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J-REIT Market Review: Growth Process and Future Outlook

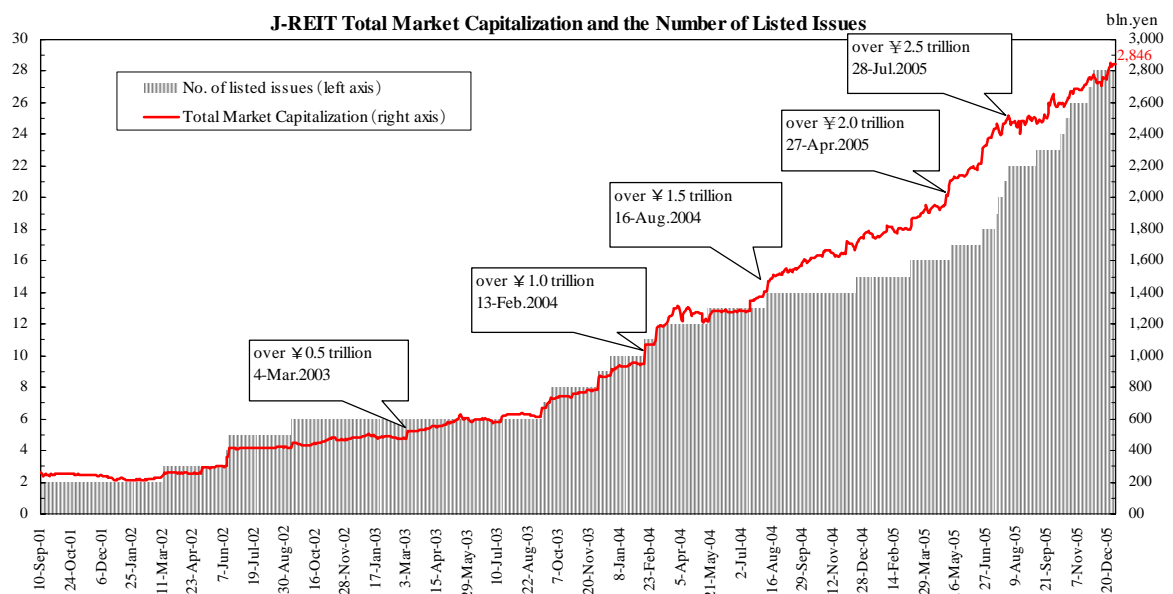
by Nobuaki Kawai, STB Research Institute Co., Ltd.

J-REIT Market Overview

Market Expansion

The J-REIT market recorded a market capitalization of 2.8 trillion yen as of the end of December 2005 with the number of listed funds reaching 28 issues (Diagram 1). This represents a nearly tenfold increase in aggregate market value since the launch of the first J-REIT in September 2001. Over the period, the types of investment properties expanded to include not only office buildings but also retail facilities and rental housings, and in May 2005, an issue investing in distribution facilities was introduced to the market for the first time. The number of listed funds has also increasing at an accelerated pace, with 13 J-REITs listing just in 2005. Accompanying the expansion in size of the J-REIT market, the use of investment properties and the types of investment corporations (investment policies) are diversifying.

Figure 1 J-REIT Total Market Capitalization and the Number of Listed Issues



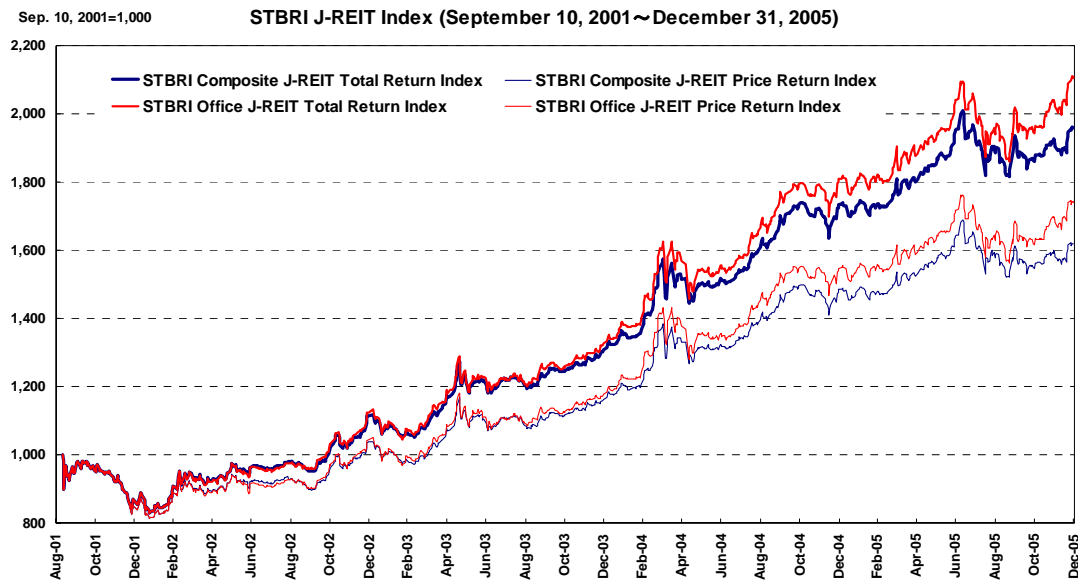
source: STB Research Institute

Performance

The STB Research Institute developed an index for J-REITs, “STBRI J-REIT Index ®”, and releases data in its website (Diagram 2). The index has its standard value set at 1,000 on the base date of September 10, 2001 when the first J-REIT became listed. The Composite Index (targeting all issues) on December 30, 2005 was at 1,959.98 including dividends or 1,619.76 excluding (Diagram 2). A calculation of total return since September 2001 applying the STBRI J-REIT Composite Index (dividend-inclusive) indicated an annualized rate of 17.3% which exceeded the 12.4% for stocks (TOPIX) over the same period of time. Meanwhile, the total return for the latest one year period (December 2004 to December 2005) was 13.0%, falling short of the 45.2% performance of stocks (TOPIX). (Diagram 3) The correlation among J-REIT, US-REIT and Australian LPT in terms of monthly return was generally low at around 0.3 points.

