

J-REIT VIEW:

~J-REIT Market at a Turning Point~

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1. Introduction

Already 7 years have passed since the first J-REITs were listed in the market on September 10, 2001. In the beginning period, there were times when the market expansion slowed down due to fears that the conditions of the real estate market would deteriorate or concerns over the product itself because it was new. However, it was fortunate that prices continued to increase and market expansion at least until the beginning of 2007. The reasons behind such phenomena were the revised tax system for J-REIT investors, stable dividends and recovery of the real estate market, among others.

However, ever since 2007, due to the impact of the U.S. subprime loan crisis, there was seen a great change in the expansion or performance of the market, such as the decrease in the number of IPOs and decrease of prices, etc. Furthermore, the characteristics of J-REITs as a financial product also altered greatly. Clearly, the J-REIT market is at a turning point and seems to be entering into a new stage.

In this report, we will try to verify such changes and assess future prospects.

2. The First Full-Fledged Price Decrease and Yield Increase

Figure 1: History of the TSE REIT Index

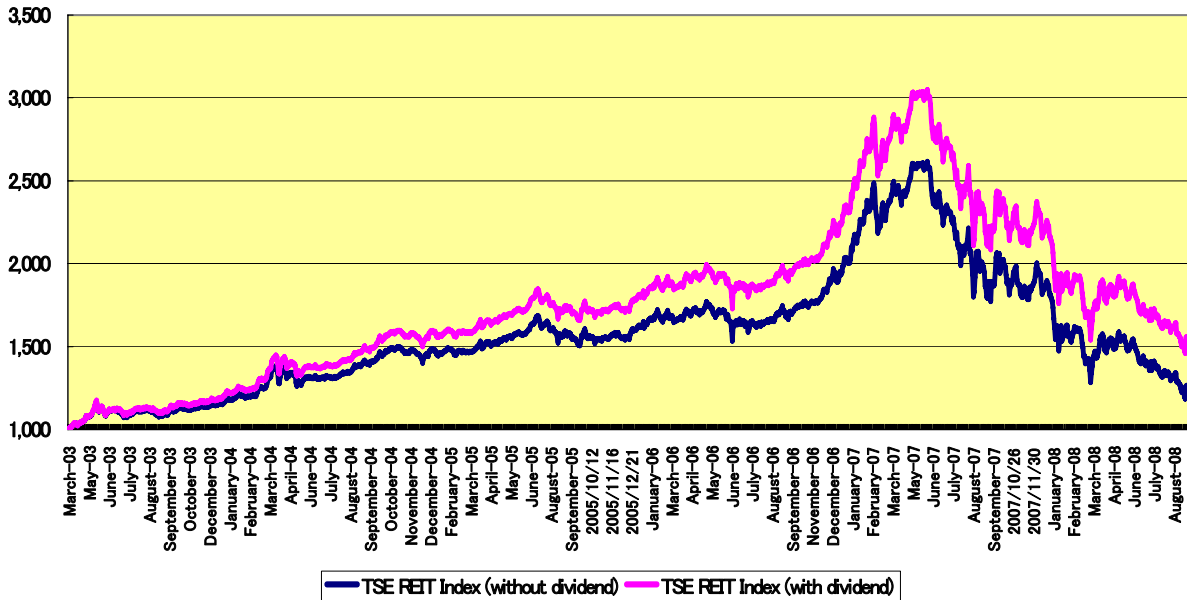


Figure 1 shows the History of the Tokyo Stock Exchange (TSE) REIT Index.

Ever since its launch at the end of March 2003, the TSE REIT Index has seen an increase spanning over several years. However the index value peaked at the end of May 2007 and recorded its first large-scale fall following this. Until March 17, 2008, compared to the level of the end of May 2007, the TSE REIT Index without dividends decreased about 50.8% and for the TSE REIT Index with dividends decreased about 49.4%. Following that, there was a slight recovery trend but it recently decreased once again, to record the year's lowest price in September 2008. Furthermore, in terms of yield, as shown in Figure 2, the significant fall of J-REIT prices was accompanied by a large rise in J-REIT dividend yields. Additionally, despite there being a difference among issues, yields on investment corporation bonds and interests on loans for J-REITs are generally trending upwards.

On the other hand, amidst such dramatic changes in J-REIT prices and yields, the performance of real estate owned by J-REITs are generally solid and as Figure 3 shows, there appears to be no significant decreasing trend in J-REIT dividends.

Furthermore, recently, due to gain on sales, J-REIT dividends for some issues are increasing significantly.

