MIRAI Corporation (3476)

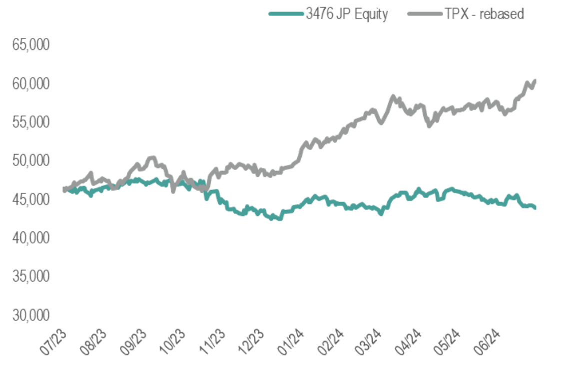
Poised to benefit from a positive operating environment

16 July 2024

FP4/24 results update

Share price: ¥44,850 **Market cap: ¥85.5bn**

- **Exceeding company's estimate** – FP4/24 results beat company guidance for NOI (net operating income). NOI increased due to lower-than-expected repair costs as a result of changing hotel operators, improved utility expenses, and higher-than-expected hotel rental income. Cost management was achieved through effective asset management and support from the Mitsui Group, which provided enhanced bargaining power for various asset running costs despite inflationary pressures. As a result, the expense ratio remained at 32.2%. Costs of borrowing were 0.66% in FP4/24 (0.61% in FP10/23 and 0.59% in FP4/23), despite a rising interest rate environment, reflecting high creditworthiness supported by Mitsui & Co's sponsorship.



Source: Bloomberg

Cost efficiency amidst inflation

- **Upgrading our earnings estimates** – we upgrade our earnings estimates for FY10/24 and beyond. We expect expense ratios to revert to the pre-COVID historical level and remain steady at 33% between FY10/24 and FY10/26. We remain bullish on operating revenue and NOI expansion in the long term. We adjust our DPU and EPU estimates, reflecting dilution associated with the 5th PO carried out in November 2023 (¥5.3bn raised from issuance of 136,000 units).
- **Valuations** – on our revised estimates, the shares are trading on P/NAV FY10/25 of 0.72x and a dividend yield of 5.9%.

Year-end	FY10/22	FY10/23	FY10/24E	FY10/25E	FY10/26E
Operating revenue (¥bn)	10.94	12.05	12.85	13.25	14.67
NOI (¥bn)	7.43	7.43	8.61	8.88	9.83
NP (¥bn)	4.57	4.60	4.93	5.09	5.63
EPU (¥)	2,579	2,597	2,586	2,667	2,952
DPU (¥)	2,580	2,520	2,560	2,667	2,952
Sales growth YoY (%)	+8.5	+10.2	+6.6	+3.1	+10.7
NOI growth YoY (%)	+11.9	-0.1	+16.0	+3.1	+10.7
NP growth YoY (%)	+8.4	+0.7	+7.2	+3.1	+10.7
EPU growth YoY (%)	+1.7	+0.7	-0.4	+3.1	+10.7
DPU growth YoY (%)	+1.7	-2.3	+1.6	+4.2	+10.7
P/NAV (x)	0.88	0.85	0.72	0.72	0.66
PER(x)	17.4	17.3	17.3	16.8	15.2
Distribution yield (%)	5.8	5.6	5.7	5.9	6.6
AFFO yield (%)	7.3	6.5	6.7	7.2	7.8
FFO/Unit	3,250	3,149	3,090	3,221	3,565
FFO payout (%)	79.4	80.0	82.9	82.8	82.8
AFFO payout ratio (%)	79.4	80.0	82.9	82.8	82.8

Source: Company, Astris Advisory (estimates)

Price Performance

	YTD	1M	3M	12M
Abs (%)	+3.2	+0.8	-1.6	-3.3
Rel (%)	-15.9	-4.7	-6.8	-25.5

Company sector

REITS-Diversified
Office REITs (GICS)