Figure 2 STBRI J-REIT Index September 10, 2001 – December 30, 2005

Total and price returns indices, rebased September 10, 2001 = 1,000



Source : STB Research Institute

Figure 3 Comparison of REIT total returns between Japan, the U.S., and Australia

| REIT | Total return over most recent year (Jan. 1, 2005 – Dec. 30, 2005) | Total return since listing of J-REITs (converted to annual rates) (Sep. 10, 2001– Dec. 30, 2005) |
|-----------------|--|--|
| Japan (J-REIT) | 13.0% | 16.9% |
| US (US-REIT) | 12.2% | 19.7% |
| Australia (LPT) | 12.7% | 17.1% |

Notes:

Japan (J-REIT) figures were calculated using STBRI Composite J-REIT Total Return Index.

U.S. (US-REIT) figures were calculated using NAREIT Equity REITs Total Return Index.

Australia (LPT) figures were calculated using S&P/ASX 300 Property Trust Accumulation Index.

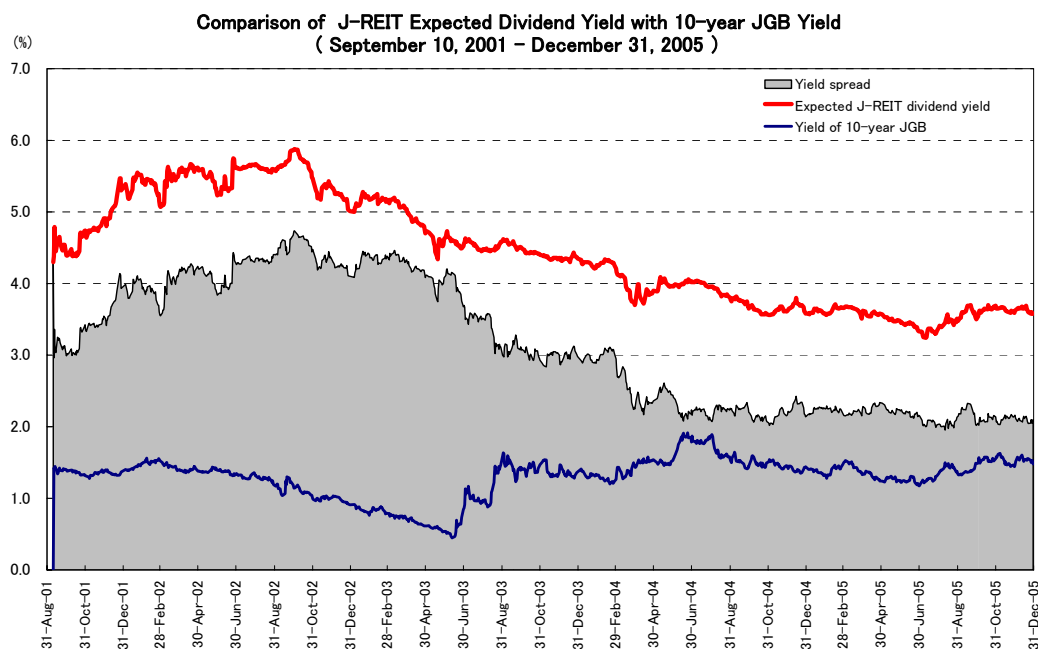
Source: Bloomberg, STB Research Institute

Dividend Yield

The dividend yield for J-REITs declined as a result of the rise in their share prices. According to the projections of individual asset management companies, the average dividend yield as of monthend December 2005 was 3.58%. The J-REIT dividend yield has been approximately 2% point spread on 10-year government bonds since April 2004 (Diagram 4). The spread has narrowed rapidly as the attractiveness of J-REITs' relatively high dividend yield in a low-interest rate environment and also with the buildup of J-REITs' track record and their rising visibility serving as contributing factors.

Meanwhile, a comparison with the yield of BBB-rated bonds indicated that the spread at around 3% point was more stable relative to 10-year government bonds. The correlation coefficient between J-REITs and BBB-rated bonds was high at 0.90 (in the case of 3-year bonds/September 2001 to December 2005/monthly). One can also observe that J-REIT prices continued to increase (dividend yield declining) during a phase when corporate bond yields fell. Since July 2005, however, the yields of BBB-rated bonds have started to rise, and likewise the dividend yields of J-REITs which hit a bottom in the end of June have made a turnaround.

Figure 4 J-REIT Dividend Yield versus 10-year Japanese Government Bond Yield
Yields and spread in %, September 2001 – December, 2005



Source : Bloomberg, STB Research Institute

Expansion through Procurement of Effectively Tax-Exempt Equity Capital

Rental Property Companies are Effectively Exempt from Corporation Taxes

J-REITs were first introduced as improvements were made in the legal structure through the amendment of "the Investment Trust Law of Japan" in May 2000 (enforced in November of the

same year) whereby the target assets for investment trusts were expanded to include real estate properties.

Currently, the investment properties are owned by entities called "Investment Corporations" and the investment style adopted can be classified as "externally managed" as in the case of Australia and Singapore. An investment corporation entrusts its asset management operation to an asset management company, and property management of individual investment assets is also outsourced. In this regard, the structure is different from the "self-managed" or "internally-managed" investment style adopted by US-REITs.

