JAPANESE REITS – EITHER WAY, FUND SELL DOWNS ARE NOW LIKELY

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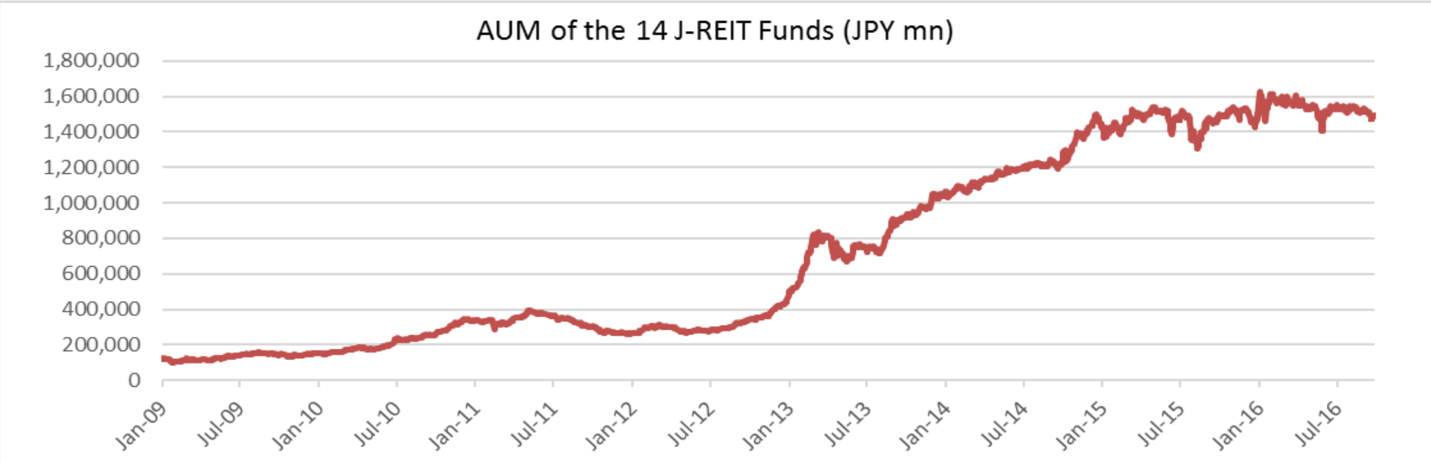
Market Views

"If the current situation persists these funds will have to either sell underlying J-REIT holdings to pay the unsustainably high dividend or cut the dividend. Which would likely precipitate fund redemptions and J-REIT sales to pay for that. Either way, significant J-REIT holdings would be sold."

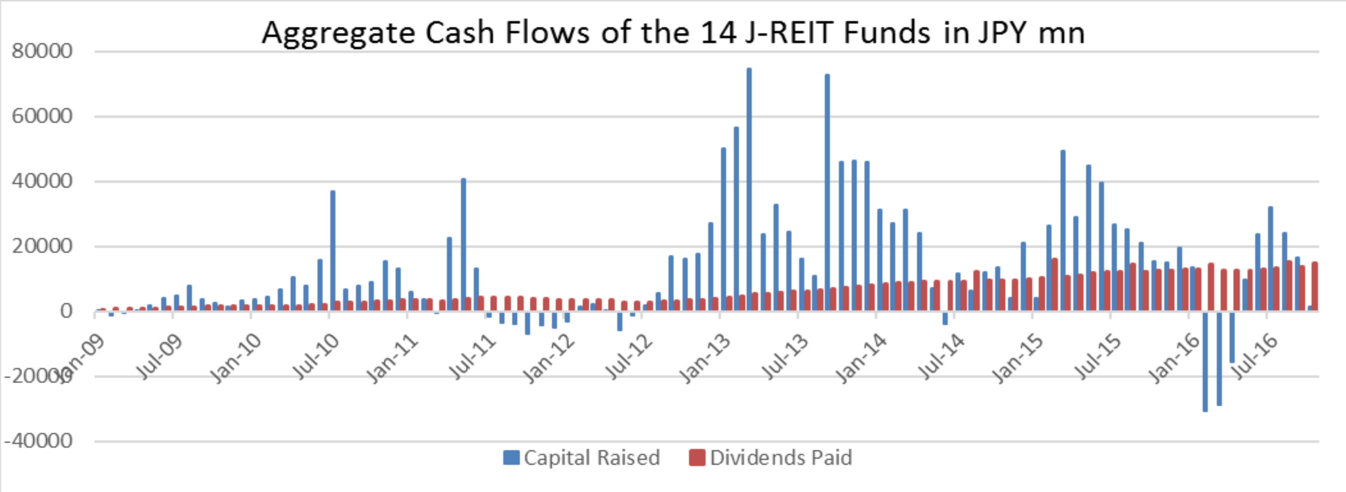
We recently wrote about Japanese funds that invest in US Real Estate Investment Trusts (US REITs) and pay 25% dividend yields. The conclusion was that these funds need to continue raising more capital or start selling underlying assets (US REITs) to maintain the dividend. There are many other funds that share this feature in Japan. Such as the Turkish Lira Double Decker Toshin, which has now seen its net asset value (NAV) decline by 65% as it sold assets to pay the dividend. There are also funds that invest in Japanese REITs (J-REITs) rather than US REITS.