**Figure 2: History of Average J-REIT Dividend Yields,
10 year Government Bond Yields and Spreads**

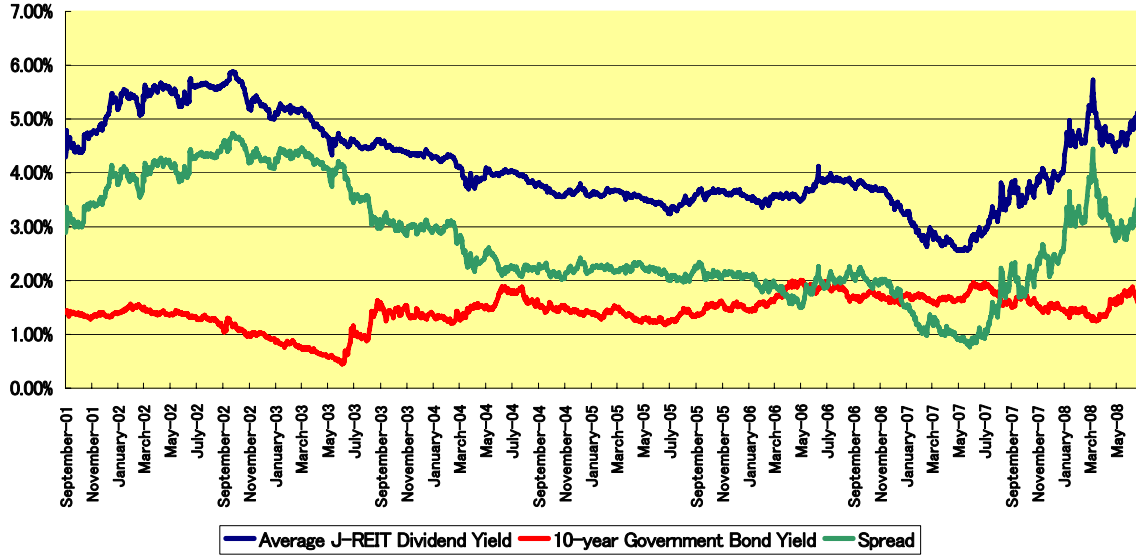
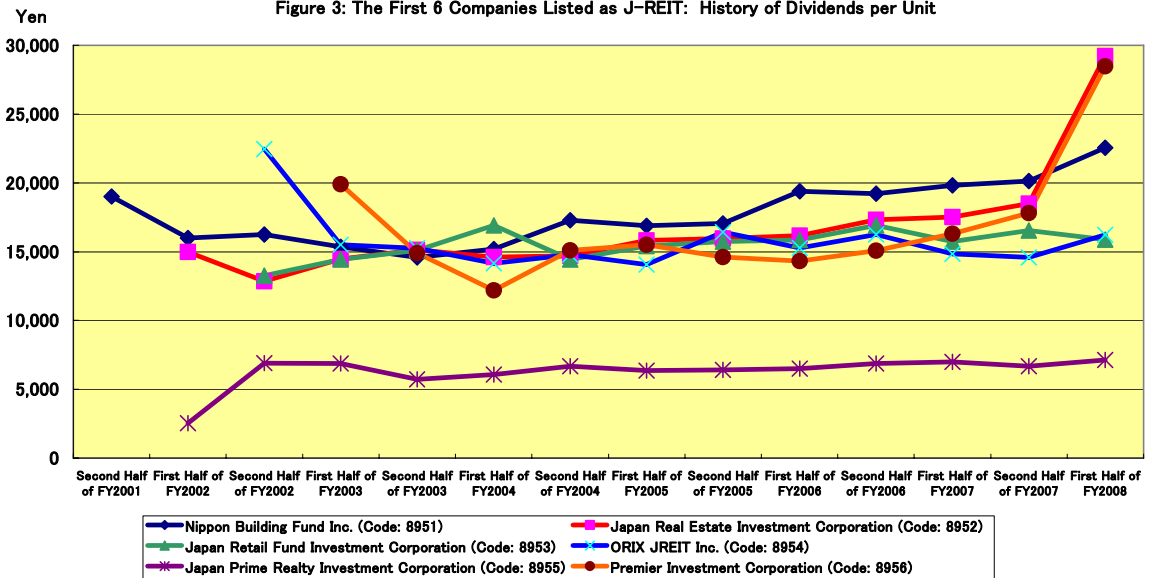


Figure 3: The First 6 Companies Listed as J-REIT: History of Dividends per Unit



Therefore, rather than due to the expectations of a decrease in cash flow, the decrease of J-REIT prices can be said to be due to the rise in investors' assessment for J-REIT risk as a result of the changing environment in the financial markets, etc. It could be said that the change of investors' assessment is expressed in the rising J-REIT dividend yields and increasing spreads between J-REIT dividend yields and government bond yields shown in Figure 2.

However, the change in investors' assessment of risk was not only targeted towards J-REIT, but this change was targeted towards the entire financial market as a result of the U.S. subprime loan crisis. Figure 4 shows the ratio of the market capitalization of J-REIT against the market capitalization of TOPIX. No dramatic decreasing trend is seen in the ratio, but it is moving stably. J-REIT market capitalization significantly decreased along with the decrease of J-REIT investment unit prices and the decrease of J-REIT market capitalization was about the same as the decrease of market capitalization of stocks. Furthermore, Figure 5 shows the ratio of J-REIT market capitalization against the market capitalization of first tier real estate firms of the TSE. There were times when this ratio was undergoing an increasing trend. It could even be said that the J-REIT market capitalization's decrease following the sub prime loan crisis was low in comparison to the decrease in the market capitalization of first tier real estate firms of the TSE.

Decrease in prices was not only the situation with J-REITs, but also a phenomenon seen in the Japanese securitization market as a whole. Furthermore, the decrease in J-REIT prices was not great when compared to the decreasing prices of other financial products, such as stocks.

3. Product Characteristics of J-REITs Seen in the Market

Amidst the changing trends of J-REIT yields, the product characteristics of J-REIT also changed greatly. Among the changes, the following are some distinct changes: (1) the increasing volatility of J-REIT returns; and (2) the increasing correlation between J-REIT returns and TOPIX returns.

(1) Volatility Rise in J-REIT Returns

Figure 6 shows the standard deviation (rolling data for 60 business days) of daily returns of J-REITs as well as Japanese stocks.

Figure 4: History of J-REIT Market Capitalization and Comparison with TOPIX Market Capitalization