The P/L and the balance sheet of J-REITs are effectively very much similar to those of business corporations that do not engage in development but only specialize in the ownership of properties for rent. What differs substantially is the fact that J-REITs are effectively exempt from corporation taxes and can thereby allocate a larger sum of earnings to dividend distribution. (By satisfying the condition of cash distributions being in excess of 90% of taxable income available for dividends, J-REITs are allowed to recognize dividends as expenses and be effectively exempt from corporation taxes.)

Conservative Financial Leverage

While the cost of J-REITs' interest bearing debts generally averages around 1% thanks to the low interest rate environment, the average loan to value (LTV) ratio is in the range of 30~50%, and compared to privately placed real estate funds, most J-REITs firmly maintain conservative financial policies. Averting risks associated with rising interest rates and securing room to borrow for future property acquisition are thought to be among the reasons for implementing such policies.

Expansion of Asset Size through Repetitive Capital Increase

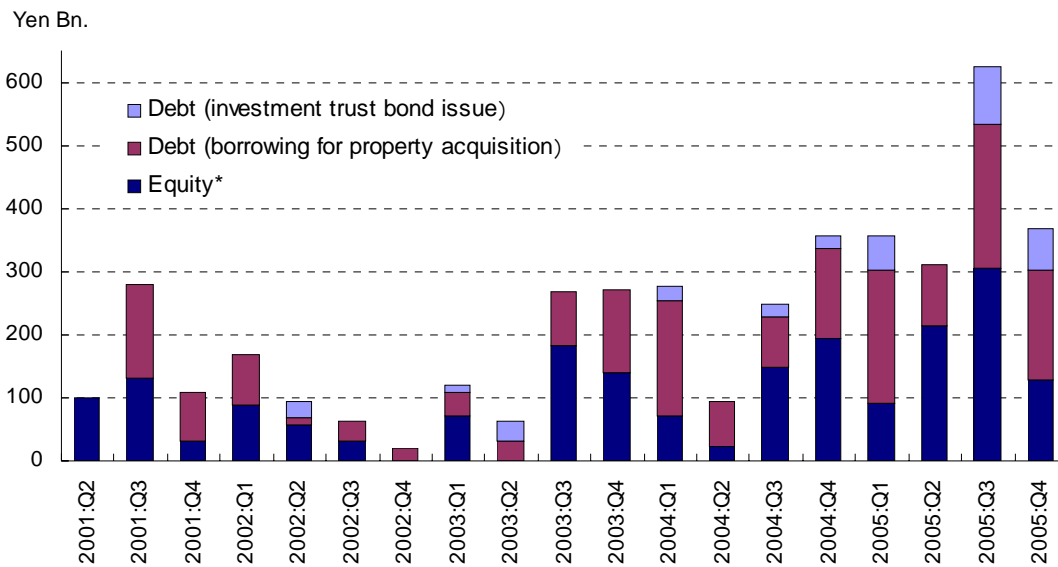
As implementing capital increase is difficult in terms of timing, financing for property acquisition is normally achieved through borrowings which are a more flexible means of fund procurement. However, capital increase becomes unavoidable in the process of expanding asset size under conservative financial leverage. In a sense, the process of J-REITs' size expansion can be interpreted as the process of repeated capital increase.

Until this point, J-REITs have successfully procured funds through capital increase leveraging on the advantages of equity financing effectively free of corporation taxes accompanied by the further cut down of equity costs due to decline in dividend yields. As such, J-REITs were able to steadily acquire additional properties and achieve size expansion (Diagrams 5.1 and 5.2).

Since the beginning of 2005, the sum of funds procured via J-REITs increased rapidly due to the series of capital increase conducted by existing funds in addition to the initial public offerings of newly-listed issues. Meanwhile, in terms of the new listed funds that entered the market after July 2005, in many cases, the share prices after the listing transitioned below their initial offer prices compounded by the adjustment phase of the market among other factors.

Figure 5a Securities offerings by J-REITs

Quarterly, 2001:Q2 – 2005:Q4



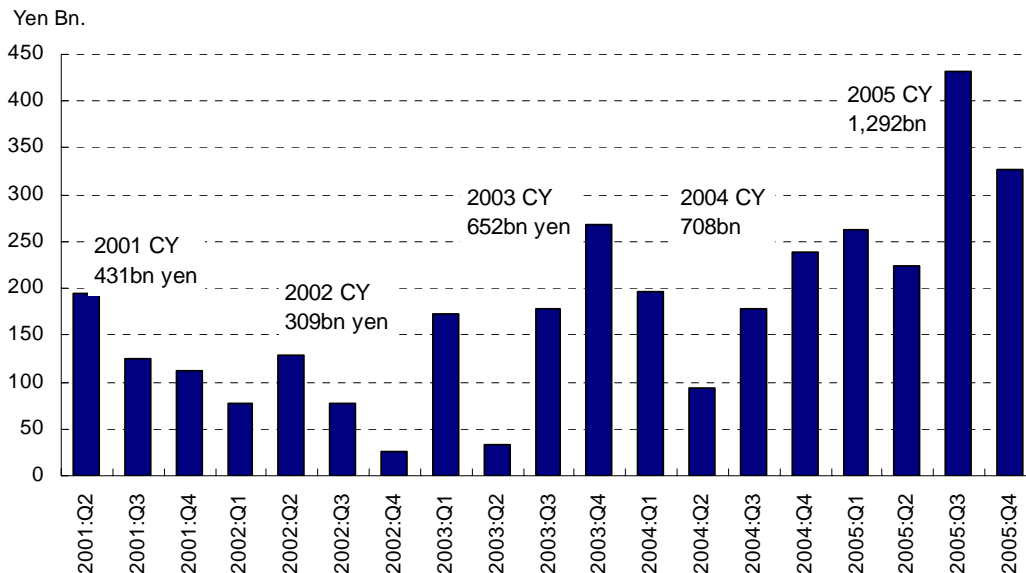
* Quarter(CY) / Q1:Jan.-Mar., Q2:Apr.-Jun., Q3:Jul.-Sep., Q4:Oct.-Dec.