Stock data

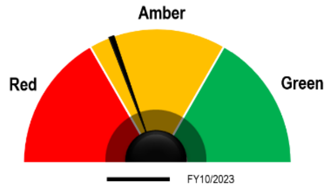
Price (¥)	44,850
Mkt cap (¥bn)	85.5
Mkt cap ($m)	539.5
52-week range (¥)	42,350-47,900
Shares O/S (m)	1.9
Average daily value ($m)	1.8
Free float (%)	99.0
Foreign shareholding (%)	16.1
Ticker	3476
Exchange	TSE
Net Debt/Equity (x)	1.0
FFO leverage (x)	6.5
BBG BUY | HOLD | SELL	0 | 0 | 0

Source: Bloomberg

Business Overview

MIRAI Corporation is a mid-sized, diversified J-REIT jointly owned by Mitsui & Co. and IDERA Capital Partners.

Astris-Sustainability ESG rating



Reference Ratings	
MSCI	N/A
Sustainalytics	N/A
Refinitiv	N/A
S&P Global	1.0
Bloomberg	1.28
CDP	N/A

Next events

FP10/24 results December 2024

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Recent results

FP4/24 NOI exceeded the company's expectations due to variable rent hikes for hotels and impressive cost control with effective asset management skills

Key financials

(¥bn)	14th FP 4/23	16th FP 4/24	YoY (%)	16th FP 4/24 Guidance	17th FP 10/24 Guidance	18th FP 4/25 Guidance
Operating revenue	6.31	5.89	**-6.7**	5.86	6.15	6.08
Real estate expenses	2.01	1.89	-5.6	2.02	2.09	1.96
Net operating income (NOI)	**3.68**	**3.99**	**+8.7**	**3.85**	**4.06**	**4.13**
Other expenses - total	1.23	1.75	+42.5	1.73	1.80	1.82
Net income	**2.45**	**2.24**	**-8.3**	**2.11**	**2.26**	**2.31**
DPU	1,305	1,150	-11.9	1,150	1,185	1,210
FFO payout ratio (%)	73.9	72.7		70.0	73.8	73.8

Source: Company

Office revenue is expected to remain solid whilst retail and hotel are expanding

Per business segment

(¥bn)	14th FP 4/23	16th FP 4/24	YoY (%)	16th FP 4/24 Guidance	17th FP 10/24 Guidance	18th FP 4/25 Guidance
Operating revenue	**6.31**	**5.89**	**-6.7**	**5.86**	**6.15**	**6.08**
Lease business revenue						
Office	2.31	2.38	+3.2	2.38	2.37	2.42
Retail	1.15	1.25	+8.7	1.21	1.34	1.28
Hotel	0.73	0.85	+16.6	0.81	0.89	0.95
Residential	0.01	0.07	+490.9	0.07	0.07	0.07
Others	0.45	0.45	-	0.46	0.46	0.46
Other lease business revenue	1.03	0.89	-13.9	0.94	1.03	0.91
Gain on sales of real estate properties	0.63	0.00	-100.0	0.00	0.00	0.00

Source: Company

Key highlights

FP4/24 results highlighted improving operating environments across all asset types and impressive cost management, leading to higher NOI than guidance.

The company initially expected to achieve the DPU target for FP4/24,in part by utilizing retained earnings. However, it was able to meet its target without tapping into retained earnings against a backdrop of positive performance. Furthermore, profit (EPU) exceeding guidance of ¥1,150 and was added to internal reserves as future provisions. The company announced DPU targets of ¥1,185 for FP10/24 and ¥1,210 for FP4/25, that it expects to meet without having to draw down on retained earnings. Retained earnings (¥188m) will be maintained at the current level to respond to any unexpected cost inflation and NAV dilution should circumstances require.

MIRAI has been reconstructing its portfolio to increase weighting for hotels with variable rents. This will allow MIRAI to better capture upside from variable rents due to upward pressure on hotel rents on the back of strong inbound and travel demand in Japan. Also, about 45% of the portfolio has tenancy contracts expiring by 2027, providing opportunities to set higher rents at tenancy renewal. With such characteristics, MIRAI's portfolio has become increasingly resilient and can offset negative earnings impact from higher interest rates.