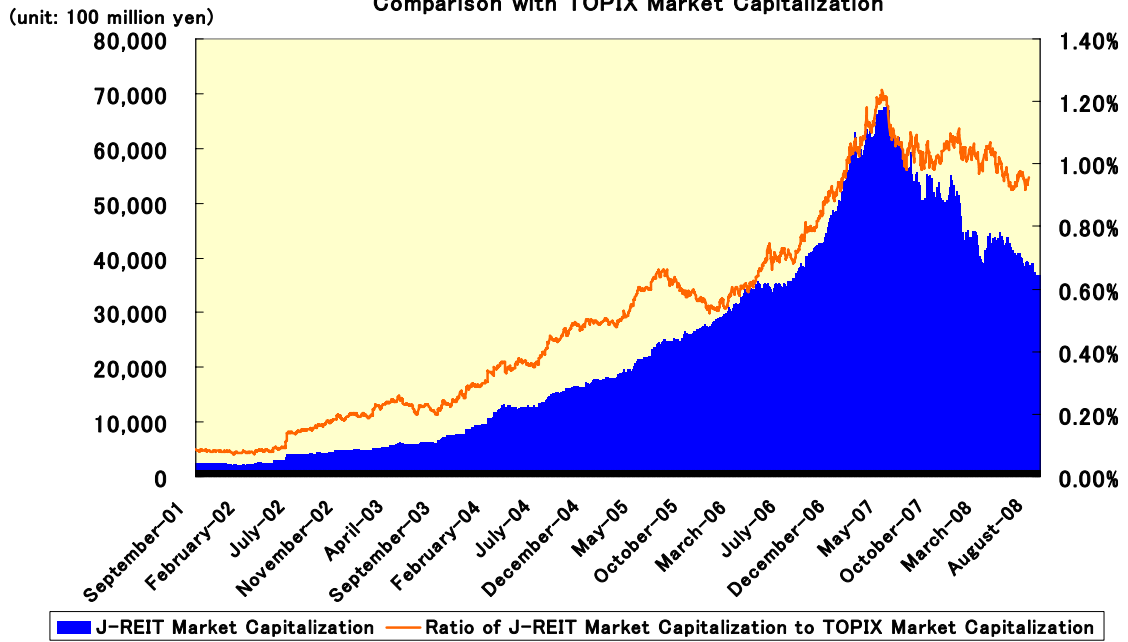


Figure 5: History of J-REIT Market Capitalization and Comparison

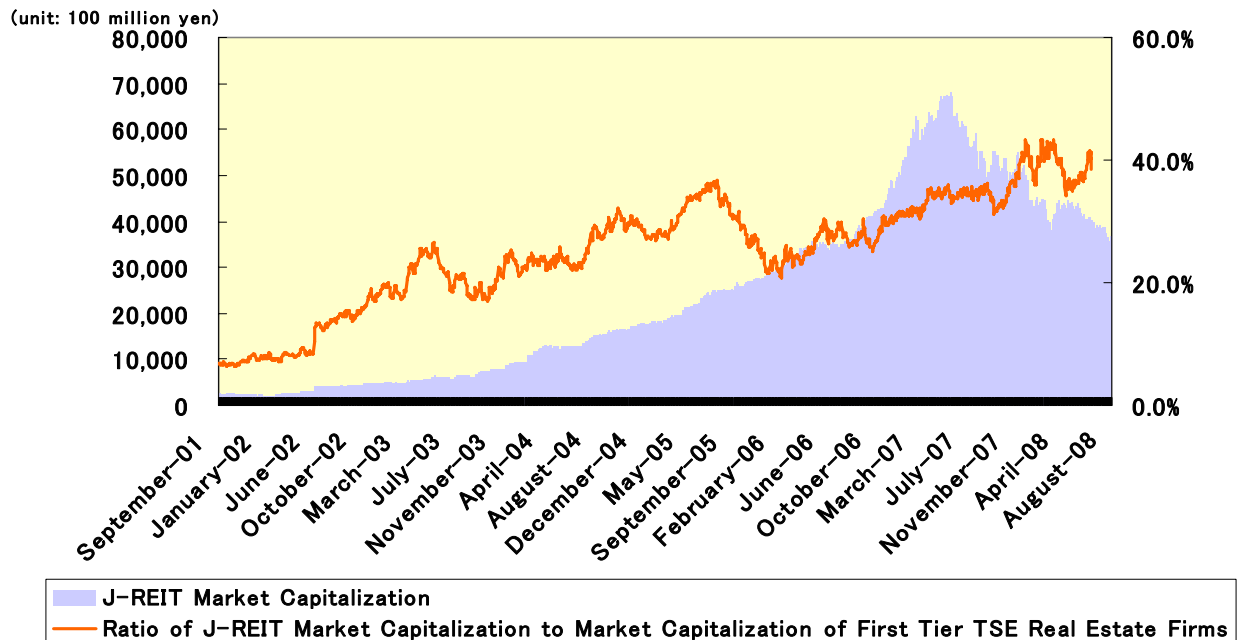
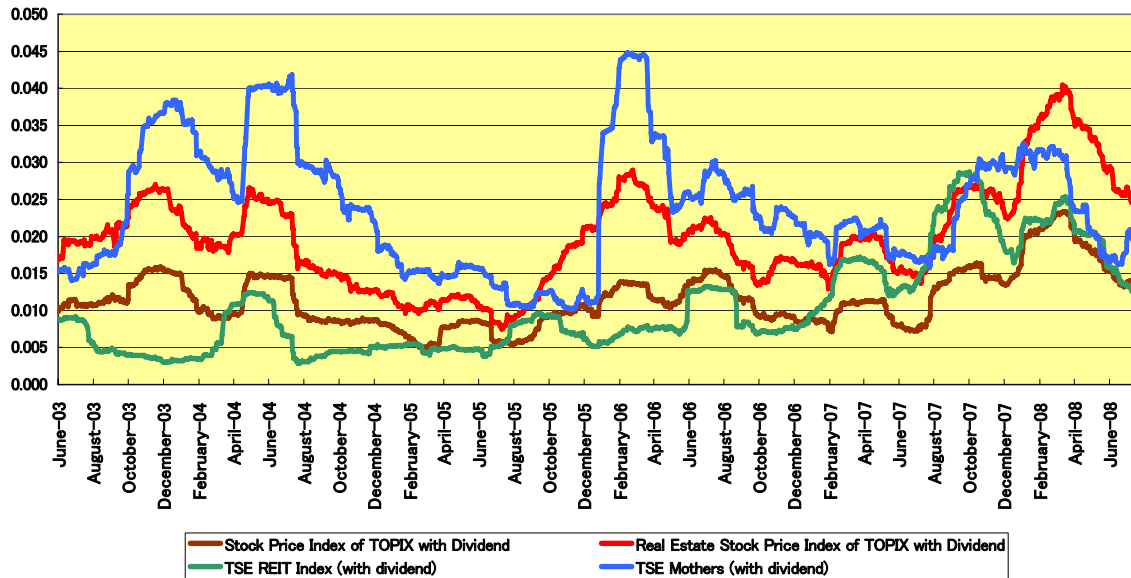


Figure 6: History of Standard Deviation of the Daily Returns for J-REITs and Japanese Stocks (60 business days rolling data)