* Equity: including the amount of securities offerings before listing

Source: STB Research Institute

Figure 5b Property acquisitions by J-REITs

Quarterly, 2001:Q2 – 2005:Q4



* Quarter(CY) / Q1:Jan.-Mar., Q2:Apr.-Jun., Q3:Jul.-Sep., Q4:Oct.-Dec.

Source: STB Research Institute

Investor Base and Trends

In the process of J-REIT market expansion, one can not ignore the importance of rule changes to promote investments in J-REITs such as those concerning investor-related tax regimes, accounting procedures, and incorporation into indices.

In terms of assessing the investor base and investment trends, the information on shareholder composition released at fiscal period-end by individual J-REITs and the investment trends by investors released by the Tokyo Stock Exchange since April 2003 serve as useful references. Partly due to the December 2002 notification by the Japanese Bankers Association (indicating that both dividend gains/losses and trading gains/losses pertaining to J-REITs are to be booked as operating profits), since 2003, the investors in J-REITs have principally been domestic financial institutions. Information released by individual funds at the latest fiscal period-end indicated that the share of shareholdings by domestic financial institutions amounted between 50% and 60%. Additionally, since the amendment of the voluntary regulations of the Investment Trusts Association in July 2003 which permitted the formation of fund of funds incorporating J-REITs, purchase volume of the investment trust sector also increased (Diagram 6). In more recent terms, beginning 2005, trading activities by overseas investors have been on the rise.

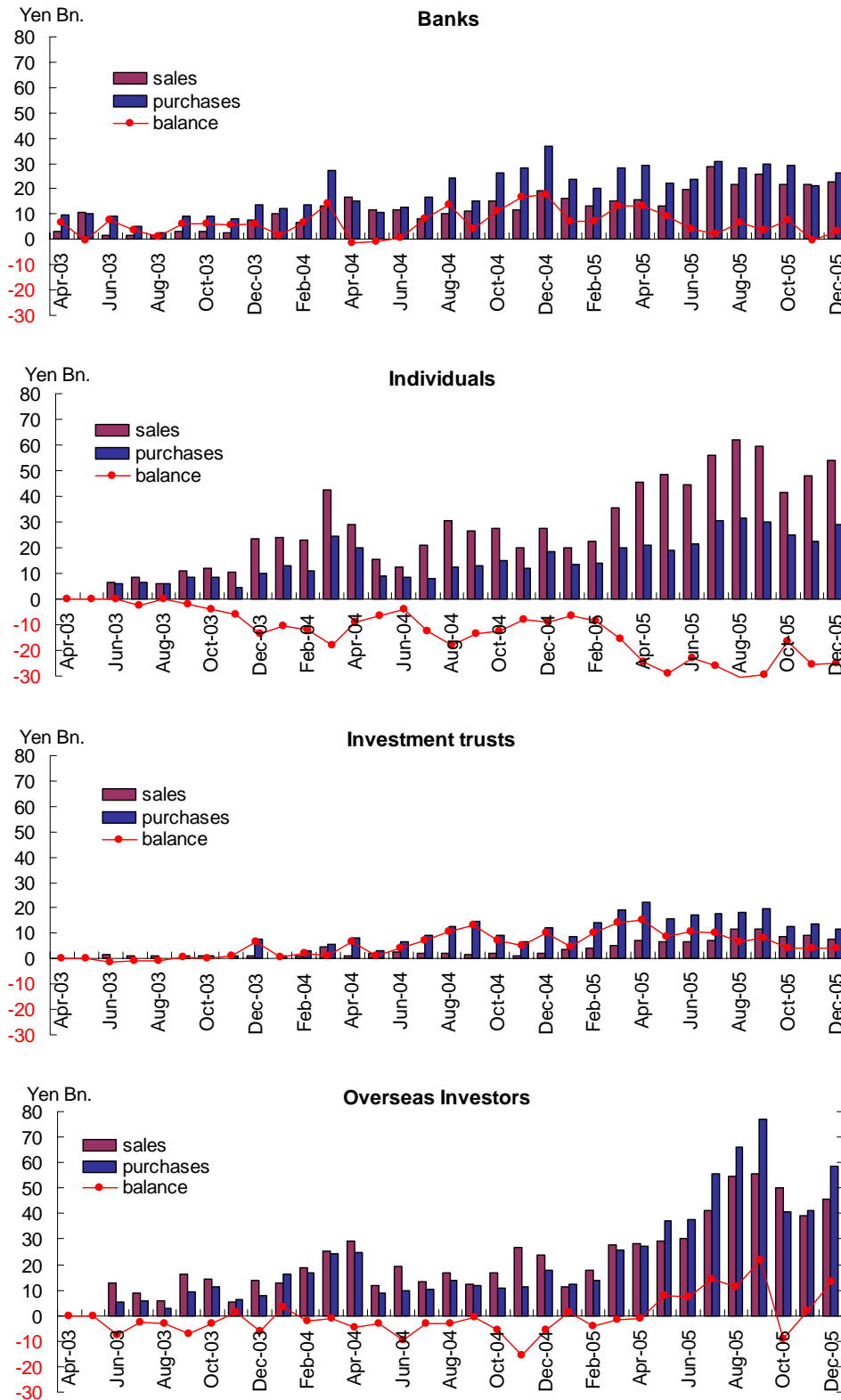
The outlook on the J-REIT and real estate markets may vary from investor to investor and their viewpoints concerning J-REIT prices may also differ. One can say that the investor base of the J-REIT market is expanding gradually and investors making various types of assessments have started to emerge.