There are 14 listed J-REIT funds that I believe are offering unsustainable dividend yields. The weighted average yield of these funds is 11.4%, which is significantly higher than the weighted average yield of 3.5% on the J-REITs they invest in. The combined assets under management (AUM) of these 14 J-REIT funds has risen to ¥1.5tn ($15bn) as Japanese monetary policy has refocused on yield suppression over recent years.



J-REITs have substantially outperformed the Topix Real Estate Index in recent years. Which is intriguing given both the J-REIT and real estate sectors generate the largest part of their earnings from renting out Tokyo office blocks. We wrote last July of the oversupply to come in the Tokyo office market. With rent declines likely to play out over a number of years real estate stocks appear to have begun pricing this in, J-REITs have not.

The following chart helps us understand why J-REITs have performed so well. It shows the aggregated cash flows of the 14 aforementioned J-REIT funds. Historically, in most months, the capital raised by these funds has exceeded the dividend the funds pay out. The funds would then purchase J-REIT shares with the residual cash inflow. However, as the funds have issued more units their dividend payout requirements have grown, recently the new capital raised by these funds has fallen below the dividend payout required. If the current situation persists these funds will have to either sell underlying J-REIT holdings to pay the unsustainably high dividend or cut the dividend. Which would likely precipitate fund redemptions and J-REIT sales to pay for that. Either way, significant J-REIT holdings would be sold.



If these funds now shift to sustained J-REIT selling, the impact on the J-REIT share prices would be significant. Using fund holding data we can determine which REITs they hold. I have also included the smaller J-REIT holdings of some other global REIT funds issued in Japan that offer even higher dividend yields and similar characteristics. The table shows the ratio of J-REIT shares owned in total by these unsustainably high dividend funds against the freely floating shares outstanding for those J-REITs. Filtered for the 25 REITs with the highest ratio.

DAIWA OFFICE INVESTMENT CORP	35.6%	ORIX JREIT INC	18.9%	INDUSTRIAL & INFRASTRUCTURE	16.9%	JAPAN EXCELLENT INC	14.3%	JAPAN PRIME REALTY INVESTMENT	13.3%
PREMIER INVESTMENT CORP	29.1%	KENEDIX RETAIL REIT CORP	18.7%	SEKISUI HOUSE REIT INC	16.7%	HEIWA REAL ESTATE REIT INC	14.1%	MORI TRUST SOGO REIT INC	13.2%
MCUBS MIDCITY INVESTMENT	23.9%	KENEDIX OFFICE INVESTMENT	18.6%	ICHIGO OFFICE REIT INVESTMENT	16.3%	NIPPON REIT INVESTMENT CORP	14.1%	FUKUOKA REIT CORP	13.2%
GLOBAL ONE REIT	23.5%	NIPPON BUILDING FUND	18.3%	ACTIVIA PROPERTIES INC	16.1%	JAPAN REAL ESTATE INVESTMENT	13.9%	TOKYU REIT INC	13.2%
HULIC REIT INC	20.0%	FRONTIER REAL ESTATE INVEST	18.1%	NIPPON PROLOGIS REIT INC	16.0%	KENEDIX RESIDENTIAL INVESTME	13.7%	SEKISUI HOUSE SI RESIDENTIAL	13.1%
MORI HILLS REIT INVESTMENT	19.4%	INVINCIBLE INVESTMENT CORP	17.9%	AEON REIT INVESTMENT CORP	14.9%	JAPAN HOTEL REIT INVESTMENT	13.7%	JAPAN RENTAL HOUSING INVESTM	12.8%

Many have blamed the Bank Of Japan's J-REIT purchases for making J-REITs the most expensive REITs in the world, however the BOJ's annual purchase rate of 0.8% of outstanding REIT market cap pales in significance for many of these REITs. With an outlook for declining fundemantal earnings, as rents decline under office oversupply, and likely selling pressure from their largest holders J-REITs offer appealing short returns.

INFORMATION

Issue Date: 28th Oct 2016

Source: Bloomberg, unless otherwise stated

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