universe, we find most value in the office sector, given: 1) upside potential to our revised target prices (TPs), 2) steep discounts to NAV, and 3) our fundamental outlook, with opportunities for balance-sheet leverage lifting DPU expectations.

How we differ

Unlike our peers, our Pan Asia and multi-valuation approach to REITs enables cross-sector and geographic market comparisons.

Key stock calls

	New	Prev.
Suntec REIT (SUN SP)		
Rating	**Buy**	Buy
Target price	**S$1.630**	S$1.600
Up/downside	**▲ 20.7%**	
CapitaCommercial Trust (CCT SP)		
Rating	**Buy**	Buy
Target price	**S$1.470**	S$1.570
Up/downside	**▲ 16.2%**	
Champion REIT (2778 HK)		
Rating	**Outperform**	Outperform
Target price	**HK$3.55**	HK$3.50
Up/downside	**▲ 10.6%**	
Sunlight REIT (435 HK)		
Rating	**Buy**	Outperform
Target price	**HK$3.20**	HK$2.77
Up/downside	**▲ 22.6%**	
Nippon B'ldg Fund (8951 JP)		
Rating	**Outperform**	Outperform
Target price	**¥880,000**	¥880,000
Up/downside	**▲ 14.1%**	
Mori Hills REIT (3234 JP)		
Rating	**Outperform**	Outperform
Target price	**¥373,000**	¥ 373,000
Up/downside	**▲ 8.4%**	

Source: Daiwa forecasts
Note: Please refer to page 3 for details.

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- **Positive** (initiation)
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How do we justify our view?

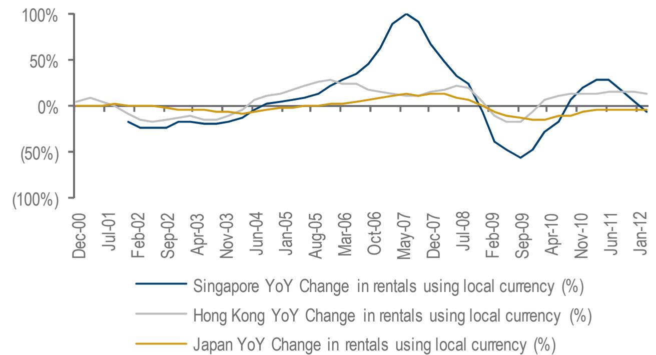
- Growth outlook ✔ ✔ ✔ ✔ ✔
- Valuation ✔ ✔ ✔ ✔ ✔
- Earnings revisions ✔ ✔ ✔ ✔ ✔

Growth outlook ✔ ✔ ✔ ✔ ✔

REITs are cyclical property entities, with near-term distribution growth tempered by a negative reversionary cycle in our Pan Asia REITs universe as a consequence of a contraction of financial services sector demand over the past 6-9 months.

While declining rents are likely to place downward pressure on capital values, we believe lower interest rates will support a modest compression in cap rates in the near term, mitigating balance-sheet risks from asset-value write-downs. In this context, we see opportunities for REITs to look to leverage their balance sheets earlier in the asset cycle, potentially delivering earnings/distribution surprises.

Pan Asia real estate markets: rental growth



Source: JLL, CEIC, Miki Shoji

Valuation ✔ ✔ ✔ ✔ ✔

Regionally, the REIT market looks attractive on underlying asset valuations. The S&P Pan Asia REIT universe (based on the companies' most recently reported book values), is trading at an average PBR of 0.92x, versus an average PBR of 1.02x since January 2005.

On yield spreads, historically low interest rates have contributed to Pan Asia REITs trading at an additional 66bps over the median spread (January 2005-May 2012). Low US dollar interest rates have seen Hong Kong yield spreads widen by 235bps (relative to historical levels since January 2005), followed by Singapore at 170bps, Australia at 162bps and Japan at 47bps.

Pan Asia REITs: valuations

	29-June-12			Median (since Jan-05)		
	PBR (x)	Yield (%)	Yield spread DPU yield vs. 3M T-bill (%)	PBR (x)	Yield (%)	Yield spread DPU yield vs. median 3M T-bill (%)
All REITs	**0.92**	**5.47**	**5.39**	**1.02**	**5.63**	**4.73**
Diversified	0.79	6.50	6.42	0.94	6.52	5.62
Industrial	1.11	5.45	5.36	1.16	5.20	4.30
Office	0.83	5.23	5.15	0.94	5.40	4.49
Residential	0.85	5.72	5.64	0.81	4.68	3.78
Retail	1.05	4.87	4.78	1.13	5.72	4.82
Specialised	0.87	5.22	5.14	0.94	5.70	4.80

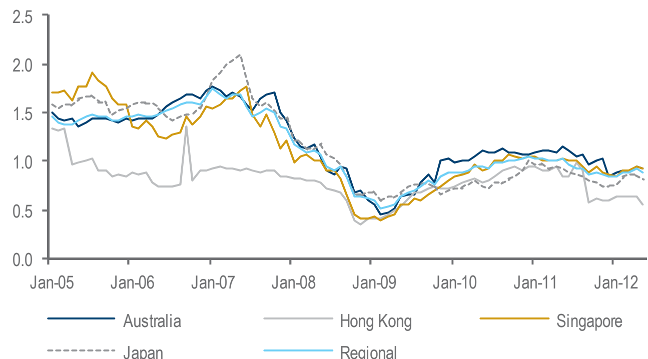
Source: Worldscope, IBES, Daiwa

Earnings revisions ✔ ✔ ✔ ✔ ✔

We have standardised our valuation approach in the core markets that we cover, namely, Tokyo, Hong Kong and Singapore, analysing REITs on the underlying structures of their property-specific cash flows and the inherent cyclicality of their individual asset markets.

Adopting a parity to DDM as our standard valuation approach in Hong Kong and Singapore, we have adjusted the target prices for our REIT universe by between -7% (CapitaCommercial Trust [CCT]) and +16% (Sunlight REIT). For the more mature Tokyo market, we have adopted an income capitalisation approach to derive underlying asset valuations for the J-REITs. Our target prices for the J-REITs are based on price-to-NAV multiples.

Pan Asia REITs: PBR valuations (x)



Source: Worldscope, IBES, Daiwa

Executive summary

A new spin on valuing REITs

REITs are cyclical property entities – balance-sheet leverage is the key to growth. Negative rental reversions should temper DPU growth. But, our newly standardised valuation approach suggests concerns are more than priced in.

▪ Investment thesis

REITs – cyclical property entities

The reality is that Asia property is cyclical. Consequently, if REITs are invested in Asia property, we view them as cyclical. The concept of the REIT market per se as 'safe' is a misnomer, in our view, though some REITs are less volatile in their underlying assets or unit prices. With REITs in Asia mandated to distribute between 90% and 100% of their distributable income, retained earnings are largely limited to revaluation gains and/or deficits. So for a REIT to grow its investment properties, it is not about reinvesting retained earnings, but about leveraging the balance sheet. During an upswing in asset prices, such a strategy can create a virtuous cycle, though on a downswing it potentially exposes the REIT to highly dilutive defensive capital raisings to stave off a sharp rise in gearing.

▪ Valuation

Valuation approach standardised; reflects inherent structure of the underlying cash flow from the real estate assets

We have looked to standardise our valuation approach in the core markets that we cover – Tokyo, Hong Kong and Singapore – analysing REITs on the underlying structures of their property-specific cash flows and the inherent cyclicality of their individual asset markets. In this context, we have utilised a 10-year DDM model as well as 10-year DCF NAV method for both Hong Kong and Singapore, replacing our previous methodologies. In determining our target prices we have adopted parity with our DDM valuations. We benchmark these valuations with our DCF NAVs to ensure that our DDM-derived valuations are consistent with the underlying values of the physical assets of the respective REIT, which enables a comparison with other comparable non-REIT property companies.

In the case of more static markets such as Tokyo (evident in the markedly lower volatility in rents in this market), the variability of future cash flows is perhaps of less concern. In this context, we have adopted an income capitalisation approach to derive the underlying asset valuation of the REIT. In deriving our target prices for the J-REITs, we have adopted a price-to-NAV multiple approach, benchmarking this multiple to the trading history of the REIT.

▪ Profit outlook

Positive on the near-to-medium term prospects for the office sector and see value in Hong Kong, Singapore and Japan

REITs in essence are cyclical companies. Distribution growth in the near term is being tempered by a negative reversionary cycle in our Pan Asia universe as a consequence of a contraction of financial services sector demand over the past 6-9 months. While Singapore and Tokyo have seen rising vacancies in recent quarters, we see potential for a turnaround in rent-growth prospects in 2013/14. Supply constraints in Hong Kong's Central district auger well for a swifter recovery in rents in 1H13 once demand returns. (Note: we are forecasting growth in rents of 2% YoY in 2013.) While declining rents are likely to place downward pressure on capital values, we expect lower interest rates to support a modest compression in cap rates in the near term, mitigating balance-sheet risks due to asset revaluations deficits.

Key picks and sector recommendation

We see greatest value in the Pan Asia office REITs sector, which is the focus of our top picks given: 1) upside potential to our our revised TPs, 2) steep discounts to NAV, and 3) our fundamental outlook, with opportunities for balance-sheet leverage lifting DPU expectations. That said, we would caution that non-REIT landlords also trade at discounts to NAVs (as in Hong Kong); hence, we reference our TPs to prevailing price-to-NAV multiples.

Our preferred REITs with exposure to the Hong Kong office markets are Champion REIT and Sunlight REIT where we have upped our TPs by 1% and 16%, respectively, following a change in our methodology to a DDM. Our preferred office REITs in Japan are Nippon Building Fund and Mori Hills REIT (TPs unchanged). In Singapore, our preferred exposure to the office market is via Suntec REIT (TP raised by 2%) and CCT where we see inherent value in its CBD office portfolio, notwithstanding a 7% cut in our TP.

In addition to our Pan Asia preference for the office sector we see selected value in the Hong Kong retail market with our preferred pick Fortune REIT where we lift our TP by 9%, and maintain our Buy (1) rating.

In Japan, outside the office sector we also see value in the residential REIT sector given valuations and the surety of cash flow underpinning DPU yields. Our preferred pick here is Daiwa House Residential offering a DPU yield of 5.8%.

Pan Asia REIT Sector (Daiwa universe) – summary valuations and sector views

REIT sector	Price-to-DDM multiple (x)	Price- to-NAV multiple (x)	Dividend yield spread (%)	Sector recommendation
Hong Kong				
Office	0.89	0.42	5.8	Positive
Retail	0.89	0.92	3.2	Positive
Industrial	0.87	0.51	6.6	Neutral
Singapore				
Office	0.86	0.84	5.4	Positive
Retail	1.03	1.01	4.1	Neutral
Industrial	0.98	1.02	5.6	Neutral
Japan				
Office	n.a.	1.01	3.8	Positive
Residential	n.a.	0.99	5.0	Positive

Source: Daiwa forecasts *Note: multiples are based on share prices of 29 June 2012*

As mentioned above, a change in our valuation methodology has seen an adjustment of our universe of REIT TPs by between +16% (Sunlight REIT) and -7% (CCT).

Given our revised TPs we have made some adjustments to our ratings based on valuation (upside/downside potential). We have raised our rating on Sunlight REIT to Buy (1) from Outperform (2), though cut our rating on Starhill Global REIT to Outperform (2) from Buy (1) and CapitaRetail China Trust to Hold (3) from Outperform (2).

Key stock calls

		Share	Rating		Target price (local curr.)			EPS (local curr.) FY1			FY2		
Company Name	Stock code	Price	New	Prev.	New	Prev.	% chg	New	Prev.	% chg	New	Prev.	% chg
Suntec REIT	SUN SP	1.35	Buy	Buy	1.630	1.600	2.1	(0.200)	(0.200)	n.a.	0.033	0.033	0.0
CapitaCommercial Trust	CCT SP	1.27	Buy	Buy	1.470	1.570	(6.5)	(0.059)	(0.059)	n.a.	0.056	0.056	0.0
K-REIT Asia	KREIT SP	1.07	Outperform	Outperform	1.210	1.080	11.8	(0.131)	(0.100)	n.a.	0.035	0.038	(7.9)
Champion REIT	2778 HK	3.21	Outperform	Outperform	3.55	3.50	1.3	0.205	0.205	0.0	0.207	0.207	0.0
Sunlight Real Estate Investment Trust	435 HK	2.61	Buy	Outperform	3.20	2.77	15.5	0.136	0.136	0.0	0.151	0.151	0.0
Fortune Real Estate Investment Trust	778 HK	4.64	Buy	Buy	5.37	4.95	8.5	0.238	0.234	1.7	0.282	0.283	(0.4)
Nippon Building Fund*	8951 JP	771,000	Outperform	Outperform	880,000	880,000	0.0	15,128	15,128	0.0	15,114	15,144	0.0
Mori Hills REIT**	3234 JP	344,000	Outperform	Outperform	373,000	373,000	0.0	8,988	8,988	0.0	8,997	8,997	0.0
Nippon Accommodations Fund***	3226 JP	517,000	Hold	Hold	582,000	582,000	0.0	14,172	14,172	0.0	13,827	13,827	0.0
Daiwa House Residential Investment***	8984 JP	557,000	Outperform	Outperform	600,000	600,000	0.0	15,690	15,690	0.0	16,204	16,204	0.0

Source: Daiwa forecasts
Prices are as of 29 June 2012
Notes: 1) six-month target prices for the Hong Kong and Singapore stocks, six-month or 12-month target prices for the Japan stocks (specified in the company sections); 2) financial year-ends are as specified in the company Financial summaries
**FY1= six months ending June 2012; FY2 = six months ending December 2012*
*** FY1 = six months ending July 2012; FY2 = six months ending January 2013*
****FY1 = six months ending August 2012; FY2 = six months ending February 2013*

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REITs: structured, cyclical property entities

REITs – if they are invested in property they probably are cyclical

REITs – what are they and what are we valuing?

The reality is that Asia property is cyclical. Consequently, if REITs are invested in Asia property, by definition they are cyclical.

The concept of the REIT market per se as 'safe' is a misnomer, in our view, though some REITs are less volatile in terms of their underlying assets or unit prices.

Structuring rental leases over three, five or more years may give the perception of secure, stable cash flows (and fund managers can clip dividends during this period), but a material change in the outlook for market rents (ie, historical rents will not be achieved in year 4 after the expiry of the three-year lease, or in year 5 after the expiry of the four-year lease, or in year 6 after the expiry of the five-year lease, etc.) will be reflected in the underlying asset values, with REITs mandatorily revaluing their properties every year.

In our view, analysts believe that REITs are 'safe' because they spend most of, if not all, their time focused on the companies' profit and loss statements. With rental reviews in Asia done characteristically every three years, a 20% annual slide in rents would be cushioned by two-thirds of the rent being paid at previous years' rents. In reality, annual dividends per unit (DPUs) from a REIT, not net asset values (NAVs), are affected more by a decline in occupancy than a change in market rentals, reinforcing the myth that they provide yield surety.

Expectations of declines in market rents, however, are likely to be reflected in expectations of the directional trend in NAVs – so the market to an extent can be seen to be ahead of analysts' fixations with DPU yield and spread over risk-free rates. In essence, lower unit prices result in higher dividend yields.

If it looks like a duck, walks and talks like a duck, it probably is a duck

The easiest way to explain the paradox in REIT valuations is by understanding the business models – if it walks, talks and looks like a duck, it should be perhaps be valued like a duck.

Hongkong Land's business model is to own and lease office buildings, with the majority of those office buildings located in Hong Kong Central. Yes, we agree that Hongkong Land has some development property though c.90% of the valuation story for Hongkong Land is the market's view of office rents and values in Central, Hong Kong, ie, the directional trend in the net asset value of the firm.

CapitaCommercial Trust (CCT), an office REIT based in Singapore, has a business model, which, not surprisingly, is very similar to the business model of Hongkong Land – it owns and leases office buildings. The only difference is that CCT's assets are located in the Singapore CBD, while Hongkong Land's are located primarily in Hong Kong Central. The only difference in terms of the practicalities of the two groups' corporate structures is that CCT is mandated to distribute 90-100% of its earnings no matter what, no questions asked. (However, it does so given regulatory mandates to ensure its tax transparency.) Consequently, earnings are not usually retained at a REIT, though such decisions in property companies are generally deliberated by respective boards when management is looking to buttress the balance sheet if the market outlook appears to be deteriorating.

The above factors have an impact on both the market's assessment of valuations and the vulnerability of REITs' balance sheets to changes in asset values.

Valuations – is there a market bias?

In our view, the market practice is to value landlord stocks such as Hongkong Land and Hysan Development on the basis of a premium or discount to NAV.

If you were to value Hongkong Land or Hysan Development on a forward EPS yield and the resultant spread over the risk-free rate (which is in essence the same as CCT's forward DPU yield), you would probably be laughed out of Exchange Square/The Lee Gardens, with the majority of the respective companies management teams as well as most esteemed fund managers highlighting that the one-year forward EPS yield for an Asian office landlord stock is the equivalent of driving a car looking at a rear-view mirror – ie, about two-thirds of the leases are guaranteed to be paid the next year at prevailing or previous market rents.

At the end of the day, Hongkong Land, Hysan Development and other landlord stocks are an asset story, in our view, with the direction of the stock in the main predicated by the market's expectation of the directional trend in the underlying asset valuation.

So if the business model of Hongkong Land and/or Hysan Development dictates that it is valued at a premium/discount to NAV – with that analysis usually based on a multi-year valuation (10-year discounted cash flow) – why is the market valuing similar businesses, such as CCT and Suntec REIT in Singapore, or for that matter Champion REIT in Hong Kong, on a dividend yield and its apparent attractiveness relative to the risk-free rate?

Indeed, why do most REIT managers themselves in presentation material continue to highlight such matrices to analysts and fund managers?

Balance sheets, the asset cycle and growth

In our view, the problem with property companies (specifically investment property companies/landlords) is that they tend to have low ROEs, with the low ROE a product of the market practice (among most companies and REITs) that they revalue their investment assets (not their undeveloped land bank) every year. As the denominator is increased, overall gearing falls. In the case of a REIT, revaluing assets are mandatory on an annual basis.

In the case of Hongkong Land, Hysan Development and other landlords, it can, to an extent, manage its gearing ratio via its dividend policy – determining what of this year's profits remain on the balance sheet; in essence saving for that rainy day. REITs do not have such a luxury and are in fact mandated to distribute the majority of all income every year (to ensure tax transparency in certain jurisdictions).

So for a REIT to grow its asset base and earnings, it is not about reinvesting retained earnings (as is the case with Hongkong Land, Hysan Development or with any other company), but about leveraging its balance sheet.

As asset prices rise, gearing, (the ratio of debt to assets), all things being equal, should fall, enabling a REIT to buy assets at more inflated prices than they were 12 months ago. In essence, this can be seen as a virtuous cycle – until of course the cycle turns.

REITs have the opportunity to sell assets and time the market cycle. For example, CCT's decision to sell both Robinson Point (in January 2010) and Starhub Centre (in July 2010), and more recently Sunlight REIT's proposed divestment of four non-core properties announced in June 2012. While divestments have occurred, most REITs, it appears, are not so inclined to sell assets, as their focus is on building the size of their assets under management (AUM), rather than second-guessing the asset cycle.

As an observation, the fact that the REIT managers themselves get paid on the quantum of property assets under management (defined as the deposited property assets) – not cash under management – highlights the possible risk that the manager's goals are not as truly aligned with those of the unit-holders.

The key in our thesis is that when the cycle turns, REITs with leveraged balance sheets and no retained earnings face the spectre of the underlying equity value of the REIT being stripped, as underlying asset values decline and as asset revaluation deficits are booked. In such circumstances, REITs are often forced into defensive equity raisings which can be highly dilutive, as such equity raisings are likely to be undertaken at a discount to the underlying book value.

Why the equity raising? In most jurisdictions there are gearing regulations designed to cap the extent of leverage and reinforce what we see as the misperception in the market that REITs are 'low-risk'. Indeed, in Singapore, according to a mandate by the Monetary Authority of Singapore (MAS), gearing cannot be more than 60% (if the REIT secures a credit rating). However, market practices have seemingly sanctioned an acceptable market gearing of c.45% or less. Consequently, REITs that breach such gearing 'norms' could see their credit ratings reassessed, affecting their underlying borrowing costs.

What valuation methodology is appropriate?

REITs are valued on a variety of parameters and generally include static measures such as:

- Funds from operations.
- DPU yield spreads.

Or alternatively, REITs are valued on multi-year valuation methods such as a:

- 10-year discounted cash flow to determine a net asset valuation.
- 10-year dividend discount model (DDM).

The appropriate valuation approach, in our view, should mirror the underlying cyclicality of the physical market, as the amplitude of the cycle will directly affect the annual variability of the underlying asset values and the REIT's stated book value; hence our preference for a multi-year valuation methodology.

■ Understanding cyclicality – office rents and capital values

Major markets	Period	Rent % chg pa	Std dev (%)	Capital value % chg pa	Std dev (%)
Tokyo	1995-11	(2.2)	3.6	n.a.	n.a.
Hong Kong	1999-11	4.8	8.2	9.0	17.4
Singapore	2003-11	7.7	20.6	10.8	17.8

Source: JLL, CBRE, CEIC, Miki Shoji

In markets where asset valuations see a high degree of variability – as in the case of Asia – we believe a multi-year valuation approach highlights the potential opportunities and risks through growth via leveraging the balance sheet, and consequently is perhaps more relevant.

The Hong Kong and Singapore office markets are naturally cyclical, given that office leases are usually for three years with the rent review to market – either up or down. In addition, the variability in demand and the lumpiness in the completion of new supply can aggravate the equilibrium between supply and demand. Actual and expected changes in these parameters can have a marked impact on rental levels, further affecting the amplitude of the potential swings in the rental/asset cycle.

■ Leasing practices and standards - Pan Asia

Japan	Leasing practice/standard
Typical lease term	Standard lease of 2-3 years with the possibility of renewal. Fixed term leases 3-5 years, though can be longer.
Frequency of rent payment	Monthly.
Basis of rent review	Open market rental value.
Frequency of rent increase	Typically at lease renewal; however with traditional leases, can be at any time during the lease term if the market rent has substantially increased or decreased.
Hong Kong	**Leasing practice/standard**
Typical lease term	Typically 3-6 years with 6-12 years for larger occupiers.
Frequency of rent payment	Monthly.
Basis of rent review	Open market rental.
Frequency of rent increase	At lease renewal or every three years for longer leases.
Singapore	**Leasing practice/standard**
Typical lease term	Three years, longer terms in excess of 5 years available for larger space users.
Frequency of rent payment	Monthly or quarterly.
Basis of rent review	Open market rental.
Frequency of rent increase	At lease renewal, usually every three years.
Australia	**Leasing practice/standard**
Typical lease term	3-5 years with 6-10 years for larger occupiers.
Frequency of rent payment	Monthly.
Basis of rent review	Open market rental (with or without ratchet) at option or mid way through the lease term. During the term of the lease there is usually a fixed increase (3.5-4.5%) or an increase linked to the consumer price index.
Frequency of rent increase	Annual fixed increase with 3 yearly upward only reviews to market.

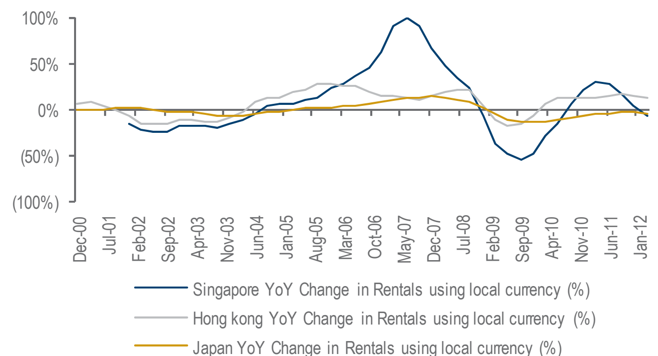
Source: JLL, Blake Dawson, Asia Pacific Investment Guide

While market participants seem mindful of the cyclicality of markets, the marked change in expectations is likely to affect valuers' assumptions in terms of both terminal capitalisation rates and longer-term growth rates when determining the property's value. More importantly, with contracted rents in a 10-year discounted cash flow averaging about three years in Hong Kong and Singapore, the underlying asset valuation is highly susceptible to a valuer's assumptions for rents and rental growth rates in years 4 through to 10, which may change from year to year.

In the case of markets such as Australia, where leases relative to Asia are firstly longer (usually 3-5 years with larger occupiers having lease 6-10 years) and structured with rent increases mandated annually – usually to either CPI or market whichever is greater, changes in the valuer's perception of the pace of growth of the underlying cash flow is lower (than in Asia) given the contracted nature of the cash flows.

Given the perceived surety of cash flows, the valuation in essence is only susceptible to a valuer's assumptions in the latter years of the 10 year DCF years beyond year six (versus beyond year 3 in Asia), which would usually only have a modest impact on the valuer's assessment of the property's underlying capital value.

■ Office rentals – Hong Kong and Singapore, Japan



Source: JLL

In markets where asset valuations see a low degree of cyclicality – due to either the market structure and/or the nature of how leases are structured in terms of both tenure as well as rental reviews – then the potential destructive risks of marked declines in asset valuations and the impact on gearing would be deemed to be lower, allowing investors to perhaps focus more on cash flow multiples, eg, Funds from Operations (FFO) or dividend yield spreads.

The Daiwa Pan Asia approach

In valuing REITs, we believe investors need to be mindful of the:

- underlying lease structures – both length and provisions for rental reviews, and
- the inherent volatility of the market per se

when determining the appropriate valuation methodology.

We believe the Pan Asia property markets have their unique characteristics and do not lend themselves to one specific valuation norm, though we would favour a multi-year valuation approach (10-year DCF of the REITs' net income/dividend) for highly cyclical markets and a cash flow multiple or income capitalisation approach for more stable asset markets.

That said, while we would have a bias to one valuation methodology over another in each individual market, it would be fair to say that at different points in the cycle, analysts and investors should look at alternative valuation approaches to obtain guidance of potential upside or downside in a REIT's valuations, given the propensity for listed entities to overshoot their underlying fundamental value both on the upside and the downside over the cycle.

To that end, we have looked to standardise our valuation approach in the core markets that we cover: Tokyo, Hong Kong and Singapore.

In a cyclical asset market, we have a preference for valuations based on 10-year forecasts of net property income and dividends, as this should enable the variances in the rental cycle to be reflected over time and ensure that when deriving a terminal value, one is capitalising into perpetuity the long-term achievable income and/or dividend (on the basis that the asset is freehold; capitalisation rates would be adjusted accordingly for leasehold properties).

While a 10-year DCF is perhaps viewed as a real estate valuer's valuation and a DDM may be construed as a 'financial market' valuation, both values in essence should be similar if one is consistent in both the discount rate and capitalisation rates, ie, the cash-flow risk from the physical asset is identical to the cash-flow risk of the listed REIT, as the source of the cash flow – the underlying real estate – is identical.

Apart from differentials in discount rates, the differential in valuations between a property NAV and a REIT's DDM would be that the dividends would reflect the levered returns of the REIT while providing to a degree the 'value' of the structure, as it would account for variability in applicable tax rates.

In the context of adopting a unified approach, we now utilise a 10-year DDM model as well as a 10-year DCF NAV for both Hong Kong and Singapore, replacing our previous methodologies.

Such an approach takes into account the cyclicality of the market and passing rents, enabling a terminal value being based on our expectations of a normalised income stream of the underlying asset/REIT. Such an approach should ensure that the value potential of REITs with expansive asset enhancement initiatives would be fully captured.

In Singapore, we had previously used a Gordon Growth Model with a finite life adjustment. While meeting our criteria of forecasting net property income/cash flow to a 'steady state', our new methodology unifies our cash flow forecast period across our Singapore REIT universe.

In Hong Kong, we had previously used a dividend capitalisation model. While our capitalisation rate was adjusted to reflect future expectations of income receipts and benchmarked to prevailing market yields, we believe the 10-year DCF/DDM approach will enable our valuation approach to be more dynamic, ensuring that underlying assumptions can be easily identified and enable our valuations to be more responsive to changes in our rental growth expectations, as well as to announcements of asset-enhancement initiatives.

For Hong Kong and Singapore, in deriving our target prices we have adopted parity with our 10-year DDM as our standard valuation approach, with the benefit of this approach enabling the valuation to capture the differing tax treatment of dividends in different jurisdictions.

For Hong Kong and Singapore, we obtain our DDM valuations from a two-stage model consisting of (1) ten years of explicit DPU forecasts, which capture several property cycles, underlying rental-growth rates, value-creation opportunities such as asset-enhancement initiatives (AEIs), and other REIT-specific developments, and (2) a terminal-value estimate, based on long-term growth assumptions of 1.5% for Singapore and 2.0% for Hong Kong.

Additionally, for Singapore, we apply a finite-life adjustment due to the leasehold nature of the S-REIT portfolios (ranging from a weighted-average remaining leasehold of 31 to 108 years) to our terminal-value estimates.

Our discount rates (equivalent to the cost of equity for a DDM valuation) are derived from a Capital Asset Pricing Model (CAPM) approach, applying betas of 0.8-1.1x and risk-free rate assumptions of 1.4% (10-year government bond yield) for Singapore and 3% (10-year EFN average yield) for Hong Kong. Overall, our discount rates (costs of equity) range from 7.9-8.9% for Hong Kong, and 7.7-9.1% for Singapore.

While adopting the DDM parity model, we nevertheless will be benchmarking these DDM derived target prices against our forward 10-year DCF-derived NAVs to ascertain the implied price-to-NAV multiple.

We believe this benchmarking is essential to ensure that our DDMs are consistent with the underlying value of physical assets of the respective REIT, as well as to ensure that the valuation assessment can be more broadly benchmarked to market valuation of comparable property companies in the same market.

In the case of more static markets, such as Tokyo (evident by its the markedly lower volatility in rents), the variability of future cash flows is perhaps of lower concern.

In this context, we have adopted an income capitalisation approach to derive our underlying asset valuation for the REIT. In deriving our target prices we have adopted a price-to-NAV multiple, benchmarking this multiple to the historical trading patterns of the REITs and the respective analysts' views of the underlying prospects for the REITs and dividend growth.

That said, we believe that even in more 'mature' or 'static' markets, 10-year DCF-based valuations provide a more dynamic valuation approach and we will calibrate our valuation platform in Japan to such a 10-year model over time.

We present FFO multiple valuations for the REITs under our universe coverage and highlight these multiples versus the FFO median multiple over the past five years. Here, we define FFO as net income (or net profit/total return) + depreciation - property divestment gains - property revaluations.

Our respective REIT teams in Hong Kong, Singapore and Tokyo have adopted valuation benchmarks they see as appropriate for each market, which reflects both the market's underlying structure as well as the analyst's assessment of the timing within the real estate asset cycle (upswing/downswing). Where necessary, these valuation benchmarks are adjusted to derive our respective target prices

■ H-REITs and S-REITs: Daiwa target price changes

	Bloomberg	Share price 29 Jun-12	Daiwa rating	New target 10-year DDM	Upside to Target price	Previous target price	TP change
Hong Kong		HK$		HK$		HK$	
Retail							
The Link REIT	823 HK	31.65	Outperform	35.43	12%	35.13	1%
Fortune REIT	778 HK	4.64	Buy	5.37	16%	4.95	9%
Office/Retail							
Champion REIT	2778 HK	3.21	Outperform	3.55	11%	3.50	1%
Sunlight REIT	435 HK	2.61	Buy	3.20	23%	2.77	16%
Industrial							
Prosperity REIT	808 HK	1.77	Outperform	2.04	15%	2.04	0%
Diversified							
Yuexiu REIT	405 HK	3.72	Hold	4.00	8%	4.00	0%
Regal REIT	1881 HK	1.80	Hold	2.05	14%	2.05	0%
Singapore		S$		S$		S$	
Office							
CapitaCommercial Trust	CCT SP	1.265	Buy	1.47	16%	1.57	-7%
Suntec REIT	SUN SP	1.35	Buy	1.63	21%	1.60	2%
K-REIT Asia	KREIT SP	1.065	Outperform	1.21	14%	1.08	12%
Retail							
CapitaMall Trust	CT SP	1.91	Hold	1.79	-6%	1.85	-3%
Frasers Centrepoint Trust	FCT SP	1.665	Hold	1.62	-3%	1.55	5%
Starhill Global REIT	SGREIT SP	0.665	Outperform*	0.72	8%	0.75	-4%
CapitaRetail China Trust	CRCT SP	1.31	Hold*	1.34	2%	1.40	-5%
Industrial							
Ascendas REIT	AREIT SP	2.15	Hold	2.13	-1%	1.95	9%
Mapletree Logistics Trust	MLT SP	0.98	Outperform	1.07	9%	1.05	2%
Cambridge Industrial Trust	CREIT SP	0.57	Hold	0.57	0%	0.56	2%
Sabana Shari'ah Compliant	SSREIT SP	0.975	Hold	0.99	1%	0.97	2%
Hospitality							
CDL Hospitality Trusts	CDREIT SP	1.95	Outperform	2.12	9%	2.10	1%
Ascott Residence Trust	ART SP	1.085	Buy	1.31	21%	1.32	-1%

*Source: Bloomberg, Daiwa; *please refer to our SGREIT and CRCT notes published on 4 July 2012*

Why a multi-valuation approach?

The multi-valuation approach enables cross-border comparisons as well as enabling analysts to focus on valuation methodologies which they believe to be most appropriate in their respective markets.

We are mindful that the universe of fund managers who invest in REITs have a number of differing investment mandates and valuation parameters. On many of our marketing trips, we have seen evidence that REITs as a sector appeal to core property funds – where an analysis of the NAV is a primary concern. Other investors include fund managers with dividend yield mandates, where yield is a key basis of assessment. In such cases, while price-to-book is a key parameter in terms of assessing fundamental value, the focus remains on the cash generative nature of the business, with the DPU yield and yield spreads cross-checked against measures such as FFO multiples.