Figure 6 Investor composition of principal funds

| | | | Nippon Building Fund | Japan Real Estate | Japan Retail Fund |
|---------------------------|---------------------------------------|----------------|----------------------|-------------------|-------------------|
| Fiscal period end | | | 2005.6 | 2005.9 | 2005.8 |
| Domestic Investors | Domestic licensed banks | City Banks | 1.8% | 2.4% | N.A. |
| | | Regional Banks | 19.1% | 24.9% | N.A. |
| | | Trust Banks | 20.9% | 20.8% | N.A. |
| | Life and non-life insurance companies | | 12.2% | 8.6% | N.A. |
| | Financial Institutions | | 58.2% | 63.9% | 61.2% |
| | Other Companies | | 13.4% | 7.4% | 7.8% |
| | Individuals | | 11.4% | 13.6% | 10.3% |
| Overseas Investors | Companies and individuals | | 12.1% | 15.1% | 20.7% |

Source: company data, STB Research Institute

Figure 7 Trading activities in J-REITs
April 2003 – December 2005



Source:Tokyo Stock Exchange, STB Research Institute

Diversification of J-REITs

Diversification of Property Types

The first J-REITs that came to the market in September 2001 were **Nippon Building Fund Inc.** and **Japan Real Estate Investment Corporation** which specialized in office building investments. Thereafter, **Nippon Retail Fund Investment Corporation** specializing in retail facilities such as shopping centers and urban retail buildings made its debut in March 2002 followed by the June 2002 listings of **ORIX JREIT Inc.**, a “diversified” fund which primarily focused on office building investments but also incorporated properties for other uses, and **Japan Prime Realty Investment Corporation**, a “compound” fund investing in two types of properties, namely office buildings and commercial facilities.

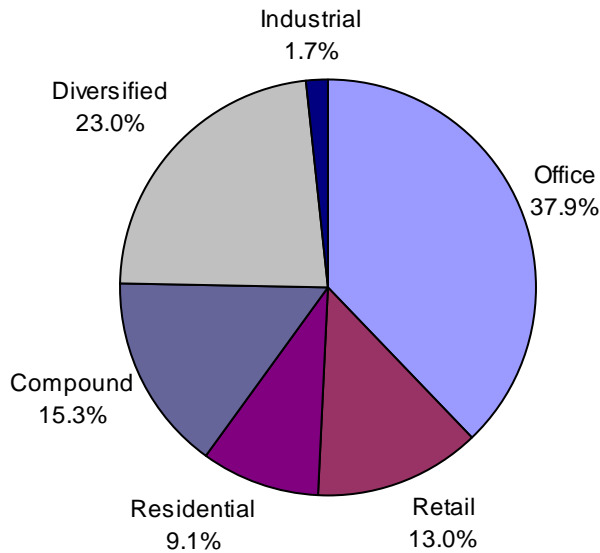
Premier Investment Company which became listed in September 2002 was the first J-REIT to launch a full-scale investment in rental housings. It was a “compound” fund investing in the two property types of office buildings and rental housings. The first J-REIT to specialize exclusively in rental housings was **Nippon Residential Investment Corp.** which entered the market in March 2004. This type of fund subsequently increased to reach the current number of seven issues. As mentioned earlier, during that span, a J-REIT focusing on distribution facilities was also introduced in May 2005.

A sector breakdown of the 26 TSE-listed funds (based on market capitalization as of monthend December 2005) indicated that 37.9% of the funds (5 funds) specialized exclusively in office buildings, 15.3% (4 funds) were “compound” funds that focused on office buildings but also incorporated one additional type of property, and 23.0% (8 funds) were “diversified” funds that incorporated three or more types of properties in their portfolios. While there were only two funds that focused exclusively on commercial facilities, their combined share based on market capitalization amounted to 13.0%. The share of listed funds specializing in residential properties which have increased in number in recent years also expanded at 9.1% (6 funds) (Diagram 8).

The total value of J-REITs’ investment properties effective monthend December 2005 was 3.4 trillion yen (aggregate acquisition value). Its breakdown by property types indicated that 58.7% were office buildings, 21.5% were commercial facilities, and 17.0% were residential properties. Other types of properties such as hotels and distribution facilities only amounted to 2.8% of the total. When compared to the breakdown as of yearend 2003 (1.2 trillion yen in total value), while the share of office buildings fell from the then 76.1%, that of residential properties increased significantly from 2.9%. Over the period of nearly two years, investments into residential properties expanded fifteen-fold from approximately 38 billion yen to 575 billion yen (Nippon Residential, the first fund to specialize in residential properties, became listed in March 2004). The share of commercial facilities generally remained constant at around 20%.

Figure 8 Market capitalization by types of fund

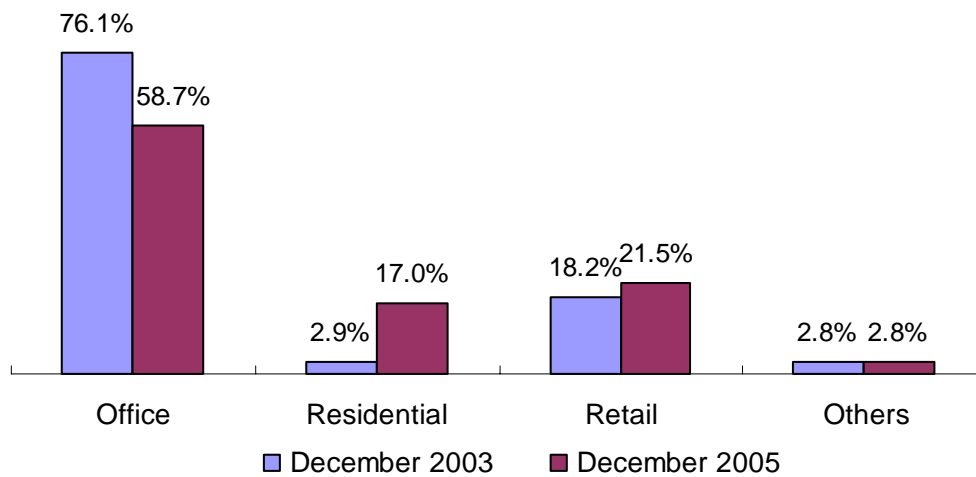
Based on market capitalization as of month end December 2005



