

Internal Growth of J-REITs

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Signs of change are emerging in the environment surrounding the J-REIT market, soon to celebrate its fifth anniversary. Intensified competition to acquire properties has rapidly driven up real estate prices and forced investment returns (cap rates) down. Consequently, the external growth that has driven the J-REIT market to date has become a difficult strategy to implement. On the other hand, with the economic recovery, the fundamentals of the real estate leasing market have improved, creating greater expectations for internal growth. In consideration of these factors, a paradigm shift of J-REIT from an emphasis on external growth to internal growth is needed if sustainable growth in profit is to be achieved within the upcoming potential phase of rising interest rates.

This report presents an explanation of the economic significance of internal growth in REIT income and its ability to resist the pressures of rising interest rates.

Internal Growth means the increase of ROA of Existing Real Estate Portfolios

There are two factors that are the source of corporate growth: internal growth and external growth.

External growth is the efficient use of a company's external resources to achieve growth in profit and improved asset value. In contrast, internal growth is the efficient use of a company's internal resources to achieve growth in profit and improved asset value. Internal growth for a J-REIT means the realization of a growth in profit and improvement in asset value through the efficient use of owned real estate and increasing the efficiency of expenses. Specific measures for accomplishing this are: 1) Raising the unit rent price and occupancy of owned real estate, 2) Lowering real estate leasing and management costs, and 3) Reducing the costs of capital.

The following shows how internal growth is linked to profit growth.

From a perspective of emphasizing income gain, the operating profit of real estate represents the value of a J-REIT. Put bluntly, the share price of a J-REIT is determined by the earnings per share (EPS; actually referred to as an “investment unit” by the J-REIT market but “share” will be used for convenience here). Therefore, J-REIT investors are always calling for a growth in EPS.

EPS can be broken down as indicated by the formula below.

$$EPS = ROA \times \frac{1}{1 - LTV} \times BPS^1$$

As indicated in the formula above, EPS can be devised from three factors: 1) The profit-generating ability of real estate (ROA), 2) Financial leverage (LTV) and 3) The net asset value per share (BPS).

1) Return on Assets (ROA)

ROA is a ratio created by dividing ordinary profit by gross assets. It is a general index that indicates the profitability and efficiency of invested capital.² In the case of J-REITs, ROA represents the gross-profit generation ability of real estate owned by a J-REIT. The higher the ROA, that is, the higher the profitability of assets as a whole and the greater the efficiency of management, the higher the EPS.

The two methods for heightening the ROA are external and internal growth. External growth is used to raise the ROA of the overall portfolio by acquiring additional properties with a high cap rate using capital procured at a low cost. On the other hand, internal growth involves increasing the existing portfolio's ROA by efficiently using existing properties and increasing the efficiency of expenses. Changes in the market environment create circumstances where it is easy to pursue external growth and other circumstances where it is easy to pursue internal growth, but fundamentally ROA

¹ See Appendix 1.

² There is also another means of external growth that is achieved by raising the asset value of the portfolio by reducing risk through diversified investment (this lowers the risk premium,) although this doesn't increase the EPS.

growth occurs through the interaction of both. The relationship between internal and external growth will be described later in this report.

2) Loan to Value (LTV)

LTV stands for the ratio of interest-bearing liability and is found by dividing interest bearing liability by gross assets. EPS will increase in the short-term when real estate is purchased with debt rather than increased capital, as long as the borrowing costs are less than the returns gained from leasing the real estate.

However, financial risk increases in line with increases in LTV and the risk premium demanded by investors also goes up. An increase in EPS caused by leverage effects is offset by an increase in the risk premium and the impact on the investment unit price becomes minute. Additionally, in the medium to long-term, J-REITs employ a process of expanding their scale through a cycle of borrowing and increasing capital. Since the LTV drops with an increase in capital, LTV has no relationship to EPS growth in the medium-to-long-term.

3) Book Value per Share (BPS)

This is the net asset value per share. When the net asset value is a fixed amount, fewer shares are needed and therefore the BPS is higher, resulting in a greater net profit per share (EPS) as long as the total profit is constant. When capital is increased, the BPS will increase if capital greater in value than the BPS is raised. In other words, BPS grows as a result of a premium capital increase. A premium capital increase is based on the premise that the investment unit price will grow. Therefore whether or not a premium capital increase can be conducted is related to the level of ROA and LTV and also has an impact on the trends of the capital markets (shares and bonds).

Table 1: Example of EPS Growth Calculation

	ROA	LTV	BPS	EPS	Change Rate
Basic Case	3.0%	40.0%	500,000	25,000	
Case 1	3.0%	40.0%	550,000	27,500	10.0%
Case 2	3.0%	45.5%	500,000	27,500	10.0%
Case 3	3.3%	40.0%	500,000	27,500	10.0%

Note: $EPS = ROA / (1 - LTV) \times BPS$

Table 1 indicates specific numerical examples of EPS growth. Cases 1-3 reveal that EPS growth occurs when BPS, LTV or ROA are increased. However, the truth is that such a simple case will never occur in real life. EPS is always a result of the interaction of ROA (internal and external growth), LTV and BPS.