■ Daiwa Pan-Asia REITs universe: ratings, valuations and key financial data

REIT Bloomberg	Unit price	Market cap	Daiwa Rating	Daiwa target price	FY12E DPU	FY13E DPU	FY12E DPU Yield (%)	FY13E DPU Yield (%)	Risk free rate (%)	FY12E Yield spread (%)	FY13E Yield spread (%)	Latest reported book	PBR (x)	5-year avg. PBR (x)	Latest NAV	P/NAV (x)	DDM Value	FY12E FFO	FY13E FFO	FY12E FFO (x)	FY13E FFO (x)	5-year avg FFO (x)
	HK$	US$bn		HK$	HK$	HK$						HK$					HK$	HK$	HK$			
Hong Kong REITS																						
Retail																						
Link REIT	31.65	9.23	Outperform	35.43	1.295	1.433	4.1	4.5	1.1	3.0	3.5	27.73	1.14	1.27	32.91	0.96	35.43	1.29	1.43	24.5	22.1	23.0
Fortune REIT	4.64	1.01	Buy	5.37	0.284	0.322	6.1	6.9	1.1	5.1	5.9	7.85	0.59	0.61	8.10	0.57	5.37	0.24	0.28	19.5	16.4	18.7
Office																						
Champion REIT	3.21	2.06	Outperform	3.55	0.225	0.226	7.0	7.0	1.1	5.9	6.0	7.82	0.41	0.58	7.89	0.41	3.55	0.20	0.21	15.7	15.5	31.4
Sunlight REIT	2.61	0.54	Buy	3.20	0.165	0.18	6.3	6.9	1.1	5.3	5.8	5.39	0.48	0.60	5.72	0.46	3.20	0.14	0.15	19.2	17.2	32.1
Industrial																						
Prosperity REIT	1.77	0.31	Outperform	2.04	0.135	0.143	7.6	8.1	1.1	6.6	7.0	3.29	0.54	0.63	3.45	0.51	2.04	0.10	0.11	18.1	16.4	20.9
Diversified																						
Yuexiu REIT	3.72	0.51	Hold	4.00	0.276	0.284	7.4	7.6	1.1	6.4	6.6	5.74	0.65	0.84	5.99	0.62	4.00	0.31	0.32	12.1	11.8	11.3
Regal REIT	1.80	0.76	Hold	2.05	0.129	0.133	7.2	7.4	1.1	6.1	6.3	3.88	0.46	0.61	3.91	0.46	2.05	0.14	0.14	12.8	12.4	12.6
Singapore REITs	S$	US$bn		S$	S$	S$						S$			S$		S$	S$	S$			
Office																						
CCT SP	1.265	2.83	Buy	1.47	0.078	0.080	6.1	6.3	1.4	4.7	4.9	1.58	0.80	0.72	1.57	0.81	1.47	0.069	0.071	18.3	17.9	18.5
SUN SP	1.35	2.38	Buy	1.63	0.098	0.099	7.3	7.4	1.4	5.9	6.0	1.99	0.68	0.79	1.60	0.85	1.63	0.091	0.085	14.9	15.8	24.5
KREIT SP	1.065	2.15	Outperform	1.21	0.076	0.081	7.2	7.6	1.4	5.8	6.2	1.27	0.84	0.64	1.19	0.89	1.21	0.068	0.073	15.7	14.5	26.6
Retail																						
CT SP	1.91	5.02	Hold	1.79	0.096	0.111	5.1	5.8	1.4	3.7	4.4	1.59	1.20	1.13	1.85	1.03	1.79	0.088	0.104	21.8	18.4	20.1
FCT SP	1.665	1.08	Hold	1.62	0.098	0.101	5.9	6.0	1.4	4.5	4.6	1.42	1.18	1.08	1.55	1.07	1.62	0.102	0.096	16.3	17.3	16.3
SGREIT SP	0.665	1.02	Outperform*	0.72	0.041	0.043	6.2	6.4	1.4	4.8	5.0	0.87	0.77	0.62	0.75	0.89	0.72	0.044	0.044	15.0	15.2	18.2
CRCT SP	1.31	0.71	Hold*	1.34	0.094	0.097	7.2	7.4	1.4	5.8	6.0	1.27	1.03	1.08	1.42	0.92	1.34	0.054	0.056	24.1	23.3	23.3
Industrial																						
AREIT SP	2.15	3.79	Hold	2.13	0.138	0.148	6.4	6.9	1.4	5.0	5.5	1.88	1.14	1.28	2.00	1.08	2.13	0.134	0.145	16.0	14.9	17.0
MLT SP	0.98	1.88	Outperform	1.07	0.070	0.073	7.2	7.4	1.4	5.8	6.0	0.90	1.09	1.08	1.07	0.91	1.07	0.069	0.072	14.1	13.6	10.9
CREIT SP	0.57	0.54	Hold	0.57	0.047	0.045	8.2	7.9	1.4	6.8	6.5	0.62	0.92	0.83	0.57	1.01	0.57	0.042	0.044	13.6	13.1	17.2
SSREIT SP	0.975	0.49	Hold	0.99	0.095	0.096	9.8	9.8	1.4	8.4	8.4	1.07	0.91	n.a	0.97	1.00	0.99	0.085	0.085	11.5	11.5	n.a
Hospitality																						
CDREIT SP	1.95	1.48	Outperform	2.12	0.122	0.136	6.2	7.0	1.4	4.8	5.6	1.58	1.23	1.29	2.16	0.90	2.12	0.121	0.133	16.1	14.7	28.5
ART SP	1.085	0.97	Buy	1.31	0.084	0.087	7.8	8.0	1.4	6.4	6.6	1.31	0.83	0.88	1.34	0.81	1.31	0.060	0.062	18.2	17.4	35.6
					Current	Next	Current	Next		Current	Next							Current	Next			
Japan REITs	¥	US$bn		¥	¥	¥						¥			¥		¥	¥	¥			
Office																						
8951 JP	771,000	5.92	O/P	880,000	15,128	15,114	3.9	3.9	0.9	3.1	3.1	733,349	1.05	1.21	796,496	0.97	n.a	25,203	25,092	15.3	15.4	13.5
8952 JP	731,000	5.03	Hold	700,000	15,864	15,298	4.3	4.2	0.9	3.5	3.3	679,131	1.08	1.21	682,340	1.07	n.a	24,424	24,295	15.0	15.0	14.8
8954 JP	358,000	1.28	Hold	362,000	10,540	10,529	5.9	5.9	0.9	5.0	5.0	542,572	0.66	0.81	499,996	0.72	n.a	20,029	20,036	8.9	8.9	8.4
8961 JP	699,000	2.12	Hold	703,000	18,823	17,506	5.4	5.0	0.9	4.5	4.1	584,409	1.20	1.41	526,626	1.33	n.a	24,173	22,661	14.5	15.4	13.9
8982 JP	445,500	0.87	Hold	368,000	12,444	11,438	5.6	5.1	0.9	4.7	4.3	543,610	0.82	0.77	515,839	0.86	n.a	17,961	18,445	12.4	12.1	11.3
8987 JP	397,000	0.94	Hold	404,000	12,217	12,526	6.2	6.3	0.9	5.3	5.5	553,082	0.72	0.79	464,582	0.85	n.a	18,314	19,157	10.8	10.4	9.4
3234 JP	344,000	1.00	O/P	373,000	8,700	8,997	5.1	5.2	0.9	4.2	4.4	449,236	0.77	0.59	392,000	0.88	n.a	11,040	12,029	15.6	14.3	17.2
Diversified																						
8955 JP	224,200	2.02	Hold	217,000	6,331	6,323	5.6	5.6	0.9	4.8	4.8	245,651	0.91	0.90	214,214	1.05	n.a	8,779	8,770	12.8	12.8	12.9
8956 JP	279,900	0.69	Hold	263,000	10,140	10,140	7.2	7.2	0.9	6.4	6.4	446,487	0.63	0.67	320,577	0.87	n.a	15,444	15,429	9.1	9.1	6.6
8957 JP	391,000	0.83	Hold	477,000	11,028	11,069	5.6	5.7	0.9	4.8	4.8	591,804	0.66	0.89	580,533	0.67	n.a	16,932	16,955	11.5	11.5	9.7
8960 JP	85,900	2.26	O/P	99,000	2,750	2,750	6.4	6.4	0.9	5.5	5.5	98,216	0.87	0.91	81,000	1.06	n.a	3,677	3,780	11.7	11.4	10.1
8966 JP	46,400	0.40	Hold	40,000	1,550	1,550	6.7	6.7	0.9	5.8	5.8	102,200	0.45	0.35	86,239	0.54	n.a	2,516	2,431	9.2	9.5	8.8
Commercial																						
8953 JP	126,500	2.98	Hold	135,000	3,668	3,687	5.8	5.8	0.9	4.9	5.0	156,884	0.81	0.80	142,784	0.89	n.a	6,170	6,451	10.3	9.8	9.6
Residential																						
3226 JP	517,000	1.26	Hold	582,000	13,812	13,827	5.3	5.3	0.9	4.5	4.5	544,746	0.95	0.93	484,997	1.07	n.a	22,587	22,695	11.4	11.4	12.3
3240 JP	409,000	0.77	Hold	360,000	12,071	12,203	5.9	6.0	0.9	5.0	5.1	504,059	0.81	0.80	407,175	1.00	n.a	18,444	18,577	11.1	11.0	10.8
3269 JP	154,900	2.14	O/P	172,000	4,565	4,564	5.9	5.9	0.9	5.0	5.0	160,641	0.96	0.95	156,459	0.99	n.a	5,902	6,024	13.1	12.9	11.6
8973 JP	338,500	0.49	Hold	377,000	10,225	10,262	6.0	6.1	0.9	5.2	5.2	449,183	0.75	0.50	374,279	0.90	n.a	16,433	16,468	10.3	10.3	10.9
8984 JP	557,000	1.12	O/P	600,000	16,100	16,204	5.8	5.8	0.9	4.9	5.0	572,339	0.97	0.69	508,618	1.10	n.a	24,063	24,997	11.6	11.1	13.8
8986 JP	38,050	0.63	O/P	44,000	1,243	1,262	6.5	6.6	0.9	5.7	5.8	64,857	0.59	0.37	55,680	0.68	n.a	2,054	2,073	9.3	9.2	10.8

Source: Daiwa

*Note: based on unit prices as at 29 June 2012; *please refer to our SGREIT and CRCT notes published on 4 July 2012*

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Pan Asia office market outlook

Demand contraction affecting short-term rental outlook, though signs of asset price stability emerging

Daiwa's view

Rents and capital values

In terms of the key REIT markets in Asia, namely, Tokyo, Hong Kong and Singapore, we are broadly positive about the medium-term prospects for both asset values and rentals. Rents during 1Q12 saw weakness in all markets, driven in the main by a contraction of demand rather than a marked oversupply of new space, with perhaps Singapore seeing the most elevated vacancies.

According to JLL, net effective rents in Hong Kong and Singapore had corrected by 5-6% QoQ in 1Q12. In Tokyo, declines in rents were a more modest 1.0% QoQ. Capital values, however, in Singapore and Hong Kong have seen a greater degree of resilience, with capital values in 1Q12 rising by 0.2% QoQ in Hong Kong and remaining flat QoQ in Singapore. Capital values in Tokyo, according to JLL, fell by 1.0%.

With net effective rents down 5-6% in 1Q12, capital value stability in Hong Kong and Singapore implies capitalisation rate compression with lower yields, perhaps reflective of lower returns on competing asset classes rather than a change in the underlying supply/demand fundamentals. In Tokyo, capitalisation rates, based on movements in rents and capital values remained unchanged in 1Q12.

Forecasts – rents and capital values

As mentioned, we expect short-term weakness in rents though a degree of resilience among capital values. Of note:

- Tokyo: notwithstanding a shift in demand to higher specification buildings, the increase in the volume of grade-A buildings is likely to weigh on market rents in 2012, and we envisage rents slipping by between 0% and 5% YoY, before stabilising in 2013.
- Hong Kong: a contraction in financial sector demand is likely to see rents in Hong Kong fall by 12.0% YoY in 2012. However, we believe the limited volume of new supply will keep vacancies in check, with vacancies forecast by Daiwa to fall from 6.6% at the end of 2011 to 5.5% in 2013. Given the improving supply/demand imbalance in 2013, we expect rents to rise modestly by 2% YoY. We forecast capital values to track rentals in 2013.
- Singapore: we expect rentals to slip by 20% over the cycle from 4Q11 to 1H13, due to the rise in new supply. With rents over the past six months having declined by 8.8% – the pace of decline can be attributed to a contraction of demand – we expect the pace of quarterly declines to slow into 2H12. As we expect rents to fall by 20% over the cycle and capital values by 10%, we envisage modest cap rate compression of up to 50bps.

■ Trend and outlook for office rents and capital values

Year to December	2010	2011	2012E	2013E
Tokyo				
Rents (YoY % chg)	(7.3)	(3.7)	0.0 to (5.0)	0.0
Capital values (YoY % chg)	n.a.	n.a.	0.0	0.0
Vacancy (23 Wards), CBRE; Q4	7.4	7.3	n.a.	n.a.
Hong Kong				
Rents (YoY % chg)	13.1	14.9	(12.0)	2.0
Capital values (YoY % chg)	24.8	15.9	(12.0)	2.0
Vacancy (%); Q4	8.5	6.6	6.5	5.5
Singapore				
Rents (YoY % chg)	(6.9)	18.8	(13.3)	(5.3)
Capital values (YoY% chg)	29.4	10.5	(8.7)	(1.0)
Vacancy (%), 4Q	5.4	7.8	8.0	7.1

Source: CBRE, JonesLang LaSalle, Miki Shoji (historical data), Daiwa forecasts

Capitalisation rates, asset values and implications for balance sheets

As alluded to earlier, asset markets, however, have perhaps surprised the market on the upside this year, with support driven by capitalisation rate compression.

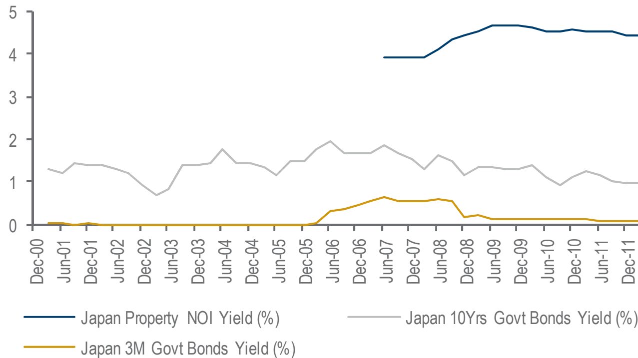
Historically, yields in Tokyo, Hong Kong and Singapore have traded at 308bps, 35bps and 172bps above the risk-free rates, respectively, with the recent period of low interest rates seeing that spread widen to 346bps in Tokyo, 119bps in Hong Kong and 204 bps in Singapore, suggesting in the short term, potential for cap rate compression.

■ Capitalisation rates and prevailing interest rates

	Current			Avg. 5 yrs		
(%)	Cap rate	10-yr bonds	Spreads	Cap rate	10-yr bonds	Spreads
Singapore	3.70	1.66	2.04	4.16	2.44	1.72
Hong Kong*	3.40	2.21*	1.19	3.64	3.28*	0.35
Tokyo	4.45	0.99	3.46	4.38	1.29	3.08

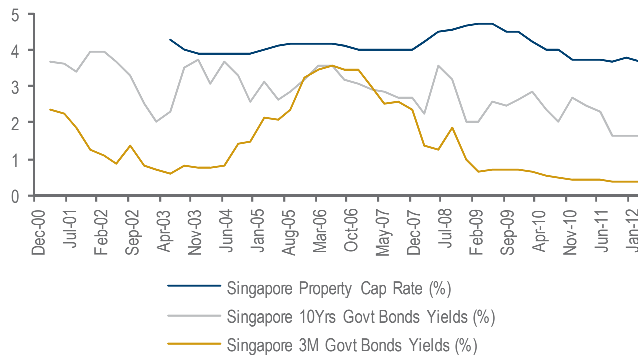
*Note: * the US 10-yr Treasury is used as a proxy for a long term bond yield in Hong Kong*
Source; CBRE, JLL, Bloomberg

■ Japan: NOI yields and interest rates (%)



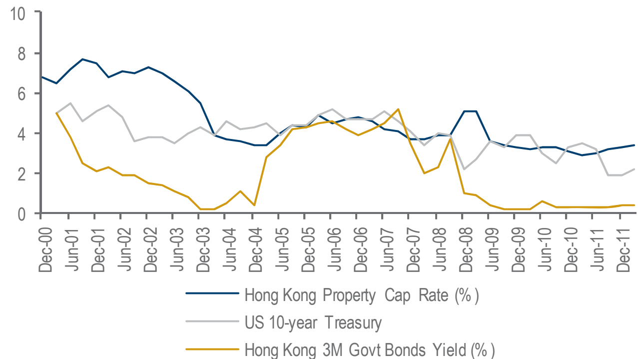
Source: CBRE, Bloomberg

■ Singapore: office yields and interest rates (%)



Source: JLL, Bloomberg

■ Hong Kong: office yields and interest rates (%)



Source: JLL, Bloomberg

Given the current monetary environment, we see modest scope for further cap rate compression of up to 50bps over the asset cycle, depending on the respective markets. However, we would expect an improvement in the rental growth outlook as we move into 2013/14, and would anticipate a normalisation of capitalisation spreads with rental growth being the primary driver for underlying asset prices.

From a REIT perspective, our view of relative resilience in office capital values compared with underlying rentals (ie, an expectation of short-term compression in underlying cap rates) underpins our expectations of limited downside risks to the REITs' balance sheets as a consequence of revaluation deficits. Given this scenario, we see limited risks for the REITs in our coverage universe to embark on defensive equity raising, in the way that they did during the global financial crisis.

Real estate consultants – rental caution, capital value resilience

Daiwa's view of emerging resilience in asset markets notwithstanding short-term weakness in the rental markets appears, in part, to be reflected in market outlooks from real estate consultancy JLL for the major Pan Asia office markets. JLL also sees rental stability and resilience in the Sydney office market.

JLL, in its recent 2Q12 global market perspective, recalibrated its own forecasts for the major Pan Asia office markets. The table that follows highlights JLL's rental growth expectations for 2012 determined in 4Q11, with the forecasts recalibrated at the end of 1Q12. Following 1Q12 QoQ rental growth performance, (shown in parentheses in the accompanying table), JLL has trimmed its expectations for the Sydney market, and expects rental growth of 0-5% YoY for 2012, versus 5-10% YoY growth expected at the end of 4Q11, While Tokyo's rents saw weakness in 1Q12, declining by 1.0% QoQ, the consultancy is maintaining its expectation of 2012 rental growth of 5-10% YoY, optimism which is not shared by our Tokyo REIT team. Our Tokyo REIT team expects supply concerns in 2012 to see rents slip by 0-5% YoY in 2012.

■ Rental growth expectations – Jones Lang LaSalle

Expected % YoY chg 2012E	As at 4Q11	As at 1Q12 (incl. QoQ growth rate)
+20%	Beijing	Beijing (+5.3%)
+10-20%	N/A	N/A
+5-10%	Tokyo, Sydney, Shanghai	Shanghai (+0.4%), Tokyo (-1.0%)
+0-5%	N/A	Sydney (+0.8%)
-0-5%	N/A	N/A
-5-10%	N/A	N/A
-10-20%	Hong Kong Singapore	Hong Kong (-6.3%), Singapore (-5.2%)

Source: JLL

Asset values, according to JLL, are expected to see resilience over 2012, in line with the Daiwa REIT team's expectation. Of note, the following table presents JLL's more sanguine view of the prospects for both Hong Kong and Singapore, with the real estate consultancy expecting asset prices in Hong Kong to rise by 0-5% YoY in 2012 (previously decline by 10-20% YoY) and Singapore to temper its slip in asset values to -5% to -10% (previously -10% to-20%). Our Singapore REIT team expects asset prices to fall 10% over the cycle (4Q11 to 1H13).

■ **Capital value growth expectations – Jones Lang LaSalle**

Expected % YoY chg 2012	As at 4Q11	As at 1Q12 (incl. QoQ growth rate)
+20%	Beijing	N/A
+10-20%	Tokyo	Beijing (+3.9%)
+5-10%	Sydney	Sydney (+1.0%), Shanghai (-0.1%), Tokyo (-1.0%)
+0-5%	Shanghai	Hong Kong (+0.2%)
-0-5%	N/A	N/A
-5-10%	N/A	Singapore (0.0%)
-10-20%	Hong Kong, Singapore	N/A

Source: JLL

REIT market outlook

Valuations look attractive amid an impending upturn in asset markets

Overview

We believe the Pan Asia REIT market looks attractive based on underlying asset valuations. The S&P Pan Asia REIT universe (based on the companies' most-recently reported book values) are trading currently at an average PBR of 0.92x, versus an average PBR of 1.02x in the period since January 2005.

In terms of yield spreads, historically low interest rates have contributed to the Pan Asia REITs trading at an additional 66bps over the median spread during the January 2005-May 2012 period. Low US dollar interest rates have seen Hong Kong REITs' yield spreads widen by 235bps (relative to their historical levels since January 2005), followed by the REITs of Singapore (170bps), Australia (162bps) and Japan (47bps).

■ Pan Asia REITs by segment – valuations

	29-June-12			Median (since Jan-05)		
	PBR (x)	Yield (%)	Yield spread; DPU yield vs 3M T-bill (%)	PBR (x)	Yield (%)	Yield spread; DPU yield vs 3M T-bill (%)
All REITS	**0.92**	**5.47**	**5.39**	**1.02**	**5.63**	**4.73**
Diversified	0.79	6.50	6.42	0.94	6.52	5.62
Industrial	1.11	5.45	5.36	1.16	5.20	4.30
Office	0.83	5.23	5.15	0.94	5.40	4.49
Residential	0.85	5.72	5.64	0.81	4.68	3.78
Retail	1.05	4.87	4.78	1.13	5.72	4.82
Specialised	0.87	5.22	5.14	0.94	5.70	4.80

Source: Worldscope, IBES, Daiwa

Regionally, the most attractive sector at present appears to be the office sector, with the Japan, Hong Kong and Singapore REITs trading at marked discounts to their historical post-January 2005 medians in terms of both PBR multiples and yield spreads.

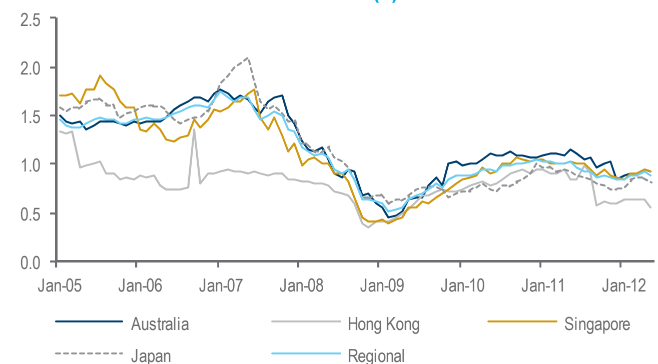
Australian office REITs, from the perspective of both asset valuations and yield spreads, are perhaps the exception, trading at a modest premium in terms of PBR relative to history – currently 0.90x (based on their most-recently reported book values) (versus 0.86x since January 2005), with the yield spread contracting by 2bps to 223bp, versus its historical (post-January 2005) median of 225bps.

■ Pan Asia REITs by country – valuations

	29-June-12			Median (since Jan-05)		
	PBR (x)	Yield	Yield spread DPU yld v.- 3M T-bill (%)	PBR (x)	Yield (%)	Yield spread DPU yld vs. - median 3M T-bill
Australia	0.95	5.78	2.25	1.10	6.24	0.64
Australia offices	0.90	5.76	2.23	0.86	7.86	2.25
Hong Kong	0.60	6.71	6.30	0.83	5.90	3.95
HK offices	0.43	6.95	6.54	0.63	7.39	5.44
Singapore	0.97	5.25	4.86	1.01	4.40	3.17
Sing. offices	0.78	5.08	4.69	0.84	4.53	3.30
Japan	0.84	5.46	5.36	0.97	5.02	4.89
Japan offices	0.87	4.87	4.77	1.01	4.75	4.62

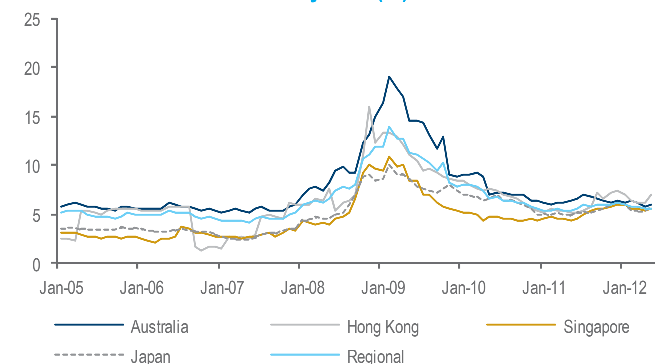
Source: Worldscope, IBES, Daiwa

■ Pan Asia REIT valuations – PBRs (x)



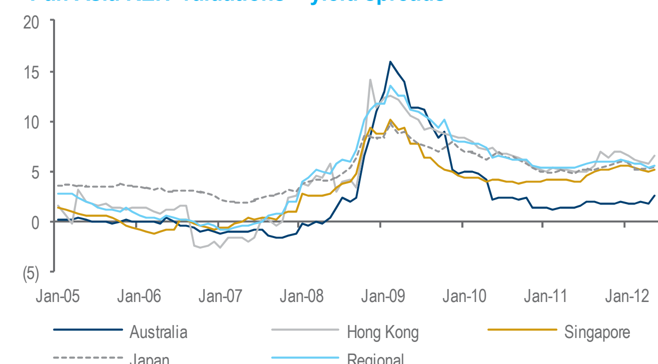
Source: Worldscope, IBES, Daiwa

■ Pan Asia REIT valuations – yields (%)



Source: Worldscope, IBES, Daiwa

■ Pan Asia REIT valuations – yield spreads



Source: Worldscope, IBES, Daiwa

Hong Kong REIT market

REITs trade at steep discounts to NAV

The S&P Hong Kong REIT universe is currently trading at significant discounts to its underlying asset values – it is currently trading at an average PBR of 0.60x (based on their most recently reported book values), versus a regional average PBR of 0.92x. Our view, however, is that the Hong Kong REIT sector has historically traded at a heavy discount to NAV. Over the course of the past 6 1/2 years (since January 2005), Hong Kong REITs have traded at a median PBR of 0.83x, at a 19.1% discount to the average PBR of 1.02x for the S&P Pan Asia REIT universe.

Does this signal that the Hong Kong REITs now offer attractive relative value or is it a value trap?

■ Hong Kong REITs – valuations

	29-June-12			Median (since Jan-05)		
	PBR (x)	Yield (%)	Yield spread DPU yld vs 3M T-bill	PBR (x)	Yield (%)	Yield spread DPU yld vs. median 3M T-bill
All REITS	0.60	6.71	6.30	0.83	5.90	3.95
Diversified	0.48	6.67	6.26	0.63	9.67	7.72
Industrial	-	-	-	-	-	-
Office	0.43	6.95	6.54	0.63	7.39	5.44
Residential	-	-	-	-	-	-
Retail	1.17	3.93	3.52	0.92	5.92	3.97
Specialised	0.46	6.67	6.26	0.57	9.10	7.14

Source: Worldscope, IBES, Daiwa

Hong Kong landlords have historically traded at discounts to their NAVs, as evident in the chart that follows, which highlights the historical PBR trading bands of Hong Kong's major office landlords – Hongkong Land (not rated) (whose portfolio is dominated by offices in Central) and Hysan Development (14 HK, HK$29.30, Buy [1]) (Hysan, whose portfolio is dominated by office and retail assets in Wanchai/Causeway Bay).

■ Hong Kong landlords – PBR trading histories (x)

Source: Bloomberg

Hongkong Land is trading currently at a 0.54x PBR (based on its most recently reported book value), versus its average PBR since June 2005 of 0.93. Hysan has similarly traded at discounts to its book value over the cycle, and is currently trading at a 0.64x PBR (on the basis of its most-recently reported book value), versus its average PBR of 0.78x over the past 10 years.

Given the comparability of business models between 'office landlord stocks', such as Hongkong Land and Hysan, and 'office REITs' – owners and lessors of office space – valuation methodologies need to take into account the specific market practice of landlords trading at discounts to book value. More importantly, the narrowing of discounts is often a function of a change in the market's outlook for capital values (and thus expected rental income), rather than an underlying shift in actual income receipts.

Value and yield

Our top picks in our Daiwa Hong Kong REIT universe are a reflection of their cyclical values, driven by low price-to-asset values (price-to-DDM, price-to-NAV and PBR multiples), and solid earnings-growth outlooks, while simultaneously offering compelling DPU yields.

■ Hong Kong REITs: key picks

REIT	BBG code	Rating	Target price (HK$)	Upside (%)	FY12E DPU yield (%)
Champion REIT	2778 HK	Outperform	3.55	10.6	7.01
Sunlight REIT	435 HK	Buy	3.20	22.6	6.32
Fortune REIT	778 HK	Buy	5.37	15.7	6.12

Source: Daiwa
Note: upsides and yields are base on unit prices of 29 June 2012

Champion REIT

We maintain our Outperform (2) rating for Champion REIT, as we believe that the perceived risks to the Hong Kong Central grade-A office market, while well known, are overstated. While we project Hong Kong Central grade-A rents to fall by 12% YoY in 2012, we expect rents stabilise in 2013, underpinned by a dearth of new completions.

Our new target price of HK$3.55 (raised from HK$3.50) is based on parity with our 10-year DDM valuation. Our target price equates to a price-to-NAV multiple of 0.45x. At our target price and based on our DPU forecast, Champion REIT would deliver a FY13E DPU yield of 6.4%.

Sunlight REIT

We upgrade our rating on Sunlight REIT to Buy (1) from Outperform (2), with a new target price of HK$3.20 (raised from HK$2.77). Our new target price is based on parity with our 10-year DDM valuation and equates to a price-to-NAV multiple of 0.56x. At our

target price and based on our DPU forecast, Sunlight REIT would deliver a FY13E DPU yield of 5.6%.

We are positive on Sunlight REIT's fundamentals and see the group positioning itself as a niche player in the decentralised grade-A office market and fringe Central office market, capturing price-sensitive office leasing demand. We project stable rental income for the group over our forecast period, driven by its retail assets in the SAR's New Towns, where we see meaningful upside for rents given the respective malls' market positioning.

Fortune REIT

We reiterate our Buy (1) rating for Fortune REIT, with a revised target price of HK$ 5.37 (formerly HK$4.95), based on parity with our 10-year DDM valuation. Our target price equates to a price-to-NAV multiple of 0.66x. At our target price and based on our DPU forecasts, Fortune REIT would deliver a FY13E DPU yield of 6%.

We believe Fortune REIT is significantly undervalued given its underleveraged balance sheet (a gearing ratio of 0.26x as at end-March 2012) and proven track-record in asset management and execution of asset-enhancement initiatives (AEI). Net property income at its key malls rose by 7.5-14.9% YoY for FY11.

Singapore REIT market

Valuations – offices attractive

Current valuations of the S&P Singapore REIT universe relative to their historical levels do not appear demanding, with the universe trading at an average PBR of 0.97x (based on the companies' most recently reported book values), versus a median PBR of 1.01x since January 2005. Based on consensus forecasts, the sector offers a 2012E DPU yield of 5.25%.

As in the case of Hong Kong, the Singapore office REIT sector trades at a discount to book value, currently at a 0.78x PBR, or a 7.0% discount to its historical (post-January 2005) PBR of 0.84x, followed by the retail REIT sector which trades at a 1.06x PBR (based on the companies' most recently reported book values), compared with its post-January 2005 average PBR of 1.08x. On a yield basis, the office sector also looks attractive, offering a 2012E DPU yield of 5.08%, 55bps higher than its median DPU yield since 2008.

We view the Singapore industrial REIT sector as fully valued, trading currently at an average PBR of 1.09x (based on most recently reported book values), versus its post-January 2005 average PBR of 1.08x. While the industrial REIT segment offers the most attractive DPU yield in the Singapore REIT space, of 5.81% for 2012E, this level of yield reflects the shorter land tenures of underlying industrial properties relative to offices and retail property in Singapore.

■ S-REITs – valuations

	29-June-2012			Median (since Jan-05)		
	PBR (x)	Yield (%)	Yield spread DPU yld vs. 3M T-bill (%)	PBR (x)	Yield (%)	Yield spread DPU yld spread vs. median 3M T-bill (%)
All REITS	0.97	5.25	4.86	1.01	4.40	3.17
Diversified	-	-	-	-	-	-
Industrial	1.09	5.81	5.42	1.08	5.63	4.40
Office	0.78	5.08	4.69	0.84	4.53	3.30
Residential	0.71	3.79	3.41	0.70	3.57	2.33
Retail	1.06	3.98	3.59	1.08	4.02	2.79
Specialised	1.23	4.12	3.73	1.19	4.19	2.96

Source: Worldscope, IBES, Daiwa

Not all Singapore REITs are created equal

In Singapore, stock screens will gladly compare the DPU yields of the REITs between various property sectors – whether office, retail, industrial or indeed serviced apartment REITs. While analysts compare absolute DPU yields and relative DPU yield spreads over the risk-free rate – and we do in this report – we are comparing 'apples with oranges', as the underlying property rights of the varying REITs are markedly different.

In Singapore, land leases vary markedly by property sector – 30-60 years for industrial properties, from 60 years to perpetuity (freehold) for retail, and normally 99 years (leasehold to freehold) for offices.

In essence, investors are buying similar physical assets but the underlying property right and the economic interest in future cash flows differ. This factor is reflected in both the underlying asset value – a low valuation on a S$/sq ft basis, especially for short-land-lease industrial properties – as well as in the underlying property yield. Properties with shorter land leases require higher paybacks and thus will by default have higher income yields.