The following are highlights by asset type:

- **Office** – **improving office occupancy rates**

  Larger offices located in the seaside area such as Shinagawa Seaside Parktower and Tokyo Front Terrace saw occupancy rates trending above average occupancy rates in the area. Although longer free rent periods are often set for new leasing properties, rental revenue is expected to increase after the end of the free rent period. We continue to view MIRAI's mid-sized office buildings as well positioned against an excess supply of large office buildings expected in 2025 as mid-sized offices are expected to see limited new supply and the locations of outside of central Tokyo.

- **Commercial properties** – **Positive momentum continues**

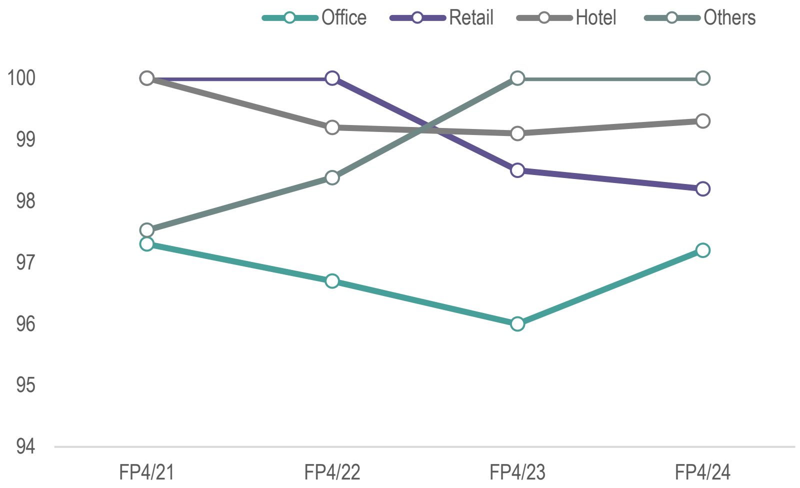
  Commercial properties are expected to enjoy recovering consumption on the back of a post-COVID economic normalization and inbound demand. MIRAI is considering more proactive investments in urban commercial properties to capture a recovering trend in mobility and consumption. In addition, the company does not rule out purchasing commercial properties with fixed rents as long as valuations are reasonable.

- **Hotel** – **Positive momentum continues**

  The operating environment is trending positively. Construction costs continued to increase, limiting new supply of budget-type hotels offering lower price points. Furthermore, inbound demand continued to be strong. As a result, we believe MIRAI will be able to increase variable rents. MIRAI plans to expand variable rent contracts going forward, which will increase the upside even further.

Occupancy rates trend strongly above 97% for all asset types.

Occupancy rates by asset type (%)

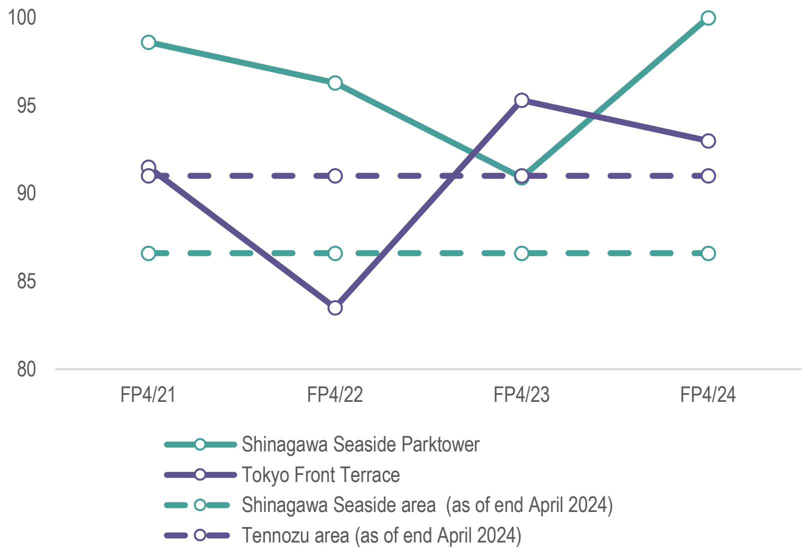


Notes: Mi Nara is included in others in FP4/21 and FP4/22. Occupancy rates for others in these periods are calculated by taking the average occupancy rates of other properties including Mi Nara. Mi Nara is added to Retail from FP4/23.