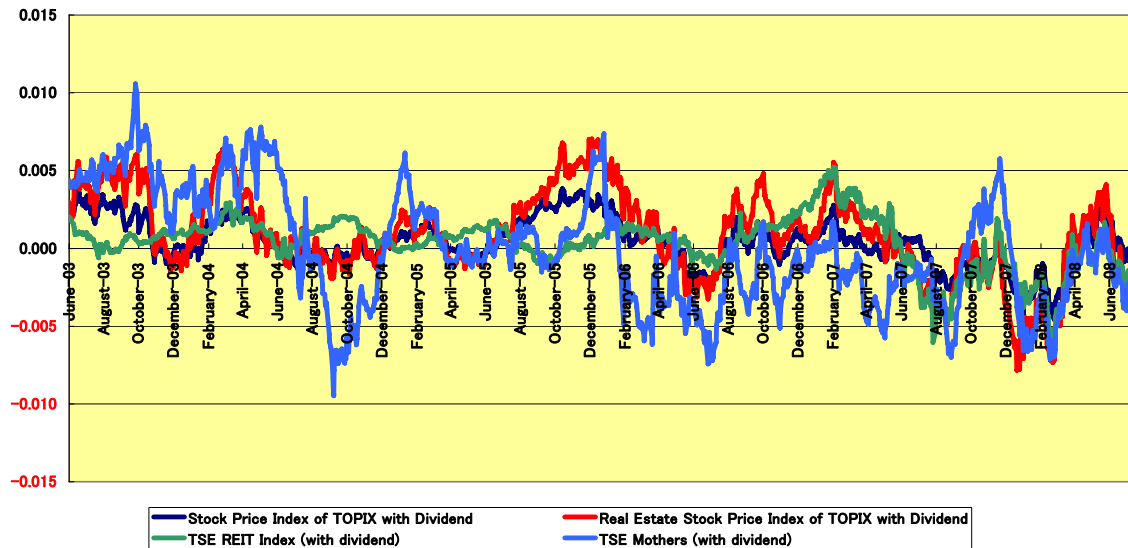


Standard deviation indicates the volatility of returns. If we look at Figure 6, we can see that the volatility of J-REIT returns data-wise, exceeded the volatility of TOPIX since the middle of January 2007. Since the numerical value for the middle of January 2007 was made based on data for the preceding 60 business days (about 3 months), it can be said that the volatility of J-REIT returns increased significantly since the latter half of 2006. Following this period, the volatility of J-REIT returns increased even further and by the beginning of August 2007, it rose to exceed the level as the volatility of the returns of the Tokyo Stock Exchange Mothers Index.

Such a significant volatility increase in J-REIT returns indicates the increasing risk of J-REIT as a financial product. It could be said that since the latter half of 2006, the high risk characteristic of J-REITs became apparent which is a product characteristic different from its original characteristics that can be envisaged from its type of assets, capital composition and product structure, etc.

However, the assets owned by J-REITs are originally real estate or assets whose cash flow is relatively stable. Furthermore, given the overall lowness of the debt ratio of J-REITs, it can be thought that J-REITs have lower risk than stocks to show a product characteristic of middle risk. In fact, in the early stage, it showed a volatility that was consistently lower than stocks.

**Figure 7: History of Average Value of Returns on Japanese Stocks and J-REIT
(60 business days rolling data)**



On the other hand, if we look at the average value of returns, the average value of daily returns on J-REITs (rolling data for 60 business days) as shown in Figure 7 rose significantly in the latter half of 2006 but then fell significantly since 2007. The fact that J-REIT prices plunged after increasing greatly since the latter half of 2006, is reflected in the increasing risk of J-REITs as a product.

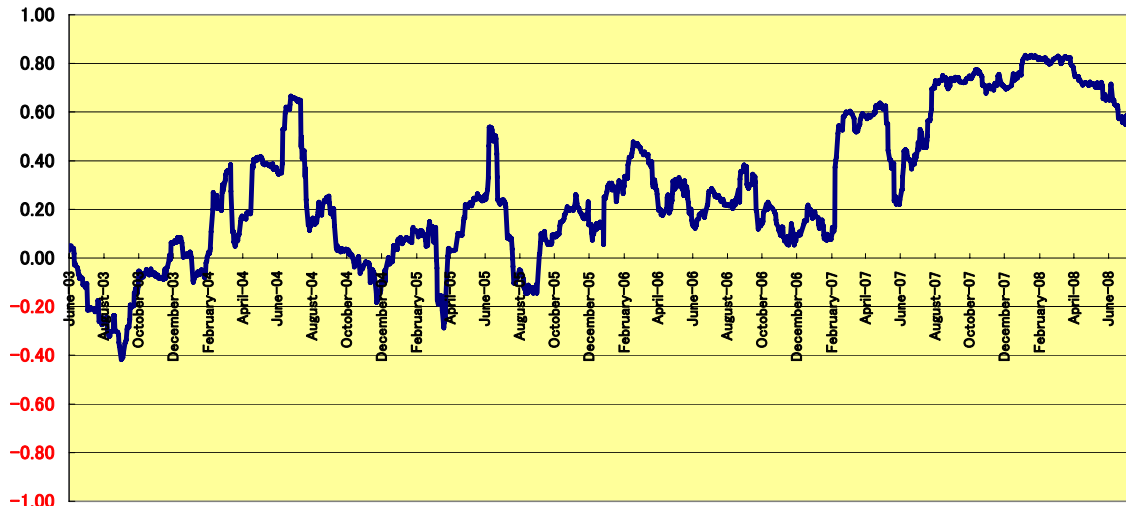
Fortunately, since the latter half of 2007, J-REIT volatility decreased to a lower level than the volatility of stock returns. This was probably because the confusion in the financial markets slightly subsided. As a result, it is thought that the original product characteristic of J-REIT of possessing lower risk than stocks has been regained.

However, J-REIT volatility is still at a high level when compared to the past and possibly still at a high risk level in comparison to the risk level that can originally be estimated for J-REITs.

(2) The Rising Correlation between J-REIT Returns and TOPIX Returns

Another important change in the product characteristics of J-REITs is the rising correlation with TOPIX returns. Figure 8 shows the history of correlation coefficient of the daily return of the TSE REIT Index and daily return of TOPIX (rolling data for 60 business days). Figure 8 shows that since 2007 the correlation coefficient has risen significantly.

**Figure 8: Correlation Coefficient of Daily Returns
(Japanese REITs versus Japanese Stocks / 60 business day basis)**



It is especially characteristic that since June 2007 the correlation coefficient rose sharply and by the beginning of 2008 reached a level exceeding 0.8. If the correlation coefficient of the returns reaches this level, it becomes difficult to receive the merits of a lower risk through the diversification of investment by investing in J-REITs and Japanese stocks. Following that period, although the correlation coefficient decreased slightly, it is still at a high level and a similar situation continues.

However, the reason why the correlation coefficient of the returns rose significantly was no other than because the stock market and J-REIT market in Japan fluctuated in the same direction as a result of the market turmoil stemming from the U.S. subprime loan crisis. Given the holding assets and structure of J-REITs, if the market turmoil subsides in the future, then it is expected that this correlation coefficient to decrease greatly to bring about an environment in which investors can receive the merits of a lower risk through the diversification of investment in J-REITs and Japanese stocks.

4. Globalization of the Real Estate Investment Market

(1) Globalization of the Real Estate Investment Market: Current State

The globalization of the real estate investment market was the cause behind the change in the market environment that we have discussed. The reason behind the

intensification of real estate investment on a global scale is the fact that the obstacle to global investments in real estate was removed due to the spread of real estate securitization. Before the spread of real estate securitization, it was not easy to invest in overseas real estate. This is because if one were to invest in actual overseas real estate, then it is necessary to lay out a situation for the enabling of audits regarding the conditions of the building and land and the relation of rights, etc. of the actual real estate under target for actual investment upon bearing in mind the laws and market movements of the nation targeted for investment. In that regard, under the current situation in which real estate securitization has spread, it has become possible to make investment decisions for real estate securitization products in the same manner as for other financial products based on disclosure information. Under such circumstances, investment in overseas real estate became popular due to investors aiming to decrease risk by internationally diversifying investment.