Such stark differences in the underlying rights to a property's cash flow – limited to 30 years or extended into perpetuity – has valuation implications. While the DPU yield spread over the risk-free rate is a pertinent valuation tool, we believe such a metric should be used in concert with other valuation tools; hence we provide a multi-valuation approach.

Cyclical value

Our key picks in our Daiwa S-REIT universe reflect cyclical value, where we see the market implying overtly negative views on the Singapore office market.

Indeed, our analysis of the underlying enterprise values (EVs) of our key office sector picks – CCT, Suntec REIT and K-REIT Asia (KREIT) – imply marked value.

■ Valuations and implied values (S$/sq ft)

Portfolio/asset class	Valuation 31 Dec 2011	Implied value based on EV
CCT	1,898	1,600
Suntec REIT	2,142	1,664
K-REIT	2,444	2,000
JLL prime grade-A office	2,430	n.m
JLL CBD core office	1,805	n.m
JLL primary retail, 1st storey	3,700	n.m
JLL primary retail, 2nd/3rd storey	1,960	n.m

Source: S-REITs, JLL, Daiwa estimates

CapitaCommercial Trust

We reaffirm our Buy (1) rating for CCT, for its combination of attractive valuations (currently trading at a 19% discount to NAV), low gearing (30.5% as at 31 March 2012) relative to its peers, and potential positive catalysts from stronger-than-expected leasing activity and possibly the initiation of share (unit) buybacks.

Our revised target price of S$1.47 (from S$1.57) is pegged to parity with our 10-year DDM value (with our methodology changed, as described in this report). This target price equates to a 0.94x multiple to our NAV of S$1.57/unit, which in our view reflects CCT's premium portfolio in the Singapore Central Business District (CBD). Our target price implies a FY13E DPU yield of 5.4% (using our DPU forecast).

Suntec REIT

We reiterate our Buy (1) rating for Suntec REIT, for what we see as its attractive valuations, and believe the AEI of S$410m of its core asset, Suntec City, could be a timely and transformational upgrade.

Our revised target price of S$1.63 (previously S$1.60) is pegged to parity with our 10-year DDM value, with what we believe to be conservative value-creation assumptions for the AEI. This target price equates to a 1.02x multiple to our NAV of S$1.60/unit.

Among the office S-REITs, Suntec offers the deepest value (trading at a discounts of 32% to its book value of S$1.99 as at 31 March 2012 and 16% to its NAV) and one of the most attractive 2012-14E DPU yields of 7.3-7.8% (based on our DPU forecasts). Our target price implies a FY13E DPU yield of 6.1%.

KREIT

We maintain our Outperform (2) rating for KREIT, for its grade-A office-asset exposure (over 93% of its asset value), by far the highest among the office S-REITs, and what we regard as its attractive valuations (particularly its DPU yields, which we believe are sustainable).

Our revised target price of S$1.21 (formerly S$1.08) is pegged to parity with our 10-year DDM valuation. This target price equates to a 1.02x multiple to our NAV of S$1.19/unit. Our DDM and NAV valuations for KREIT are inclusive of income support from the vendors of its most recent acquisitions. Our target price implies an FY13E DPU yield of 6.7%.

Japan REIT market

J-REITs should gain momentum in 2013

We believe the Japan REIT market will gain momentum in 2013, aided by a likely improvement in the momentum of the real estate securitisation market. Over the near term, we expect the TSE REIT Index to be range-bound, within about 5% of the 1,000-point mark. We expect near-term upside at around the 1,050-point level, which we estimate equates to a price-to-NAV of 1.0x.

Current valuations, relative to historical (ie, since January 2005) levels do not appear demanding to us, with the S&P J-REIT universe trading at an average 0.84x PBR (based on the companies' most recently reported book values), versus a median PBR of 0.97x since January 2005. The J-REIT sector as a whole offers an average 2012E DPU yield of 5.5% based on consensus forecasts. Like Hong Kong and Singapore, the office sector, which is trading at a 13.8% discount to its average post-January 2005 PBR multiple, appears the most attractive on an asset valuation basis. The residential REIT sector, while trading at its median historical PBR multiple, offers a yield that is 17bps (based on consensus numbers) above its historical norm.

■ J-REITs – valuations

	29-June-12			Median (since Jan-05)		
	PBR (x)	Yield (%)	Yield spread DPU yld vs. 3M T-bill (%)	PBR (x)	Yield (%)	Yield spread DPU yld spread vs. median 3M T-bill (%)
All REITS	0.84	5.46	5.36	0.97	5.02	4.89
Diversified	0.70	6.54	6.44	0.81	5.95	5.83
Industrial	1.07	4.71	4.61	0.99	4.88	4.76
Office	0.87	4.87	4.77	1.01	4.75	4.62
Residential	0.87	5.77	5.67	0.83	5.60	5.47
Retail	0.95	5.79	5.69	1.08	5.27	5.14
Specialised	0.54	6.54	6.44	0.45	6.97	6.84

Source: IBES, Worldscope, Daiwa

We are positive about a recovery in valuations of the office REIT sector in late 2012 and 2013, with the improving outlook for the physical office property market likely to underpin the broad J-REIT sector

given the high weighting of office assets in J-REITs' property portfolios. In addition, the attractive yield spreads that the J-REIT market offers – the current median yield spread over the risk-free rate is 536bps, versus a past-five-year average of 489bps – should attract investment flows. Consequently, we envisage a meaningful rally in the REIT sector from late 2012 into 2013.

Macro trends – support from BOJ

Currently, the J-REIT market is being supported by intervention by the Bank of Japan (BOJ), which continues to purchase J-REIT units following the launch of its asset purchase programme in November 2010. Since December 2010, the BOJ has purchased ¥88.1bn worth of J-REIT units.

On 27 April 2012, the BOJ raised the upper limit for its own purchases of J-REIT units from ¥110bn to ¥120bn. While the BOJ's purchases of REIT units have been sporadic, the move has supported REIT unit-price expectations.

J-REITs' opportunity for leveraged growth

With few exceptions, J-REITs have shored up their balance sheets post the global financial crisis and have been prudent in their approach to acquisitions. Current gearing in the J-REIT sector is 0.44x, versus an average of 0.37x since January 2005.

Funding for the sector is readily available, with the banking sector adopting a somewhat lenient lending stance to the real estate sector.

Given the ready availability of funding, we see scope for an improvement in the DPU outlook for the J-REIT sector via:

- Refinancing at competitive interest rates of commercial-backed mortgage securities (CMBS) issued in 2006-07 and other debt instruments.
- Opportunities for under-leveraged REITs to take advantage of the widening yield spread between net operating income and underlying funding costs, specifically for properties with fixed long-term lease contracts or term rental contracts.
- Scope for under-leveraged REITs to capitalise on a likely impending uptick in asset prices, acquire prime properties and prudently gear up for the next asset up-cycle.

  In addition, given the broader improvement in the leasing markets and expectations of bottoming market rents, we expect underlying cash flows for our universe of REITs to improve in the near term.

The ability of J-REITs to increase their leverage moving into the next asset upcycle is likely to be specific to certain REITs, given that the sector as a whole is not over-leveraged and has a total debt-to-asset ratio of 0.44x currently, versus an average ratio of 0.37x since January 2005.

J-REITs – sector leverage (gross debt/assets), PBR and yield

	29-June-12			Median (since Jan-05)		
	PBR (x)	Yield (x)	Total debt-to-asset ratio (%)	PBR	Yield	Total debt to asset (%)
All REITS	0.84	5.46	44.4	0.97	5.02	37.1
Diversified	0.70	6.54	40.2	0.81	5.95	39.7
Industrial	1.07	4.71	34.6	0.99	4.88	22.3
Office	0.87	4.87	42.0	1.01	4.75	40.1
Residential	0.87	5.77	52.6	0.83	5.60	50.1
Retail	0.95	5.79	31.4	1.08	5.27	32.3
Specialized	0.54	6.54	46.0	0.45	6.97	42.1

Source: IBES, Worldscope

Stock selection based on financial strength and profitability

While we remain positive on the J-REIT sector overall, we recommend that investors remain selective, with J-REIT unit prices currently approaching NAVs. We have an underlying preference for the office and residential REITs, with our top picks highlighted in the following table.

Here, we prefer under-leveraged REITs, where DPU growth should be underpinned by leveraged acquisitions given that net-operating-income (NOI) yields in the physical market range of 5.5-5.9%, with prevailing cap rates in the vicinity of 5.0-5.9%.

J-REITs: preferred exposure

REIT	BBG code	Rating	Target price (¥)	Upside (%)	FY12E DPU yield %
Nippon Building Fund	8951 JP	Outperform	880,000	14.1	3.9
Mori Hills REIT	3234 JP	Outperform	373,000	8.4	5.1
Daiwa House Residential Investment	8984 JP	Outperform	600,000	7.7	5.8
Nippon Accommodations Fund	3226 JP	Hold	582,000	12.6	5.3

Source: Daiwa forecasts
Note: upsides and yields are base on unit prices as at 29 June 2012

The attraction of residential REITs remains their defensive characteristics and high dividend yields due to their properties' consistently high occupancy rates and less volatile rents compared with other property classes. There are currently 11 residential REITS in the TSE REIT Residential Index. Among our coverage universe, residential REITs offer an average FY2E DPU yield of 5.84%, versus the overall REIT sector's average yield of 4.97% (using our DPU forecasts).

Nippon Building Fund

Nippon Building Fund (NBF) is currently yielding 3.92%, based on our dividend forecasts for the six-month periods ending June 2012 and December 2012. The units are trading at 0.97x based on Daiwa's current NAV estimate of ¥796,496/unit. The implied cap rate stands at 4.86% based on Daiwa's NOI (net operating income) estimate for the six-month period ending June 2012.

Our target price is maintained at ¥880,000, based on our price-to-NAV multiples analysis, and which represents a multiple of 1.1x based on our NAV estimate. This multiple represents a premium over its domestic peer group, which we believe is justifiable given NBF's underlying stable property portfolio with high occupancy and modest negative rental reversions, with the REIT delivering, in our view, organic growth and potentially growth via acquisitions earlier than the market expects.

Mori Hills REIT

Mori Hills REIT (Mori Hills) is a diversified REIT targeting properties in premium locations in the Tokyo metropolitan area (such as Tokyo's five central wards and surrounding areas).

Mori Hills boasts a property portfolio capable of generating stable rental income in a market that still faces downside risk for rents, especially in the office space. We believe this justifies its current price-to-NAV multiple of 0.95x. As such, we derive a target price of ¥373,000 (unchanged), based on our price-to-NAV multiple approach. Further property transactions between the REIT and its sponsor still need to take place to enhance its portfolio, in our view, but our target price suggests a prospective dividend yield of 5.1% for the medium term, based on our assumption of a stable medium-term DPU. We expect the shares to experience multiple expansion if the REIT enters a phase of asset expansion via increased property acquisitions in premium locations.

Daiwa House Residential Investment REIT

Daiwa House Residential Investment REIT (DHI) invests mainly in residential properties. Its main sponsor is Daiwa House Industry. The fund's AUM increased markedly following the April 2010 merger with residential REIT New City Residence.

Looking forward, the fund intends to operate as a residential REIT, providing opportunities for the manager to recycle capital astutely – divesting non-core assets and increasing its exposure to the residential sector. Acquisitions as well divestments of non-core assets still offer opportunities to deliver DPU growth and enhance DHI's underlying net asset value. The REIT currently trades at a price-to-NAV multiple of 1.1x and offers what we consider an attractive dividend yield of 5.8% based on our FY12 DPU forecast. Our target price of ¥600,000 is derived from our price-to-NAV multiple approach.

Nippon Accommodations Fund

Nippon Accommodations Fund (NAF) has a portfolio that comprises mainly properties in the Tokyo metropolitan area (mainly 23 Tokyo wards), and the fund specialises in large residential properties, primarily those with single-person households and compact housing. The fund has a high-quality portfolio, with its portfolio of properties in excellent locations, as well as a strong balance sheet. Mitsui Fudosan, its main sponsor, has established an integrated business framework that covers everything from planning and development through to management and operation.

NAF's high occupancy rate and strong balance sheet should offer DPU stability while offering the potential for leveraged growth in its business. While its current price-to-NAV multiple of 1.1x is at a premium to its domestic peer group, the attraction is its dividend yield of 5.3% (based on our FY12 DPU forecast). Our maintained target price of ¥582,000 is based on our price-to-NAV multiple approach.

Daiwa property market outlook: Tokyo

Offices – rents should bottom out in 2013

Grade-A office market likely to be the focus of a rent recovery

In recent years, the Tokyo office market has been characterised by broad weakness in rents as a consequence of elevated vacancies. According to real estate consultancy Miki Shoji, vacancies in the Five Central Tokyo wards have hovered at around 9% since mid-2010, with demand keeping pace with new completions.

Vacancy levels for grade-S (akin to premium grade-A) and grade-A office buildings are still low, reflecting the trend to upgrade to higher-specification buildings while simultaneously capitalising on the lower rental environment.

While demand has improved for grade-S and grade-A buildings, new supply has contributed to the pick-up in vacancies in grade-A office buildings in recent quarters.

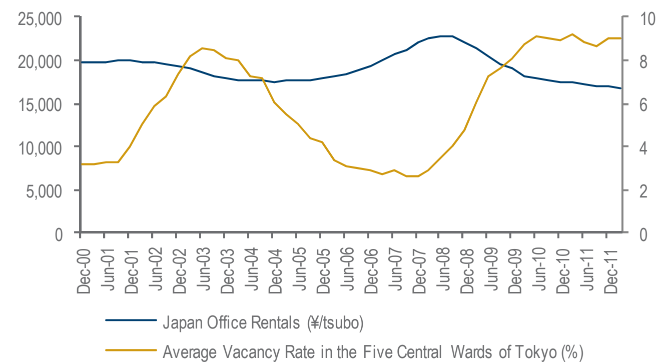
■ Tokyo vacancy rate (%)

	1Q11	4Q11	1Q12	pp chg YoY	pp chg QoQ
Tokyo - 23 wards+	7.6	7.3	7.2	(0.4)	(0.1)
Tokyo Central - 5 wards*	9.2	9.0	9.0	(0.2)	0.0
Tokyo Central - 5 wards+	7.4	7.2	7.1	(0.3)	(0.1)
Tokyo Central - 5 wards - grade A+	4.6	5.1	6.4	1.8	1.3

Source: CBRE Miki Shoji
*Note: + CBRE, * Miki Shoji*

Changes in average asking rents normally lag vacancy rates by around 6-12 months.

■ Japan: prime office vacancy rate and rents



Source: CBRE, Miki Shoji

According to CB Richard Ellis (CBRE), the average asking rents in the five central Tokyo wards fell by 6.6% YoY in 1Q12.

■ Average achievable rentals (¥/tsubo)

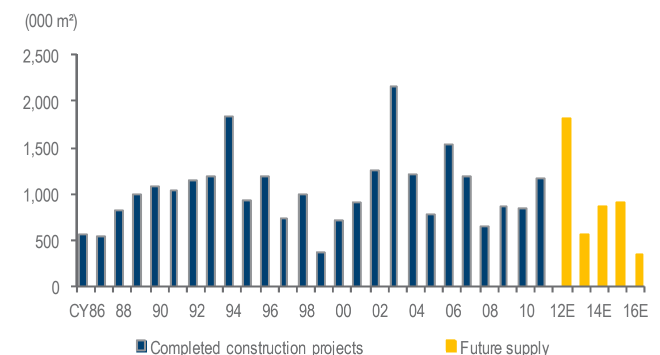
	1Q11	4Q11	1Q12	% chg YoY	% chg QoQ
Tokyo - 23 wards+	13,680	13,050	12,800	(6.4)	(1.9)
Tokyo Central - 5 wards*	17,495	16,932	16,716	(4.5)	(1.3)
Tokyo Central - 5 wards+	14,150	13,470	13,210	(6.6)	(1.9)
Tokyo Central - 5 wards - grade A+	30,450	29,050	29,800	(2.1)	2.6

Source: CBRE Miki Shoji
*Note: + CBRE, * Miki Shoji*

Better quality, higher-specification grade-A buildings have fared better and seen more modest declines in rental levels in recent quarters. CBRE estimates that grade-A achievable rents declined by only 2.1% YoY in 1Q12.

We expect this trend in rents to continue, notwithstanding expectations of an increase in new supply specifically in 2012. According to JLL, approximately 360,000 sq m of new supply will be completed in Tokyo (five Central wards), increasing stock by around 8.4% YoY. The supply is concentrated in the prime office areas of Otemachi and Marunouchi. Major new completions during 1Q12 included the Marunouchi Eiraku Building (51,000 sq m in net lettable area [NLA]) and Palace Building (42,000 sq m in NLA).

■ Office supply: Tokyo's 23 wards



Source: Miki Shoji

In our view, demand for earthquake-resistant office buildings and the trend for demand to concentrate in prime location should temper downward pressure on rentals specifically for grade-S and grade-A properties. With some 70% of the new supply concentrated in the Otemachi and Marunouchi precincts, pre-commitment levels, according to real estate consultants, are expected to stay firm given prevailing rent levels.

Indeed, despite a modest up-tick in vacancies in 1Q12 to 6.4% (from 5.1% in 4Q12), grade-A properties in Tokyo have been able to garner marginal increases in headline rents of 2.6% QoQ in 1Q12, according to CBRE. That said, the continuation of leasing incentives is weighing on the growth of net effective rents. JLL estimates that grade-A rents in Tokyo slipped by 1.0% QoQ in 1Q12.

While prospects for the grade-S and grade-A office market appear encouraging, class B buildings and buildings in the surrounding areas of Tokyo as well as in the Kansai and Nagoya areas are likely to experience elevated vacancies and continued rental pressure in the near term.

Daiwa's Tokyo REIT team expects the deterioration in office rents to be arrested in 2013, when we expect office rentals to bottom out. Our projection of an improved outlook for the office sector is underpinned by our expectation of a slowdown in new completions levels rather than a pick-up in office demand from foreign firms expanding their operations in Japan and/or new demand from emerging industries.

Given a muted recovery in demand, we expect vacancies overall in Tokyo to remain elevated, resulting in only modest gains in overall office rents in Tokyo. That said, we expect to see a continued shift in demand to the better-quality higher-specification (earthquake-resistant) office buildings in the grade-S and grade-A market. With supply in this market segment likely to be limited in 2013, we expect the recovery in rentals to be led by the grade-S and grade-A office buildings.

Residential – improving fundamentals

Capital values firming, rents stabilising

The fundamentals of the Japan residential leasing market appear to be improving, on the back of improving occupancy levels.

■ Japan residential market – key indicators

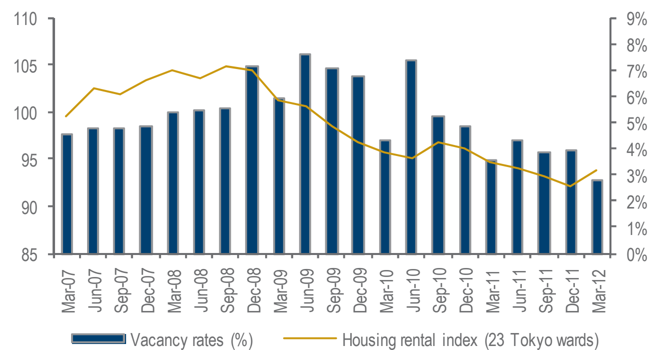
	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
Capital values (¥/Tsubo)	2,158	2,075	2,057	2,124	2,195
YoY change (%)	(7.9)	(2.1)	(12.2)	(1.6)	1.7
QoQ change (%)	(0.1)	(3.9)	(0.8)	3.2	3.4
Rental index (2004=100)	94.6	94.0	93.2	92.2	93.7
YoY change (%)	(1.2)	(1.2)	(3.7)	(4.3)	(0.9)
QoQ change (%)	(1.7)	(0.6)	(0.9)	(1.1)	1.7
Occupancy (%)	96.4	95.7	96.2	96.0	97.2

Source: Real Estate Information Network for East Japan, Miki Shoji

Occupancy for our universe of residential J-REITs has witnessed a steady improvement and was 97.2% at the end of 1Q12.

Rents have seen a degree of stability in recent quarters, rising by 1.7% QoQ in 1Q12. Indeed, in our view asking rentals appear to have bottomed out following their recent decline.

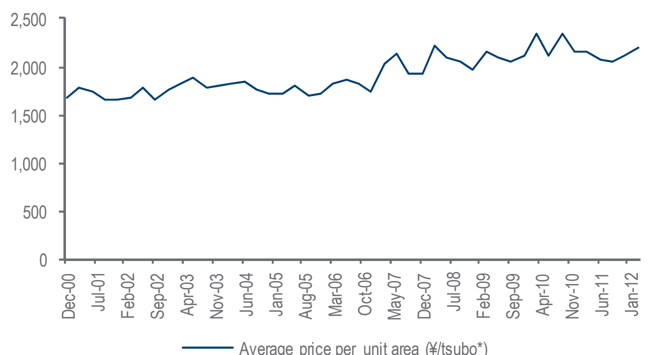
■ Residential rental index (LHS), residential REIT vacancy (RHS)



Source: Company Data, Real Estate Information Network for East Japan

Rents over the past year (1Q11 to 1Q12) have posted a decline of 0.9%. Residential rents in the most recent cycle peaked in 3Q08 and have fallen 10.7% over the period since then. Since March 2010, when capital values peaked (in the most recent cycle) rents have dipped by 2.1% while capital values have slipped at a faster rate of 6.3%. Capital values have seen a degree of resilience in recent quarters, rising by 3.4% QoQ and 1.7% YoY in 1Q12.

■ Residential capital values, Tokyo



Source: Real Estate Economic Institute

Supply/demand conditions in the residential leasing market look favourable, given the persistence of a long-term trend of migration to urban areas, a segment of the market where our universe of residential REITs is predominantly positioned.

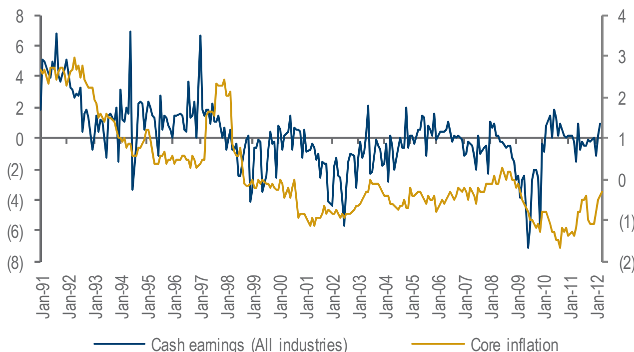
Components of demand

Demand for residential rental accommodation is driven by the following:

- Tenants' capacity to pay, reflected in real household income/ wage growth
- Urbanisation

According to the Ministry of Health, Labour & Welfare and the Ministry of Internal Affairs & Communications, monthly labour cash earnings (for employers with a minimum of five employees) trended broadly flat YoY in 2011, with the core nationwide consumer price index (excluding fresh foods) remaining unchanged.

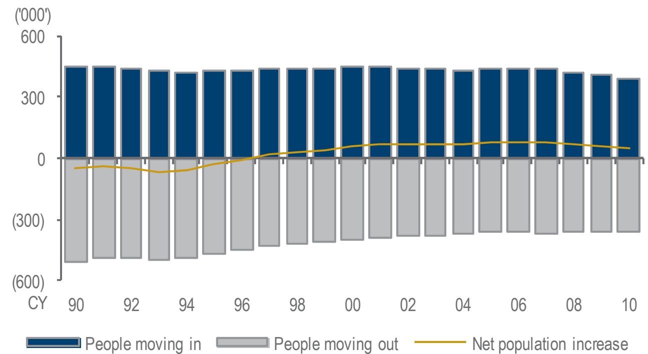
■ Household income vs. core inflation



Footnote: Core inflation excludes fresh foods, alcohol and energy
Source: Ministry of Health, Labour & Welfare, Ministry of Internal Affairs & Communication, Daiwa

As noted above, residential rents have been weak since 2008. That said, the decline in rents is moderating in large urban areas such as Tokyo as a consequence of net migration to city centres, notwithstanding the overall decline in population growth. Indeed, rents in Tokyo's 23 wards have seen their pace of decline arrested in recent quarters, with rents up by 1.7% QoQ in 1Q12.

■ Net migration to Tokyo



Source: Tokyo Metropolitan Government, Ministry of Internal Affairs, Daiwa

We attribute this trend to the increased prevalence of single-person and dual-person households – 'DINKS' (dual income, no kids) households.

The emergence of single-person households and 'DINKS' households are a reflection of lifestyle changes as well as the broader trend for people to marry later. The net impact is a shift in demand away from conventional family housing toward single/dual-person housing. According to data from the Tokyo Metropolitan Government, the number of single households and 'DINKS' households has risen at CAGRs between 1995 and 2010 of 3.0% and 2.2%, respectively, while the population of Tokyo has seen overall growth of 1.7% over the period.

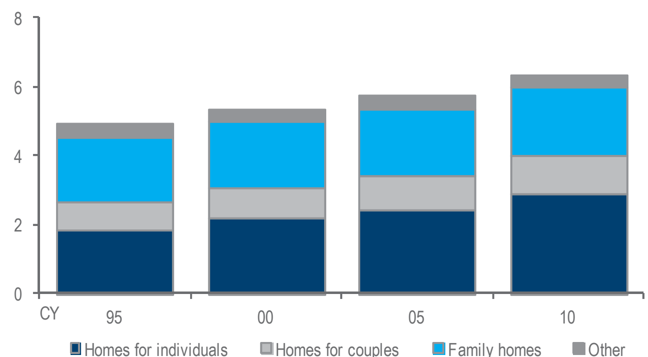
We expect this trend to continue and underpin occupancy for residential REITs, in turn supporting underlying rents and REITs' cash flows.

■ Tokyo household composition (m)

Household type	1995	2000	2005	2010	CAGR 1995-2010 (%)
Single households	1.9	2.2	2.4	2.9	3.0
Dual households	0.8	0.9	1.0	1.1	2.2
Family homes	1.9	1.9	1.9	2.0	0.4
Others	0.4	0.4	0.4	0.4	(0.7)
Total	5.0	5.4	5.7	6.4	1.7

Source: Tokyo Metropolitan Government

■ Tokyo residential: household composition



Source: Tokyo Metropolitan Government, Ministry of Internal Affairs, Daiwa

Daiwa property market outlook: Hong Kong

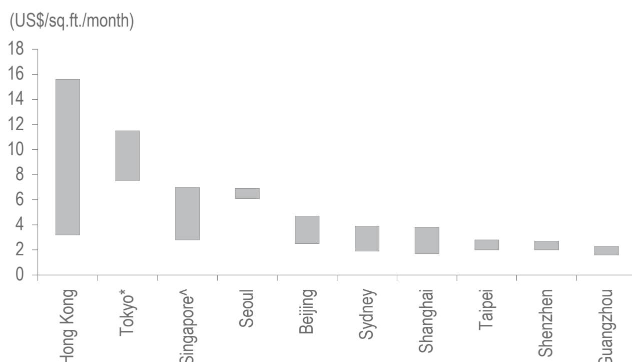
Office – decentralisation set to continue

An unusual supply and economic context

In retrospect, 4Q97-2Q03 was arguably the worst-performing period for Hong Kong office rents, which plunged by almost 70% from peak to trough. Subsequently, a reluctance on the part of many property companies to initiate capital-intensive commercial property projects, coupled with the near-absence of a major new supply of office sites from the Hong Kong Government for sale, have resulted in an unprecedented low supply of new office space for over a decade – so much so that the International Commerce Centre (ICC) and One Island East are almost the two only major new sizeable office buildings to have been completed in the core areas over the past 13 years.

Superimposed on this unusual supply backdrop, however, has been Hong Kong's significant ascendance in scale and status as an international financial centre. During 1997-2011, the market capitalisation of the Hong Kong stock market surged by 4.08x to HK$17.45tn, with average daily turnover rising 3.48x to HK$69.4bn. Hong Kong, too, was the world's number-one stock market in terms of funds raised from IPOs in each of 2009, 2010 and 2011. We believe this unusual supply backdrop and economic context is key to an understanding of the Hong Kong office market as it stands today.

■ Hong Kong: range of regional grade-A office rents



Source: Savills
*Note: * Tokyo comprises five wards; ^Singapore comprises the CBD*

Average rents mask variances

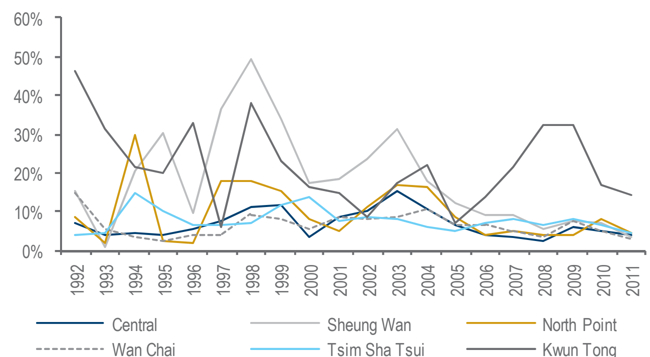
One consequence of Hong Kong's development is that grade-A office rents have become among the world's highest. However, we would note that the elevated level of office rents (US$20/sq ft) is limited to a handful of ultra-prime office buildings, and that in terms of the range of grade-A office rents, Hong Kong has one of the steepest rental gradients (the range between the highest achieved rents and lowest achieved rents), with the wide differential reflecting the divergence in the quality of office buildings and the willingness/ reluctance of tenants to pay a premium to secure space in the premium grade-A buildings in Central Hong Kong.

Trend for office decentralisation looks set to continue

We believe the recorded rents commanded by a few office towers in Hong Kong could also be seen as the market's way of saying that the current stock of International grade-A offices in Hong Kong is insufficient relative to demand, and as such that they could be seen as 'market signals' for property companies and managers to supply more alternatives.

In addition, we believe the completions of several quality buildings in Kowloon and Kowloon East (notably the ICC) mean that the long-standing psychological barrier related to accepting Kowloon as a credible location has finally been broken, and that we are poised for a trend of tenants in non-financial sectors, or even some tenants in the financial services sector, relocating out of Central. We expect this to be a major structural trend in the Hong Kong office market in the coming years.

■ Vacancy rates for grade-A offices in various districts



Source: CEIC, Daiwa

Short-term pressure likely on Central rents

We note that the gap between office rents in Central and other locations within the Special Administrative Region (SAR) is the widest ever recorded, and we expect there to be an overhang on Central grade-A office rents as long as demand from the financial services sector remains weak. That said, barring major corporate failures in the finance industry, we do not envisage a plunge in grade-A office rents in Central for the following reasons:

- The vacancy rate in Central is low (currently 4.3% for grade-A space, according to CBRE).
- Aside from a handful of premier buildings, the passing rents for the other buildings in Central are not as high as some have thought (in 2011, the passing rent for Hongkong Land's office portfolio was HK$87.0/sq ft on a net lettable basis.)
- Rents in alternative locations (such as Wanchai, Causeway Bay and Kowloon East) are firm and vacancy rates are low. Selected higher-quality buildings could even command rents not much below the lower-tier office buildings in Central.
- The new supply of offices in the core areas looks set to remain tight until at least 2015, and the new supply from the new designated business district in Kowloon East will not come out until at least 2016 at the earliest.
- Most of the stock and new supply in decentralised areas are owned by landlords, which also have significant exposure to the Central-Admiralty office market.

■ **Hong Kong office market – key indicators**

Indicator	Unit	2007	2008	2009	2010	2011	2012E	2013E	2014E	Comments
Supply	sq ft	3,078,478	3,562,854	1,388,544	1,237,850	1,345,489	1,497,445	674,763	970,776	Supply looks limited in the next few years and less than 30% is in the traditional core areas
Demand	sq ft	1,506,947	3,767,369	-764,238	3,143,062	2,507,991	1,437,341	1,437,341	1,437,341	We have factored in only modest demand
Vacancy	%	9.7	8.9	11.5	8.5	6.6	6.5	5.5	4.8	Vacancy rate should remain low given limited new supply
Rents	Index	140.6	146.9	137.7	155.7	178.9	157.4	160.5	168.6	Outside the finance sector, demand still appears healthy
% change	%	*14.6%*	*4.5%*	*-6.3%*	*13.1%*	*14.9%*	*-12.0%*	*2.0%*	*5.0%*	
Capital values	Index	199	165.4	207	258.4	305.7	269.0	274.4	288.1	Capital values are expected to remain firm
% change	%	*41.8%*	*-16.9%*	*25.2%*	*24.8%*	*15.9%*	*-12.0%*	*2.0%*	*5.0%*	
Yield	%	3.7	5.1	3.3	3.1	3.3	3.3	3.3	3.3	Low-yield environment is likely to continue

Source: JLL, CEIC, Daiwa forecasts

Retail – embracing a new era

IVS transformed retail demand

In retrospect, 2003 was a watershed year in the Hong Kong property sector, as the Individual Visit Scheme (IVS) for visitors from Mainland China was announced that year and it has had a transformational impact on the Hong Kong retail property sector.

We note that the existing annual number of Mainland tourist arrivals is already at a high multiple of Hong Kong's population, and that the average retail spending amount of Mainlanders is generally over 3x that of local residents. Against this backdrop, we believe the sharp rises in retail spending and retail rents for some retail properties seen since the IVS was introduced could be significant. In any case, we think the occupancy cost for various major retail properties in Hong Kong remains at 14-16%, which we believe still looks reasonable by international standards.