Source:STB Research Institute

Figure 9 Composition by types of investment properties

As of month end December 2003 and month end December 2005, based on acquisition values



Source:STB Research Institute

Expansion of Investment Areas

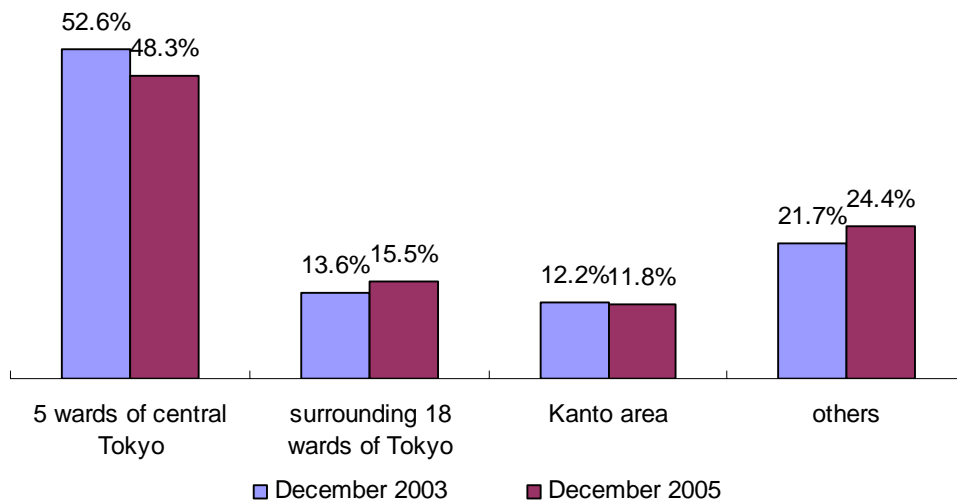
To date, approximately half of the investment properties of J-REITs have been located in the five wards of central Tokyo (Chiyoda, Chuo, Minato, Shinjuku and Shibuya). The ratio exceeds 60% when expanding the area to include all 23 wards of Tokyo. Meanwhile, property prices in central Tokyo have increased due to the aggressive acquisition activities by real estate funds among other factors, and as such, the Cap rates have been exhibiting a declining trend. For this reason, there has also been a move to pursue investment opportunities in regional urban properties that offered relatively high yields.

Furthermore, a number of J-REITs specializing in area-specific properties have also entered the market. The first fund that clearly indicated an area focus in its investment policy was TOKYU REIT, Inc. characterized by its pin-pointed investments in the areas along the Tokyu railway line particularly centering on Shibuya, and in central Tokyo. Fukuoka REIT Corporation specializing in Kyushu's economic zone and Hankyu REIT, Inc. with a policy to invest over 50% in the Kansai area (portfolio at the time of listing was 100% comprised of Kansai properties) entered the market in June and October 2005 respectively.

A second J-REIT to specialize in distribution facilities and another focusing on hotels are also scheduled for listing and going forward, investment targets are believed to further diversify.

Figure 10 Geographical composition of investment properties

As of month end December 2003 and month end December 2005



Source:STB Research Institute

Diversification of Founding Sponsors

The first J-REIT was a fund sponsored by major real estate companies including Mitsui Fudosan and Mitsubishi Estate. Since then, multiple funds backed by major real estate companies have entered the market (in addition to real estate firms, sponsors also include life and nonlife insurance companies). These funds began their investments on an allocation of certain rental properties owned by the sponsor companies and they subsequently expanded their fund sizes

by additionally acquiring properties from external parties. Such J-REIT funds characteristically share a common strategy of applying the property management and business knowhows of the sponsor real estate companies to their own operations.

When looking at today's sponsors, one can understand that in addition to real estate firms, the sphere has expanded into such sectors as general trading, financial institution, nonbank, railway, food (Japan Tobacco), and real estate brokerage. Furthermore, the asset management companies of privately-placed real estate funds (listed companies including Pacific Management, Kenedix, daVinci Advisors, etc.) have also recently formed J-REITs and have gone public.

Growth Mechanism of J-REITs

We shall now examine the growth mechanism of J-REIT to better understand the background of market expansion and development. The fact that the earlier issues have maintained a relatively stable performance in distributing dividends has been instrumental to the expansion of J-REIT market. Meanwhile, J-REITs did not emerge during an uptrend of the real estate market. There was also an impact of the so-called "2003 Problem" when the massive supply of large-scale office buildings in central Tokyo adversely effected the demand and supply environment of the rental office market, thereby elevating the vacancy rate and triggering a rent drop. Why is it then that the dividends of J-REIT did not slip into a downtrend?

The value of J-REIT (share price) is determined based on the income from property investment, and therefore, an increase of such income, or more directly, an increase of per share dividend leads to the enhancement of the J-REIT value. The driving forces behind dividend increase, when examined in light of historical investment performances, can be broken down into four factors; namely (1) internal growth, (2) external growth, (3) financial leverage and (4) effect of capital increase at a price exceeding the BPS.