Source: Company

MIRAI's occupancy rates are trending higher than comparable office buildings in seaside areas

Occupancy rates of MIRAI's larger office buildings (%)



Source: Company

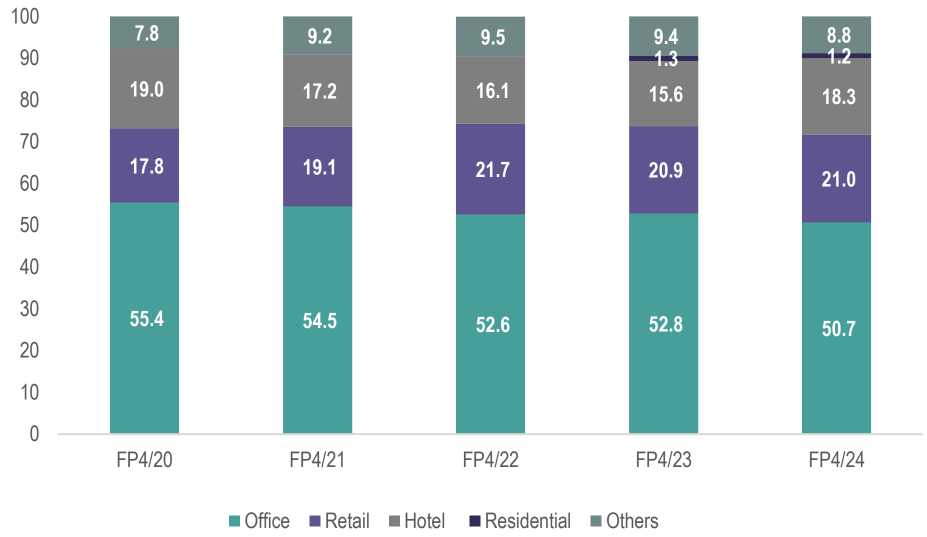
MIRAI's portfolio is getting more benefits from geographical diversification

MIRAI's portfolio by location (%)

Source: Company

Portfolio weighting shifted away from office to hotel

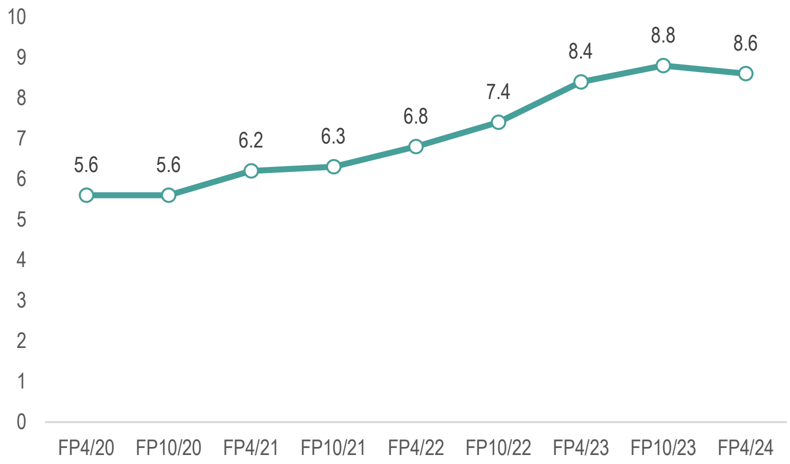
MIRAI's portfolio by location (%)



Source: Company

Unrealized gain margins remain high after the acquisition of new assets

Unrealized gain margins (%)



Source: Company

Astris earnings estimates and key assumptions

We have revised our earnings estimates reflecting the following:

- Ability to contain cost inflation through leveraging the Mitsui & Co sponsorship
- Continous expense control will lead to steady expense ratios and higher NOI

Our key earnings forecasts are as follows:

Astris Advisory earnings estimates

Year-end	FY10/24E OLD	FY10/24E NEW	FY10/25E OLD	FY10/25E NEW	FY10/26E OLD	FY10/26E NEW
Revenue (¥bn)	**12.85**	**12.85**	**13.25**	**13.25**	**14.67**	**14.67**
YoY (%)	+6.6	+6.6	+3.1	+3.1	+10.7	+10.7
NOI (¥bn)	**7.64**	**8.61**	**7.92**	**8.88**	**9.02**	**9.83**
YoY (%)	+2.9	+16.0	+3.6	+3.1	+13.9	+10.7
NOI Margin (%)	59.5	67.0	59.8	67.0	61.5	67.0
NP (¥bn)	**4.80**	**4.93**	**4.98**	**5.09**	**5.67**	**5.63**
YoY (%)	+4.4	+7.2	+3.6	+3.1	+13.9	+10.7
EPU (¥)	**2,711**	**2,586**	**2,810**	**2,667**	**3,200**	**2,952**
YoY (%)	+4.4	-0.4	+3.6	+3.1	+13.9	+10.7
DPU (¥)	**2,575**	**2,560**	**2,650**	**2,667**	**3,100**	**2,952**
YoY (%)	+2.2	+1.6	+2.9	+4.2	+17.0	+10.7

Notes: EPU and DPU were adjusted, reflecting the 5th PO carried out in November 2023 with an issuance of 129,500 units.

Source: Astris Advisory

The core assumptions for our estimates are as follows:

- **Revenue growth** – single-digit revenue growth expectations in FY10/24 and FY10/25 followed by double-digit growth in FY10/26. We believe internal growth from office operations will be the most important driver for growth given more than 50% of the portfolio is offices.
- **Profitability** – an improvement in NOI margin with increasing revenue YoY and effective expense control; internal growth will drive a margin recovery.
- **DPU** – the company is guiding for a ¥1,300 (semi-annual) DPU target in the current medium-term management plan running through the end of 2025. We expect DPU target to be met primarily through internal growth combined with external growth.

Summary

MIRAI Corporation ("MIRAI") is a **diversified J-REIT jointly sponsored by Mitsui & Co. (8031) and IDERA Capital Management (majority owned by the Fosun Group (0656 HK)).** Almost half of the assets consist of B-class office properties in three metropolitan areas (Tokyo, Osaka, and Nagoya), which have limited supply and will face a smaller risk of rental reductions than the larger A-class office buildings.

The four largest B-class office buildings with more than ¥10bn acquisition prices make up 36% of the portfolio as of April 2024. The rest of the properties are smaller with acquisition prices below ¥10bn. The variations in size and property type provide diversification.

More than 80% of its portfolio comprises properties in major metropolitan areas in Tokyo, Osaka, and Nagoya. The company plans to expand AUM to ¥200bn during the current medium-term plan, which will bring more diversification to the portfolio. Five properties have been added in FP4/24 after the fifth PO as part of a post-COVID reversal. There was limited AUM expansion during the pandemic when the market was stagnant because the company's focus was more on portfolio reconstruction to enhance the stability of the portfolio than expansion of assets.

As part of its external growth strategy, MIRAI will focus on properties that can benefit from structural changes such as domestic inflation and further improvement in inbound demand from overseas, rather than being confined to investment ratios by asset type alone. Specifically, this may involve introducing variable rents in hotels, including those with expiring contracts, as well as considering urban commercial facilities that are more likely to benefit from inflation or have rents linked to sales. Furthermore, there is an expectation that opportunities for external growth through M&A, backed by the creditworthiness of sponsor Mitsui & Co., will also be pursued.

Major Japanese credit agency JCR has an A+ credit rating for MIRAI but revised its outlook from stable to positive in February 2024. The reasoning was based on an expectation of stable cash flows driven by MIRAI's efforts to add more defensiveness to its portfolio. As it continues to expand AUM, the likelihood of a credit rating upgrade will increase, in our view. Any upgrade would open up investment in MIRAI to regional financial institutions that invest in J-REITs, but only those with credit ratings of AA or higher.