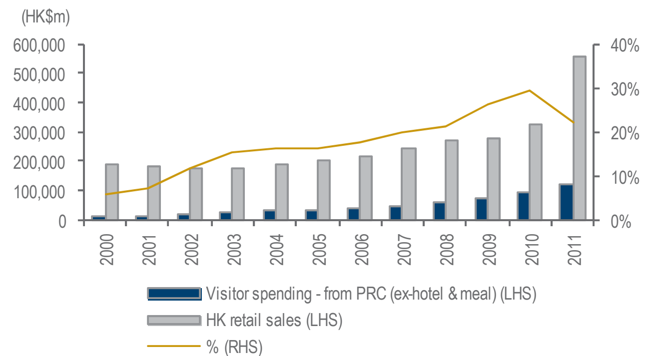
Potential for a new AEI cycle

Premium rents in the retail market (as in the office market) suggest a willingness by tenants to pay up and/or a dearth of available competitive supply. In our view, the shift in the demand parameters is likely to prompt landlords to engage in AEIs to improve the relative competitiveness of their retail centres within the SAR.

Retail property management is key

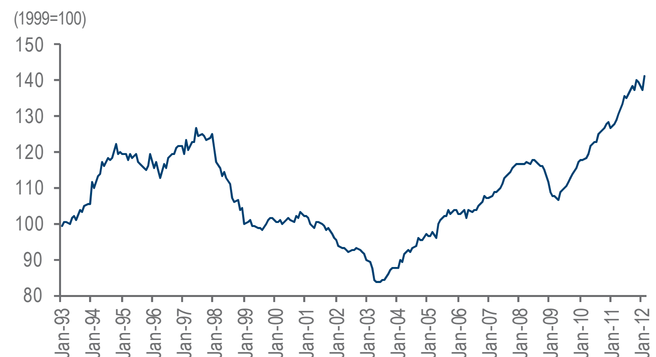
We see effective management as key to the performance of retail property assets, and we believe the industry backdrop described above provides a very favourable environment for those retail property assets that have not been managed that well in the past to catch up with better-managed assets. Hysan's Causeway Bay properties as a case in point, as are Champion REIT's Langham Place mall, Sunlight REIT's Sheung Shui Shopping Arcade, and probably Fortune REIT's retail property portfolio. We also think that rising retail rents in first-tier and second-tier retail properties will oblige retailers to seek alternatives, which should put The Link REIT's portfolio in a favourable position.

■ Growth in Hong Kong retail sales and relative contribution from Mainland tourists



Source: CEIC, Daiwa

■ Hong Kong: retail property rental indices



Source: CEIC, Daiwa

■ Hong Kong retail property market – key indicators

Indicator	Unit	2007	2008	2009	2010	2011	2012E	2013E	2014E	Comments
Supply	sq ft	516,668	527,432	904,168	699,654	452,084	1,171,000	340,206	387,732	Limited new supply in the 3 core areas after the completion of Hysan Place
Demand	sq ft	2,271,185	-419,793	452,084	1,453,128	-75,347	803,705	803,705	803,705	We expect demand for retail spaces in the core areas to remain strong
Vacancy	%	8.10%	8.69%	8.74%	7.86%	7.96%	8.23%	7.81%	7.43%	Vacancies likely to exist mainly in fringe areas
Rents	index	116.4	111.6	117.3	128.5	140.7	147.7	156.6	166.0	Retail rents are expected to hold up
% change	%	*8.9%*	*-4.1%*	*5.1%*	*9.5%*	*9.5%*	*5.0%*	*6.0%*	*6.0%*	
Capital Values	index	188.8	170.2	225.9	287.8	333.6	350.3	371.3	393.6	Capital values should remain firm
% change	%	*20.6%*	*-9.9%*	*32.7%*	*27.4%*	*15.9%*	*5.0%*	*6.0%*	*6.0%*	
Yield	%	4.3	4.7	3.7	3.2	3.0	3.0	3.0	3.0	Low-yield environment is likely to continue

Source: JLL, CEIC, Daiwa forecasts

Industrial – structural change

From factories to hi-tech 'godowns'

The current stock of industrial properties in Hong Kong of 253m sq ft is much larger than that of office and retail properties in the territory, reflecting the fact that Hong Kong was once a vibrant manufacturing centre for several key industries and was also once the world's busiest container port.

This industrial heritage has not disappeared completely – Hong Kong companies still have a sizable manufacturing base in southern China and ports throughput in Hong Kong remain sizeable by global standards. That said, it seems fair to say that manufacturing has long ceased to be Hong Kong's growth engine and its relative importance to the overall Hong Kong economy is likely to diminish further in the years to come.

Land values and shift in demand are driving the use of industrial land

In broad terms, we note that industrial premises, notably factories, are no longer the highest and best use of the land in many industrial locales in Hong Kong, given a shift in underlying demand.

This demand shift, which began in the mid-1990s with the introduction of an industrial classification of industrial/office (I/O) properties, continues to evolve– with an increasing emphasis on the 'O' rather than the 'I'. In addition, the gentrification of the older industrial areas has increased opportunities for residential development.

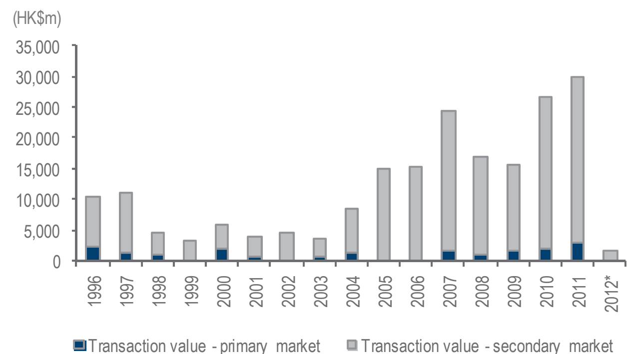
The current trend of higher transacted land/property values for industrial properties is being driven by expectations of either an enhancement of use (more offices) or alternatively a change of use (residential) rather than improved prospects for the existing industrial asset.

From 'godowns' to logistics

In Hong Kong, warehouse were traditionally known as 'godowns', but are increasingly being referred to as logistics facilities, with their primary purpose not the 'storage' of goods per se but transhipments of goods, with the focus now on throughput of goods via a warehouse facility rather than static storage.

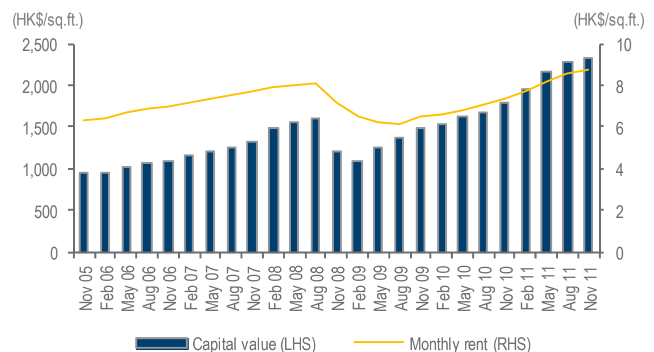
Given Hong Kong's strategic location, its connectivity in terms of both airport and port facilities and the change under way in the type of goods transhipped from manufactured goods to more fast-moving/high-value consumer items, we expect demand for logistics facilities to rise. Investments made by the Goodman Property Group from Australia in the Hong Kong logistics' market, along with its strong leasing commitments to these projects highlight underlying market demand for quality logistic/warehouse facilities.

■ Annual transacted value of industrial properties in Hong Kong



Source: CEIC, Centaline, Daiwa

■ Rental and prices of industrial properties in Hong Kong



Source: CEIC, Daiwa

■ Hong Kong industrial property market – key indicators

Indicator	Unit	2007	2008	2009	2010	2011	2012E	2013E	2014E	Comments
Supply	sq ft	172,223	753,474	32,292	226,042	344,445	516,668	290,626	309,447	The bulk of the supply is from non-listed companies
Demand	sq ft	1,517,711	-1,151,738	-3,121,534	2,809,381	914,932	170,429	170,429	170,429	
Vacancy	%	6.20%	6.50%	8.00%	6.70%	6.00%	6.17%	6.22%	6.29%	Vacancy is likely to be stable
Rents	HK$/sq ft	7.72	7.18	6.47	7.31	8.72	7.8	8.0	8.4	Rents are expected to hold up
% change	%	*10.9%*	*-7.0%*	*-9.9%*	*13.0%*	*19.3%*	*-10.6%*	*3.0%*	*5.0%*	
Capital values	HK$/sq ft	1321	1199	1481	1786	2319	2319	2435	2630	Capital values should remain firm
% change	%	*20.0%*	*-9.2%*	*23.5%*	*20.6%*	*29.8%*	*0.0%*	*5.0%*	*8.0%*	
Yield	%	7.01%	7.19%	5.24%	4.91%	4.51%	4.0%	4.0%	3.8%	Low-yield environment is likely to continue

Source: JLL, CEIC, Daiwa forecasts

Daiwa property market outlook: Singapore

Office: rental weakness, resilient capital values

Not a bad place to hide

We believe the Singapore office sector is not a bad place to hide during the current global uncertainty. Although we still expect some signs of weakness, already evident in the Jones Lang LaSalle prime grade-A office rental declines of 4.4% QoQ for 4Q11 and 4.6% QoQ for 1Q12, we believe the current market correction will be relatively mild in relation to the collapse in rents that occurred during the global financial crisis. Moreover, the most-recent peak of S$10.20/sq ft in 3Q11 was not particularly high, at about where office rent levels were in late 2006.

We believe it was fortunate, in retrospect, that the record supply of new office space from 2009-11 (mostly in the new downtown Marina Bay area) kept rents from appreciating too rapidly during the post-global financial crisis recovery period, when Singapore's GDP growth rebounded to 14.8% YoY for 2010 and 4.9% YoY for 2011. We regard current core-CBD rents as undemanding.

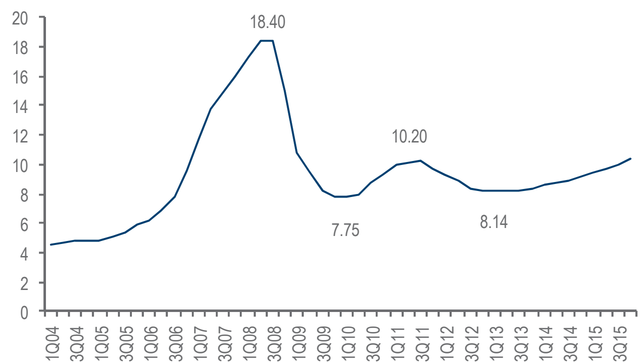
We see 20% downside risk for rents from 3Q11 to 1H13

Nevertheless, we expect the combination of weak economic growth (for 2012), renewed Eurozone concerns, and still-elevated overall vacancy levels in the CBD to continue to exert negative pressure on rents until 1H13. Even today, the supply overhang has not been removed completely, with overall vacancy rates (14.7% for the downtown core, according to URA data, and 7.9% for the CBD core, according to JLL data) at the end of March 2012 above their long-term average levels.

We assume that office rents will continue to decline gradually and bottom out at S$8.14/sq ft in 1H13, representing a peak-to-trough decline of 20% from S$10.20/sq ft in 3Q11.

So far, we see no reason to expect prime grade-A office rents to breach the global-financial-crisis trough level of S$7.75/sq ft.

■ Prime grade-A office monthly rentals (S$/sq ft)

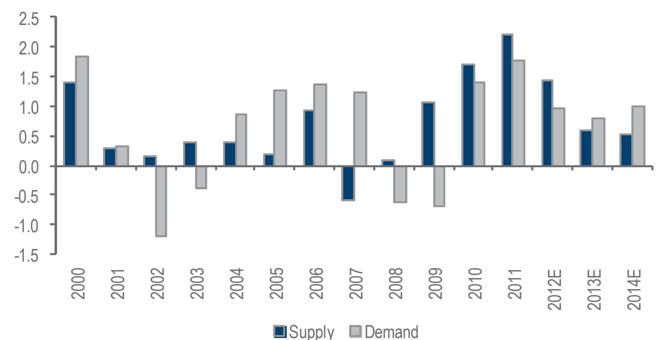


Source: JLL, Daiwa forecasts (from 1Q12)

Demand should catch up from 2013

Annual net demand (net take-up of office space) was extremely robust for 2010 and 2011 compared with previous years, but it was outpaced by the sheer volume of new supply. The annual increase in new office space for 2009-11 was probably the highest ever over a three-year period in Singapore.

■ Downtown core: annual supply and demand (m sq ft)



Source: URA, Daiwa forecasts

■ Singapore office market: vacancy rates

Source: URA, JLL, Daiwa forecasts

We expect supply to outstrip demand for another year for 2012, before take-up exceeds the new supply additions over 2013-14. By then, we expect the vacancy rate to improve gradually.

More new office space from 2015

Following the lull in 2013-14, there will be no shortage of new office space available in the downtown core, with several schemes scheduled for completion in 2015, sites available on the reserve list, as well as a choice white sites with considerable office-space content (Rochor/Orphir and Marina South) that will eventually be released for development by the Temasek/Khazanah joint venture.

Over the longer term, we expect these new additions to be paced broadly with demand from tenants, economic growth, and the state of the office market. While short-term supply-demand imbalances can never be eliminated, we believe it is premature to be overly concerned about the state of the office market in 2015.

The office sector should also face a structural change, from the availability of new and decentralised office space in targeted suburban regional centres, such as the Jurong Gateway, one-North, and the Tampines Regional Centre, which includes Changi Business Park.

■ **Core CBD: scheduled new office supply**

Scheduled completion	Development	NLA (sq ft)
4Q11-2012	1 Raffles Place Tower 2	334,783
1Q12	MBFC Tower 3	1,304,585
	2012 subtotal	1,639,368
2Q13	Asia Square Tower 2	775,100
	2013 subtotal	775,100
2014	CapitaGreen	720,000
	2014 subtotal	720,000
2015	PS100 (SOHO)	286,000
	Peck Seah St/Choon Guan St	800,000
	V on Shenton	270,000
	Robinson Square	35,355
	Oxley Tower (The Corporate Office)	111,713
	International Factors Bldg and Robinson Towers redevelopment	215,283
	South Beach Development*	502,000
	2015 sub-total	2,220,351

Source: JLL, Daiwa

*Note: *South Beach is not within core CBD but would certainly compete for CBD tenants, in our view*

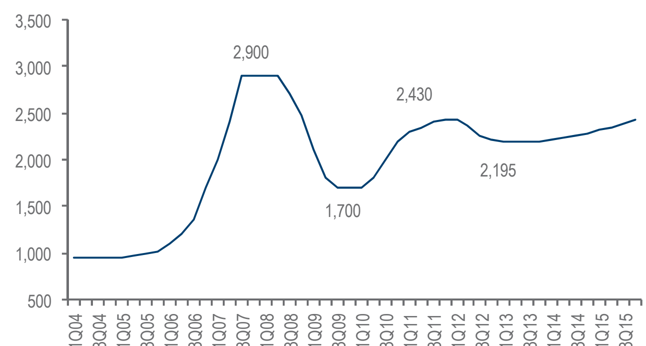
Asset values more resilient now

Compared with our office-rent forecasts, we expect asset values during the downward phase of the current office cycle to be more resilient. We note that since the global financial crisis, Singapore office capital values, compared with rentals, have declined less during market corrections and appreciated more during recoveries.

We expect this trend to continue in the current low-interest-rate and high-liquidity environment. Moreover, the increasing investment restrictions in the private-residential market have made commercial properties, as an asset class, even more attractive to investors.

This newfound demand can be seen from the rapid convergence of strata-titled office values and en-bloc office values. Hence, although we forecast a peak-to-trough decline of about 20% for office rents, we do not expect capital values to decline by more than 10% (from peak to trough) during the current office-market downturn. Currently, office capital values are flat compared with their 3Q11 levels, and our forecast for even a 10% capital-value decline could prove to be too bearish.

■ **Prime grade-A office capital values (S$/sq ft)**



Source: JLL, Daiwa forecasts (from 1Q12)

Negatives look priced in

Since the sharp sell-down in 3Q11, we believe the stock market has fully discounted the negative consequences to the listed office plays (office S-REITs as well as property companies with high office exposure, such as Keppel Land (Not rated) and Overseas Union Enterprise (Not rated), of a local office-market downturn and the eventual fallout from a bad outcome in Europe.

Although these uncertainties are still relevant and cannot be ignored, we believe the Singapore office market is on a better footing compared with expectations 6-9 months ago, following a relatively resilient operational performance from the office S-REITs in 1Q12.

With share prices still discounting what we believe to be an unrealistically bleak scenario, we believe the risk is now firmly on the upside, and any positive data over the coming quarters (such as better-than-expected office rent trajectories or stronger-than-expected take-up rates) could trigger a sector rerating.

■ Singapore office market – key indicators

Singapore office	Unit	2007	2008	2009	2010	2011	2012E	2013E	2014E	Comment
Supply (private downtown core)	m sq ft	(0.60)	0.08	1.08	1.69	2.20	1.40	0.58	0.52	Some respite likely in 2013-14E
Demand (private downtown core)	m sq ft	1.23	(0.62)	(0.68)	1.41	1.77	0.96	0.81	0.99	
Vacancy URA downtown core (end of year)	%	4.9	7.5	13.3	13.5	13.9	14.7	13.8	12.3	Still structurally higher after the additions in 2009-12
Vacancy JLL CBD core average (end of year)	%	2.7	4.1	10.2	5.4	7.8	8.0	7.1	5.6	
Rents (annual average)										
Prime grade-A office (JLL)	S$/sq ft/mth	14.13	17.26	9.06	8.44	10.03	8.69	8.22	8.84	We expect this cycle to bottom in 1H13
YoY change	%	85.2	22.2	(47.5)	(6.9)	18.8	(13.3)	(5.3)	7.5	
Capital values (end of year)										
Prime grade-A office (JLL)	S$/sq ft	2,900	2,480	1,700	2,200	2,430	2,218	2,195	2,285	Capital values could be resilient due to liquidity
YoY change	%	70.6	(14.5)	(31.5)	29.4	10.5	(8.7)	(1.0)	4.1	
Yield (JLL core CBD) (end of quarter)	%	4.00	4.70	4.50	3.75	3.80	3.59	3.69	3.71	We expect short-term yield compression

Source: Singapore URA, Jones Lang LaSalle, Daiwa forecasts

Retail: suburban supply in 2013, but should be manageable

We believe the retail-property sector is still supported by positive fundamentals, although the short-term economic uncertainty could moderate rental growth for 2012.

A soft economic outlook for 2012

For 2011, Singapore's real GDP grew by 4.9% YoY, compared with 14.8% YoY for 2010. However, for 1Q12, real-GDP growth slowed considerably to 1.6% YoY.

It appears that economic growth for 2012 will be positive, but extremely weak (especially for 1H12). Daiwa forecasts 2012 GDP growth of 2.3% YoY, while the Singapore Government's current real-GDP growth forecast range is 1.0-3.0% YoY.

Entering a downturn with strong momentum

Even with the muted GDP-growth outlook, most signs suggest that the underlying fundamentals of the Singapore retail sector remain highly favourable.

Singapore's unemployment rate was 2.1% for 1Q12, a slight increase from 2.0% for 4Q11. The country's average unemployment rate for 2011 was 2.0%, a 14-year low. Barring a severe and prolonged recession, we do not expect a sharp rise in the unemployment rate, which peaked at 3.3% during the global financial crisis.

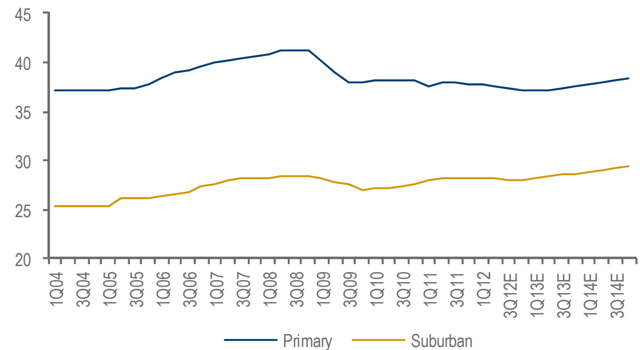
Retail sales remain resilient. For April 2012, retail sales (excluding motor vehicles) increased by 2.9% YoY. For March 2012, retail sales (excluding motor vehicles) increased by 6.5% YoY.

Visitor arrivals in January-April 2012 of 4.77m showed growth momentum, up 13.2% YoY, although we expect some moderation for the remainder of the year. We forecast visitor arrivals to rise by 5% YoY for 2012 and 8% YoY for 2013, compared with rises of 13% YoY for 2011 and 20% YoY for 2010. Tourists in Singapore typically shop in the primary, Orchard Road, shopping area.

Stable outlook for retail rents

Given the uncertain economic outlook, we expect discretionary, high-end spending and possibly tourist-related spending to be more vulnerable than non-discretionary, suburban-mall spending.

■ Grade-A retail rents, prime-level shops (S$/sq ft/month)



Source: JLL, Daiwa forecasts (from 1Q12)

For the primary shopping area (Orchard Road), we forecast rents to drop by 1.2% YoY for 2012 and 0.4% YoY for 2013 before increasing by 1.9% YoY for 2014. Since considerable new supply was added on Orchard Road in 2009, the rental market has been stable but soft for several years, due possibly to natural tenant volatility arising from the new supply.

For suburban rents, we forecast almost no change (down 0.1% YoY) for 2012, before a rise of 1.1% YoY for 2013 and 2.5% YoY for 2014. Our relatively stable outlook for retail rentals is underpinned by what we view as a moderate and well-paced supply of new retail space for 2012-14.

■ Average (monthly) rents for prime space in Grade-A centres

	Primary* S$/sq ft	YoY chg (%)	Suburban S$/sq ft	YoY chg (%)
2003	36.84	0.1	25.03	0.1
2004	37.10	0.7	25.30	1.1
2005	37.44	0.9	25.94	2.5
2006	39.05	4.3	26.82	3.4
2007	40.34	3.3	28.02	4.5
2008	41.16	2.0	28.43	1.4
2009	38.71	(6.0)	27.64	(2.8)
2010	38.10	(1.6)	27.28	(1.3)
2011	37.80	(0.8)	28.15	3.2
2012E	37.33	(1.2)	28.13	(0.1)
2013E	37.19	(0.4)	28.44	1.1
2014E	37.89	1.9	29.16	2.5

Source: JLL, Daiwa forecasts
*Note: *primary shopping area (Orchard Road)*

A manageable, well-paced pipeline

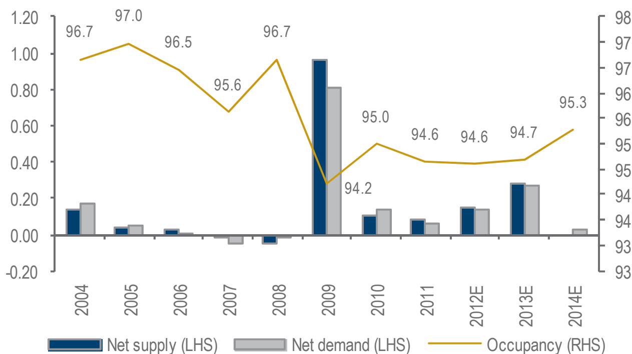
For new retail space on Orchard Road, we regard projects such as The Atrium @ Orchard extension (integrated with Plaza Singapura) and Orchard Gateway as relatively modest additions, which could be easily absorbed by existing (or a few new) retail concepts. These malls also appear to complement (and not cannibalise) the major retail malls in their vicinity and along the rest of Orchard Road.

■ Singapore retail pipeline

	Project	Location	NLA (sq ft)
	2012E supply		
A	The Atrium @ Orchard extension	Dhoby Ghaut	150,500
B	Marina Bay Link Mall (MBFC) Tower 3	Marina Bay	82,200
B	Asia Square Tower 2 - retail	Marina View	27,000
C	Star Vista (CMA)	One-North	163,000
C	Jcube (CMT)	Jurong East St 13	210,000
		2012 subtotal	632,700
	2013E supply		
A	Former Yen Sang Building	268 Orchard Rd	103,230
A	Orchard Gateway	277/218 Orchard Rd	180,000
B	Chinatown Point addition	New Bridge Road	157,175
C	Jem (Lend Lease)	Jurong Gateway Road	572,600
C	Westgate (CMA/CMT/CapitaLand)	Boon Lay Way	402,272
C	Big Box (Lucrum Capital)	Boon Lay Way	258,334
		2013 subtotal	1,673,611
	2014E supply		
C	Shopping development in Sports Hub	Stadium Boulevard	166,819
C	Bedok Town Centre	Bedok	262,683
		2014 subtotal	429,502
		2012-2014E total	2,735,813

Source: JLL, Daiwa estimates
Note: A = Orchard Road, B = downtown core, C = rest of island (suburbs)

■ Orchard Road: annual supply, demand (m sq ft) and occupancy rate (%)

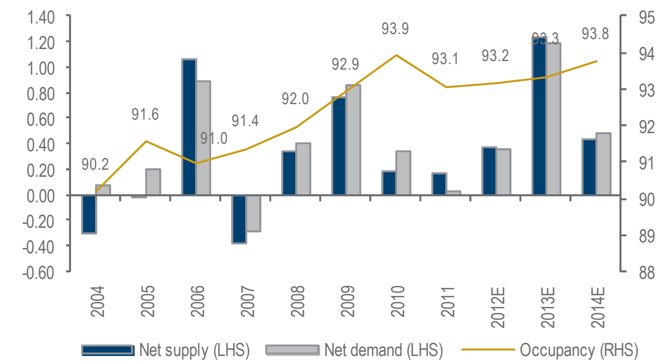


Source: Singapore URA, Daiwa forecasts

Suburban supply concentrated in regional centres

For new suburban retail space, there will be a clear concentration in 2013 in Jurong Gateway, an up-and-coming commercial hub in western Singapore next to the Jurong East MRT station. Jurong Gateway is one of three regional centres under the Urban Redevelopment Authority's (URA) concept plan and decentralisation strategy. With the government targeting the development of this regional centre, which includes new homes, parks, and recreational areas, and proven developers and mall operators such as Lend Lease (Not rated) and CapitaMalls Asia (Not rated) leasing the new projects, we do not see any major vacancy risk over the medium-to-long term.

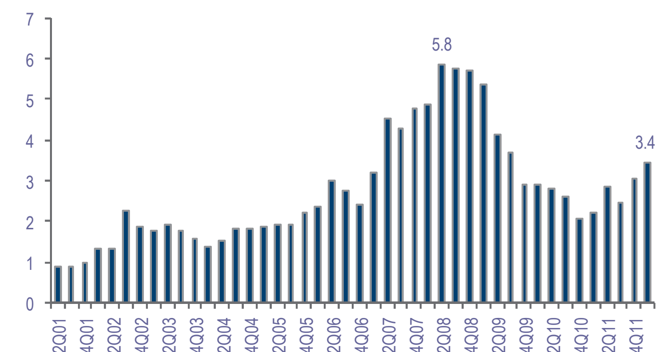
■ Suburbs: annual supply, demand (m sq ft) and occupancy rate (%)



Source: Singapore URA, Daiwa forecasts

On an aggregate level, the amount of private shop space under construction at the end of 2011 does not appear high relative to the levels over the previous decade.

■ Private shop space under construction (m sq ft)



Source: Singapore URA

Stable occupancy rates, with a positive medium-term bias

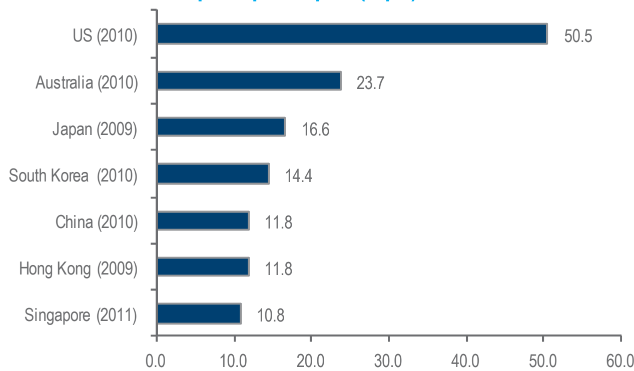
We expect demand and new supply to be fairly balanced for 2012-14 and believe there will be modest increases (of less than 2pp p.a.) in occupancy rates for both Orchard Road and the suburbs. All in, we forecast the overall island-wide (private-sector) occupancy rate to rise from 93.7% at the end of 2011 to 94.3% at the end of 2014.

Some secular potential

Compared with the major developed economies and the major economies in Asia, Singapore still appears to be under-shopped on a retail space per-capita basis. Although this might not be evident to visitors on Orchard Road (or even many expatriate residents), we believe the country's retail potential lies in its most populous towns, dominated by public housing (HDB) estates, which could probably support many more malls. However, the viability of suburban malls is no

longer a secret to developers or investors, judging by the aggressive bids in recent government land tenders and the high asking prices of suburban-mall owners.

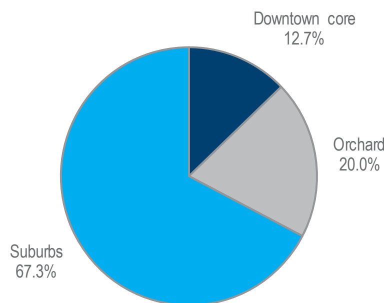
■ **Total retail floor space per capita (sq ft)**



Source: Urbis (from CMT 2011 annual report)

Singapore's total private retail space (25.2m sq ft as at 31 December 2011) consists of Orchard Road (the primary shopping area), the downtown core, and everything else (suburbs).

■ **Singapore: breakdown of retail-space stock**

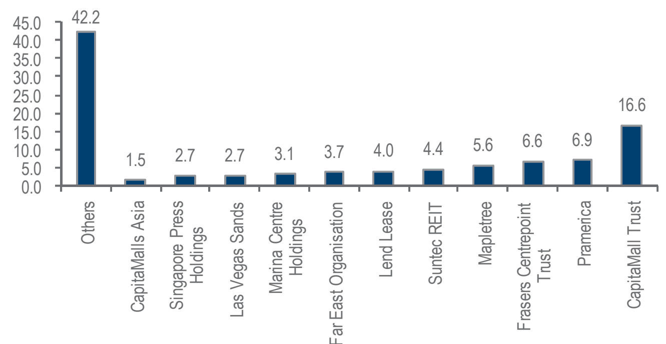


Source: Singapore URA

A few major players

In Singapore, the top-10 owners (assuming CMT and CMA are one entity) of the major shopping centres (those over 100,000 sq ft) account for less than 60% of the market. After CMT/CMA, the scale of the remaining large owners drops off considerably. Relative to its competitors, CMT/CMA's network of malls should provide it with superior economies of scale and market information. However, despite CMT/CMA's advantages, the other major malls, with few exceptions, also appear to be thriving. We expect a long-term trend of industry consolidation, but judging by recent third-party acquisitions, such as CMT's acquisition of Iluma, single-asset owners will probably require hefty premiums to market values for them to sell their assets.

■ **Shares of major shopping-centre floor space**



Source: Urbis (from CMT 2011 annual report)
Note: for malls greater than 100,000 sq ft NLA as at end of 2011

■ **Singapore retail market – key indicators**

Singapore retail		2007	2008	2009	2010	2011	2012E	2013E	2014E	Comment
Core assumptions										
Supply (private island-wide)	m sq ft	(0.42)	0.20	1.70	0.80	0.28	0.63	1.67	0.43	Jurong Gateway regional centre represents bulk of 2013 supply
Demand (private island-wide)	m sq ft	(0.27)	0.30	1.59	0.89	0.19	0.59	1.61	0.54	
Vacancy (end of year)	%	7.2	6.7	6.7	6.1	6.3	6.3	6.2	5.7	Barring a severe recession, we expect stable vacancy rates
Rents (annual average)										
Prime grade-A Orchard	S$/sq ft/month	40.34	41.16	38.71	38.10	37.80	37.47	37.33	38.03	We expect slight weakness in 2012 due to economic downturn
YoY change	%	3.3	2.0	(6.0)	(1.6)	(0.8)	(0.9)	(0.4)	1.9	
Prime grade-A suburban	S$/sq ft/month	28.02	28.43	27.64	27.28	28.15	28.13	28.44	29.16	... with suburban rents slightly more resilient than Orchard
YoY change	%	4.5	1.4	(2.8)	(1.3)	3.2	(0.1)	1.1	2.5	
Capital values (end of year)										
1st storey Orchard	S$/sq ft	3,555	3,660	3,345	3,450	3,700	3,645	3,681	3,755	
YoY change	%	14.3	3.0	(8.6)	3.1	7.2	(1.5)	1.0	2.0	
1st storey suburban	S$/sq ft	1,185	1,230	1,130	1,185	1,350	1,345	1,372	1,411	New supply should help moderate suburban capital-value growth
YoY change	%	16.2	3.8	(8.1)	4.9	13.9	(0.4)	2.0	2.8	
Yield (Orchard) (end of quarter)	%	5.3	5.6	5.5	5.0	4.9	5.0	4.9	4.9	

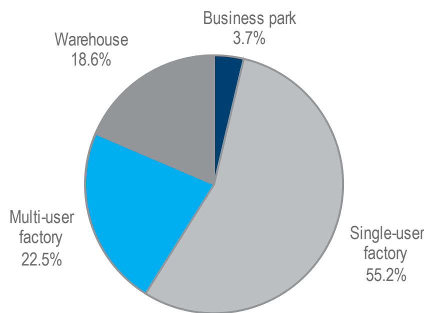
Source: Singapore URA, Jones Lang LaSalle, Daiwa forecasts

Industrial: gradual shift to higher productivity

Stock dominated by factories, single users

Singapore's industrial-property sector comprises factory space (business parks, single-user factories, and multi-user factories) and warehouse space. With warehouses and the high-end business parks accounting for 18.6% and 3.7% of stock, respectively, nearly 80% of the sector is made up of factory space for single or multiple users. The private sector owns about 84% of industrial-property factory space (the ownership rate is broadly the same for each sub-segment) and over 99% of warehouse space.

■ Singapore industrial-property sector: composition



Source: Singapore URA; total space of 415.8m sq ft as at 31 March 2012

Overall supply about 10% of existing stock

The supply-demand situation is not uniform across the sub-segments. If we define supply narrowly as properties under construction by the URA, all scheduled for completion in 2012-15 for factory space and 2012-14 for warehouse space, the overall supply represents about 10% of the industrial-property sector's stock of 415.8m sq ft as at 31 March 2012. However, the amount of supply varies from 7% for single-user factory space (the biggest sub-segment) to 32% for business-park space.