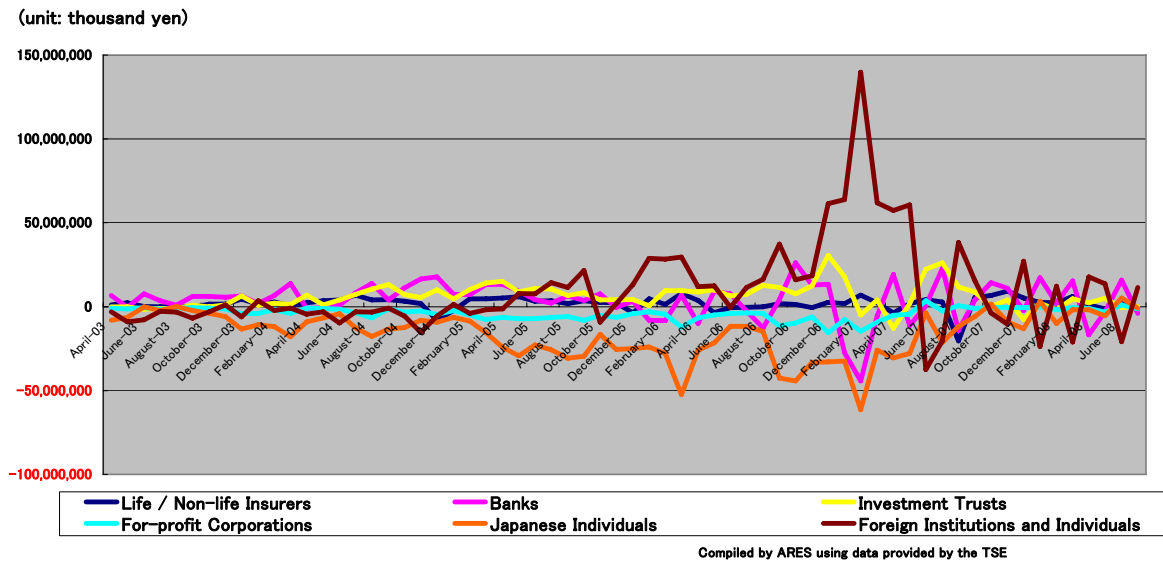
For example, it can be inferred from Figure 9, which shows the “History of Sales and Purchasing Data of J-REITs Organized by Investor Category” (compiled using data from the TSE), that the abovementioned phenomenon was the cause behind the intensification of the sales and purchasing of J-REITs by foreign investors.

Foreign investors who had continued to purchase a significant amount of J-REITs since the latter half of 2006, suddenly shifted to becoming significant net sellers in June 2007. When foreign investors were buying large amounts of J-REITs, J-REIT prices rose sharply and when foreign investors started to sell J-REIT at a large amount, J-REIT prices greatly fell. Thus it can be speculated that there is an extremely high possibility that these sales and purchasing trends of foreign investors had an impact on J-REIT prices. In addition, there appeared overseas REITs that invest in Japanese real estate. Among them are many overseas REIT issues that only invest in Japanese properties, indicating that investment by foreign funds in Japanese real estate is expanding.

On the other hand, investing in overseas REITs by Japanese investors is also active via fund of funds. Furthermore, in May 2008, the rules of the TSE were revised, allowing J-REITs to invest in overseas real estate. In the future, we can even envisage J-REITs directly acquiring overseas real estate.

Within the real estate market, cross-border transactions are growing as a result of the advancing of globalization.

Figure 9: History of Sales and Purchasing Data of J-REITs Organized by Investor Category (TSE)



(2) Change in Market Environment as a Result of Market Globalization

As globalization of real estate investment markets progresses, we are about to welcome an era where it becomes easier for the change or shock occurring in one nation's market environment propagating to another nation. The U.S. subprime loan crisis in 2007, which has spread to other nations of the world, is a prime example. In 2007, J-REIT prices fell greatly, but REIT prices of other nations fell as well. It is almost unquestionable that this was the result of the problems in one nation, or the U.S., spreading to the REIT markets of many other nations. Furthermore, one of the reasons behind the significant increase of J-REIT prices in the latter half of 2006 was the decrease of overseas real estate yields that accompanied the rise in real estate prices, causing the appeal of the Japanese real estate investment market to increase in relative terms. We can say that this is an example of a change in the overseas market environment, having an effect on the Japanese real estate investment market.

If we think on such terms, then it can be expected that the markets of nations have some kind of correlation as the globalization of the real estate investment market progresses. In this respect, looking at the average value of daily returns of global REIT indices shown in Figure 10, it cannot be denied that there appears to be a degree of correlation among them.

Figure 10: REIT Indices for Japan, the U.S. and Europe: History of Average Value of Daily Returns (60 business day basis)

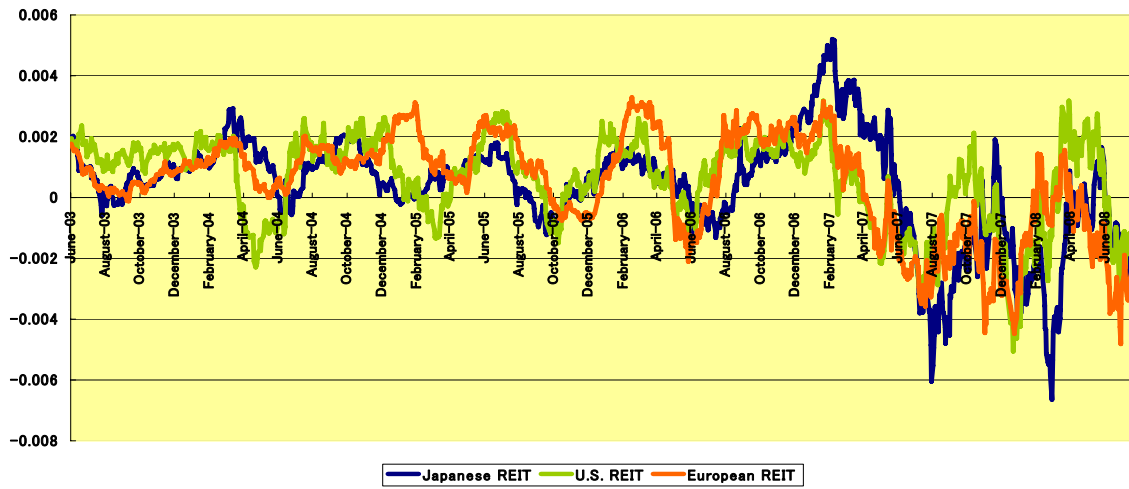


Figure 11: Correlation coefficient of Daily Returns (Japanese REIT versus U.S. REIT / 60 business day basis)