The following considers the situation of an economic recession (where there is a drop in real estate prices and a decline in interest rates). In such a situation real estate prices drop and the cap rate of newly acquired properties climbs, making it easy to achieve improved ROA through external growth. Since interest rates are low, the burden for paying the interest is small, allowing for the LTV to be set high. The return demanded by investors drops and premium capital increases are possible because of the ensuing increase in share unit prices. Even if rents fall, the decline in income can be covered with reduced costs, which allows for any drop in profit to be kept to a minimum. Thus there are a variety of methods for achieving EPS growth within an economic recession.

On the other hand, during an economic recovery (both real estate prices and interest rates rise) it becomes difficult for ROA to be increased via external growth. Further, the rise in interest rates reduces the leverage effect and also makes it difficult to issue a premium capital increase. The only means remaining is internal growth by raising rents. However, it is inappropriate to judge the results of external growth during an economic recovery based on the cap rate at the time of acquisition alone. That is, even if a property is acquired at a low cap rate, the overall ROA will increase as long as internal growth is realized after acquisition by steadily raising returns. External growth becomes possible if internal growth is achieved and thus raises the possibility of a premium capital increase. Consequently, internal growth during an economic recovery is vital.

Differences between Internal and External Growth

The following is a comparison of the characteristics of internal and external growth.

The main characteristic of external growth is that it is largely affected by the external environment including the real estate transaction market and the financial market. The cap rate at which a property can be acquired and the cost at which a property can be financed are aspects that are difficult for a J-REIT fund manager to control.

The enlargement of a portfolio alone is not external growth. It is possible to increase the EPS in the short-term just by raising the LTV level even if the cap rate of an acquired property is low. However, EPS will not grow if the cap rate remains low as it will reduce the ROA in the medium to long-term. Therefore, external growth in the true sense is the enlargement of a portfolio in a manner that increases the ROA.⁴

In the case of internal growth, the costs are commonly covered using liquid funds that the fund already possesses and capital is almost never procured from outside sources to achieve internal growth. Since time is needed to negotiate rents with tenants and reduce costs, internal growth is expected to achieve steady results through strategic planning and diligent effort; however, it is not possible to achieve rapid growth in profit like that achieved through external growth.

Additionally, the impact of external growth on the asset value of existing individual properties is very small, but internal growth directly contributes to increasing the asset value of existing properties by heightening the profitability of existing properties.

Can internal growth counter interest rate increases?

The greatest risk that J-REITs face is generally considered to be a rise in interest rates. Any rise in interest rates will increase the interest payment and lower the EPS. Furthermore, the demand for higher cap rates by investors drives down prices. However, if internal growth initiated by a J-REIT can raise revenues from real estate management to a point greater than the increase in paid interest it becomes possible to absorb the impact of an interest rate rise. Below is an example used to verify the effect internal growth has in countering an interest increase using a calculation example for an imaginary J-REIT.

The profit and loss statement and balance sheet of the imaginary J-REIT are shown in [Figure 1](#) below using the settlement results of J-REITs as a reference.

Figure 1: Balance Sheet and Profit and Loss of an Imaginary J-REIT

Profit and Loss of an Imaginary J-REIT (unit: 100 million)			Balance Sheet of an Imaginary J-REIT		
7.5%	Rental returns	75	Managed real estate (100 billion yen)	Interest bearing liabilities (40 billion yen)	⇒ Fixed rate borrowing ratio: 60% Average interest rate: 1.25% (Weighted average for variable interest rate and fixed interest rate)
3.0%	Rental expenses	30		Total equity invested (60 billion yen)	⇒ Number of units outstanding: 120,000 BPS: 500,000 yen
1.0%	Asset Management fee and sales management costs	10			
0.5%	Paid interest	5			
3.0%	Net profit	30			

Under the provisional terms of an LTV of 40%, a BPS of 500,000 yen and an ROA of 3%, the present annual forecast EPS is 25,000 yen. Table 2 indicates the EPS levels when only the interest rate and rental income are adjusted.

Let's analyze the results. The value that is shaded is the juncture at which the EPS increases and decreases. The horizontal space indicates the minimum rate of increase in rental income needed to maintain the EPS under conditions in which the interest rate rises only within a certain range. The vertical space indicates the maximum range of interest rate hike that can be withstood to maintain the EPS under conditions in which the rental income rises at a set rate.