Plenty of business-park space now and for the foreseeable future

We believe the considerable supply of business-park space, along with the structurally high vacancy rate of the segment from 2009, is one manifestation of the government's long-term plans to promote decentralised, but well-developed business clusters for targeted high-technology or value-added businesses. It is also consistent with the government's renewed initiative to lift the productivity of the manufacturing sector and the broader economy through the introduction of economic incentives and penalties, which we expect to increase and broaden in the coming years.

■ Singapore industrial properties: stock and supply (m sq ft)

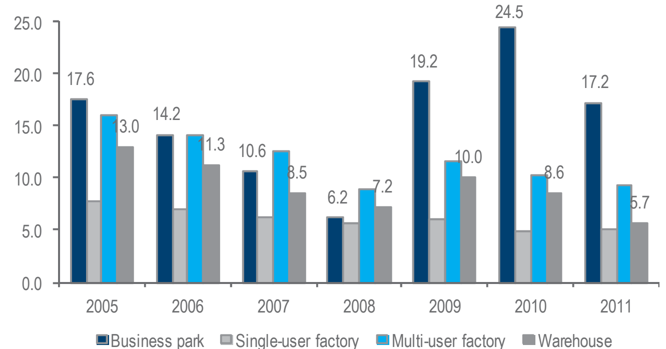
	Stock m sq ft	Supply m sq ft	Supply to stock
Business parks	15.4	4.9	32%
Single-user factories	229.6	15.8	7%
Multi-user factories	93.6	10.4	11%
Warehouses	77.2	10.5	14%
Total	415.8	41.6	10%

Source: Singapore URA, Daiwa

Business-park vacancies still at structurally high levels

The trend in vacancy rates shows that each sub-segment is broadly correlated to macroeconomic factors such as the global financial crisis-induced recession in Singapore in 2009, and the economic rebound in 2010 and 2011, although absolute vacancy rates reflect the supply-demand situation for each segment. Compared with the other industrial-property sub-segments, the vacancy rate for business parks (17.2% at the end of 2011) remains structurally high.

■ Singapore industrial-properties: vacancy rates

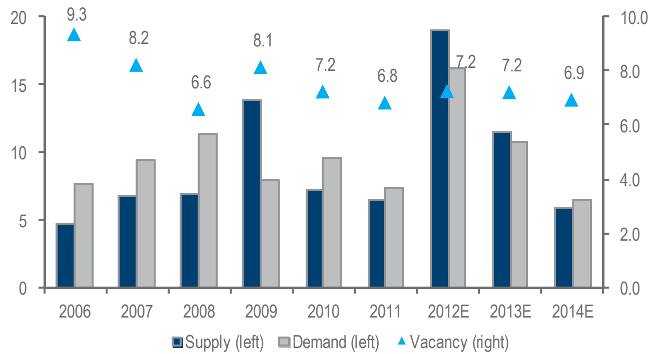


Source: Singapore URA; as at year-end

Strong level of supply for 2012

A major infusion of new supply of overall factory space is due in 2012. Our (net) supply forecasts assume that all properties under construction will be completed on schedule according to the URA's projections (as at 31 March 2012), and that 70% of the planned supply (those developments that have received planning approval but have not started construction) will be built, along with annual demolition of 1.7m sq ft (in line with the past-12-year average). However, in view of the robust levels of underlying demand, which has outstripped supply for the past six years (with the notable exception of 2009), and as long as economic growth does not decelerate sharply for 2012-13, we expect relatively stable vacancy rates over the next several years.

■ Singapore factory space: supply (m sq ft), demand (m sq ft), and vacancy rate (%)

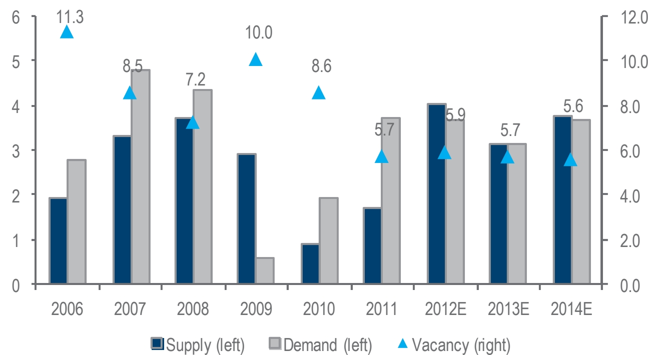


Source: Singapore URA, Daiwa forecasts

Supply-demand outlook more favourable for warehouses

The supply-demand picture is slightly more positive for warehouse space. Although the new supply for 2012 represents a considerable increase from the levels in 2010-11, it is in line with the take-up rates in 2007-8 and 2011.

■ Singapore warehouse space: supply (m sq ft), demand (m sq ft), and vacancy rate (%)



Source: Singapore URA, Daiwa forecasts

We expect rent declines for 2H12-1H13

We forecast industrial-property rents to soften from 2Q12 to mid-2013 by 11% for business-park space, 8% for factory space, and 5% for warehouse space, driven by slower economic growth and new supply in 2012. We expect vacancy rates to rise on a YoY basis for 2012 before declining gradually for 2013-14.

Even shorter land leases

On 11 June 2012, the Singapore Ministry of Trade and Industry announced that it had reduced the land tenure for industrial sites under its industrial government land sales programme (IGLS) to 30 years from 60 years, to make industrial properties more affordable for end users. We regard the announcement as a further move by the government to remove speculation from the industrial-property market. Since 1H12, strata-title subdivision of a new development has been forbidden within the first 10 years for certain sites near MRT stations, and the minimum GFA for a single unit for all multiple-user developments is 150m.

The industrial-property S-REITs were never active in speculative developments or land-banking of multi-user industrial sites, so we see no major change in their asset-acquisition and DPU-growth strategies. However, the government's move to reduce land-lease tenures should eventually lower the average remaining leaseholds of industrial S-REIT portfolios over time. Currently, the industry average is about 40 years.

Properties with shorter remaining land leases should also be priced cheaper (with higher yields) to reflect their shortened lives. S-REIT managers will have to take the new IGLS rules (assuming that 30-year leases will be a permanent feature) into consideration in their asset acquisitions and recycling strategies.

■ Singapore industrial market: core property metrics – record and assumptions

Singapore industrial		2007	2008	2009	2010	2011	2012E	2013E	2014E	Comment
Supply (factory island-wide)	m sq ft	6.68	6.90	13.87	7.20	6.48	18.96	11.44	5.83	New supply in 2012 should dampen rental growth, raise vacancy rate
Demand (factory island-wide)	m sq ft	9.47	11.37	7.98	9.59	7.39	16.15	10.76	6.46	Demand has outstripped supply in previous years (except 2009)
Vacancy (end of year)	%	8.2	6.6	8.1	7.2	6.8	7.2	7.2	6.9	Barring a severe recession, we expect stable vacancy rates
Rents (4Q)										
Business parks	S$/sq ft/mth	2.60	4.27	3.33	3.60	3.90	3.60	3.49	3.63	High vacancy rates still exist at business parks
YoY change	%	2.0	64.2	(22.0)	8.1	8.3	(7.8)	(3.0)	4.1	
Multi-user factories	S$/sq ft/mth	1.59	1.67	1.47	1.64	1.91	1.84	1.79	1.82	We expect some softening of rents for 2012-13
YoY change	%	33.4	5.1	(12.1)	11.7	16.2	(3.6)	(3.0)	2.0	
Capital values (end of year)										
Multi-user factories	S$/sq ft	344	351	302	373	474	491	446	437	Government will shorten new leases to 30 years from 60 years
YoY change	%	16.2	2.1	(14.2)	23.7	27.1	3.5	(9.0)	(2.1)	
Yield (end of quarter)										
Multi-user factories	%	5.5	5.7	5.9	5.3	4.8	4.5	4.8	5.0	

Source: Singapore URA, Jones Lang LaSalle, Daiwa forecasts

Company Section

Champion REIT
(2778 HK, HK$3.21, Outperform)
Market cap: US$2.06bn
Target price: HK$3.50 → HK$3.55
Upside: +10.6%
Improving risk-reward profile

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What we recommend

We maintain our Outperform (2) rating for Champion REIT as we believe the perceived risks to the Hong Kong Central grade-A office market, while well known, are overstated. While we forecast Central grade-A rents to fall by 12% YoY for 2012, we expect them to be stable in 2013, underpinned by a dearth of new completions.

Over the short term, a compression of the capitalisation rate is likely, as we expect asset values to remain more resilient relative to rents. Beyond the Central office market (and the impact of Champion REIT's main asset, Citibank Plaza), the performance of Langham Place Mall in Mongkok has continued to improve steadily in terms of achieved retail sales. The occupancy rate currently remains at 100%, unchanged from December 2011.

We are raising our six-month target price to HK$3.55 (from HK$3.50), reflecting our change of methodology to a par with our 10-year DDM value, as discussed earlier in this report.

As a reality check, we benchmark our new target price against a 10-year DCF net-asset valuation. Our 2012 NAV suggests an intrinsic asset valuation of HK$7.89/unit, compared with our DDM-model value of HK$3.55/unit, after ascribing higher risk premiums.

Our target price of HK$3.55 represents 0.45x our estimated underlying NAV of HK$7.89/unit for Champion REIT, as we are mindful that other landlords in Hong Kong – Hongkong Land and Hysan Development – are trading at price-to-book multiples of 0.54-0.64x but offer much lower dividend yields. At our target price, Champion's 2013E DPU yield would be 6.4%.

The major risks to our rating, forecasts and target price would be a significant retrenchment in demand from the financial services sector, which would have a material impact on our rental and capital-value expectations.

Unit-price catalysts

Major leasing or investment transaction in the grade-A office market in Central. Global uncertainty is affecting both investment and leasing demand for grade-A offices, especially in Hong Kong Central. With multinational financial service companies apparently adopting a wait-and-see attitude, office demand over the near term could be sourced from business (legal) and retail services. In the capital market, there has been some evidence of investment interest in the Central office market. We note the recent investment sale of 50 Connaught Road for HK$4.88bn, which suggests an initial or passing yield on acquisition of about 4%. A pick-up in activity for both leasing and investment deals will be the key to the current market concerns being reassessed. Champion REIT, along with other office landlords in Hong Kong, should be a primary beneficiary.

Announcement of plans to redevelop office buildings in Central. We believe landlords have been pondering the redevelopment potential of some buildings in Central, and we think the announcement of some redevelopment plans would provide a boost to the sector, as this would instil confidence in long-term rental growth and simultaneously prompt relocation activity and the backfilling of vacant office space.

Valuations look attractive

As a landlord in Central, Champion REIT is trading at a price-to-NAV multiple of 0.41x and a PBR of 0.41x, compared with office peer Hongkong Land, which is trading at a PBR of 0.54x, though Champion REIT offers a much higher dividend yield at current share prices. In terms of its trading history, Champion REIT's current PBR of 0.41x compares with an average PBR of 0.58x since 2006. Its current PBR multiple is now over 1SD below the mean since the REIT was listed in 2006.

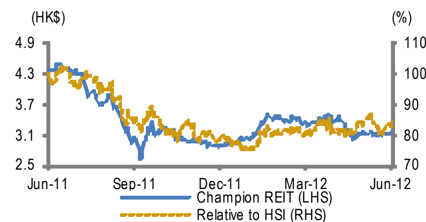
Despite our expectation of negative rental reversions in the office portfolio, the contribution from Langham Place should, to some extent, mitigate the contraction in net property income that we project for Champion REIT over the next 12 months.

Forecast revisions (%)

Year to 31 Dec	12E	13E	14E
Revenue change	0.0	0.0	0.0
Net-property-income change	0.0	0.0	0.0
DPU change	0.0	0.0	0.0

Source: Daiwa forecasts

Share price performance



12-month range	2.65-4.51
Market cap (US$bn)	2.07
Average daily turnover (US$m)	2.09
Shares outstanding (m)	4,993
Major shareholder	Great Eagle Holdings (64.3%)

Financial summary (HK$)

Year to 31 Dec	12E	13E	14E
Revenue (m)	2,040	2,113	2,197
Net property income (m)	1,694	1,770	1,841
Distribution (m)	1,126	1,137	1,162
Core EPU	0.205	0.207	0.204
EPU change (%)	48.7	1.2	(1.5)
Daiwa vs Cons. DPU (%)	(1.7)	3.7	10.0
PER (x)	15.7	15.5	15.7
DPU yield (%)	7.0	7.0	7.2
DPU	0.225	0.226	0.230
P/NAV (x)	0.4	0.4	0.4
ROE (%)	2.7	2.8	2.7

Source: Bloomberg, Daiwa forecasts

Financial summary

■ Key assumptions

Year to 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Debt to assets (%)	24.2	33.1	30.0	28.4	24.4	26.3	26.0	26.1
Interest cover ratio (x)	1.7x	1.8x	2.0x	1.7x	2.4x	5.5x	4.9x	4.1x
Interest service ratio (x)	1.0x	0.9x	1.9x	1.1x	1.1x	1.1x	1.1x	0.9x
Average portfolio cap rate (%)	3.0%	4.0%	4.6%	3.7%	3.5%	3.8%	3.9%	4.1%
Funds from operations (m)	3,238	(2,877)	3,745	5,309	6,493	1,020	1,038	1,071
Adj. funds from operations (m)	2,548	(3,070)	3,709	5,308	6,493	986	1,005	1,038

■ Profit and loss (HK$m)

Year to 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Total revenue	**839**	**1,614**	**2,035**	**1,876**	**1,940**	**2,040**	**2,113**	**2,197**
Operating expenses	(158)	(280)	(326)	(367)	(378)	(346)	(343)	(357)
Net property income	**681**	**1,334**	**1,709**	**1,509**	**1,562**	**1,694**	**1,770**	**1,841**
Other income	0	0	2	0	0	0	0	0
Management fees	(82)	(160)	(205)	(181)	(187)	(212)	(215)	(217)
Other operating expenses	(11)	(17)	(16)	(14)	(16)	(16)	(16)	(16)
Depreciation and amortisation	0	0	0	0	0	0	0	0
EBIT	**588**	**1,157**	**1,490**	**1,314**	**1,359**	**1,466**	**1,539**	**1,608**
Net-int. income/(expenses)	(355)	(627)	(752)	(751)	(565)	(267)	(317)	(397)
Share of associates	0	0	0	0	0	0	0	0
Revaluation gains/(loss)	3,696	(3,678)	3,562	4,924	5,883	0	0	0
Except./other inc./(exp.)	2	0	0	0	0	0	0	42
Profit before tax	**3,931**	**(3,148)**	**4,300**	**5,487**	**6,677**	**1,199**	**1,222**	**1,253**
Taxation	(693)	271	(556)	(178)	(184)	(180)	(183)	(182)
Min. int./pref. div./others	0	0	0	0	0	0	0	0
Net profit	**3,238**	**(2,877)**	**3,745**	**5,309**	**6,493**	**1,020**	**1,038**	**1,071**
Total return	**233**	**492**	**650**	**496**	**681**	**1,020**	**1,038**	**1,029**
Adjustments	418	546	663	588	488	129	122	157
Distributable income	**650**	**1,038**	**1,312**	**1,084**	**1,170**	**1,148**	**1,160**	**1,186**
Distribution rate	1.00	1.00	0.95	0.95	1.00	0.98	0.98	0.98
Distribution	**650**	**1,038**	**1,242**	**1,029**	**1,170**	**1,126**	**1,137**	**1,162**
EPU (HK$)	**0.083**	**0.131**	**0.141**	**0.102**	**0.138**	**0.205**	**0.207**	**0.204**
DPU (HK$)	**0.340**	**0.318**	**0.261**	**0.216**	**0.224**	**0.225**	**0.226**	**0.230**

■ Cash flow (HK$m)

Year to 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Profit before tax	233	530	738	562	794	1,199	1,222	1,211
Depreciation and amortisation	0	0	0	0	0	0	0	0
Net-interest expenses	355	627	752	751	565	267	317	397
Share of associate	0	0	0	0	0	0	0	0
Change in working capital	38	36	(19)	68	(20)	120	54	62
Tax paid	(144)	(5)	(84)	(109)	(46)	(180)	(183)	(182)
Other operating CF items	82	160	205	113	112	127	129	0
Cash flow from operation	**563**	**1,348**	**1,592**	**1,386**	**1,406**	**1,534**	**1,538**	**1,488**
Capex	(690)	(193)	(35)	(1)	0	(34)	(34)	(34)
Net investment and sale of FA	0	(8,298)	0	0	0	0	0	0
Other investing CF items	57	26	11	42	71	0	0	0
Cash flow from investing	**(633)**	**(8,465)**	**(25)**	**41**	**71**	**(34)**	**(34)**	**(34)**
Change in debt	56	7,047	863	1,247	(1,902)	0	0	0
Equity raised/(repaid)	0	5,634	0	0	0	0	0	0
Distribution paid	(526)	(1,188)	(541)	(941)	(1,055)	(1,185)	(1,061)	(1,209)
Other financing CF items	(97)	(3,866)	(1,173)	(1,527)	739	(265)	(324)	(412)
Cash flow from financing	**(568)**	**7,628**	**(851)**	**(1,221)**	**(2,217)**	**(1,450)**	**(1,386)**	**(1,622)**
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	**(637)**	**510**	**717**	**206**	**(740)**	**50**	**119**	**(167)**

Source: Company, Daiwa forecasts

Financial summary continued ...

Balance sheet (HK$m)

As at 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Cash & cash equivalent	605	1,115	1,832	2,038	1,293	1,348	1,467	1,430
Accounts receivable	43	116	103	108	180	117	121	126
Other current assets	0	0	0	61	2	0	0	0
Total current assets	**648**	**1,231**	**1,935**	**2,207**	**1,475**	**1,465**	**1,588**	**1,556**
Investment properties	28,343	40,049	44,241	50,223	54,857	53,792	53,819	53,846
Fixed assets	0	0	0	0	0	0	0	0
Associates	0	0	0	0	0	0	0	0
Goodwill and intangible assets	0	0	0	0	0	0	0	0
Other long-term assets	709	105	98	6	0	0	0	0
Total assets	**29,700**	**41,385**	**46,274**	**52,436**	**56,332**	**55,257**	**55,407**	**55,402**
Short-term debt	0	0	0	7,898	0	0	0	0
Accounts payable	1,111	1,413	1,381	1,521	1,575	1,632	1,690	1,758
Other current liabilities	411	665	681	608	667	0	0	0
Total current liabilities	**1,522**	**2,078**	**2,063**	**10,027**	**2,242**	**1,632**	**1,690**	**1,758**
Long-term debt	7,785	14,832	15,695	9,044	15,040	15,866	15,866	15,866
Other non-current liabilities	849	647	1,156	1,987	294	294	294	294
Total liabilities	**10,156**	**17,557**	**18,914**	**21,058**	**17,576**	**17,792**	**17,850**	**17,918**
Unitholders' funds	**19,544**	**23,829**	**27,360**	**31,377**	**38,756**	**37,464**	**37,557**	**37,484**
Minority interests	0	0	0	0	0	0	0	0
Total equity & liabilities	**29,700**	**41,385**	**46,274**	**52,436**	**56,332**	**55,257**	**55,407**	**55,402**
NAV per unit (HK$)	**6.98**	**5.37**	**5.67**	**6.36**	**7.82**	**7.50**	**7.47**	**7.41**

Key Ratios

Year to 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Total revenue (YoY)	n.a.	92.4	26.1	(7.8)	3.4	5.2	3.6	4.0
Net property income (YoY)	n.a.	95.9	28.1	(11.7)	3.6	8.5	4.5	4.0
Net profit (YoY)	n.a.	111.3	32.1	(23.6)	37.2	49.6	1.9	(0.9)
Distribution (YoY)	n.a.	59.6	19.6	(17.1)	13.6	(3.8)	1.0	2.2
EPU (YoY)	n.a.	57.7	7.4	(28.0)	35.7	48.7	1.2	(1.5)
DPU (YoY)	n.a.	(6.3)	(18.0)	(17.2)	3.7	0.6	0.4	1.5
ROE	1.2	2.3	2.5	1.7	1.9	2.7	2.8	2.7
ROA	0.8	1.4	1.5	1.0	1.3	1.8	1.9	1.9
ROCE	1.8	3.5	3.2	2.8	2.6	2.3	2.5	2.6
ROIC	1.8	3.5	3.2	2.8	2.6	2.4	2.5	2.6
Net debt to equity	36.7	57.6	50.7	47.5	35.5	38.8	38.3	38.5
Effective tax rate	17.6	n.a.	12.9	3.2	2.8	15.0	15.0	14.5

Source: Company, Daiwa forecasts

Company profile

Champion REIT is the second-largest REIT in Hong Kong and one of the largest in Asia. Champion REIT owns approximately 2.2m sq ft of Grade A office space and 650,000 sq ft of prime retail space in Hong Kong. The trust assets include Citibank Plaza in Central Hong Kong and the retail and office areas of Langham Place. Both assets were acquired from its parent company, Great Eagle (Not rated).

Sunlight REIT
(435 HK, HK$2.61, Outperform → Buy)

Market cap: US$540.18m

Target price: HK$2.77 → HK$3.20

Upside: +22.6%

An emerging niche player

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What we recommend

We are upgrading our rating for Sunlight REIT to Buy (1) from Outperform (2), and raising our six-month target price to HK$3.20 (from HK$2.77), now based on a 10-year DDM (previously a target DPU yield derived from our yield spread model).

We are positive on Sunlight REIT's prospects and see the REIT positioning itself as a niche player in the decentralised grade-A office market and fringe Central office market, attracting price-sensitive leasing demand. Income stability should be supported by its retail assets in Hong Kong's new towns, where we see meaningful upside to its achieved rent given the respective malls' market positioning.

Sunlight REIT's active management and focus on shareholder value has been characterised by a willingness to divest non-core assets. On 4 June 2012, the group announced its intention to divest four non-core retail assets and said it would look to recycle that capital through a unit buyback. This follows the granting of a general repurchase mandate that allows the purchase of 10% of the aggregate number of units in issue in any given year.

As a reality check for our new target price, we benchmark it against a 10-year DCF net-asset valuation. Our FY12 NAV forecast suggests an intrinsic asset valuation of HK$5.72/unit, compared with our DDM-model value of HK$3.20/unit.

Our target price represents a 0.56x multiple to our estimated underlying NAV, as we are mindful that other landlords in Hong Kong – Hong Kong Land and Hysan Development – are trading at price-to-book multiples of 0.54-0.64x but offer much lower DPU yields. At our target price, Sunlight REIT's FY13E DPU yield would be 5.6%.

The major risk to our rating, forecasts and target price would be a significant retrenchment in demand from the financial services sector, which would materially affect our rental and capital-value expectations. As Sunlight REIT's key retail assets are in the New Territories – Sheung Shui, Yuen Long and Tseung Kwan O – a deterioration in domestic retail consumption and/or cross-border shopping from Mainlanders would affect our operational expectations for these centres.

Unit-price catalysts

Realising value from the sale of non-core assets. On 4 June, Sunlight REIT stated that it intended to divest four non-core assets that are valued on its balance sheet at HK$465m, with the valuation based on a capitalisation rate of 4.0-4.35%. With the underlying properties valued at an average of HK$5,797/sq ft (on gross rentable area [GRA]), the divestment proceeds could exceed current valuations and market expectations, given that the implied yields of many smaller commercial property assets in Hong Kong are only about 3% or less.

Arbitraging between physical market and unit price. Sunlight REIT has also announced that it will use the surplus cash and proceeds from the sale of its three non-core assets to buy back units. We view this proactive stance to capital management as positive, and believe it will help to narrow the marked trading discount with its underlying asset value.

Riding on three structural trends in the physical market. Sunlight REIT has three key assets: an office building in Wanchai – 248 Queen Rd East, with a GRA of 376,381 sq ft – and two shopping centres in the New Territories – Sheung Shui Shopping Arcade (122,339-sq-ft GRA) and Metro City One, Tsueng Kwan O (188,889-sq-ft GRA). These assets, which account for 68.8% of the REIT's net property income, are well-positioned to capitalise on three structural trends in the Hong Kong Commercial Property Sector:

- the decentralisation of grade-A offices,
- cross-border shopping by Mainlanders, and

- Tseung Kwan O's transformation into a middle-class precinct.

Notwithstanding general market caution about their uses, we see these assets as being able to underpin Sunlight's above-average DPU growth. Our FY13-14 DPU forecasts are 0.5-4.0% above those of the Bloomberg consensus.

Valuation

Among the H-REITs, Sunlight REIT offers the greatest exposure to the aforementioned structural trends in the H-REIT sector.

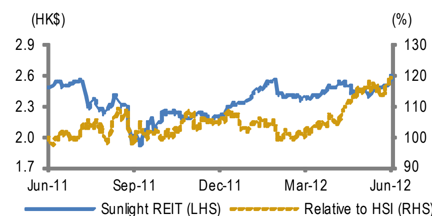
Our target price of HK$3.20/unit represents a 0.56x multiple to our end-FY12 NAV forecast. At the current share price, Sunlight REIT offers a FY13E DPU yield of 6.9% and, at our target price, would offer a FY13E DPU yield of 5.6%.

Forecast revisions (%)

Year to 30 Jun	12E	13E	14E
Revenue change	0.0	0.0	0.0
Net-property-income change	0.0	0.0	0.0
DPU change	0.0	0.0	0.0

Source: Daiwa forecasts

Share price performance



12-month range	1.93-2.61
Market cap (US$m)	541.89
Average daily turnover (US$ '000)	379.56
Shares outstanding (m)	1,611
Major shareholder	Shau Kee Financial Enterprises Ltd (23.9%)

Financial summary (HK$)

Year to 30 Jun	12E	13E	14E
Revenue (m)	595	639	680
Net property income (m)	458	498	532
Distribution (m)	266	293	307
Core EPU	0.136	0.151	0.155
EPU change (%)	23.3	11.4	2.6
Daiwa vs Cons. DPU (%)	(1.2)	4.0	0.5
PER (x)	19.2	17.2	16.8
DPU yield (%)	6.3	6.9	7.1
DPU	0.165	0.180	0.186
P/NAV (x)	0.5	0.5	0.5
ROE (%)	2.6	3.0	3.1

Source: Bloomberg, Daiwa forecasts

Financial summary

■ Key assumptions

Year to 30 Jun	2008	2009	2010	2011	2012E	2013E	2014E
Debt to assets (%)	34.3	37.4	33.3	28.6	29.2	27.6	27.2
Interest cover ratio (x)	1.5x	1.6x	1.3x	2.3x	3.0x	3.1x	2.9x
Interest service ratio (x)	0.9x	0.8x	0.9x	1.5x	0.8x	1.1x	1.1x
Average portfolio cap rate (%)	4.2%	5.0%	4.6%	4.4%	4.9%	5.2%	5.6%
Funds from operations (m)	729	(491)	1,389	1,655	217	245	254
Adj. funds from operations (m)	727	(508)	1,375	1,642	204	232	241

■ Profit and loss (HK$m)

Year to 30 Jun	2008	2009	2010	2011	2012E	2013E	2014E
Total revenue	**431**	**472**	**489**	**532**	**595**	**639**	**680**
Operating expenses	(113)	(121)	(119)	(125)	(137)	(141)	(148)
Net property income	**319**	**351**	**370**	**407**	**458**	**498**	**532**
Other income	0	0	0	0	0	0	0
Management fees	(50)	(48)	(54)	(61)	(63)	(64)	(65)
Other operating expenses	(9)	(12)	(10)	(10)	(10)	(10)	(10)
Depreciation and amortisation	0	0	0	0	0	0	0
EBIT	**259**	**291**	**306**	**337**	**386**	**425**	**457**
Net-int. income/(expenses)	(174)	(179)	(234)	(145)	(130)	(136)	(158)
Share of associates	0	0	0	0	0	0	0
Revaluation gains/(loss)	590	(803)	1,344	1,494	0	0	0
Except./other inc./(exp.)	91	78	0	0	0	0	0
Profit before tax	**766**	**(614)**	**1,417**	**1,685**	**256**	**288**	**299**
Taxation	(37)	122	(28)	(30)	(38)	(43)	(45)
Min. int./pref. div./others	0	0	0	0	0	0	0
Net profit	**729**	**(491)**	**1,389**	**1,655**	**217**	**245**	**254**
Total return	**75**	**100**	**58**	**174**	**217**	**245**	**254**
Adjustments	183	170	129	91	76	79	85
Distributable income	**259**	**270**	**186**	**264**	**294**	**324**	**339**
Distribution rate	1.00	1.00	1.00	0.91	0.91	0.91	0.91
Distribution	**259**	**270**	**186**	**239**	**266**	**293**	**307**
EPU (HK$)	**0.050**	**0.065**	**0.037**	**0.110**	**0.136**	**0.151**	**0.155**
DPU (HK$)	**0.242**	**0.246**	**0.144**	**0.176**	**0.165**	**0.180**	**0.186**

■ Cash flow (HK$m)

Year to 30 Jun	2007	2008	2009	2010	2011	2012E	2013E	2014E
Profit before tax		86	112	72	191	256	288	299
Depreciation and amortisation		0	0	0	0	0	0	0
Net-interest expenses		174	179	234	145	130	136	158
Share of associate		0	0	0	0	0	0	0
Change in working capital		23	39	33	121	(100)	7	7
Tax paid		(19)	(41)	(16)	(18)	(38)	(43)	(45)
Other operating CF items		50	48	27	61	44	45	45
Cash flow from operation		**313**	**337**	**350**	**501**	**292**	**433**	**464**
Capex		(3)	(16)	(14)	(13)	(13)	(13)	(13)
Net investment and sale of FA		0	0	0	0	0	0	0
Other investing CF items		67	95	78	0	0	0	0
Cash flow from investing		**64**	**79**	**64**	**(13)**	**(13)**	**(13)**	**(13)**
Change in debt		4	4	1	0	0	0	0
Equity raised/(repaid)		0	0	0	0	0	0	0
Distribution paid		(221)	(281)	(258)	(213)	(257)	(279)	(300)
Other financing CF items		(140)	(140)	(133)	(228)	(98)	(102)	(118)
Cash flow from financing		**(357)**	**(417)**	**(389)**	**(441)**	**(355)**	**(382)**	**(419)**
Forex effect/others		0	0	0	0	0	0	0
Change in cash		**21**	**(1)**	**25**	**48**	**(76)**	**39**	**33**

Source: Company, Daiwa forecasts

Financial summary continued ...

Balance sheet (HK$m)

As at 30 Jun	2008	2009	2010	2011	2012E	2013E	2014E
Cash & cash equivalent	228	223	225	261	185	224	257
Accounts receivable	119	109	24	27	22	24	26
Other current assets	7	41	47	169	47	47	47
Total current assets	**353**	**373**	**295**	**456**	**254**	**295**	**329**
Investment properties	10,151	9,364	10,722	12,222	12,229	12,236	12,243
Fixed assets	0	0	0	0	0	0	0
Associates	0	0	0	0	0	0	0
Goodwill and intangible assets	0	0	0	0	0	0	0
Other long-term assets	292	204	204	210	401	970	979
Total assets	**10,796**	**9,941**	**11,221**	**12,888**	**12,884**	**13,500**	**13,551**
Short-term debt	0	0	15	3,948	0	0	0
Accounts payable	53	86	99	223	119	128	136
Other current liabilities	119	130	203	158	306	384	463
Total current liabilities	**172**	**216**	**316**	**4,329**	**425**	**512**	**600**
Long-term debt	3,936	3,940	3,944	0	3,948	3,948	3,948
Other non-current liabilities	1,524	1,521	246	297	336	880	850
Total liabilities	**5,631**	**5,678**	**4,507**	**4,626**	**4,708**	**5,339**	**5,397**
Unitholders' funds	**5,164**	**4,264**	**6,715**	**8,262**	**8,175**	**8,161**	**8,154**
Minority interests	0	0	0	0	0	0	0
Total equity & liabilities	**10,796**	**9,941**	**11,221**	**12,888**	**12,884**	**13,500**	**13,551**
NAV per unit (HK$)	**3.41**	**2.76**	**4.29**	**5.21**	**5.07**	**5.01**	**4.95**

Key Ratios

Year to 30 Jun	2008	2009	2010	2011	2012E	2013E	2014E
Total revenue (YoY)	n.a.	9.4	3.6	9.0	11.8	7.3	6.5
Net property income (YoY)	n.a.	10.0	5.5	10.1	12.5	8.7	6.8
Net profit (YoY)	n.a.	32.4	(41.9)	199.7	25.1	12.8	3.8
Distribution (YoY)	n.a.	4.2	(30.9)	28.3	11.1	10.3	4.7
EPU (YoY)	n.a.	30.2	(43.0)	195.9	23.3	11.4	2.6
DPU (YoY)	n.a.	1.5	(41.4)	22.3	(6.3)	9.1	3.6
ROE	1.5	2.1	1.1	2.3	2.6	3.0	3.1
ROA	0.7	1.0	0.5	1.4	1.7	1.9	1.9
ROCE	2.7	3.4	3.2	2.9	2.7	3.0	3.2
ROIC	2.4	2.9	3.0	2.9	2.7	2.9	3.1
Net debt to equity	71.8	87.2	55.6	44.6	46.0	45.6	45.3
Effective tax rate	4.8	n.a.	1.9	1.8	15.0	15.0	15.0

Source: Company, Daiwa forecasts

Company profile

Sunlight REIT started out by acquiring 20 properties from Shau Kee Financial Enterprises and Henderson Land and became listed in 2006. Its current portfolio comprises a mixture of office and retail properties in Hong Kong Island, Kowloon, and the New Territories.

Fortune REIT

(778 HK, HK$4.64, Buy)

Market cap: US$1.01bn

Target price: HK$4.95 → HK$5.37

Upside: +15.7%

Reinforcing its credentials

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What we recommend

We reiterate our Buy (1) rating for Fortune REIT and raise our six-month target price to HK$5.37 (from HK$4.95), on par with our 10-year DDM valuation (previously a DPU yield derived from our yield spread model). We see Fortune REIT as undervalued given its underleveraged balance sheet (gearing ratio of 0.26x as at March 2012), proven track-record in asset management and execution of asset-enhancement initiatives (AEI). Net property income of its key malls rose by 7.5-14.9% YoY for 2011.