Internal Growth

Internal growth can be defined as an increase in rent revenue through rent increase or rise in the occupancy rate of owned properties or an increase in the NOI (Net Operating Income: income from the rental business before deduction of depreciation costs) through reduction of operating expenses. When looking at the average J-REIT occupancy rate for offices, one can see that the investment performance has so far exceeded the overall market average. This can be attributed to the high property management capabilities of J-REITs. The internal growth is at times measured by focusing on the NOI, an earnings indicator for owned properties, and by monitoring the shift in year-on-year NOI on a same-property basis (as in the case of same-store sales in retail). Until this point, the impact of the decline in rent revenues was such that the drop in same-property NOI was controlled by reducing expenses. However, according to recent year-end results, the decline in same-property NOI finally bottomed out with some J-REITs managing to mark slight increases.

External Growth

External growth is the increase in revenue and profit margin through the expansion of asset size. The shifts in the average NOI yield of owned properties ($\text{portfolio NOI} \div \text{total acquisition price}$) and the ROA serve as useful indicators to assess external growth.

There are additional benefits to asset size expansion such as reducing the impact of revenue fluctuation at the individual property level (risk diversification effect in portfolio management) or facilitating the implementation of planned renovation for the entire portfolio. Expansion of asset size is therefore valued not only in terms of increasing profit but from various perspectives including risk control.

Financial Leverage

Financial leverage is another factor that could materially impact dividends. Under the current low interest rate environment, the real estate yield is at a level exceeding J-REITs' borrowing rate, and as such, if additional properties are acquired using borrowings, the leverage gained in the process can be applied to realize dividend increase. However, J-REITs are currently adopting a financial policy of maintaining conservative LTV.

The process of expanding asset size is a process of continuous borrowing and capital increase, but naturally, financial leverage will not become a contributing factor for mid- to long-term dividend increase unless we see a gradual rise in the average debt ratio.

Effect of Capital Increase at a price exceeding the BPS

The fourth factor is the effect of capital increase on dividend growth. A capital increase at a price exceeding the BPS (book value per share) results in an increase in BPS. Size expansion pursued through continuous capital increase during an upward phase in share price performance will lead to a gradual dividend increase even if the yield of the real estate portfolio or the ROA remains constant.

Naturally, this growth factor relies on the price increase of shares, and is also substantially vulnerable to changes in the financial and capital market environment. As such, a J-REIT manager sets an objective to realize mid- to long-term dividend growth and conducts property acquisition and financing by carefully assessing the trends of the real estate, financial and capital markets. Successful capital increase which in turn raises the BPS has been a considerable factor in realizing stable dividend distribution up to now.

As outlined above, dividend growth from an increase in financial leverage could not necessarily be considered a factor contributing to mid- to long term growth. Nor could it be assumed that growth resulting from capital increase at a premium would continue to be successful as in the past. In this sense, we have reached a phase where the internal and external growths of J-REITs are again being put to test.

Challenges and Outlook Going Forward

The Real Estate Market Tying Up with the Capital Market

Historically in the Japanese real estate market, the rental market and the sale/purchase market were detached from one another. While it is now generally accepted to evaluate the value of commercial properties based on profits they generate, during the past bubble period, property prices soared mostly due to the buildup of excessive anticipation for future price rise, regardless of the actual profits from the properties. The income approach to value that we see today is an

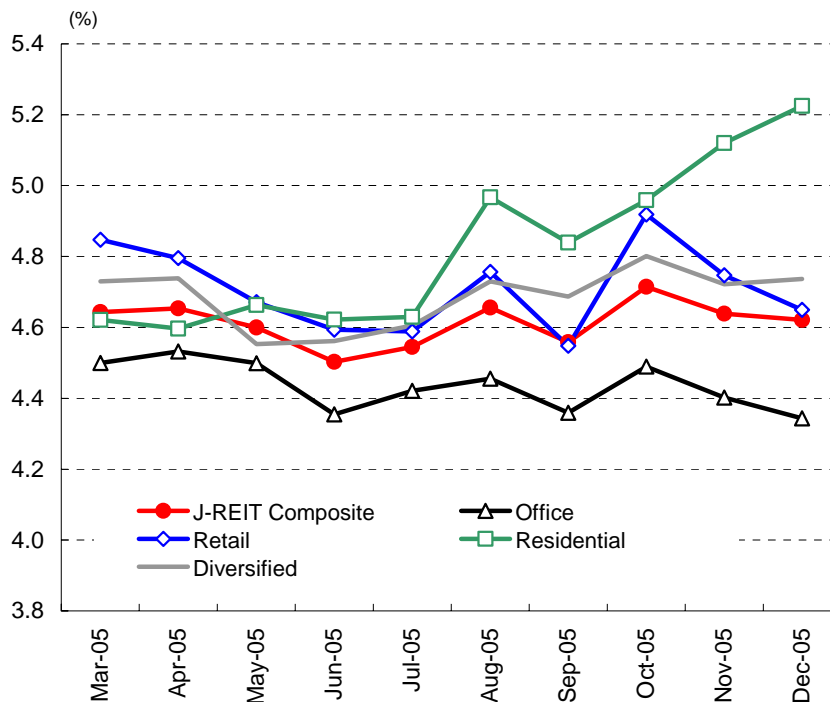
indication that the rental market and the sale/purchase market have started to develop a close relationship.

Furthermore, with the introduction of the J-REIT market, the capital market has also begun to exert influence on the real estate markets.

Because of the nature of J-REITs in relation to other financial assets, J-REITs' dividend yield or NOI yield is expected that risk premium is added onto risk free rate. The Implied Cap Rate¹ serves as an indicator of such. Today's J-REIT managers secure yield from their investment properties or make decisions on property acquisition prices in an effort to distribute dividends that match the return expected by the market (that is to say they would hesitate to invest in a property at a high price that could unduly lower the yield rate).

The investment stance taken by J-REITs, now significant players in the property sale/purchase market, also influences the activities of privately placed real estate funds and other real estate investors. This suggests that if the capital market of J-REITs can properly fulfill its functions (adjusting functions) in the market, Japan may not have to experience the same type of mistake she made during the past real estate bubble. For this reason, it is imperative that efforts are made to maintain a healthy J-REIT market.