Table 2: Interest Rate Rises vs. Internal Growth

variation rate in rental income interest rate rise and fall (bps)	-1.0%	-0.5%	0.0%	0.5%	1.0%	1.5%	2.0%	2.5%	3.0%	3.5%	4.0%
-30	24,775	25,088	25,400	25,713	26,025	26,338	26,650	26,963	27,275	27,588	27,900
-20	24,642	24,954	25,267	25,579	25,892	26,204	26,517	26,829	27,142	27,454	27,767
-10	24,508	24,821	25,133	25,446	25,758	26,071	26,383	26,696	27,008	27,321	27,633
0	24,375	24,688	25,000	25,313	25,625	25,938	26,250	26,563	26,875	27,188	27,500
10	24,242	24,554	24,867	25,179	25,492	25,804	26,117	26,429	26,742	27,054	27,367
20	24,108	24,421	24,733	25,046	25,358	25,671	25,983	26,296	26,608	26,921	27,233
30	23,975	24,288	24,600	24,913	25,225	25,538	25,850	26,163	26,475	26,788	27,100
40	23,842	24,154	24,467	24,779	25,092	25,404	25,717	26,029	26,342	26,654	26,967
50	23,708	24,021	24,333	24,646	24,958	25,271	25,583	25,896	26,208	26,521	26,833
60	23,575	23,888	24,200	24,513	24,825	25,138	25,450	25,763	26,075	26,388	26,700
70	23,442	23,754	24,067	24,379	24,692	25,004	25,317	25,629	25,942	26,254	26,567
80	23,308	23,621	23,933	24,246	24,558	24,871	25,183	25,496	25,808	26,121	26,433
90	23,175	23,488	23,800	24,113	24,425	24,738	25,050	25,363	25,675	25,988	26,300
100	23,042	23,354	23,667	23,979	24,292	24,604	24,917	25,229	25,542	25,854	26,167

Source: STB Research Institute

For example, in the event that the interest rate is hiked 50 bps hereafter, the rental

income must be raised by at least 1.5% for EPS to be maintained or for EPS to grow. The actual variation in rental income depends on the content of the real estate portfolio under management, but let's consider a situation in which the assets under management are medium-sized office buildings. In consideration of the impact of the year 2003 problem and the basic recent tone of raising rents, let's assume a situation in which the new rent contracts are 10% higher than existing rents (e.g., from 20,000 yen to 22,000 yen per tsubo, per month). When the annual turnover in tenants is 15%, it is possible to raise the annual rental income by 1.5%. The rental income can also be increased by more than 1.5% if more existing tenants renew contracts at the higher rent.

On the other hand, reducing costs is a way of securing internal growth, in addition to raising rents and occupancy or increasing floor space to raise rental income. Excluding public charges, depreciation and other fixed costs, the largest expenses of the rental business are utilities and management fees (property management fees and subcontracting fees). Methods that can be used to reduce utility costs include energy conservation measures such as the installation of power control devices and energy saving equipment. Further, searching for the power company with the most competitive rates will also reduce costs. As for management contracting costs, the efficiency of cost can be maximized by utilizing market principles such as selecting property managers through a bid process and reviewing subcontractors.

In the area of financial management it is also possible to minimize additional payment burdens caused the impact of any sudden interest rate rises by lowering the LTV level, raising the ratio of fixed interest borrowings and spreading out repayment deadlines. In fact, there are many J-REITs with fixed interest borrowing ratios of at least 80% and cases where the costs for raising capital are reduced by obtaining ratings.

In other words, the raising of rents is not the only means for combating interest rate hikes, it is possible to take a multi-faceted approach that includes reducing real estate rental costs and implementing appropriate financial measures.

Future Prospects

Within intensified competition to acquire properties, J-REITs are becoming more

cautious in their acquisitions. However, there are limits to internal growth alone, making it necessary to maintain some level of external growth. Consequently, it has become important when acquiring properties to determine whether or not internal growth is possible. Even if a property has a low cap rate at the time of acquisition, it is possible to heighten the profitability through active management when a property has room for internal growth and thus raise the asset value. In such a case, there can be expectations for synergistic effects from the combination of internal and external growth.

Already, it is important for investors to discern which J-REITs can achieve internal growth and which cannot. J-REITs that can achieve internal growth can secure chances for external growth even in an environment of rising real estate prices by utilizing their abilities for achieving internal growth. Conversely, J-REITs without this ability will not be able to achieve steady, reliable external growth. A further bi-polarization of J-REITs will occur as the differences in the abilities of each J-REIT to achieve internal growth become apparent.

Appendix 1

$$\begin{aligned}
 \text{EPS} &= \frac{\text{Current profit}}{\text{Number of outstanding share}} \\
 &= \frac{\text{Current profit}}{\text{Net assets}} \times \frac{\text{Net assets}}{\text{Number of outstanding share}} = \text{ROE} \times \text{BPS} \\
 &= \frac{\text{Current profit}}{\text{Gross assets}} \times \frac{\text{Gross assets}}{\text{Net assets}} \times \frac{\text{Net assets}}{\text{Number of outstanding share}} \\
 &= \frac{\text{Ordinary profit}}{\text{Gross assets}} \times \frac{\text{Gross assets}}{\text{Net assets}} \times \frac{\text{Net assets}}{\text{Number of outstanding share}} \\
 &= \text{ROA} \times \frac{\text{Gross assets}}{\text{Net assets}} \times \text{BPS} \\
 &= \text{ROA} \times \frac{1}{1 - \text{LTV}} \times \text{BPS} \quad \text{Gross assets/Net assets is called Leverage Ratio}
 \end{aligned}$$

Note: J-REITs are in fact exempt from corporation tax as long as they satisfy certain conditions making the following equation true: Current profit = ordinary profit.

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