As a reality check for our new target price, we benchmark it against a 10-year DCF net-asset valuation. Our 2012 NAV suggests an intrinsic asset valuation of HK$8.10/unit for Fortune REIT, compared with our DDM-model value of HK$5.37/unit.

Our target price represents a 0.66x multiple to our estimated underlying NAV, as we are mindful that other landlords in Hong Kong – Hongkong Land and Hysan Development – are trading at price-to-book multiples of 0.54-0.64x but offer much lower DPU yields. At our target price, Fortune REIT's 2013E DPU yield would be 6.0%.

While its retail portfolio is diversified, a deterioration in domestic retail consumption would affect our expectations for its malls, materially affecting our net property income and DPU forecasts, and represents a risk.

Unit-price catalysts

Market recognition of enhanced operational performance. We believe Fortune REIT's FY12 results highlight to the market its asset management and execution capabilities in delivering AEIs. Indeed, rental reversions on the back of its recent AEI led to growth in its distributable income of 20.8% YoY for 1Q12.

Fortune REIT's three key assets (Fortune City One, Ma On Shan Plaza, and Metro Town) are well-positioned to bring in tenants with high rent-paying capacity, and bodes well for the group's ability to continue to deliver a promising performance over the coming quarters.

Acquisition of more assets from Cheung Kong Group. Given an acquisition-debt capacity of HK$2.6bn (with gearing below 35%), business growth through acquisitions sourced from the market or Cheung Kong remains likely. The group's recent acquisition of Belvedere Garden Property and Provident Centre Property from Cheung Kong Group for HK$1.9bn reflects Fortune REIT's ability to source deals. We estimate that the acquisitions were yield-accretive, and believe they strengthen the underlying revenue-growth prospects of the REIT.

Valuation

We think Fortune REIT's track record in AEIs and yield-accretive acquisitions is only just being recognised by the market.

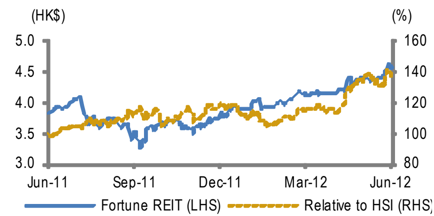
Our target price of HK$5.37 represents an NAV multiple of 0.66x and implies a 2013E DPU yield of 6.0%, above the average for the group's HK-REIT peers of 5.3%, based on our DPU forecasts.

Forecast revisions (%)

Year to 31 Dec	12E	13E	14E
Revenue change	0.9	(0.2)	(0.4)
Net-property-income change	0.9	(0.2)	(0.4)
DPU change	1.4	(0.2)	(0.4)

Source: Daiwa forecasts

Share price performance



12-month range	3.29-4.64
Market cap (US$bn)	1.02
Average daily turnover (US$m)	1.38
Shares outstanding (m)	1,704
Major shareholder	Cheung Kong Holdings (24.7%)

Financial summary (HK$)

Year to 31 Dec	12E	13E	14E
Revenue (m)	1,050	1,109	1,137
Net property income (m)	743	794	823
Distribution (m)	491	552	569
Core EPU	0.238	0.282	0.290
EPU change (%)	17.9	18.7	2.7
Daiwa vs Cons. DPU (%)	(3.0)	0.3	(1.2)
PER (x)	19.5	16.4	16.0
DPU yield (%)	6.2	6.9	7.1
DPU	0.288	0.321	0.329
P/NAV (x)	0.6	0.6	0.6
ROE (%)	3.1	3.8	4.0

Source: Bloomberg, Daiwa forecasts

Financial summary

■ Key assumptions

Year to 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Debt to assets (%)	21.0	23.6	18.8	16.9	13.5	23.2	23.2	23.4
Interest coverage ratio (x)	3.9x	4.5x	4.9x	4.0x	3.5x	4.6x	4.9x	4.8x
Interest service ratio (x)	1.0x	1.0x	1.4x	1.1x	1.2x	1.1x	1.1x	1.0x
Average portfolio cap rate (%)	6.3%	7.4%	6.1%	6.3%	5.5%	5.9%	6.3%	6.4%
Funds from operations (m)	704	(855)	1,113	2,019	3,363	403	483	500
Adj. funds from operations (m)	686	(875)	1,060	1,980	3,313	354	434	451

■ Profit and loss (HK$m)

Year to 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Total revenue	**615**	**637**	**701**	**837**	**909**	**1,050**	**1,109**	**1,137**
Operating expenses	(165)	(174)	(207)	(240)	(267)	(307)	(315)	(313)
Net property income	**450**	**463**	**495**	**597**	**642**	**743**	**794**	**823**
Other income	0	0	0	0	0	0	0	0
Management fees	(28)	(28)	(28)	(37)	(46)	(72)	(53)	(53)
Other operating expenses	(15)	(12)	3	(38)	(22)	(22)	(22)	(22)
Depreciation and amortisation	0	0	0	0	0	0	0	0
EBIT	**407**	**423**	**469**	**522**	**574**	**649**	**719**	**748**
Net-int. income/(expenses)	(105)	(93)	(96)	(131)	(166)	(143)	(148)	(157)
Share of associates	0	0	0	0	0	0	0	0
Revaluation gains/(loss)	461	(1,131)	806	1,706	3,047	0	0	0
Except./other inc./(exp.)	1	0	0	0	0	(30)	0	0
Profit before tax	**764**	**(801)**	**1,179**	**2,097**	**3,456**	**477**	**571**	**591**
Taxation	(60)	(54)	(66)	(78)	(92)	(74)	(89)	(92)
Min. int./pref. div./others	0	0	0	0	0	0	0	0
Net profit	**704**	**(855)**	**1,113**	**2,019**	**3,363**	**403**	**483**	**500**
Total return	**257**	**281**	**322**	**328**	**338**	**403**	**483**	**500**
Adjustments	28	22	15	78	104	88	69	69
Distributable income	**285**	**303**	**338**	**406**	**442**	**491**	**552**	**569**
Distribution rate	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Distribution	**285**	**303**	**338**	**406**	**442**	**491**	**552**	**569**
EPU (HK$)	**0.317**	**0.344**	**0.321**	**0.197**	**0.202**	**0.238**	**0.282**	**0.290**
DPU (HK$)	**0.351**	**0.369**	**0.302**	**0.243**	**0.263**	**0.288**	**0.321**	**0.329**

■ Cash flow (HK$m)

Year to 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Profit before tax	303	330	373	391	409	477	571	591
Depreciation and amortisation	0	0	0	0	0	0	0	0
Net-interest expenses	113	101	96	132	174	143	148	157
Share of associate	0	0	0	0	0	0	0	0
Change in working capital	(3)	(6)	144	23	92	24	18	8
Tax paid	(49)	(45)	(66)	(61)	(71)	(74)	(89)	(92)
Other operating CF items	28	28	28	37	46	72	53	53
Cash flow from operation	**392**	**408**	**576**	**522**	**650**	**642**	**702**	**718**
Capex	(17)	(20)	(53)	(39)	(50)	(49)	(49)	(49)
Net investment and sale of FA	0	1	(2,003)	0	0	(1,900)	0	0
Other investing CF items	8	8	1	(79)	(53)	0	0	0
Cash flow from investing	**(10)**	**(11)**	**(2,055)**	**(118)**	**(103)**	**(1,949)**	**(49)**	**(49)**
Change in debt	5	4	516	43	363	1,536	0	0
Equity raised/(repaid)	0	0	1,811	0	0	0	0	0
Distribution paid	(278)	(292)	(314)	(381)	(422)	(465)	(520)	(559)
Other financing CF items	(116)	(104)	(169)	(110)	(112)	(127)	(132)	(141)
Cash flow from financing	**(390)**	**(393)**	**1,844**	**(447)**	**(171)**	**943**	**(653)**	**(700)**
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	**(7)**	**4**	**365**	**(44)**	**376**	**(364)**	**1**	**(31)**

Source: Company, Daiwa forecasts

Financial summary continued ...

Balance sheet (HK$m)

As at 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Cash & cash equivalent	242	243	515	506	882	518	518	487
Accounts receivable	36	37	48	63	50	72	76	78
Other current assets	(1)	(1)	0	0	0	0	0	0
Total current assets	**277**	**279**	**563**	**569**	**932**	**590**	**594**	**565**
Investment properties	9,714	8,602	11,500	13,300	16,388	17,668	17,668	17,668
Fixed assets	0	0	0	0	0	0	0	0
Associates	0	0	0	0	0	0	0	0
Goodwill and intangible assets	0	0	0	0	0	0	0	0
Other long-term assets	0	0	0	0	0	0	0	0
Total assets	**9,991**	**8,881**	**12,063**	**13,869**	**17,320**	**18,258**	**18,262**	**18,233**
Short-term debt	0	0	2,786	79	420	820	820	820
Accounts payable	192	194	276	270	348	394	416	426
Other current liabilities	7	21	34	211	235	246	276	284
Total current liabilities	**199**	**215**	**3,097**	**560**	**1,003**	**1,459**	**1,512**	**1,531**
Long-term debt	2,339	2,343	0	2,772	2,794	3,930	3,930	3,930
Other non-current liabilities	148	168	133	203	295	170	170	170
Total liabilities	**2,686**	**2,726**	**3,230**	**3,536**	**4,092**	**5,559**	**5,612**	**5,631**
Unitholders' funds	**7,307**	**6,156**	**8,833**	**10,334**	**13,228**	**12,699**	**12,650**	**12,602**
Minority interests	0	0	0	0	0	0	0	0
Total equity & liabilities	**9,993**	**8,882**	**12,063**	**13,869**	**17,320**	**18,258**	**18,262**	**18,233**
NAV per unit (HK$)	**9.00**	**7.50**	**5.32**	**6.18**	**7.85**	**7.45**	**7.37**	**7.28**

Key Ratios

Year to 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Total revenue (YoY)	0.1	3.6	10.1	19.4	8.6	15.5	5.7	2.4
Net property income (YoY)	2.9	2.9	6.8	20.7	7.6	15.7	6.9	3.6
Net profit (YoY)	3.1	9.3	14.7	1.8	3.0	19.1	19.9	3.5
Distribution (YoY)	3.0	6.3	11.6	20.3	8.8	10.9	12.4	3.1
EPU (YoY)	2.5	8.5	(6.7)	(38.7)	2.4	17.9	18.7	2.7
DPU (YoY)	2.4	5.2	(18.2)	(19.5)	8.0	9.7	11.6	2.3
ROE	n.a.	9.1	4.1	3.4	2.9	3.1	3.8	4.0
ROA	n.a.	6.3	3.0	2.5	2.2	2.3	2.6	2.7
ROCE	n.a.	10.0	4.3	4.1	3.8	3.2	3.5	3.6
ROIC	n.a.	10.0	4.4	4.2	3.9	3.3	3.6	3.7
Net debt to equity	28.7	34.1	25.7	22.7	17.6	33.3	33.5	33.8
Effective tax rate	7.8	n.a.	5.6	3.7	2.7	15.5	15.5	15.5

Source: Company, Daiwa forecasts

Company profile

Fortune REIT holds only retail properties in Hong Kong. It was listed on the Singapore Stock Exchange in 2003 and then gained a dual listing in Hong Kong in April 2010. It started by acquiring the retail-property assets of the Cheung Kong group. The current REIT manager is ARA Asset Management (Not rated), which is listed in Singapore.

Nippon Building Fund
(8951 JP, ¥771,000, Outperform [2])

Market cap: US$5.92bn

Target price: ¥880,000

Upside: +14.1%

Dividend likely to be flat throughout 2012

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Investment opinion

NBF currently offers a DPU yield of 3.92% based on our DPU forecasts for 2012. The units are trading at a 0.97x multiple on our FY12E NAV forecast of ¥796,496/unit. The implied capitalisation rate stands at 4.86%, based on our NOI forecast for the six-month period ending June 2012. We assume a loan-to-value (LTV) ratio (interest-bearing debt/total assets) of 43-48% including tenant deposits and guarantees, or 47% including deposits/guarantees under management.

We maintain our Outperform (2) rating and six-month target price of ¥880,000, based on 1.1x our NAV estimate. This represents a premium over its domestic peer group, which we believe is justifiable given NBF's underlying stable property portfolio with high occupancy and modest negative rental reversions, with the REIT delivering, in our view, organic growth and potentially growth via acquisitions earlier than the market currently expects.

- NBF's portfolio at the end of December 2011 had an occupancy rate of 98.1%, compared with 98.0% at the end of December 2010.
- We expect negative rental reversions in NBF's high-quality office portfolio to moderate earlier than for its peers, which are likely to see negative reversions until the end of 2013.
- We expect NBF to seek acquisition opportunities to drive DPU growth. We see this being funded by a combination of both debt and equity, given the fund's current gearing level of 0.48x.

Business overview

NBF invests mainly in large office properties. It has been listed since the J-REIT market was first established in 2001, and is one of the largest REITs in Japan in terms of asset size.

NBF owns or has an interest in 67 properties with a total net leasable area (NLA) of 893,369 sq m. The portfolio is located primarily in Tokyo, with 64.7% of the NLA in the capital's CBD, 24.0% in the Greater Tokyo area, and 11.3% in regional cities.

The NOI yield based on the acquisition value of the entire portfolio was 4.5% for the six-month period ended December 2011. The end-December 2011 LTV ratio stood at 44.2%, at 49.1% including tenant deposits and guarantees, and 48.2% including deposits/guarantees under management (NBF's LTV benchmark is based on this definition).

Earnings and financial overview

DPS rose by 0.4% to ¥15,200 for 2H11

For calendar 2H11 (ie, ended December 2011), the DPU was ¥15,200 (up 0.4% from the previous six-month period), ¥100 above the REIT's target of ¥15,100.

The DPU exceeded management's guidance as repair and other costs were below its expectations. We note that NBF booked ¥572m in gains on land sales associated with the sale of the NBF Sudacho Verde Building, of which ¥334m had been provisioned as a result of a 'reduction entry', suggesting additional capacity for future dividend payouts.

For 2H11, NBF booked operating revenue of ¥29,773m (up 6.0% HoH) and net income of ¥9,127m (up 4.2% HoH). Rent revisions lowered average rents at existing buildings, but operating revenue rose as the Mitsubishi Heavy Industries Building (in which the REIT acquired a 60% stake for ¥36.3bn in September 2011) made its first contribution. The sale of the NBF Sudacho Verde Building (for ¥3.25bn, with the building sold in August 2011 and the land sold in December 2011) resulted in a ¥200m loss for 2H11. The REIT did not lease this property as it expected to sell it, so the impact of the sale on its rental-business earnings was minimal.

Based on the entire portfolio, the occupancy rate stood at a high 98.1% at the end of December 2011 (it averaged 98.0% for the six-month period ended December 2011), up from 97.1% at the end of June 2011 (96.8% for the six-month period ended June 2011).

Unrealised gains (appraisal value less book value) rose from ¥42.1bn at the end of June 2011 to ¥45.7bn at the end of December 2011. The weighted average interest rates declined by 0.09pp HoH to 1.61%, based on the average interest-bearing debt outstanding.

NBF raised ¥20.9bn (which is the upper limit of its authorised threshold) from new share issuance (with the proceeds received on 25 January 2012, and on 21 February for the private placement). It plans to acquire the following five properties for an aggregate consideration of ¥22.61bn: Higashi Gotanda Square (acquisition value, ¥8.35bn; NOI yield assumed by the REIT, 5.1%), Ryukakusan Building (acquisition value,¥4.05bn; 5.6%), Shin Kawasaki Mitsui Building (acquisition value for additional stake, ¥5.52bn; 7.0%), Hiroshima Fukuromachi Building (acquisition value for additional stake, ¥1.38bn; 7.0%); and Schloss Nichigin-mae (acquisition value, ¥3.31bn; 7.2%). The acquisition of these small but high-yielding properties should help maintain or improve the NOI yield for NBF's entire portfolio.

Dividend outlook

Dividend outlook appears stable

We forecast a DPU of ¥15,128 for the six-month period ending June 2012, and ¥15,114 for the six-month period ending December 2012.

Management guides for DPUs of ¥15,100 for both the period ends, but this guidance does not factor in the use of reserves booked as a result of a 'reduction entry'. NBF expects occupancy rates of 97.9% at the end of June 2012 and 98.1% at the end of December 2012.

For the six-month period ending June 2012, we expect lower rental income HoH, due mainly to negative rental revisions, but believe overall revenue for the rental business will improve on a HoH basis on the full-period contributions from properties acquired in the previous six-month period, as well as contributions from those to be acquired in the period ending June 2012.

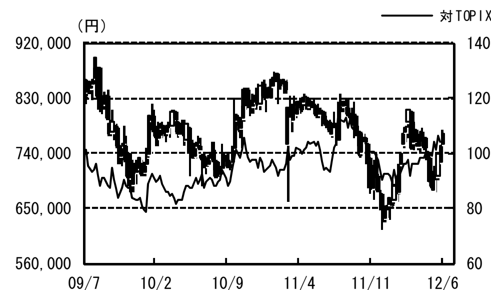
Although NBF will begin to report on the income statement the property/city planning taxes for properties acquired in 1H12 and is likely to book the costs related to new shares issued, we expect recurring profit to rise HoH on the back of growth in operating revenue, a fall in interest-rate expenses, and a reduction in the losses booked from asset disposals.

For 2H12, we expect recurring profit to remain largely unchanged from 1H12, assuming the following:

- One-off charges and gains are broadly similar.
- Negative rental reversions in the original portfolio are offset by an increase in net property income from full-year contributions by new acquisitions.

The major risk to our rating, forecasts and target price includes a faster-than-anticipated contraction in demand, which would negatively impact our rental growth assumptions.

Share price performance



Market Data

	12/11	6/12E	12/12E
P/E(X)	24.4	25.5	25.5
EV/EBITDA(X)	22.5	22.7	22.7
P/B(X)	1.05	1.12	1.12
Dividend yield(%)	3.94	3.92	3.92
ROE(%)	4.3	4.3	4.2

Investment Indicators

12-month range (Y)	614,000-837,000
Market cap (Y mil;29 Jun)	472,623
Shares outstanding (6/12)	613,000
Foreign ownership (%;6/11)	29.5

(Y mil)	12/11	6/12E	12/12E
Op revenue	29,773	30,000	30,100
Op profit	12,186	12,330	12,266
Rec profit	9,128	9,273	9,265
Net income	9,127	9,273	9,265
EPS (Y)	15,777	15,128	15,114
EPS (Y)	15,200	15,128	15,114

Source: Compiled by Daiwa, Company, Daiwa forecasts

Financial summary

■ Profit and loss (JPYm)

	Jun-09	Dec-09	Jun-10	Dec-10	Jun-11	Dec-11	Jun 12 E	Dec 12 E
Total revenue	**30,761**	**29,928**	**28,341**	**27,314**	**28,081**	**29,774**	**30,000**	**30,100**
Operating expenses	(9,756)	(9,805)	(9,896)	(9,653)	(9,417)	(10,244)	(10,229)	(10,450)
Net property income	**21,005**	**20,123**	**18,445**	**17,661**	**18,664**	**19,530**	**19,771**	**19,650**
Other income	-	-	-	-	-	-	-	-
Management fees	(1,134)	(1,078)	(988)	(943)	(973)	(1,027)	(1,036)	(1,038)
Other operating expenses	(5,573)	(5,521)	(5,285)	(5,399)	(5,772)	(6,317)	(6,405)	(6,346)
Depreciation and amortisation	-	-	-	-	-	-	-	-
EBIT	**14,298**	**13,524**	**12,172**	**11,319**	**11,919**	**12,186**	**12,330**	**12,266**
Net-int. income/(expenses)	(2,527)	(2,826)	(2,868)	(2,893)	(2,866)	(3,015)	(2,971)	(2,971)
Share of associates	-	-	-	-	-	-	-	-
Revaluation gains/(loss)	-	-	-	-	-	-	-	-
Except./other inc./(exp.)	32	(35)	(22)	(26)	(295)	(43)	(86)	(30)
Profit before tax	**11,803**	**10,663**	**9,282**	**8,400**	**8,758**	**9,128**	**9,273**	**9,265**
Taxation	(1)	(1)	(1)	(1)	(1)	(1)	-	-
Min. int./pref. div./others	-	-	-	-	-	-	-	-
Net profit	**11,802**	**10,662**	**9,282**	**8,399**	**8,757**	**9,127**	**9,273**	**9,265**
EPS (Y)	**21,774**	**19,671**	**17,124**	**15,495**	**15,280**	**15,777**	**15,128**	**15,114**
DPS (Y)	**21,775**	**19,672**	**17,125**	**15,495**	**15,138**	**15,200**	**15,128**	**15,114**

■ Cash flow (JPYm)

Year to 31 Dec	Jun-09	Dec-09	Jun-10	Dec-10	Jun-11	Dec-11	Jun 12 E	Dec 12 E
Funds from operations	17,156	15,944	14,354	13,570	14,497	15,226	5,450	15,38
Real estate sales	-	-	3,272	-	-	3,319	-	-
Other operating CF items	(1,405)	1,014	(347)	531	(1,403)	1,975	(164)	-
Cash flow from operation	**15,751**	**16,959**	**17,279**	**14,101**	**13,094**	**20,520**	**15,286**	**15,382**
Real estate acquisitions	(22,565)	(1,435)	(1,501)	(1,756)	(60,042)	(39,809)	(25,263)	(1,975)
Net investment and sale of FA	-	-	-	-	-	-	-	-
Other investing CF items	(585)	(487)	(1,823)	(620)	3,165	966	-	-
Cash flow from investing	**(23,150)**	**(1,921)**	**(3,323)**	**(2,376)**	**(56,878)**	**(38,843)**	**(25,263)**	**(1,975)**
Change in debt	20,000	(625)	(4,375)	(8,375)	25,625	26,625		
Equity raised/(repaid)	-	-	(54)	-	28,881	(53)	20,898	-
Distribution paid	(12,056)	(11,802)	(10,659)	(9,281)	(8,396)	(8,757)	(8,793)	(9,273)
Other financing CF items	-	-	-	-	-	-	-	-
Cash flow from financing	**7,944**	**(12,427)**	**(15,088)**	**(17,656)**	**46,110**	**17,815**	**12,104**	**(9,273)**
Forex effect/others	-	-	-	-	-	-	-	-
Change in cash	**545**	**2,610**	**(1,132)**	**(5,931)**	**2,326**	**(509)**	**2,127**	**4,134**

Source: Company, Daiwa forecasts

Financial summary continued …

Balance sheet (JPYm)

	Jun-09	Dec-09	Jun-10	Dec-10	Jun-11	Dec-11	Jun 12 E	Dec 12 E
Cash & cash equivalent	38,121	40,731	39,600	33,668	35,995	35,486	37,444	41,577
Accounts receivable	-	-	-	-	-	-	-	-
Other current assets	-	-	-	-	-	-	-	-
Total current assets	**38,121**	**40,731**	**39,600**	**33,668**	**35,995**	**35,486**	**37,444**	**41,577**
Investment properties	740,125	736,271	729,233	725,823	780,381	811,032	830,118	825,976
Fixed assets	-	-	-	-	-	-	-	-
Associates	-	-	-	-	-	-	-	-
Goodwill and intangible assets	-	-	-	-	-	-	-	-
Other long-term assets	5,547	5,309	5,546	5,711	7,329	6,337	6,337	6,337
Total assets	**783,793**	**782,311**	**774,379**	**765,203**	**823,705**	**852,855**	**873,899**	**873,890**
Short-term debt	89,750	46,750	24,750	48,750	73,750	64,750	22,000	22,000
Accounts payable	-	-	-	-	-	-	-	-
Other current liabilities	-	-	-	-	-	-	-	-
Total current liabilities	**89,750**	**46,750**	**24,750**	**48,750**	**73,750**	**64,750**	**22,000**	**22,000**
Long-term debt	248,750	291,125	308,750	276,375	277,000	312,625		
Other non-current liabilities	47,315	47,599	45,422	45,504	49,083	51,238	51,237	51,237
Total liabilities	**385,815**	**385,473**	**378,921**	**370,629**	**399,833**	**428,613**	**428,612**	**428,612**
Unitholders' funds	**397,978**	**396,838**	**395,458**	**394,575**	**423,872**	**424,242**	**445,286**	**445,278**
Minority interests	-	-	-	-	-	-	-	-
Total equity & liabilities	**783,793**	**782,311**	**774,379**	**765,203**	**823,705**	**852,855**	**873,899**	**873,890**

Key Ratios

	Jun-09	Dec-09	Jun-10	Dec-10	Jun-11	Dec-11	Jun 12 E	Dec 12 E
Total revenue (YoY)		-2.7%	-5.3%	-3.6%	2.8%	6.0%	.8%	0.3%
Net property income (YoY)		-4.2%	-8.3%	-4.3%	5.7%	4.6%	1.2%	-0.6%
Net profit (YoY)		-9.7%	-13.0%	-9.5%	4.3%	4.2%	1.6%	-0.1%
EPS (YoY)		-9.7%	-12.9%	-9.5%	-1.4%	3.3%	-4.1%	-0.1%
DPS (YoY)		-9.7%	-12.9%	-9.5%	-2.3%	0.4%	-0.5%	-0.1%
ROE						4.3%	4.3%	4.2%

Source: Company, Daiwa forecasts

Company profile

Nippon Building Fund (NBF) currently comprises 64 properties comprising 861,153 sq m with the portfolio focusing on large scale office buildings in the Tokyo CBD. NBF was the first J-REIT listed on the Tokyo Stock Exchange, listing in September 2001. NBF's sponsor is Mitsui Fudosan.

Mori Hills REIT
(3234 JP, ¥344,000, Outperform [2])

Market cap: US$1.0bn

Target price: ¥373,000

Upside: +8.4%

Improving portfolio quality with help from sponsor

Tomohiro Sumiya
(81) 3 5555 7014

Business overview

Mori Hills is a diversified REIT, targeting properties in premium locations in the Tokyo metropolitan area (such as the city's five central wards and surrounding areas).

The REIT's sponsor, Mori Building (Not listed) is a diversified developer that was founded in June 1959 and had total assets of ¥1.2tn as at the end ofMarch 2012. It has an established track record in redeveloping properties in Tokyo, mainly in the central Minato Ward. The REIT's name aims to capitalise on the brand value of large projects by the Mori Building group that include the word 'hills' in their name.

Mori Hills focuses on premium properties, which it aims to account for over 50% of the portfolio based on purchase prices. More specifically, it is focused on the office market, with the goal of office buildings accounting for at least 50% of the portfolio (based on purchase prices), and housing and commercial facilities together making up less than 50%. The REIT targets a portfolio that has at least 80% of the properties in the Tokyo metropolitan area (with at least 50% of them being premium properties) and no more than 20% of its properties in other major cities.

Based on the disclosed portfolio as at the end of June 2012, the REIT has an interest in nine properties with a total acquisition price of ¥210.8bn. Based on the purchase prices, Tokyo metropolitan-area properties currently account for all of the portfolio (76.7% in Minato Ward, 12.9% in Bunkyo Ward, and 10.4% in Shibuya Ward). The portfolio breaks down to 79.2% office buildings, 10.4% residential, and 10.4% commercial facilities. The two major properties are ARK Mori Building, an office building; (28.0% of the total portfolio) and Akasaka Tameike Tower (office building with some residential space representing; 20.8% of the total portfolio).

For the six-month period ended January 2012, the NOI yield based on the acquisition value of the portfolio stood at 3.6%. For the same period, the LTV ratio (interest-bearing debt/total assets) was 48.8%. We estimate that the LTV ratio was also 48.8% in May, following a reshuffle of the portfolio. According to its guidance, the management team targets an effective LTV ratio of 50%.

At the end of January 2012, Mori Hills had interest-bearing debt of ¥107.0bn on its books, ¥17.0bn in short-term debt and ¥65.0bn in long-term debt, and ¥25.0bn in investment corporation bonds. Total interest-bearing debt had an average maturity of 1.46 years and an average funding cost of 1.56%. Of the total interest-bearing debt, 84% was long-term, while 46% carried fixed rates. Excluding short-term debt, the REIT will need to refinance loans of at least ¥10bn on the following dates: ¥14.7bn in July 2012, ¥20.0bn in January 2013, ¥15.0bn in January 2014, ¥10.0bn in July 2014, and ¥20.0bn in January 2015. As such, it has a balanced distribution of loan repayment deadlines.

Mori Hills is rated AA- (stable) by the Japan Credit Rating Agency (JCR) (for long-term senior debt) and Baa2 (negative) by Moody's Japan (for the issuer).

Restructuring portfolio in concert with sponsor

Since January 2011, Mori Hills has been transferring low-yielding properties to its sponsor, Mori Building, and purchasing high-yielding ones from it, with the aim of raising the NOI yield. In addition, Mori Hills has been selling properties to its sponsor priced above the appraised value and/or book value, while purchasing properties below their appraised values. This has been working to improve net unrealised gains/losses, while the decline in the LTV ratio (based on appraised values should reduce borrowing costs. Also, for the acquired properties, the REIT has a fixed-rent master-leasing contract with its sponsor, which helps stabilise revenue from properties.

In May 2012, Mori Hills transferred two properties to its sponsor, Roppongi First Building (sold for ¥20.4bn;

appraised at ¥18.6bn; book value of ¥20.2bn; NOI yield of 2.2%) and ARK Forest Terrace (sold for ¥5.1bn; appraised at ¥2.9bn; book value of ¥5.1bn; NOI yield of 2.1%). Meanwhile, the REIT purchased about 20% of Atago Green Hills (acquired for ¥25.6bn; appraised at ¥27.6bn; and with a NOI yield estimated by us at 4.7%) from its sponsor, marking the fourth property transaction between the REIT and Mori Hills' Building.

We forecast the restructuring of the property portfolio to boost the NOI yield, based on the acquisition value of the portfolio, from 3.7% for six-month period ended July 2010 to 3.9% for the six-month period ending July 2012 (assuming a full-period contribution from the acquired properties). We forecast unrealised losses to contract from ¥26.8bn at the end of July 2010 to ¥13.9bn at the end of July 2012. The percentage of properties with fixed-rent contracts has risen to 84.7%, from 10% over the same period, which includes 82.3% (period ending July 2012) leased to the sponsor or the sponsor's affiliate. Such collaboration with the sponsor has helped to stabilise revenue.

Properties for potential transfer include two with NOI yields based on acquisition values of less than 4%, namely Koraku Mori Building (book value of ¥26.1bn; appraisal value of ¥21.6bn; NOI yield of 2.9% at the end of July 2012 as estimated by the REIT) and Roppongi First Plaza (¥2.2bn; ¥1.6bn; 3.8%). We forecast a difference of 2.0-2.5% in the NOI yield between the properties purchased and those sold to boost the DPU by about ¥1,000-1,300 on a ¥25bn asset swap.

Dividend outlook

We forecast a DPU of ¥8,700 and ¥8,997 for the next two six-month periods

We forecast a DPU of ¥8,700 for the six-month period ending July 2012 and ¥8,997 for the six-month period ending January 2013. For the six month period ending July 2012, Mori Hills expects a DPU of ¥8,700 (up 0.9% HoH from the previous period.

We forecast net income per share of ¥8,988 (up 4.2% HoH) for the six-month period ending July 2012 and ¥8,997 (up 0.1% HoH) for the six-month period ending January 2013. For the six-month period ending July 2012, we forecast operating revenue of ¥4,823m (up 1.2% HoH), operating profit of ¥3,173m (up 2.1% HoH), and recurring profit of ¥2,081m (up 4.2% HoH]). For the six month period ending January 2013, we forecast operating revenue of ¥4,691m (down 2.7% HoH), operating profit of ¥3,092m (down 2.6% HoH), and recurring profit of ¥2,083m (up 0.1% HoH).

For the six-month period ending July 2012, we forecast the acquisition of one property done in May and the transfer of two properties to its sponsor to boost profit by contributing ¥110m to rental income, generating a ¥10m gain on property sales, and reducing financial expenses by ¥10m. However, we also forecast lower HoH rental income from Koraku Mori Building and a ¥40m increase in property and city planning taxes associated with the acquisitions of Roppongi Hills Mori Tower and Ark Mori Building in the previous period, (FY11). We assume that some of the gains on property sales will be added to retained earnings.

For the six-month period ending January 2013 we expect the overall DPU to increase. New contributions from from Atago Green Hills, acquired in the previous period (FY11), along with reductions in financial costs, in our view, will offset the loss of revenue from those assets divested as part of the restructuring exercise.

Maintain Outperform (2) rating

Based on our DPU forecasts and at the current unit price, Mori Hills has a dividend yield of 5.54% for 1H FY12E (ie, the six-month period ending July 2012) and 5.73% for 2FY12E. For 2H FY12E, we assume the following: 1) the current portfolio of properties is maintained, 2) no gains from property sales, and 3) the booking of property and city planning taxes on the income statement. On this basis, we estimate an NAV per share of ¥392,000, corresponding to a price-to-NAV multiple of 0.88x. Based on the prospective NOI for FY12E, we peg the implied capitalisation rate at 4.54%. We forecast an LTV ratio of 49% for FY12E, or 52% including tenant deposits and guarantees.