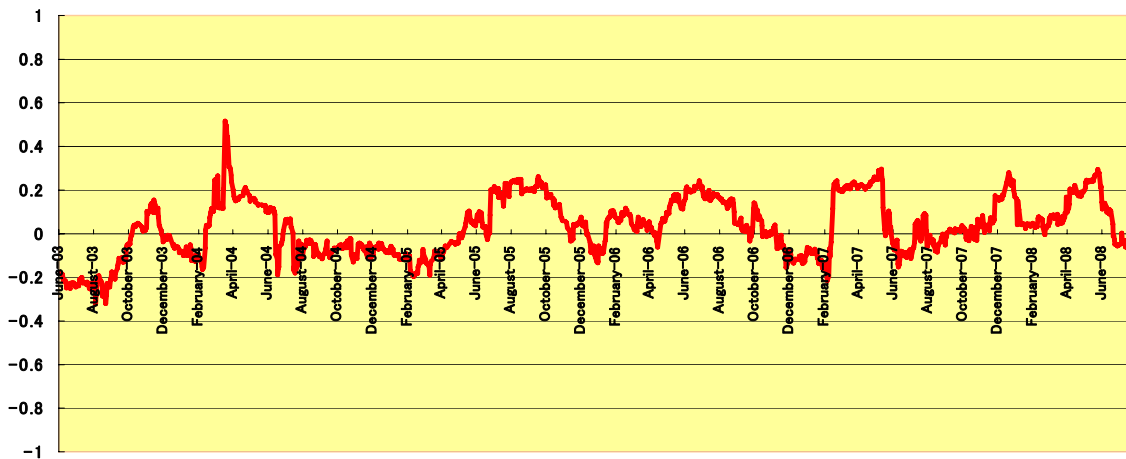
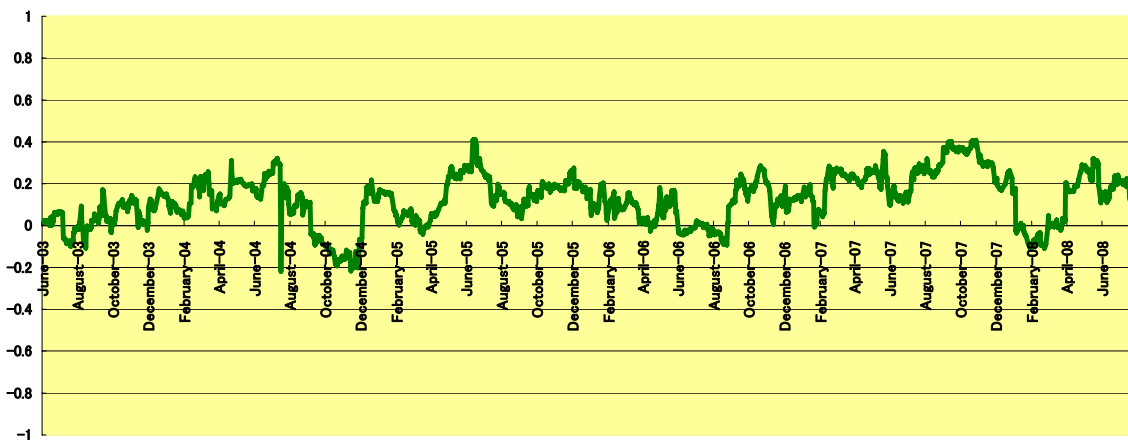


Figure 12: History of Correlation Coefficient of Daily Returns (Japanese REIT versus European REIT / 60 business day basis)



However, even there it appears to be a certain level of correlation in terms of the average value of returns between global REIT indices of nations, the correlation coefficient between J-REIT returns and U.S. REIT returns and the correlation coefficient between J-REIT returns and European REIT returns are moving at a level close to 0, as shown in Figures 11 and 12. While they show some correlation in terms of movement, most likely, because of the difference in phases, the result is a low correlation in terms of returns. This is in contrast with the extremely high correlation coefficient between J-REIT returns and TOPIX returns. In Japan, while we cannot expect to receive the merits of a lower risk by diversifying investment by investing in J-REITs and TOPIX, we can count on receiving the merits of a lower risk through the diversification of REIT investment on an international level.

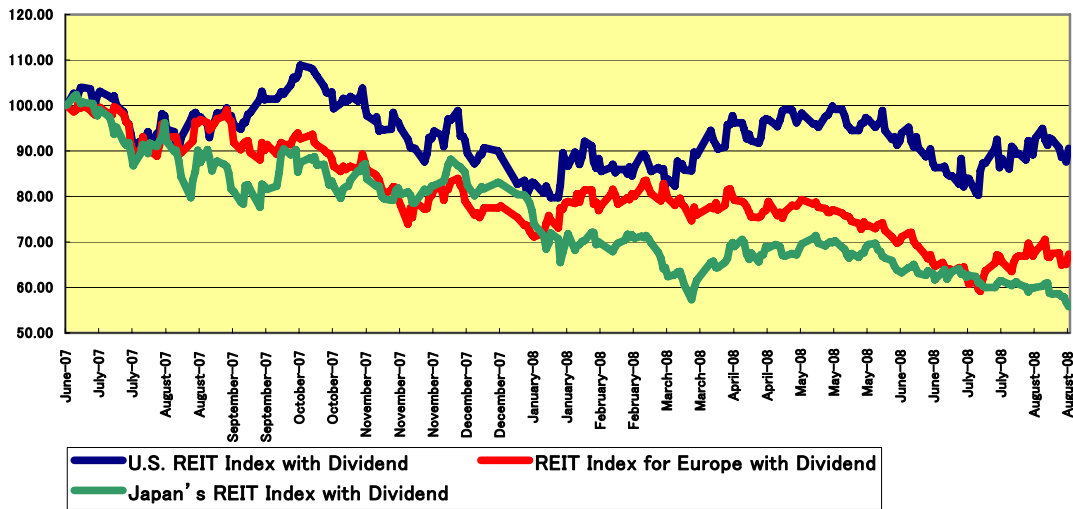
In this respect, it can be said that the expanding needs for diversifying investments on an international basis is a natural flow of events and may expect the further globalization of the real estate investment market.