The company has embarked on a medium-term strategy (2022-25) based on the following (all increases are compared to FP10/21):

- **DPU: ¥1,300 (vs. ¥1,289 in FP10/21)**
- **NAV/U: Over ¥53,000 (CAGR about +2%)**
- **AUM: ¥200bn (CAGR about +7%)**

Astris Advisory estimates MIRAI Corporation will drive medium-term growth via the following factors:

- **Termination of free rent periods and rent holidays –** the main driver for internal growth in our view as more than 50% of the portfolio consists of offices that will benefit from the termination of free rent periods (a period of rent exemption after occupancy begins), which were offered to tenants after COVID-19 and rent

holidays (a period of rent exemption during a certain period of the contract term) in future.

- **Increasing variable rent ratio** – A shift towards tenancy contracts with variable rents will expand NOI and DPU on the back of inbound demand from overseas, a strong appetite for domestic travel, and domestic inflation. In particular, hotels and urban retail properties should benefit.
- **Improving profitability through office conversions for hotels** – MIRAI's proven track record in enhancing asset value through operational optimization. For instance, it has improved profitability by converting some hotels that went bankrupt during the pandemic into serviced offices.
- **Acquisition of properties** – We believe external growth through property acquisitions with POs will be a key driver.

Whilst there is a near-term headwind against offices in Tokyo due to excess supply of S and A class offices, we believe this impact is somewhat mitigated for MIRAI due to their exposure to mid-sized offices where new supply is relatively limited. The mid-sized office market has limited new supply due to budget constraints associated with recent increases in construction costs. This is why MIRAI puts more focus on mid-sized offices.

Company description

Overview

MIRAI is a diversified J-REIT jointly sponsored by Mitsui & Co. and IDERA Capital Management. Listing on the Tokyo Stock Exchange in 2016, it was added to the FTSE/EPRA Nareit Global Index in 2021. Its investment fund is classified as a diversified REIT with more than **50% invested in offices, about 21% in retail, and about 18% in hotels** as of April 2024. Regionally the focus has been on three metropolitan areas (Tokyo, Osaka, and Nagoya) with high population concentrations. Properties in these areas make up more than 80% of the portfolio. **Most properties are classified as B-class** which is defined as buildings older than 15 years and below 30,000 m^2 in size. Unlike A-class offices which target a smaller number of large domestic and foreign corporates, it is relatively easier for B-class office buildings to maintain more stable occupancy rates and more sustainable cash flows over time because of a broader tenant base and limited new supply.

Assets under management totaled ¥178.2bn as of April 2024 with an appraisal value of ¥196.2bn and an occupancy rate of 98.3%. Appraisal NOI yield (based on appraisal value) is 4.7% based on purchase value.

A key competitive strength lies in credit enhancement opportunities backed by Mitsui & Co.'s creditworthiness. The credit rating by JCR is already A+ but given a credit rating upgrade in February 2024 from Stable to Positive, a potential improvement towards AA- or higher could further expand the investment universe to include local financial institutions that can only invest in J-REITs above an AA credit rating.

Timeline summary

Key dates	Details
November 2015	Establishment of MIRAI Corporation by Mitsui & Co. & IDERA Partners
December 2016	**IPO**
May 2018	**1st PO (public offering)**
October 2018	**2nd PO**
July 2019	Attempt to rescue Sakura Sogo REIT Investment as a white knight from Star Asia Group's TOB. The acquisition would have expanded MIRAI's AUM above ¥200bn, facilitating inclusion into a global index. This was the first TOB in the J-REIT sector.
August 2019	The attempt of the white knight fell short. Sakura Sogo was acquired by Star Asia at the end
December 2019	**3rd PO**
December 2021	**Inclusion into the FTSE/EPRA Nareit Global Index**
December 2021	**4th PO**
November 2023	**5th PO**
February 2024	**JCR improved MIRAI's outlook from stable to positive on an A+ credit rating**