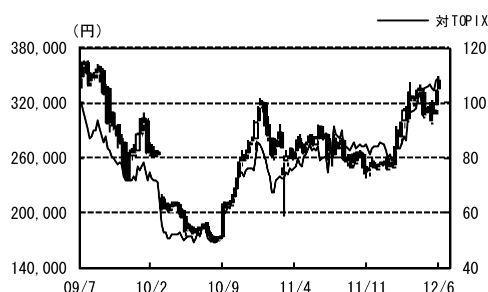
We recently initiated coverage of Mori Hills with an Outperform (2) rating and maintain that rating, along with our 12-month target price of ¥373,000, based on our price-to-NAV multiples analysis. In September 2010, Mori Hills adopted a new management policy, with an emphasis on dividends. There have since been four property transactions between the REIT and its sponsor, which we applaud for improving the quality of the portfolio. We believe there is clear visibility on the REIT achieving its medium-term dividend target of ¥10,000/unit, assuming its portfolio reshuffles include the sales of properties such as Koraku Mori Building. The REIT appears to be on track with its turnaround plan, which emphasises improvements in dividends and financial health. Over the next few years, we expect Mori Hills to maintain its emphasis on dividends. We also think the time is approaching for its market cap to expand as the REIT leverages on the rich property pipeline provided by its sponsor.

Mori Hills boasts a property portfolio capable of generating stable rental income in a market that still faces downside risk to rents, especially in the office space. We believe this justifies a price-to-NAV multiple of 0.95x, which we use to ascertain our target price.

We see further prospects for asset divestments/acquisitions between the REIT and its sponsor. Our target price of ¥373,000 implies a prospective dividend yield of 4.8%. We believe the trust could potentially be rerated if the REIT enters a phase of asset expansion through increased property acquisitions in premium locations.

The major risk to our rating, forecasts and target price includes a faster-than-anticipated contraction in demand, which would negatively impact our rental growth assumptions.

Share price performance



Market Data

	1/12	7/12E	1/13E
P/E(X)	19.9	19.1	19.1
EV/EBITDA(X)	23.6	23.0	23.2
P/B(X)	0.77	0.77	0.77
Dividend yield(%)	5.01	5.06	5.23
ROE(%)	3.8	4.0	4.0

Investment Indicators

12-month range (Y)	238,000-353,000
Market cap (Y mil;29 Jun)	79,643
Shares outstanding (6/12)	231,520
Foreign ownership (%;7/10)	1.0

(Y mil)	1/12	7/12E	1/13E
Op revenue	4,765	4,823	4,691
Op profit	3,108	3,173	3,092
Rec profit	1,997	2,081	2,083
Net income	1,996	2,081	2,083
EPS (Y)	8,622	8,988	8,997
EPS (Y)	8,622	8,700	8,997

Source: Compiled by Daiwa, Company, Daiwa forecasts

Financial summary

■ Profit and loss (JPYm)

	Jul-10	Jan-11	Jul-11	Jan-12	Jul 12 E	Jan 13 E
Total revenue	**5,388**	**5,484**	**5,258**	**4,766**	**4,823**	**4,691**
Operating expenses	(1,553)	(1,728)	(1,544)	(889)	(875)	(597)
Net property income	**3,835**	**3,756**	**3,714**	**3,877**	**3,948**	**4,094**
Other income	-	-	-	-	-	-
Management fees	(315)	(299)	(221)	(223)	(225)	(225)
Other operating expenses	(840)	(500)	(433)	(545)	(550)	(777)
Depreciation and amortisation	-	-	-	-	-	-
EBIT	**2,680**	**2,957**	**3,060**	**3,109**	**3,173**	**3,092**
Net-int. income/(expenses)	(877)	(891)	(878)	(853)	(822)	(733)
Share of associates	-	-	-	-	-	-
Revaluation gains/(loss)	-	-	-	-	-	-
Except./other inc./(exp.)	(279)	(225)	(247)	(259)	(270)	(276)
Profit before tax	**1,524**	**1,841**	**1,935**	**1,997**	**2,081**	**2,083**
Taxation	(1)	(1)	(1)	(1)	-	-
Min. int./pref. div./others	-	-	-	-	-	-
Net profit	**1,523**	**1,840**	**1,934**	**1,996**	**2,081**	**2,083**
EPS (Y)	**7,229**	**7,947**	**8,352**	**8,622**	**8,988**	**8,997**
DPS (Y)	**6,577**	**7,947**	**8,352**	**8,622**	**8,700**	**8,997**

■ Cash flow (JPY m)

Year to 31 Dec	Jul-10	Jan-11	Jul-11	Jan-12	Jul 12 E	Jan 13 E
Funds from operations	2,270	2,256	2,281	2,456	2,556	2,785
Real estate sales	-	21,452	15,877	35,679	25,600	-
Other operating CF items	152	165	374	7	-	-
Cash flow from operation	**2,422**	**23,873**	**18,532**	**38,142**	**28,156**	**2,785**
Real estate acquisitions	(10,375)	(22,144)	(16,833)	(36,075)	(25,650)	(50)
Net investment and sale of FA	-	-	-	-	-	-
Other investing CF items	237	(810)	(31)	218	-	-
Cash flow from investing	**(10,138)**	**(22,954)**	**(16,864)**	**(35,857)**	**(25,650)**	**(50)**
Change in debt	(2,216)	(113)	(1,650)	(113)	(113)	-
Equity raised/(repaid)	14,569	-	-	-	-	-
Distribution paid	(1,727)	(1,517)	(1,839)	(1,932)	(1,996)	(2,014)
Other financing CF items	-	-	-	-	-	-
Cash flow from financing	**10,627**	**(1,629)**	**(3,489)**	**(2,044)**	**(2,108)**	**(2,014)**
Forex effect/others	-	-	-	-	-	-
Change in cash	**2,911**	**(711)**	**(1,820)**	**241**	**398**	**721**

Source: Company, Daiwa forecasts

Financial summary continued ...

Balance sheet (JPYm)

	Jul-10	Jan-11	Jul-11	Jan-12	Jul 12 E	Jan 13 E
Cash & cash equivalent	11,581	10,870	9,050	9,291	9,886	10,540
Accounts receivable	-	-	-	-	-	-
Other current assets	-	-	-	-	-	-
Total current assets	**11,581**	**10,870**	**9,050**	**9,291**	**9,886**	**10,540**
Investment properties	208,904	208,886	209,177	208,919	208,295	207,643
Fixed assets	-	-	-	-	-	-
Associates	-	-	-	-	-	-
Goodwill and intangible assets	-	-	-	-	-	-
Other long-term assets	881	874	723	909	910	910
Total assets	**221,366**	**220,630**	**218,951**	**219,119**	**219,091**	**219,093**
Short-term debt	36,735	45,735	53,925	51,875	8,978	8,978
Accounts payable	-	-	-	-	-	-
Other current liabilities	-	-	-	-	-	-
Total current liabilities	**36,735**	**45,735**	**53,925**	**51,875**	**8,978**	**8,978**
Long-term debt	72,113	63,000	53,188	55,125		
Other non-current liabilities	8,998	8,052	7,894	8,112	8,112	8,112
Total liabilities	**117,845**	**116,786**	**115,006**	**115,112**	**114,999**	**114,999**
Unitholders' funds	**103,521**	**103,844**	**103,945**	**104,007**	**104,091**	**104,093**
Minority interests	-	-	-	-	-	-
Total equity & liabilities	**221,366**	**220,630**	**218,951**	**219,119**	**219,091**	**219,093**

Key Ratios

	Jul-10	Jan-11	Jul-11	Jan-12	Jul 12 E	Jan 13 E
Total revenue (YoY)		1.8%	-4.1%	-9.4%	1.2%	-2.7%
Net property income (YoY)		-2.1%	-1.1%	4.4%	1.8%	3.7%
Net profit (YoY)		20.8%	5.1%	3.2%	4.3%	0.1%
EPS (YoY)		9.9%	5.1%	3.2%	4.2%	0.1%
DPS (YoY)		20.8%	5.1%	3.2%	0.9%	3.4%
ROE				3.8%	4.0%	4.0%

Source: Company, Daiwa forecasts

Company profile

Mori Hills REIT was listed on the J-REIT Securitis Section of the Tokyo Stock Exchange in November 2006. Mori Hills REIT is focused on investing in premium properties in the central five wards of Tokyo.

Nippon Accommodations Fund

(3226 JP, ¥517,000, Hold [3])

Market cap: US$1.26bn

Target price: ¥582,000

Upside: +12.6%

High occupancy rate, solid finances

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Valuation

Based on our annualised DPU forecast for the period ending February 2013(2HFY12), NAF is trading currently at a dividend yield of 5.3%, or 0.95x the most recent book value (end-February 2012) (a price-to-NAV multiple of 1.07x based on the most recent appraisal value). Applying our fair price-to-NAV multiple assumption of 1.2x, we maintain our six-month target price of ¥582,000. We believe NAF should trade at a premium to other J-REITs, given its prospects for stable rental business revenue and solid financial standing.

Business overview

NAF's portfolio consists of properties in the Tokyo metropolitan area and major cities in other regions. The REIT specialises in large residential properties, mostly those with a single-person household, and compact housing.

Its main sponsor is Mitsui Fudosan, and everything from planning and development to property and operational management is kept consistent throughout the group. The REIT's acquisition strategy focuses on rental housing, but also invests in 'other accommodation assets', such as school dormitories and senior housing.

NAF's assets are managed by Mitsui Fudosan Accommodations Fund Management, a wholly owned subsidiary of Mitsui Fudosan. As at the end of February 2012, the REIT owned 87 properties with a total acquisition value of ¥231.2bn.

Based on the purchase price, 86% of NAF's properties are in Tokyo's 23 main wards with an additional 4% classified as 'other accommodation assets'.

The Okawabata Apartment Communities (River Point Tower, Parkside Wings, and Pier West House) accounted for 13% of the portfolio by acquisition value at the end of February 2012. The occupancy rate at the property, which consists of large housing units with relatively high rents, stood at 91% at the end of February, lower than the occupancy rate of 96% for the entire portfolio. Asking rents for the entire portfolio have shown signs of bottoming out, but the average rents for the Okawabata Apartment Communities have seen recent weakness, warranting caution.

Earnings overview

For the six-month period ended February 2012, operating revenue rose by 4% HoH to ¥7,857m as average rents declined more slowly than in the previous half-period, the end-period occupancy rate rose, and properties acquired during the period made contributions to revenue. In addition, a high percentage of tenants whose leases ended during the period opted to renew their contracts, leading to a sharp drop in maintenance costs. Net income rose by 8% HoH to ¥2,832m, helped in part by the absence of new-share issuance costs. The DPU increased by 8% to ¥14,548.

To fund property purchases, NAF borrowed ¥7.5bn in the six-month period ended February 2012. By raising the weighting of long-term new debt when refinancing existing liabilities, the REIT increased the overall weighting of long-term liabilities from 90% to 94% of its total liabilities at the end of February 2012. We credit NAF for improving its finances steadily by extending the average maturity and spreading out payment deadlines.

Dividend outlook

We forecast DPUs of ¥13,812 and ¥13,827 for the two six-month periods (ending 1HFY12 and 2HFY12, respectively).

In the current period thus far (ie, 2H FY11, ended February 2012), NAF has acquired two properties (acquisition value: ¥1.7bn, NOI yield: 7.7% based on purchase price) from Itochu in the 'other

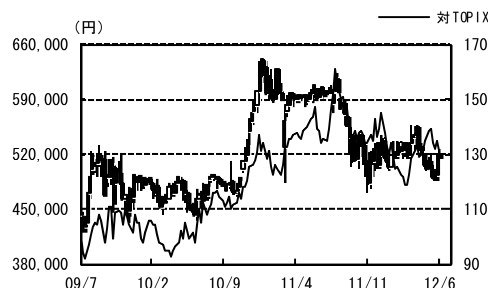
accommodation assets' category in order to achieve steady DPU growth and diversify the portfolio. It divested Park Cube Keio Hachioji in FY11, based on the property-location strategy of its portfolio.

We forecast operating revenue of ¥8,075m, up 3% HoH, for the period ending August 2012 (ie, 1H FY12), factoring in contributions from these new acquisitions, gains on property sales (about ¥85m), as well as the prospects for continued high occupancy rates. However, we forecast rental business expenses to rise by 8% HoH to ¥3,705m due to increases in taxes and public dues (such as property taxes) and other expenses. Thus, we expect net income to decline by 3% HoH to ¥2,759m. We assume the REIT will retain a part of the gain on the sale of Park Cube Keio Hachioji through a transfer to the reduction entry reserves (¥70m). Consequently, we forecast DPU for 1H FY12 to decline by 5% HoH to ¥13,812.

For the six-month period ending February 2013, we expect residential rental revenue to remain more or less flat on a HoH basis, as occupancy rates are likely to remain high. Even so, we forecast operating revenue to drop by 1% HoH to ¥8,002m in the absence of gains sales of properties in the previous period (1H FY13). We forecast net income of ¥2,692m (down 2% HoH). We assume NAF pays out all net income as dividends, resulting in a DPU of ¥13,827, essentially flat over the previous reporting period (HoH).

The major risk to our rating, forecasts and target price includes a faster-than-anticipated contraction in demand, which would negatively impact our rental growth assumptions. Upside potential would come from a better-than-expected outlook for demand.

Share price performance



Market Data

	2/12	8/12E	2/13E
P/E(X)	17.8	18.2	18.7
EV/EBITDA(X)	20.9	20.9	21.0
P/B(X)	0.95	0.95	0.95
Dividend yield(%)	5.63	5.34	5.35
ROE(%)	5.3	5.2	5.1

Investment Indicators

12-month range (Y)	471,000-622,000
Market cap (Y mil;29 Jun)	100,666
Shares outstanding (6/12)	194,711
Foreign ownership (%;2/12)	16.7

(Y mil)	2/12	8/12E	2/13E
Op revenue	7,857	8,075	8,002
Op profit	3,613	3,560	3,494
Rec profit	2,833	2,759	2,692
Net income	2,832	2,759	2,692
EPS (Y)	14,548	14,172	13,827
EPS (Y)	14,548	13,812	13,827

Source: Compiled by Daiwa, Company, Daiwa forecasts

Financial summary

■ Profit and loss (JPYm)

	Aug-09	Feb-10	Aug-10	Feb-11	Aug-11	Feb-12	Aug 12 E	Feb 13 E
Total revenue	**4 475**	**5,919**	**6,217**	**6,180**	**7,566**	**7,858**	**8,075**	**8,002**
Operating expenses	(967)	(1,740)	(1,447)	(1,341)	(1,802)	(1,745)	(2,066)	(1,981)
Net property income	**3,508**	**4,179**	**4,770**	**4,839**	**5,764**	**6,113**	**6,009**	**6,021**
Other income	-	-	-	-	-	-	-	-
Management fees	(317)	(433)	(440)	(441)	(537)	(563)	(571)	(562)
Other operating expenses	(1,022)	(736)	(1,434)	(1,454)	(1,806)	(1,937)	(1,878)	(1,965)
Depreciation and amortisation	-	-	-	-	-	-	-	-
EBIT	**2,169**	**3,010**	**2,896**	**2,944**	**3,421**	**3,613**	**3,560**	**3,494**
Net-int. income/(expenses)	(623)	(734)	(752)	(746)	(791)	(785)	(806)	(807)
Share of associates	-	-	-	-	-	-	-	-
Revaluation gains/(loss)	-	-	-	-	-	-	-	-
Except./other inc./(exp.)	1	-	4	3	1	6	5	5
Profit before tax	**1,547**	**2,276**	**2,148**	**2,201**	**2,631**	**2,834**	**2,759**	**2,692**
Taxation	(1)	(1)	(1)	(1)	(1)	(1)	-	-
Min. int./pref. div./others	-	-	-	-	-	-	-	-
Net profit	**1,546**	**2,275**	**2,147**	**2,200**	**2,630**	**2,833**	**2,759**	**2,692**
EPS (Y)	**13,626**	**16,137**	**13,748**	**14,085**	**13,518**	**14,548**	**14,172**	**13,827**
DPS (Y)	**13,626**	**14,567**	**13,748**	**14,086**	**13,508**	**14,548**	**13,812**	**13,827**

■ Cash flow (JPY m)

	Aug-09	Feb-10	Aug-10	Feb-11	Aug-11	Feb-12	Aug 12 E	Feb 13 E
Funds from operations	2,397	2,780	3,388	3,451	4,217	4,532	4,398	4,419
Real estate sales	-	2 543	-	-	-	-	1,020	-
Other operating CF items	38	726	275	(280)	582	(129)	(3)	-
Cash flow from operation	**2,435**	**6,049**	**3,663**	**3,172**	**4,799**	**4,403**	**5,415**	**4,419**
Real estate acquisitions	(183)	(44,022)	(7,689)	(179)	(38,970)	(7,903)	(1,865)	(114)
Net investment and sale of FA	-	-	-	-	-	-		
Other investing CF items	(64)	562	37	(7)	90	97		
Cash flow from investing	**(247)**	**(43,460)**	**(7,651)**	**(186)**	**(38,880)**	**(7,806)**	**(1,865)**	**(114)**
Change in debt	-	18,000	5,960	-	14,500	6,500	1,500	-
Equity raised/(repaid)	-	20,060	-	-	22,084	-	-	-
Distribution paid	(1,654)	(1,546)	(2,269)	(2,147)	(2,199)	(2,629)	(2,689)	(2,692)
Other financing CF items	-	-	-	-	-	-	-	-
Cash flow from financing	**(1,654)**	**36,514**	**3,691**	**(2,147)**	**34,385**	**3,871**	**(1,189)**	**(2,692)**
Forex effect/others	-	-	-	-	-	-	-	-
Change in cash	**534**	**(897)**	**(298)**	**839**	**305**	**469**	**2,361**	**1,613**

Source: Company, Daiwa forecasts

Financial summary continued ...

Balance sheet (JPYm)

	Aug-09	Feb-10	Aug-10	Feb-11	Aug-11	Feb-12	Au 12 E	Feb 13 E
Cash & cash equivalent	4,533	3,637	3,339	4,179	4,483	4,952	7,257	8,873
Accounts receivable	-	-	-	-	-	-	-	-
Other current assets	-	-	-	-	-	-	-	-
Total current assets	**4,533**	**3,637**	**3,339**	**4,179**	**4,483**	**4,952**	**7,257**	**8,873**
Investment properties	141,250	181,656	188,119	187,047	224,430	230,633	229,753	228,140
Fixed assets	-	-	-	-	-	-	-	-
Associates	-	-	-	-	-	-	-	-
Goodwill and intangible assets	-	-	-	-	-	-	-	-
Other long-term assets	758	1,136	1,021	1,135	1,639	1,638	1,639	1,638
Total assets	**146,542**	**186,429**	**192,479**	**192,360**	**230,551**	**237,222**	**238,649**	**238,651**
Short-term debt	28,500	37,500	43,000	29,000	22,000	24,500	8,500	8,500
Accounts payable	-	-	-	-	-	-	-	-
Other current liabilities	-	-	-	-	-	-	-	-
Total current liabilities	**28,500**	**37,500**	**43,000**	**29,000**	**22,000**	**24,500**	**8,500**	**8,500**
Long-term debt	52,500	61,500	62,000	76,000	97,500	101,500	-	-
Other non-current liabilities	3,016	4,051	4,229	4,058	5,185	5,154	5,154	5,154
Total liabilities	**84,017**	**103,051**	**109,229**	**109,057**	**124,686**	**131,154**	**132,654**	**132,654**
Unitholders' funds	**62,525**	**83,378**	**83,250**	**83,303**	**105,865**	**106,068**	**105,994**	**105,997**
Minority interests	-	-	-	-	-	-	-	-
Total equity & liabilities	**146,542**	**186,429**	**192,479**	**192,360**	**230,551**	**237,222**	**238,649**	**238,651**

Key Ratios

	Aug-09	Feb-10	Aug-10	Feb-11	Aug-11	Feb-12	Aug 12 E	Feb 13 E
Total revenue (YoY)	-0.7%	32.3%	5.0%	-0.6%	22.4%	3.9%	2.8%	-0.9%
Net property income (YoY)	-2.9%	19.1%	14.1%	1.4%	19.1%	6.1%	-1.7%	0.2%
Net profit (YoY)	-6.6%	4 .2%	-5.6%	2.5%	19.5%	7.7%	-2.6%	-2.4%
EPS (YoY)	-6.6%	18.4%	-14.8%	2.5%	-4.0%	7.6%	-2.6%	-2.4%
DPS (YoY)	-6.6%	6.9%	-5.6%	2.5%	-4.1%	7.7%	-5.1%	0.1%
ROE						5.3%	5.2%	5.1%

Source: Company, Daiwa forecasts

Company profile

Nippon Accommodations Fund (NAF) invests in accommodation assets including rental apartments,dormitory/student apartments senior residences and corporate housing. The REIT's current portfolio is focused on the 23 Wards of Tokyo and rental accommodation (over 95% of assets by value). NAF's sponsor is Mitsui Fudosan.

Daiwa House Residential Investment

(8984 JP, , ¥557,000, Outperform [2])

Market cap: US$1.12bn

Target price: ¥600,000

Upside: +7.7%

Steady progress in shoring up core profitability

Tomohiro Sumiya
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Valuation

Based on our annualised DPU forecast for the six-month period ending February 2013, DHI is trading currently at a dividend yield of 5.8%, or 0.97x its most recent book value (end-February 2012), and at a price-to-NAV multiple of 1.1x based on most recent appraisal value.

We have a six-month target price of ¥600,000, based on what we deem a fair price-to-NAV multiple of 1.2x. We think DHI should trade at a higher multiple than its Japan peers, as the REIT can reshuffle its property portfolio to boost profitability by leveraging its balance sheet.

REIT overview

DHI was listed in March 2006 as BLife Investment, with Morimoto as its main sponsor and Daiwa House Industry as the sub-sponsor. The REIT started out by investing principally in residential and commercial properties.

However, DHI increased the weighting of residential properties in its portfolio significantly when it merged with residential REIT New City Residence in April 2010.

In July 2011, DHI's asset-management company became a wholly owned subsidiary of Daiwa House Industry, and changed its name to Daiwa House Asset Management in August 2011 (it had previously been called Daiwa House Morimoto Asset Management). The REIT also shifted to a policy of leveraging on the overall strength of the Daiwa House group to support DPU growth. Since listing, DHI has mainly acquired residential properties, and the asset manager's strength lies in that area. Thus, the REIT revised its asset-management guidelines in September 2011 such that it can invest only in residential facilities. In December 2011, the REIT changed its name from BLife Investment to Daiwa House Residential Investment.

The NOI yield based on the acquisition value of the entire portfolio stood at 5.3% for the six-month period ended February 2012. At the end of February 2012, the LTV ratio (interest-bearing debt/total assets) was 56.5%, or 57.5% including tenant deposits and guarantees.

Earnings overview

For the six-month period ended February 2012, operating revenue rose by 10% HoH period to ¥7,421m, backed by an improvement in the occupancy rate and the contributions from newly purchased properties. Net income increased sharply, by 59% HoH to ¥2,234m, as losses on property sales contracted, and the higher occupancy rate worked to reduce intermediary costs. The REIT drew down ¥334m from dividend reserves (¥536m in the previous six-month period), so DPU fell by 2% HoH to ¥16,000. Following this, dividend reserves stood at ¥19.5bn.

In 2H FY11, DHI raised ¥17.6bn in capital and acquired six properties for a total of ¥18.9bn. It also sold two properties, which resulted in net unrealised losses (appraised value less end-period book value) narrowing to ¥7.7bn (compared with ¥9.6bn at the end of the previous period (1H FY12)). From March 2012, the REIT reduced its rehabilitation obligations by repurchasing and cancelling unsecured investment corporation bonds issued by the former New City Residence. Also, DHI has issued new investment corporation bonds, lengthening the average maturity of its borrowings and spreading out the repayment dates. The REIT's financial stability has improved gradually as a result of these moves. It fulfilled the conditions for releasing security interests on Term Loan I (effective date: 4 October 2011), making all of the REIT's interest-bearing debt unsecured.

DHI has been steadily shoring up the profitability of its core operations. The acquisitions of properties developed by its sponsor, in addition to its

warehousing projects (short-term investments in buildings and other commercial facilities, as well as securing divestment gains from sales of existing properties, should underpin long-term DPU growth, in our view.

Dividend outlook

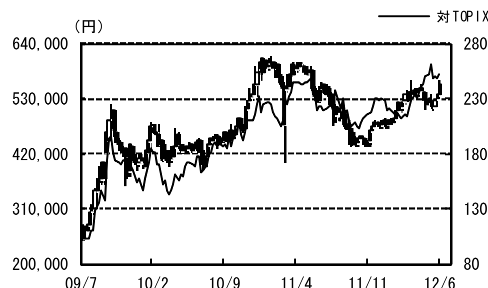
We forecast DPUs of ¥16,100 and ¥16,204 for the next two six-month periods (2H FY12 and 1H FY13, respectively).

For the six months ending August 2012, we forecast operating revenue of ¥7,655m (up 3% HoH), underpinned by full-period contributions from properties acquired in the previous six months, gains on properties sold in March, and the purchase of two new properties (total acquisition price of ¥4.0bn). We forecast net income to rise by 13% HoH to ¥2,518m, buoyed by the purchase and cancellation of rehabilitation obligations, along with the absence of impairment charges on New City Residence Toyoda. and new-share issuance costs booked in the previous six months. DHI plans to bolster dividends by drawing down ¥70m from dividend reserves, so we forecast the DPU to rise 1% HoH to ¥16,100.

For the six months ending February 2013, we forecast operating revenue to decline by 1% HoH to ¥7,595m, with the absence of gains on property sales outweighing the positive of high occupancy rates. However, we forecast net income to rise by 3% HoH to ¥2,601m, backed by a decline in interest expenses, and DPU to increase by only 1% HoH to ¥16,204, as we do not assume that DHI will draw down dividend reserves.

The major risk to our rating, forecasts and target price includes a faster-than-anticipated contraction in demand, which would negatively impact our rental growth assumptions.

Share price performance



Market Data

	2/12	8/12E	2/13E
P/E(X)	19.0	17.8	17.2
EV/EBITDA(X)	21.2	20.7	20.6
P/B(X)	0.97	0.97	0.97
Dividend yield(%)	5.75	5.78	5.82
ROE(%)	5.4	5.5	5.7

Investment Indicators

12-month range (Y)	434,500-569,000
Market cap (Y mil;29 Jun)	89,418
Shares outstanding (6/12)	160,535
Foreign ownership (%;8/11)	20.4

(Y mil)	2/12	8/12E	2/13E
Op revenue	7,421	7,655	7,595
Op profit	3,434	3,515	3,507
Rec profit	2,357	2,518	2,601
Net income	2,234	2,518	2,601
EPS (Y)	14,665	15,690	16,204
EPS (Y)	16,000	16,100	16,204

Source: Compiled by Daiwa, Company, Daiwa forecasts

Financial summary

■ Profit and loss (JPYm)

	May-09	Nov-09	Aug-10	Feb-11	Aug-11	Feb-12	Aug 12 E	Feb 13 E
Total revenue	**1,559**	**1,479**	**6,514**	**7,794**	**6,729**	**7,421**	**7,655**	**7,595**
Operating expenses	(269)	(316)	(1,664)	(2,898)	(1,878)	(1,803)	(1,995)	(1,875)
Net property income	**1,290**	**1,163**	**4,850**	**4,896**	**4,851**	**5,618**	**5,660**	**5,720**
Other income	-	-	-	-	-	-	-	-
Management fees	61	57	307	460	404	446	495	495
Other operating expenses	(496)	(477)	(2,205)	(1,560)	(2,777)	(2,630)	(2,640)	(2,708)
Depreciation and amortisation	-	-	-	-	-	-	-	-
EBIT	**855**	**743**	**2,952**	**3,796**	**2,478**	**3,434**	**3,515**	**3,507**
Net-int. income/(expenses)	(218)	(202)	(890)	(880)	(876)	(826)	(833)	(743)
Share of associates	-	-	-	-	-	-	-	-
Revaluation gains/(loss)	-	-	-	-	-	-	-	-
Except./other inc./(exp.)	(88)	(103)	18,857	330	(200)	(373)	(164)	(163)
Profit before tax	**549**	**437**	**20,919**	**3,246**	**1,402**	**2,235**	**2,518**	**2,601**
Taxation	(1)	(1)	(1)	(1)	(1)	(1)	-	-
Min. int./pref. div./others	-	-	-	-	-	-	-	-
Net profit	**549**	**437**	**20,918**	**3,246**	**1,402**	**2,234**	**2,518**	**2,601**
EPS (Y)	**11,138**	**8,861**	**237,562**	**27,334**	**11,806**	**14,665**	**15,690**	**16,204**
DPS (Y)	**11,138**	**8,862**	**15,341**	**16,880**	**16,320**	**16,000**	**16,100**	**16,204**

■ Cash flow (JPYm)

	May-09	Nov-09	Aug-10	Feb-11	Aug-11	Feb-12	Aug 12 E	Feb 13 E
Funds from operations	823	711	2,959	3,152	3,114	3,785	3,863	4,013
Real estate sales	-	-	663	13 445	3,363	821	2,455	-
Other operating CF items	(19)	(292)	120	602	(692)	(1,143)	-	-
Cash flow from operation	**804**	**419**	**3,742**	**17,199**	**5,785**	**3,463**	**6,318**	**4,013**
Real estate acquisitions	(36)	(28)	(2,980)	(13,783)	(3,691)	(20,052)	(4,418)	-
Net investment and sale of FA	-	-	-	-	-	-	-	-
Other investing CF items	6	20	100	(57)	199	249	41	-
Cash flow from investing	**(30)**	**(8)**	**(2,880)**	**(13,840)**	**(3,492)**	**(19,803)**	**(4,377)**	**-**
Change in debt	-	(11)	(114)	10,396	(104)	19,167	22,072	-
Equity raised/(repaid)	-	-	-	-	-	17,540	-	-
Distribution paid	(612)	(549)	(437)	(1,817)	(1,999)	(1,933)	(2,568)	(2,584)
Other financing CF items	-	-	(889)	(11,186)	(546)	(16,488)	(22,267)	-
Cash flow from financing	**(612)**	**(560)**	**(1,440)**	**(2,607)**	**(2,648)**	**18,287**	**(2,764)**	**(2,584)**
Forex effect/others	-	-	-	-	-	-	-	-
Change in cash	**161**	**(149)**	**(578)**	**752**	**(355)**	**1,947**	**(823)**	**1,429**

Source: Company, Daiwa forecasts

Financial summary continued ...

Balance sheet (JPYm)

	May-09	Nov-09	Aug-10	Feb-11	Aug-11	Feb-1	Aug 12 E	Feb 13 E
Cash & cash equivalent	2,609	2,461	8,833	9,586	9,230	11,177	10,424	11,853
Accounts receivable	-	-	-	-	-	-	-	-
Other current assets	-	-	-	-	-	-	-	-
Total current assets	**2,609**	**2,461**	**8,833**	**9,586**	**9,230**	**11,177**	**10,424**	**11,853**
Investment properties	51,699	51,453	192,108	191,477	190,612	208,544	209,091	207,679
Fixed assets	-	-	-	-	-	-	-	-
Associates	-	-	-	-	-	-	-	-
Goodwill and intangible assets	-	-	-	-	-	-	-	-
Other long-term assets	149	367	604	1,030	857	1,983	1,984	1,984
Total assets	**54,457**	**54,280**	**201,545**	**202,092**	**200,699**	**221,704**	**221,499**	**221,516**
Short-term debt	28,685	12,800	208	31,957	44,372	38,154	3,200	3,200
Accounts payable	-	-	-	-	-	-	-	-
Other current liabilities	-	-	-	-	-	-	-	-
Total current liabilities	**28,685**	**12,800**	**208**	**31,957**	**44,372**	**38,154**	**3,200**	**3,200**
Long-term debt	-	15,874	28,352	23,019	10,500	42,300	-	-
Other non-current liabilities	1,221	1,167	99,822	72,531	71,843	49,369	4,538	4,538
Total liabilities	**29,906**	**29,841**	**128,383**	**127,506**	**126,715**	**129,823**	**129,668**	**129,668**
Unitholders' funds	**24,552**	**24,440**	**73,163**	**74,587**	**73,985**	**91,880**	**91,830**	**91,847**
Minority interests	-	-	-	-	-	-	-	-
Total equity & liabilities	**54,457**	**54,280**	**201,545**	**202,092**	**200,699**	**221,704**	**221,499**	**221,516**

Key Ratios

	May-09	Nov-09	Aug-10	Feb-11	Aug-11	Feb-12	Au 12 E	Feb 13 E
Total revenue (YoY)	-70.6%	-5.1%	340.4%	19.6%	-13.7%	10.3%	3.2%	-0.8%
Net property income (YoY)	-68.0%	-9.8%	317.0%	0.9%	-0.9%	15.8%	0.7%	1.1%
Net profit (YoY)	-93.0%	-20.4%	4686.7%	-84.5%	-56.8%	59.3%	12.7%	3.3%
EPS (YoY)	-69.7%	-20.4%	2581.0%	-88.5%	-56.8%	24.2%	7.0%	3.3%
DPS (YoY)	n.m	-20.4%	73.1%	10.0%	-3.3%	-2.0%	0.6%	0.6%
ROE						5.4%	5.5%	5.7%

Source: Company, Daiwa forecasts

Company profile

Daiwa House Residential Investment Corporation was listed on the J-REIT market of the Tokyo Stock Exchange in March 2006. In April 2010 DHR merged with New City Residence Investment Corporation. The REIT owns over 9,100 leasable residential units. DHR's sponsor is the Daiwa House Group.

Suntec REIT

(SUN SP, S$1.35, Buy [1])

Market cap: US$2.38bn

Target price: S$1.60 → S$1.63

Upside: +20.7%

A transformational AEI

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What we recommend

We reiterate our Buy (1) rating for Suntec REIT due to what we consider as its attractive valuations, and believe the S$410m AEI of its core asset, Suntec City, will be a timely and transformational upgrade.

We are raising our six-month target price to S$1.63 (from S$1.60), after changing our target-price approach to a 10-year DDM from a finite-life Gordon Growth Model. This target price equates to 1.02x our NAV estimate of S$1.60/unit.

The major risks to our rating, forecasts and target price include an unexpected deterioration in demand and rents in the Singapore office market and an inability to deliver satisfactory returns from the Suntec City AEI.