5. Expectations of the Smooth Functioning of the Market Mechanism

As a result of incorporating real estate into financial products and of market globalization, the performance of real estate securitization products such as J-REIT, etc. is not only affected by the performance of the real estate that is incorporated into the product, but also is about to become affected by a number of factors, such as the movements of other financial assets, or the economic conditions of other nations, etc. Furthermore, since it can be estimated that listed J-REITs will become the investment target for funds that seek high liquidity, this tendency is especially strong for listed J-REITs. Therefore, a situation can be easily envisioned where a shock of some kind occurring in another nation spreading to the Japanese market, leading to the excessive fluctuation of J-REIT prices. It could even be said that the rise in J-REIT prices since the latter half of 2006 due to the purchases by foreign investors and the plunge of J-REIT prices as a result of the shock related to the U.S. subprime loan problem that followed, is one example.

As you can see, the performance of J-REIT may fluctuate due to a variety of factors. If J-REIT prices were to fluctuate greatly as a result of shocks occurring in other nations or other circumstances, then we can say that the resulting product characteristic of J-REIT differs from the characteristics of real estate, its underlying asset. If we focus our attention on such a point, then we may have difficulty in acknowledging J-REITs as a small-unit product from which we can receive the merits of

Figure 13: History of the REIT Price Index for Japan, the U.S. and Europe (with dividend) (100 = End of June 2007)



Compiled by ARES based on data provided by

its characteristics as a real estate product while maintaining liquidity.

Certainly, it is true that J-REITs have shown high volatility and can say that it has a different characteristic than that of real estate. Furthermore, while we do not necessarily expect it to occur frequently, we cannot deny the possibility of a similar case occurring again. However, even if supposedly J-REIT prices fluctuate excessively for some sort of reason, such as a shock occurring in another nation, etc., if prices were quickly adjusted back to their appropriate levels in a short period of time, then J-REITs can be said to be a product that basically possesses a characteristic similar to real estate. Furthermore, in order for J-REITs to possess this kind of characteristic on a medium-to-long-term perspective, the smooth functioning of the market mechanism is the key.

Figure 13 indicates the history of major REIT price indices of the world, with the index values at the end of June 2007 standardized at 100.

Firstly, if we look at the U.S. REIT Index, it is characteristic that there are a number of times when prices correct slightly after decreasing to a certain extent. As a result, U.S. REIT prices have not decreased as much as J-REITs or European REITs. It can be said that in the U.S., which has the longest REIT history, people find themselves in an environment where it is easy to make predictions of the range of REIT price fluctuations based on past data. Therefore, it is suspected that the situation there is that when REIT prices have decreased to a certain degree, then investors who think that they are undervalued buy REITs at a relatively early timing, thereby making it

easy to evade excessive price decreases. In other words, it is inferred that in the U.S. REIT market, there has been prepared an environment in which the market mechanism can function relatively easily.

On the other hand, J-REIT prices continued to decrease without rebounding much, and as a result, the range of price decrease became large. In Japan, since the history of the REIT market is short, there does not exist much past data. Because J-REITs have not undergone various economic phases, we cannot deny that it is difficult to predict how they will fluctuate or how they will perform on a medium-to-long-term perspective. Therefore, in Japan, even if J-REIT prices decrease to a certain degree, it would not be a surprise if it takes time for many investors to determine that they are undervalued and resume proactive investment. If that is the case, if supposedly the level of J-REIT prices decreases to a lower level than is appropriate, there is also the fear that those prices will not be corrected immediately. Needless to say, an important issue for the J-REIT market is how to avoid such a situation from now on.

6. Investor Expectations that Sway Price Movements

Amidst the severe changes in the market environment due to the shock stemming from the U.S. subprime loan crisis, the current J-REIT market is in the process of making adjustments as a market. Under such circumstances, it is a fact that J-REIT prices remain stagnant, but based on the solid movements of the real estate rental market, there should be many market players who expect the current situation to end. Of course, in the case that prices rise exceedingly, it is true that the real estate securitization market is expected to attain fair pricing by subduing prices through its market mechanism. Thus some may be of the view that, if the recent decrease in J-REIT prices is viewed as something that arises during the process of price adjustment, then it should not be necessarily become cause for pessimism. However, as we mentioned before, despite J-REIT prices having decreased to an undervalued level, it is possible that buying is not taking place because investors find themselves in a situation where it is difficult to determine whether that is so. There may also be the view that J-REIT prices are continuing to fall despite solid movements in the real estate rental market precisely because of the phenomenon mentioned above.

Only, whatever the case, because the majority of assets held by J-REITs are real estate, a real asset, and because of the low debt ratio of J-REITs, the possibility of J-REIT prices getting infinitely close to zero should not be high. In other words, it can be expected that the decrease of J-REIT prices will end sometime. Therefore, as J-REIT

prices fall to a great extent, the number of investors who expect a recovery of prices as they seek opportunities for investment should increase and would look for the right timing to buy J-REIT.

Even so, it is not easy to predict how much further J-REIT prices will fall and when those prices will head for recovery. Both of these would depend upon the expectations of qualified institutional investors who are to become the providers of loans to J-REIT as well as the expectations of investors who make an investment in J-REIT investment units. If supposedly investors become overly pessimistic, even if J-REIT prices fall under the appropriate value, there is the possibility that J-REIT prices may fall even further. In order to avoid that kind of situation, it is important to establish a market environment in which a large number of investors can put their trust in, based on expectations that even if J-REIT prices deviate excessively from appropriate levels, they will adjust back to appropriate levels in the short term.