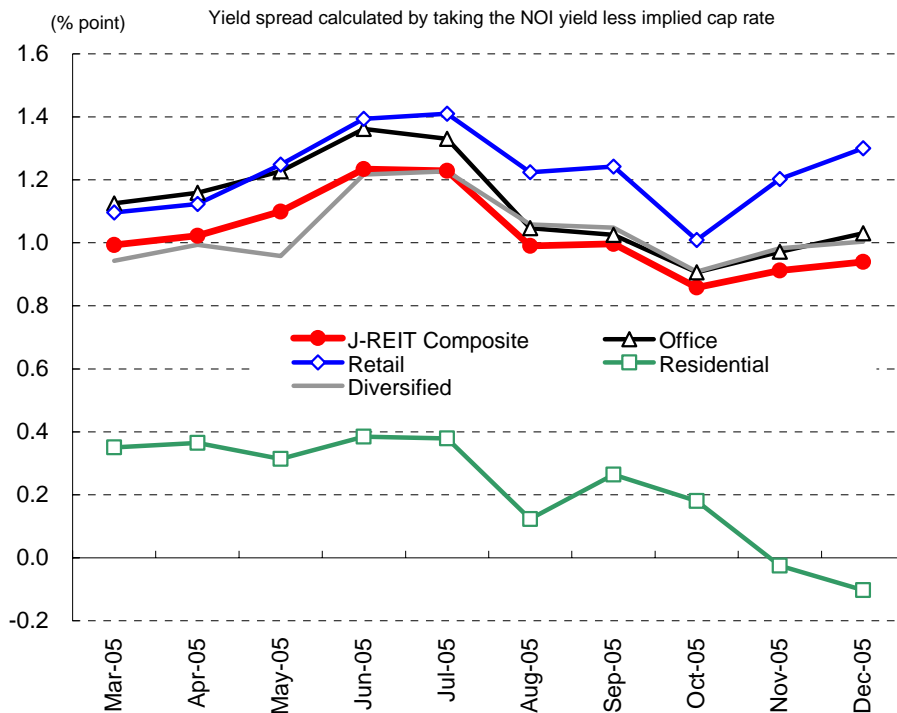
Figure 11 Implied Cap Rate



Notes: Implied Cap Rate equals the annual net operating income of real estate portfolios divided by J-REITs' takeover value(market capitalization plus net interest bearing debt plus deposits/guarantees received)

Source: STB Research Institute

¹ Implied Cap Rate equals the annual net operating income of real estate portfolios divided by the J-REITs' takeover value (market capitalization plus net interest bearing debt plus deposits/guarantees received)

Figure 12 Yield Spread between Implied Cap Rate and NOI Yield

Notes: 1. NOI: Estimated annual net operating income
 2. NOI yield = $\text{NOI} \div \text{operating real estate value (total acquisition value)}$
 Source: STB Research Institute

Responding to Increases in Interest Rate and Real Estate Prices

An interest rate rise is a significant risk factor for real estate companies and real estate funds such as J-REITs. While the financial leverage of J-REITs is at a conservative level compared to that of privately-placed real estate funds, the presence of a dividend reduction risk from an increase in interest rate can nonetheless be denied. The funds are taking countermeasures such as fixing long-term debts, spreading apart maturity and diversifying financing methods. The key going forward is whether or not the funds can assess the rate increase timing and maintain a good balance between securement of distribution and management of financing costs.

The risk of interest rate appreciation triggering an increase in expected dividend yield and inducing a decline in share prices is subject to the level of future growth in J-REIT income which is the source of dividend distribution. As such, the timing for rent increase vis-à-vis interest rate increase is becoming a crucial matter.

Furthermore, there is a growing concern that, in some instances, the yield of properties acquired by J-REITs is declining and additional property acquisition is not necessarily improving portfolio profit margin. Investment skills to enhance post-acquisition profitability along with management skills to assess portfolio risks/returns from a longer-term perspective and to acquire or replace properties accordingly are now increasingly required of J-REIT management companies.

Examining the J-REIT System and Decision-Making Processes

It has been repeatedly pointed out that the greatest drawback of externally-managed J-REITs is the existence of conflict of interest between the J-REIT investors and the asset management companies. However, there are also merits such as the fact that a mutual checking system between the investment corporations and the asset management companies came in place or that high transparency facilitated monitoring by the market. Problems associated with externally-managed J-REITs can to a certain extent be resolved through consolidation of the checking functions; one of the challenges going forward.

During the growth process of J-REITs, under an environment of limited investment grade properties, the procurement of properties by sponsors based on pipeline support agreements, etc. was appreciated by the market. However, given the recent rise in acquisition prices and the decline in yield rates thereof, the expansion of asset size through aggressive property acquisition is no longer always well received.

Today, all J-REITs have established procedures to avoid conflict of interest in the decision-making processes pertaining to acquisitions and management operations and have stipulated rules. With regard to information disclosure, voluntary disclosure beyond the statutory requirements is being conducted. Nonetheless, the need for monitoring by investors and independent evaluation organizations is unlikely to disappear but rather may increase in the future.

The J-REIT market has functions to promote structural changes in the Japanese real estate market and to enhance its transparency. There is also expectation for the J-REIT market to play a significant role in positioning real estate assets more clearly within the scope of investors' investment assets. The evolution of the past four years was smooth beyond what was initially imagined. However, for the market to continue its sound growth going forward, it goes without saying that the managing side must firmly maintain an investment stance that is sincere and mindful of investors' interests. At the same time, it is imperative that the investors assess the situation with calmness and with an understanding of the mid- to long-term implications of risks and returns.

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