Unit-price catalysts

Budgeting for an ROI of over 10%. Suntec REIT's AEI for Suntec City consists of S$230m for Suntec City Mall and S$180m for Suntec International Convention and Exhibition Centre (Suntec Singapore), the REIT's 60.8%-owned subsidiary. It will be completed in four stages, from mid-2012 to mid-2015. For Suntec City Mall, management has projected average rents to improve to S$12.59/sq ft after the AEI (from S$10.10/sq ft just before the AEI), representing annual incremental net property income of S$23.2m, which works out to an ROI of 10.1%.

Suntec REIT has adequately addressed the operational and financial risks of the AEI. We believe management has adequately minimised the operational risk by breaking down the AEI into four digestible stages. Moreover, the proceeds from the disposal of Chijmes for S$177m should provide a valuable source of funding and DPU stabilisation for any income disruption during the AEI period. We do not expect Suntec REIT to raise equity for the AEI and only expect additional debt funding at the later stages to increase gearing by 2-3pp. However, in our view, the current lingering operational and financial concerns surrounding the AEI provide a good opportunity for investors to buy Suntec REIT units.

Suntec Office Towers exceeding expectatations. In 2012 so far, the occupancy rate remains high (99.5% at the end of 1Q12) and spot rents look resilient (S$8.79/sq ft for 1Q12) at Suntec City Office Towers. Contrary to market expectations, rents and overall occupancy at this core property have been holding up well during the current office-market downturn, which began in 4Q11. We attribute this to the relatively small amount of large spaces up for renewal, after the manager successfully renewed leases due in 2012 ahead of time.

Valuation

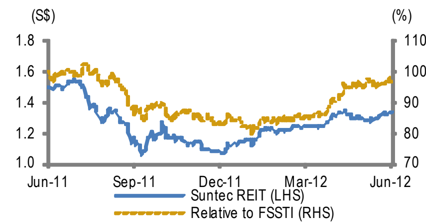
Among the office S-REITs, Suntec REIT offers the deepest value (trading at discounts of 32% to its book value of S$1.99 as at 31 March 2012 and 16% to our NAV of S$1.60) and among the most attractive 2012-14E DPU yields of 7.3-7.8% (based on our DPU forecasts). Our target price implies a 2013E DPU yield of 6.1%.

Forecast revisions (%)

Year to 31 Dec	12E	13E	14E
Revenue change	0.0	0.0	0.0
Net-property-income change	0.0	0.0	0.0
DPU change	0.0	0.0	0.0

Source: Daiwa forecasts

Share price performance



12-month range	1.065-1.550
Market cap (US$bn)	2.38
Average daily turnover (US$m)	6.50
Shares outstanding (m)	2,255
Major shareholder	Suntec City Development (6.3%)

Financial summary (S$)

Year to 31 Dec	12E	13E	14E
Revenue (m)	291	297	319
Net property income (m)	192	194	212
Distribution (m)	220	225	241
Core EPU	(0.200)	0.033	0.156
EPU change (%)	n.a.	n.a.	373.1
Daiwa vs Cons. DPU (%)	6.8	9.3	12.0
PER (x)	n.a.	40.9	8.6
DPU yield (%)	7.3	7.4	7.8
DPU	0.098	0.099	0.105
P/NAV (x)	0.8	0.8	0.8
ROE (%)	n.a.	2.0	9.5

Source: Bloomberg, Daiwa forecasts

Financial summary

Key assumptions

Year to 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Debt to assets (%)	31.4	34.3	33.3	38.4	37.3	40.8	41.5	40.6
Interest cover ratio (x)	3.7x	4.1x	3.4x	2.9x	3.9x	4.4x	6.0x	6.5x
Funds from operations (m)	231	96	57	158	275	202	192	207
Adj. funds from operations (m)	223	86	47	148	265	193	183	197
Core investment-property value (S$/sq ft)	1,923	1,888	1,765	2,007	2,142	1,969	1,940	1,985

Profit and loss (S$m)

Year to 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Total revenue	**199**	**240**	**253**	**249**	**270**	**291**	**297**	**319**
Operating expenses	(55)	(58)	(61)	(56)	(77)	(99)	(102)	(107)
Net property income	**143**	**182**	**192**	**193**	**193**	**192**	**194**	**212**
Other income	6	26	26	22	48	55	51	50
Management fees	(21)	(28)	(27)	(28)	(36)	(37)	(36)	(36)
Other operating expenses	(1)	(5)	(2)	(3)	(5)	(4)	(4)	(4)
Depreciation and amortisation	0	(26)	(25)	(21)	(39)	(36)	(25)	(18)
EBIT	**128**	**149**	**164**	**164**	**160**	**172**	**182**	**205**
Net-int. income/(expenses)	(35)	(43)	(56)	(63)	(52)	(47)	(34)	(34)
Share of associates	139	(35)	(73)	31	142	45	56	60
Revaluation gains/(loss)	1,291	(317)	(151)	249	396	(613)	(93)	166
Except./other inc./(exp.)	0	0	0	0	(6)	(3)	0	0
Profit before tax	**1,523**	**(245)**	**(116)**	**380**	**641**	**(446)**	**110**	**396**
Taxation	(1)	(2)	(3)	(2)	(6)	(4)	(3)	(2)
Min. int./pref. div./others	0	0	0	8	(3)	4	(33)	(39)
Net profit	**1,522**	**(247)**	**(119)**	**386**	**632**	**(446)**	**74**	**355**
Total return	**1,522**	**(247)**	**(119)**	**386**	**632**	**(446)**	**74**	**355**
Adjustments	(1,400)	409	309	(203)	(411)	667	151	(115)
Distributable income	**122**	**161**	**190**	**182**	**221**	**220**	**225**	**241**
Distribution rate	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Distribution	**122**	**161**	**190**	**182**	**221**	**220**	**225**	**241**
EPU (S$)	**0.915**	**(0.145)**	**(0.069)**	**0.203**	**0.285**	**(0.200)**	**0.033**	**0.156**
DPU (S$)	**0.074**	**0.098**	**0.109**	**0.099**	**0.099**	**0.098**	**0.099**	**0.105**

Cash flow (S$m)

Year to 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Profit before tax	1,523	(245)	(116)	380	641	(446)	110	396
Depreciation and amortisation	0	26	25	21	39	36	25	18
Net-interest expenses	35	43	56	63	52	47	34	34
Share of associate	(139)	35	73	(31)	(142)	(45)	(56)	(60)
Change in working capital	18	22	1	5	(10)	2	3	2
Tax paid	(1)	0	0	(6)	(2)	(4)	(3)	(2)
Other operating CF items	(1,274)	341	175	(226)	(361)	614	222	(56)
Cash flow from operation	**162**	**221**	**213**	**206**	**217**	**205**	**336**	**333**
Capex	(10)	(3)	(1)	(1)	(4)	(61)	(110)	(122)
Net investment and sale of FA	(917)	(67)	(13)	(1,199)	(91)	147	0	0
Other investing CF items	3	21	17	27	89	64	75	80
Cash flow from investing	**(925)**	**(48)**	**3**	**(1,173)**	**(6)**	**150**	**(35)**	**(42)**
Change in debt	887	76	(125)	830	112	0	0	0
Equity raised/(repaid)	0	0	149	419	0	0	0	0
Distribution paid	(116)	(147)	(186)	(185)	(210)	(220)	(224)	(237)
Other financing CF items	(28)	(61)	(78)	(76)	(61)	(54)	(54)	(54)
Cash flow from financing	**743**	**(132)**	**(240)**	**988**	**(159)**	**(274)**	**(278)**	**(290)**
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	**(19)**	**41**	**(23)**	**21**	**52**	**81**	**24**	**1**

Source: Company, Daiwa forecasts

Financial summary continued …

Balance sheet (S$m)

As at 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Cash & cash equivalent	13	54	31	52	104	186	210	211
Accounts receivable	13	7	6	3	14	14	14	14
Other current assets	3	3	12	4	1	1	1	1
Total current assets	**30**	**64**	**49**	**60**	**119**	**200**	**224**	**225**
Investment properties	4,594	4,352	4,202	4,452	5,242	4,816	4,721	4,804
Fixed assets	0	0	0	0	8	8	8	8
Associates	1,094	952	881	2,040	2,087	1,827	1,803	1,873
Goodwill and intangible assets	0	61	36	100	61	29	4	0
Other long-term assets	0	2	2	0	0	0	0	0
Total assets	**5,719**	**5,432**	**5,170**	**6,652**	**7,517**	**6,879**	**6,760**	**6,910**
Short-term debt	0	0	0	0	0	0	0	0
Accounts payable	31	39	35	41	81	81	81	81
Other current liabilities	14	23	25	31	20	20	20	20
Total current liabilities	**45**	**62**	**60**	**72**	**101**	**101**	**101**	**101**
Long-term debt	1,798	1,861	1,722	2,555	2,804	2,804	2,804	2,804
Other non-current liabilities	37	52	60	40	63	65	68	70
Total liabilities	**1,880**	**1,976**	**1,842**	**2,667**	**2,968**	**2,970**	**2,972**	**2,975**
Unitholders' funds	**3,839**	**3,456**	**3,328**	**3,985**	**4,434**	**3,796**	**3,675**	**3,822**
Minority interests	0	0	0	0	113	113	113	113
Total equity & liabilities	**5,719**	**5,432**	**5,170**	**6,652**	**7,514**	**6,879**	**6,760**	**6,910**
NAV per unit (S$)	**2.26**	**2.01**	**1.78**	**1.80**	**1.99**	**1.68**	**1.61**	**1.66**

Key Ratios

Year to 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Total revenue (YoY)	16.0	20.8	5.4	(1.4)	8.3	7.7	2.0	7.4
Net property income (YoY)	13.9	27.0	5.6	0.4	0.2	(0.5)	1.0	9.2
Net profit (YoY)	136.0	n.a.	n.a.	n.a.	63.8	n.a.	n.a.	377.8
Distribution (YoY)	28.4	32.2	17.7	(3.8)	20.9	(0.1)	2.2	6.9
EPU (YoY)	113.2	n.a.	n.a.	n.a.	40.3	n.a.	n.a.	373.1
DPU (YoY)	17.3	33.2	11.1	(9.7)	0.7	(1.1)	1.2	5.8
ROE	49.4	n.a.	n.a.	10.5	15.0	n.a.	2.0	9.5
ROA	33.8	n.a.	n.a.	6.5	8.9	n.a.	1.1	5.2
ROCE	3.3	3.4	3.8	3.8	3.3	3.4	3.7	4.2
ROIC	3.3	3.3	3.8	3.8	3.3	3.4	3.8	4.3
Net debt to equity	46.5	52.3	50.8	62.8	59.4	67.0	68.5	65.9
Effective tax rate	0.1	n.a.	n.a.	0.5	0.9	n.a.	2.3	0.5

Source: Company, Daiwa forecasts

Company profile

Listed on 9 December 2004, Suntec Real Estate Investment Trust (Suntec) holds a commercial-property portfolio consisting of Suntec City Mall, Suntec City Office Towers, Park Mall, a one-third interest in One Raffles Quay and Marina Bay Financial Centre phase 1 (MBFC1), and a 60.8% interest in the Suntec Singapore International Convention & Exhibition Centre.

CapitaCommercial Trust

(CCT SP, S$1.265, Buy [1])

Market cap: US$2.81bn

Target price: S$1.57 → S$1.47

Upside: +16.2%

Attractive from many angles

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What we recommend

We reaffirm our Buy (1) rating for CCT due to its combination of attractive valuations (at a 19% discount to our NAV estimate), low gearing (30.5% as at 31 March 2012) relative to its peers, and potential positive catalysts from stronger-than-expected leasing activity and possibly the initiation of unit buybacks.

We are lowering our six-month target price to S$1.47 from S$1.57, after changing our valuation approach to a 10-year DDM from a finite-life Gordon Growth Model. This target price equates to 0.94x our current NAV estimate of S$1.57/unit.

The biggest risk to our rating, forecasts and target price would be a significant and unexpected deterioration in demand and rents in the Singapore office market in 2013.

Unit-price catalysts

Leasing uncertainty is an opportunity to accumulate. CCT's year-to-date unit-price performance has been dampened by vacancy concerns from the reported relocation of major tenants such as Cisco Systems from Capital Tower, where it occupies about 80,000 sq ft, to UE Bizhub East at Changi Business Park, where the company will take up 110,000 sq ft, when its lease ends in 1Q13. We do not foresee major problems for CCT to re-lease the spaces, given the attractive locations and features of its office properties and the strength of its leasing team.

CCT's gearing is the lowest among office S-REITs. CCT expects its gearing to rise from 30.5% as at 31 March 2012 to 32.3% after the completion of the CapitaGreen office development in late 2014. After assuming that capital values will fall by as much as 10% by 1H13, we estimate that CCT's gearing will peak at just below 35% at the end of 2013. We believe the risk of a defensive equity fundraising is negligible.

Buyback mandate for its units is a positive step. CCT now has a unit-buyback mandate in place (approved on 27 April 2012), which will allow the buyback of up to 2.5% of total issued units each year. Although the mandate might not be utilised in 2012, it is clear, in our view, that management recognises that CCT trades at a considerable discount to its NAV and is exploring ways, including those related to capital management, to narrow the discount.

Valuation

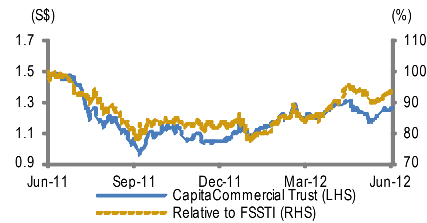
CCT trades at 2012-14E DPU yields of 6.1-6.8% based on our DPU forecasts, and at a 20% discount to its book value of S$1.58 as at 31 March 2012. Moreover, we estimate the market is valuing its core assets at an implied asset value of S$1,600/sq ft, based on its current enterprise value. Our target price implies an FY13E DPU yield of 5.4%.

Forecast revisions (%)

Year to 31 Dec	12E	13E	14E
Revenue change	0.0	0.0	0.0
Net-property-income change	0.0	0.0	0.0
DPU change	0.0	0.0	0.0

Source: Daiwa forecasts

Share price performance



12-month range	0.960-1.490
Market cap (US$bn)	2.81
Average daily turnover (US$m)	5.25
Shares outstanding (m)	2,846
Major shareholder	CapitaLand (32.1%)

Financial summary (S$)

Year to 31 Dec	12E	13E	14E
Revenue (m)	386	396	422
Net property income (m)	296	306	326
Distribution (m)	220	228	245
Core EPU	(0.059)	0.056	0.211
EPU change (%)	n.a.	n.a.	277.1
Daiwa vs Cons. DPU (%)	4.9	6.7	11.2
PER (x)	n.a.	22.6	6.0
DPU yield (%)	6.1	6.3	6.8
DPU	0.078	0.080	0.086
P/NAV (x)	0.9	0.9	0.8
ROE (%)	n.a.	3.9	14.0

Source: Bloomberg, Daiwa forecasts

Financial summary

Key assumptions

Year to 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Debt to assets (%)	23.9	37.3	32.9	28.2	29.9	33.5	34.6	33.5
Interest cover ratio (x)	3.1x	2.5x	3.1x	3.1x	3.5x	3.3x	3.3x	3.4x
Funds from operations (m)	109	128	196	190	196	196	202	218
Adj. funds from operations (m)	101	116	181	175	182	181	186	202
Core investment-property value (S$/sq ft)	1,874	1,951	1,718	1,798	1,898	1,798	1,784	1,832

Profit and loss (S$m)

Year to 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Total revenue	**240**	**335**	**403**	**392**	**361**	**386**	**396**	**422**
Operating expenses	(66)	(102)	(103)	(93)	(84)	(89)	(90)	(95)
Net property income	**174**	**233**	**300**	**299**	**277**	**296**	**306**	**326**
Other income	0	0	0	0	0	0	0	0
Management fees	(14)	(16)	(20)	(19)	(19)	(21)	(21)	(22)
Other operating expenses	(12)	(10)	4	(9)	10	0	(2)	(2)
Depreciation and amortisation	0	0	0	0	0	0	0	0
EBIT	**148**	**207**	**285**	**271**	**268**	**276**	**283**	**302**
Net-int. income/(expenses)	(48)	(83)	(93)	(87)	(77)	(84)	(86)	(88)
Share of associates	9	4	4	7	5	4	4	4
Revaluation gains/(loss)	1,306	204	(1,035)	193	277	(365)	(42)	384
Except./other inc./(exp.)	1	0	0	115	2	0	0	0
Profit before tax	**1,416**	**332**	**(839)**	**498**	**474**	**(169)**	**159**	**603**
Taxation	0	0	0	0	0	0	0	0
Min. int./pref. div./others	0	0	0	0	0	0	0	0
Net profit	**1,416**	**332**	**(839)**	**498**	**474**	**(169)**	**159**	**603**
Total return	**1,416**	**332**	**(839)**	**498**	**474**	**(169)**	**159**	**603**
Adjustments	(1,296)	(179)	1,038	(277)	(262)	389	69	(358)
Distributable income	**120**	**153**	**198**	**221**	**213**	**220**	**228**	**245**
Distribution rate	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Distribution	**120**	**153**	**198**	**221**	**213**	**220**	**228**	**245**
EPU (S$)	**1.023**	**0.238**	**(0.361)**	**0.177**	**0.168**	**(0.059)**	**0.056**	**0.211**
DPU (S$)	**0.087**	**0.110**	**0.071**	**0.078**	**0.075**	**0.078**	**0.080**	**0.086**

Cash flow (S$m)

Year to 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Profit before tax	1,416	332	(839)	498	474	(169)	159	603
Depreciation and amortisation	0	0	0	0	0	0	0	0
Net-interest expenses	48	83	93	87	77	84	86	88
Share of associate	(9)	(4)	(4)	(7)	(5)	(4)	(4)	(4)
Change in working capital	0	0	0	0	0	0	0	0
Tax paid	0	0	0	0	0	0	0	0
Other operating CF items	(1,277)	(165)	1,047	(255)	(339)	384	34	(402)
Cash flow from operation	**178**	**246**	**296**	**323**	**208**	**295**	**275**	**284**
Capex	(44)	(34)	(27)	(30)	(18)	(35)	(35)	(10)
Net investment and sale of FA	(2)	(1,296)	0	0	(261)	(524)	(120)	(93)
Other investing CF items	(35)	1	2	584	(23)	5	4	5
Cash flow from investing	**(82)**	**(1,328)**	**(25)**	**554**	**(303)**	**(554)**	**(151)**	**(99)**
Change in debt	0	370	(23)	23	(36)	5	0	0
Equity raised/(repaid)	0	0	828	0	0	0	0	0
Distribution paid	(96)	(134)	(175)	(215)	(218)	(217)	(224)	(236)
Other financing CF items	(6)	878	(656)	(362)	290	76	10	13
Cash flow from financing	**(102)**	**1,114**	**(25)**	**(554)**	**36**	**(135)**	**(214)**	**(223)**
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	**(6)**	**31**	**246**	**323**	**(59)**	**(394)**	**(90)**	**(37)**

Source: Company, Daiwa forecasts

Financial summary continued ...

Balance sheet (S$m)

As at 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Cash & cash equivalent	35	67	312	636	577	183	93	56
Accounts receivable	5	19	9	6	25	25	25	25
Other current assets	0	0	0	0	0	0	0	0
Total current assets	**40**	**85**	**322**	**642**	**602**	**208**	**118**	**81**
Investment properties	5,110	6,711	5,702	5,475	5,730	5,830	5,823	6,227
Fixed assets	1	1	1	1	283	361	481	574
Associates	65	64	63	67	67	67	67	67
Goodwill and intangible assets	0	0	0	0	0	0	0	0
Other long-term assets	63	10	12	11	72	7	7	7
Total assets	**5,279**	**6,871**	**6,100**	**6,196**	**6,754**	**6,473**	**6,496**	**6,957**
Short-term debt	0	0	0	0	0	0	0	0
Accounts payable	47	97	91	122	88	103	103	103
Other current liabilities	11	27	20	27	14	11	11	11
Total current liabilities	**59**	**124**	**111**	**148**	**102**	**115**	**115**	**115**
Long-term debt	1,260	2,562	2,004	1,747	2,018	2,168	2,248	2,334
Other non-current liabilities	23	31	29	27	93	29	29	29
Total liabilities	**1,341**	**2,717**	**2,144**	**1,922**	**2,212**	**2,311**	**2,391**	**2,477**
Unitholders' funds	**3,938**	**4,155**	**3,956**	**4,274**	**4,541**	**4,162**	**4,105**	**4,480**
Minority interests	0	0	0	0	0	0	0	0
Total equity & liabilities	**5,279**	**6,871**	**6,100**	**6,196**	**6,754**	**6,473**	**6,496**	**6,957**
NAV per unit (S$)	**2.84**	**2.97**	**1.41**	**1.51**	**1.60**	**1.46**	**1.44**	**1.57**

Key Ratios

Year to 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Total revenue (YoY)	57.7	39.7	20.3	(2.8)	(7.8)	6.8	2.7	6.5
Net property income (YoY)	55.1	34.2	28.6	(0.4)	(7.2)	6.9	3.4	6.6
Net profit (YoY)	231.9	(76.6)	n.a.	n.a.	(4.7)	n.a.	n.a.	278.2
Distribution (YoY)	(72.4)	27.1	29.7	11.3	(3.7)	3.5	3.5	7.3
EPU (YoY)	153.9	(76.7)	n.a.	n.a.	(5.0)	n.a.	n.a.	277.1
DPU (YoY)	18.7	26.4	(35.8)	10.9	(3.9)	3.1	3.1	7.0
ROE	36.0	8.2	n.a.	12.1	10.8	n.a.	3.9	14.0
ROA	26.8	4.8	n.a.	8.0	7.0	n.a.	2.5	8.7
ROCE	2.9	3.5	4.5	4.6	4.3	4.3	4.5	4.6
ROIC	2.9	3.5	4.7	4.9	4.7	4.6	4.6	4.7
Net debt to equity	31.1	60.0	42.8	26.0	31.7	47.7	52.5	50.9
Effective tax rate	0.0	0.0	n.a.	0.0	0.0	n.a.	0.0	0.0

Source: Company, Daiwa forecasts

Company profile

CapitaCommercial Trust (CCT) owns a portfolio of ten properties in Singapore's downtown core. For 2011, 64% of CCT's gross rental income came from offices, 21% from retail and 15% from hotels and convention centre. As at the end of March 2012, CCT's investment property portfolio was valued at S$6.2bn (excluding properties under construction).

K-REIT Asia

(KREIT SP, S$1.065, Outperform [2])

Market cap: US$2.19bn

Target price: S$1.08 → S$1.21

Upside: +13.6%

Loaded with grade-A assets

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What we recommend

We reiterate our Outperform (2) rating for KREIT due to its grade-A office-asset exposure (over 93% of asset value in Singapore), by far the highest among the office S-REITs, and attractive valuations (particularly its DPU yields, which we believe are sustainable).

We are raising our six-month target price to S$1.21 from S$1.08 after changing our target price approach to a 10-year DDM from a finite-life Gordon Growth Model. This target price equates to a 1.02x multiple to our NAV of S$1.19/unit. Our DDM and NAV valuations for KREIT are inclusive of income support from the vendors of its most recent acquisitions.

The major risks to our rating, forecasts and target price include an unexpected deterioration in demand and rents in the Singapore office market.

Unit-price catalysts

Long WALE, low renewals. Compared with its S-REIT and office-S-REIT peers, KREIT stands out for its long weighted average lease expiry (WALE) profile of 6.7 years for the entire portfolio and 8.2 years for its top-10 tenants (as at 31 December 2011). The major benefit of the relatively long WALE is that it reduces annual leasing risk and provides more certainty in rental income.

High financial-tenant concentration. With a high level of exposure to international grade-A properties in Singapore, about 50% of KREIT's tenants are concentrated in the banking, insurance, and financial services industries, slightly higher than its more diversified office S-REIT peers. We believe KREIT's long WALE and the ability of the relatively new international grade-A offices to attract new tenants will mitigate some of the risk of having a high concentration of tenants in the financial-services sector.

Incorporating a 99.9% interest in OFC. We are raising our 2012-14 DPU forecasts by 1.1-3.0%, after incorporating KREIT's acquisition (announced on 25 June) of an additional 12.39% stake in Ocean Financial Centre (OFC) into our forecasts. KREIT's stake in OFC following the acquisition will rise to 99.9%. Moreover, we estimate that the additional interest in OFC, acquired on essentially the same terms (S$2,379/sq ft excluding income support) as its initial 87.51% stake from its sponsor in December 2011, adds about S$0.03 (2.5%) to KREIT's DDM value.

Valuation

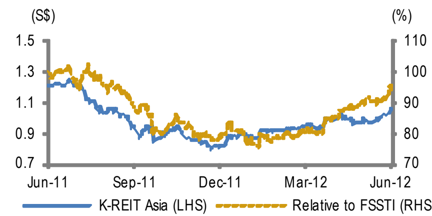
KREIT is trading at a 16% discount to its book value of S$1.27 as at 31 March 2012, and at 2102-14E DPU yields of 7.2-7.7% based on our new forecasts. Our target price of S$1.21 represents a 2% premium to our NAV of S$1.19 and implies a FY13E DPU yield of 6.7%.

Forecast revisions (%)

Year to 31 Dec	12E	13E	14E
Revenue change	0.1	0.2	0.2
Net-property-income change	0.1	0.2	0.2
DPU change	1.1	2.9	3.0

Source: Daiwa forecasts

Share price performance



12-month range	0.805-1.256
Market cap (US$bn)	2.19
Average daily turnover (US$ '000)	792.75
Shares outstanding (m)	2,632
Major shareholder	Keppel Land/Keppel Corp (77.1%)

Financial summary (S$)

Year to 31 Dec	12E	13E	14E
Revenue (m)	154	183	188
Net property income (m)	116	144	149
Distribution (m)	198	215	218
Core EPU	(0.131)	0.035	0.119
EPU change (%)	n.a.	n.a.	238.9
Daiwa vs Cons. DPU (%)	6.2	13.1	11.8
PER (x)	n.a.	30.2	8.9
DPU yield (%)	7.2	7.6	7.7
DPU	0.076	0.081	0.082
P/NAV (x)	1.0	1.0	1.0
ROE (%)	n.a.	3.3	11.3

Source: Bloomberg, Daiwa forecasts

Financial summary

Key assumptions

Year to 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Debt to assets (%)	54.2	27.6	22.0	31.8	36.9	43.4	45.0	44.0
Interest cover ratio (x)	2.6x	3.5x	4.9x	15.2x	13.3x	6.7x	6.5x	6.6x
Funds from operations (m)	14	43	52	74	97	176	194	196
Adj. funds from operations (m)	9	30	39	59	74	137	156	158
Core investment-property value (S$/sq ft)	1,707	1,707	1,616	2,157	2,444	2,263	2,240	2,307

Profit and loss (S$m)

Year to 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Total revenue	**40**	**53**	**63**	**85**	**78**	**154**	**183**	**188**
Operating expenses	(12)	(13)	(14)	(17)	(16)	(37)	(38)	(39)
Net property income	**28**	**40**	**49**	**67**	**62**	**116**	**144**	**149**
Other income	1	25	23	26	46	78	50	41
Management fees	(5)	(13)	(13)	(15)	(24)	(39)	(38)	(38)
Other operating expenses	(2)	(1)	(1)	(6)	(5)	(3)	(3)	(3)
Depreciation and amortisation	(1)	(27)	(27)	(23)	(36)	(71)	(46)	(37)
EBIT	**21**	**23**	**31**	**50**	**42**	**82**	**108**	**111**
Net-int. income/(expenses)	(9)	(15)	(12)	(5)	(6)	(23)	(24)	(23)
Share of associates	0	11	8	10	37	58	71	76
Revaluation gains/(loss)	433	11	(72)	32	229	(445)	(55)	159
Except./other inc./(exp.)	0	0	0	26	0	0	0	0
Profit before tax	**446**	**30**	**(44)**	**113**	**302**	**(328)**	**99**	**324**
Taxation	0	(3)	(2)	(3)	(6)	(9)	(6)	(6)
Min. int./pref. div./others	0	0	0	0	(6)	(3)	0	0
Net profit	**445**	**27**	**(46)**	**109**	**290**	**(340)**	**93**	**318**
Total return	**445**	**27**	**(46)**	**109**	**290**	**(340)**	**93**	**318**
Adjustments	(424)	31	116	(24)	(177)	538	122	(101)
Distributable income	**22**	**58**	**71**	**86**	**113**	**198**	**215**	**218**
Distribution rate	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Distribution	**22**	**58**	**71**	**86**	**113**	**198**	**215**	**218**
EPU (S$)	**1.836**	**0.058**	**(0.046)**	**0.081**	**0.206**	**(0.131)**	**0.035**	**0.119**
DPU (S$)	**0.088**	**0.089**	**0.078**	**0.064**	**0.071**	**0.076**	**0.081**	**0.082**

Cash flow (S$m)

Year to 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Profit before tax	446	30	(44)	113	302	(328)	99	324
Depreciation and amortisation	1	27	27	23	36	71	46	37
Net-interest expenses	9	15	12	5	6	23	24	23
Share of associate	0	(11)	(8)	(10)	(37)	(58)	(71)	(76)
Change in working capital	2	(24)	(16)	(36)	(49)	0	(1)	(1)
Tax paid	0	0	0	0	0	0	0	0
Other operating CF items	(428)	2	85	(80)	(216)	448	34	(171)
Cash flow from operation	**29**	**39**	**55**	**14**	**42**	**156**	**131**	**136**
Capex	0	0	0	0	0	0	0	0
Net investment and sale of FA	(940)	0	(110)	(1,215)	(1,721)	(314)	(90)	(5)
Other investing CF items	0	45	51	346	108	142	137	138
Cash flow from investing	**(940)**	**45**	**(59)**	**(868)**	**(1,614)**	**(172)**	**47**	**133**
Change in debt	942	(551)	0	412	765	193	85	0
Equity raised/(repaid)	0	552	620	0	986	70	0	0
Distribution paid	(18)	(38)	(66)	(77)	(96)	(201)	(210)	(217)
Other financing CF items	(7)	(26)	(18)	(29)	(34)	(50)	(56)	(57)
Cash flow from financing	**917**	**(63)**	**536**	**307**	**1,620**	**12**	**(182)**	**(274)**
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	**6**	**21**	**532**	**(547)**	**48**	**(4)**	**(3)**	**(6)**

Source: Company, Daiwa forecasts

Financial summary continued ...

Balance sheet (S$m)

As at 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Cash & cash equivalent	23	44	576	50	86	73	63	52
Accounts receivable	3	10	11	22	38	38	39	40
Other current assets	0	0	0	0	10	0	0	0
Total current assets	**26**	**54**	**587**	**72**	**134**	**111**	**103**	**92**
Investment properties	1,110	1,117	1,163	1,026	3,472	3,216	3,391	3,484
Fixed assets	0	0	0	0	0	0	0	0
Associates	865	862	849	1,981	2,093	1,899	1,875	1,947
Goodwill and intangible assets	86	59	33	37	138	113	81	55
Other long-term assets	0	0	0	0	37	117	0	0
Total assets	**2,088**	**2,092**	**2,632**	**3,116**	**5,874**	**5,455**	**5,449**	**5,577**
Short-term debt	0	0	0	0	0	0	0	0
Accounts payable	12	13	29	49	32	32	32	32
Other current liabilities	10	14	16	13	30	28	28	28
Total current liabilities	**23**	**26**	**45**	**62**	**63**	**60**	**60**	**60**
Long-term debt	1,131	577	579	990	2,166	2,370	2,455	2,455
Other non-current liabilities	0	3	5	8	153	191	191	191
Total liabilities	**1,154**	**607**	**629**	**1,060**	**2,381**	**2,622**	**2,706**	**2,706**
Unitholders' funds	**934**	**1,486**	**2,003**	**2,056**	**3,279**	**2,834**	**2,743**	**2,871**
Minority interests	0	0	0	0	213	0	0	0
Total equity & liabilities	**2,088**	**2,092**	**2,632**	**3,116**	**5,874**	**5,455**	**5,449**	**5,577**
NAV per unit (S$)	**3.78**	**2.28**	**1.50**	**1.52**	**1.29**	**1.08**	**1.03**	**1.07**

Key Ratios

Year to 31 Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E
Total revenue (YoY)	67.9	31.4	19.3	34.6	(7.8)	97.4	18.7	2.7
Net property income (YoY)	68.1	40.3	23.3	37.7	(8.4)	88.9	24.0	2.9
Net profit (YoY)	714.9	(93.8)	n.a.	n.a.	165.5	n.a.	n.a.	242.0
Distribution (YoY)	95.2	166.7	21.2	21.4	31.9	75.3	8.7	1.2
EPU (YoY)	714.0	(96.9)	n.a.	n.a.	152.8	n.a.	n.a.	238.9
DPU (YoY)	90.5	1.0	(12.3)	(18.5)	11.1	8.0	6.5	0.3
ROE	62.5	2.3	n.a.	5.4	10.9	n.a.	3.3	11.3
ROA	32.0	1.3	n.a.	3.8	6.5	n.a.	1.7	5.8
ROCE	2.2	1.7	2.1	3.4	1.8	2.4	3.0	3.3
ROIC	2.2	1.8	2.7	4.4	1.8	2.3	2.9	3.1
Net debt to equity	118.7	35.9	0.2	45.7	59.6	81.1	87.2	83.7
Effective tax rate	0.0	9.6	n.a.	3.1	2.1	n.a.	6.3	1.8

Source: Company, Daiwa forecasts

Company profile

Listed on 28 April 2006, K-REIT Asia owns stakes in five Singapore office properties, Prudential Tower, Bugis Junction Towers, One Raffles Quay, and Marina Bay Financial Centre Phase 1 and Ocean Financial Centre. It also owns office buildings in Australia: 275 George Street in Brisbane and 77 King Street and 8 Chifley Square (under construction) in Sydney.

Daiwa's Asia Pacific Research Directory

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