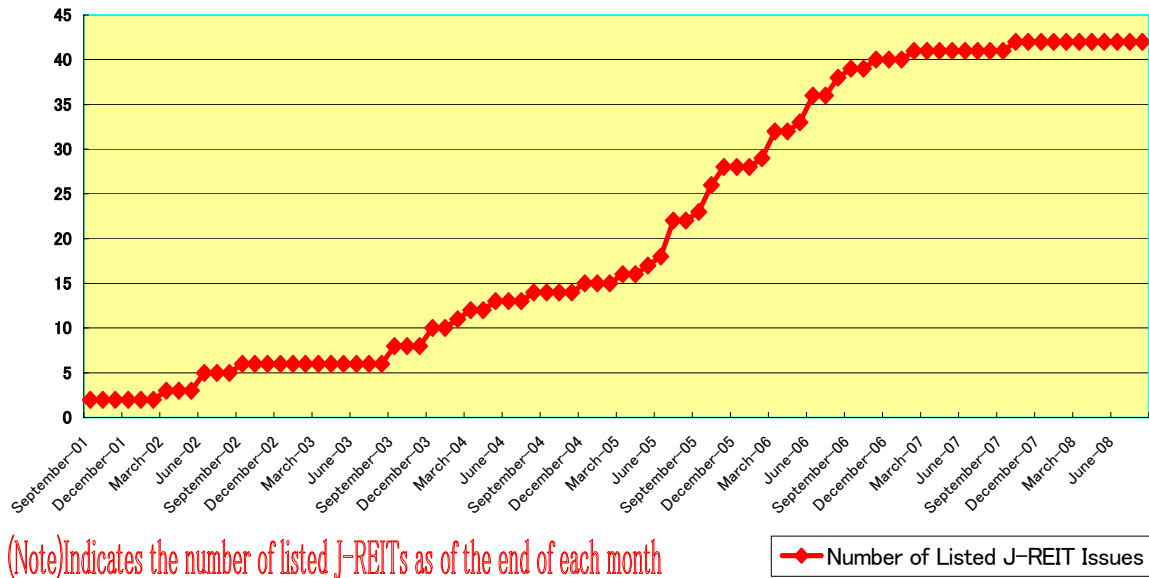
Of course, in order to realize such a market environment and considering that J-REIT must face various phases going forward, it is true that there is an even greater need for gaining understanding about the Japanese real estate cycle and the volatility of J-REIT prices, etc. On the other hand, it is also important to take the necessary process, before this kind of long period of time passes, of conducting activities to establish a market environment in which it is easy for the market mechanism to function. For example, if we can ensure a route for transmitting information in an easily understandable manner to investors from among the abundant disclosure information by J-REIT, it would become easier for investors to make investment decisions on J-REIT. Furthermore, by establishing an environment where it is easy to access J-REIT market data, many market players would analyze J-REIT data, making the product characteristic of J-REIT easier to understand.

The “J-REIT View” and “ARES J-REIT Property Database”, both information services provided via website by the Association for Real Estate Securitization (http://www.ares.or.jp/en/index_en.html), precisely fall under such activity.

Of course, as the J-REIT market matures over time, it is also important to inspect on a regular basis, whether a structural factor that prevents the smooth functioning of the market mechanism has arisen and to work towards solving such problems as necessary.

7. Future Outlook of the Market

Figure 14: History of the Number of Listed J-REIT Issues



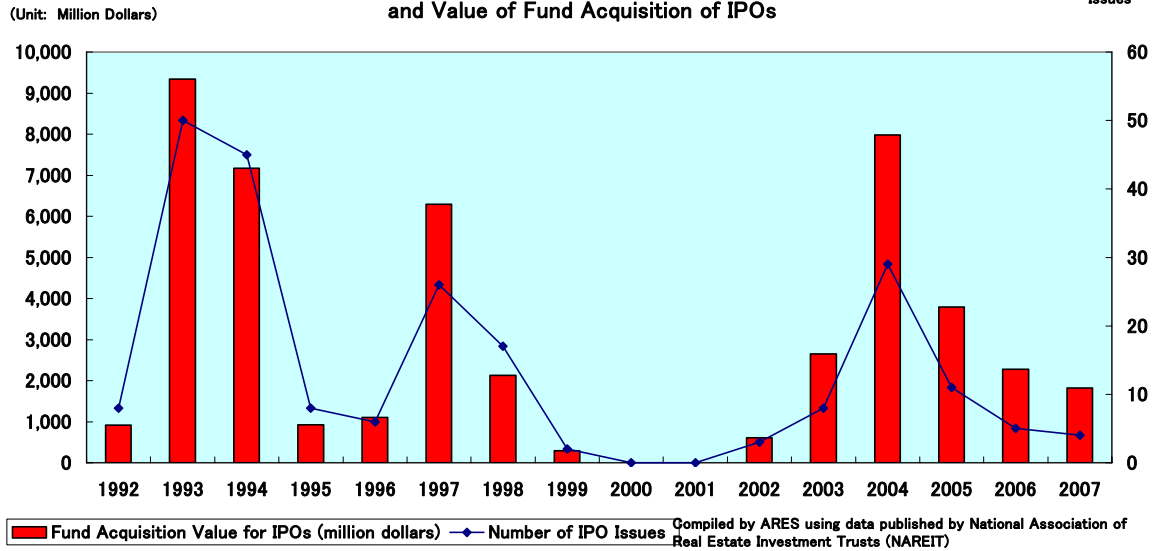
There are a growing number of cases where IPO applications have either been postponed or cancelled, and as Figure 14 indicates, the number of newly listed J-REITs is significantly decreasing.

Additionally, there are even cases where the acquisition of properties are not conducted according to schedule, or cancelled also causing the situation in which individual J-REITs find it difficult to expand assets. In view of these circumstances and the decrease of J-REIT market capitalization etc., it might seem that the expansion of the J-REIT market has ended. However, the scope of expansion of the J-REIT market is still extremely large.

The greatest reason is that in Japan, only a fraction of profit-generating real estate has been securitized. Currently, it is expected that there will be the acquisition of high quality real estate not yet securitized owned by companies, etc. by J-REITs.

Furthermore, on a GDP basis, despite the scale of the Japanese economy amounting to about one third of that of the U.S., Japanese REIT market capitalization amounts to a scale that slightly is above one eighth of that of the U.S. When taking into consideration the scale of the Japanese economy, it will not be a surprise should the REIT market in Japan expand even further. Furthermore, it is normal for the rate of expansion to change largely depending on market conditions. So as long as there is ample room for the J-REIT market to grow, even if the market expansion deteriorates as

Figure 15: U.S. REIT: History of the Number of IPO Issues and Value of Fund Acquisition of IPOs



it is doing now, there is enough possibility for the market to return to an expanding trend yet again. As Figure 15 indicates, in the U.S. as of recent times, there were times when the number of new listings fell due to the deterioration in the capital markets, but in 2004, there once again arrived a wave of new listings along with the recovery of market conditions. We can also envisage a similar scenario for Japan.

It cannot be denied that the first full-fledged price slump experience by the J-REIT market led to market turmoil. Due to this, we find ourselves in a situation where it is difficult to predict short-term market trends. However, on a medium-to-long-term perspective, it can be said that the real estate market in Japan, like other nations, is cyclic and it can be anticipated that prices of real estate securitization products, such as REITs, will become adjusted within a range that does not excessively deviate from a fair value, considering the fluctuation of real estate prices. The current situation shall be considered not merely as a change in market trends, but as an important turning point towards the aforementioned future vision.