Source: Company

Financial Summary

Income statement (¥bn)	FY 10/22	FY 10/23	FY 10/24E	FY 10/25E	FY 10/26E
Operating revenue	**10.94**	**12.05**	**12.85**	**13.25**	**14.67**
Real estate expenses	3.40	4.00	4.24	4.51	4.91
Net operating income (NOI)	**7.43**	**7.43**	**8.61**	**8.75**	**9.75**
NOI margin (%)	67.9	61.6	67.0	66.0	66.5
Depreciation expense	1.30	1.39	1.54	1.66	1.83
Other operating expenses	1.08	1.16	1.03	0.99	1.28
Interest & other expenses	0.59	0.60	0.31	0.42	0.53
Tax expense/benefit	0.00	0.08	0.02	0.02	0.02
Net income	**4.57**	**4.60**	**4.93**	**5.09**	**5.63**
Sales growth YoY (%)	+8.5	+10.2	+6.6	+3.1	+10.7
NOI growth YoY (%)	+11.9	-0.1	+16.0	+3.1	+10.7
NP growth YoY (%)	+8.4	+0.7	+7.2	+3.1	+10.7
EPU growth YoY (%)	+1.7	+0.7	-0.4	+3.1	+10.7
DPU growth YoY (%)	+1.7	-2.3	+1.6	+4.2	+10.7

Cash flow statement (¥bn)	FY 10/22	FY 10/23	FY 10/24E	FY 10/25E	FY 10/26E
FFO	5.76	5.37	5.89	6.14	6.80
Capital expenditure	(11.79)	(11.22)	(17.99)	(7.95)	(14.67)
Cash from investing	**(11.44)**	**(11.13)**	**(17.99)**	**(7.95)**	**(14.67)**
Dividends paid	(4.38)	(4.64)	(4.88)	(5.09)	(5.63)
Cash from financing	**5.86**	**(3.14)**	**6.93**	**(0.35)**	**2.19**
Net cash flow	**2.26**	**(1.49)**	**(4.06)**	**(1.04)**	**(3.26)**
Free cash flow	**(3.95)**	**1.56**	**(10.99)**	**(0.69)**	**(5.45)**
EBITDA	6.46	6.68	7.58	7.88	8.55

Balance sheet (¥bn)	FY 10/22	FY 10/23	FY 10/24E	FY 10/25E	FY 10/26E
Real estate portfolio	164.67	167.80	184.25	190.54	203.38
Cash and cash equivalents	4.51	3.00	(1.06)	(2.10)	(5.36)
Accounts &notes receivables	0.26	0.26	0.27	0.28	0.31
Other long-term assets	0.72	1.05	1.05	1.05	1.05
Restricted assets	2.63	2.64	2.64	2.64	2.64
Total assets	**172.79**	**174.75**	**187.16**	**192.42**	**202.03**
Accounts payables	0.71	0.74	0.78	0.81	0.90
Short-term liabilities and deposit	7.06	7.00	7.50	8.00	9.70
Unsecured debt	84.00	85.50	91.30	96.04	103.86
Secured debt	0.00	0.00	-	-	-
Other long-term liabilities	0.00	0.12	0.12	0.12	0.12
Total liabilities	**91.76**	**93.35**	**99.70**	**104.97**	**114.57**
Minority interest	0.00	0.00	-	-	-
Shareholder equity	81.03	81.39	87.46	87.45	87.45
Total equity	**81.03**	**81.39**	**87.46**	**87.45**	**87.45**
Total liabilities & equity	**172.79**	**174.75**	**187.16**	**192.42**	**202.03**

Key metrics	FY 10/22	FY 10/23	FY 10/24E	FY 10/25E	FY 10/26E
P/NAV (x)	0.88	0.85	0.72	0.72	0.66
P/E (x)	17.4	17.3	17.3	16.8	15.2
Dividend yield (%)	5.8	5.6	5.7	5.9	6.6
AFFO yield (%)	7.3	6.5	6.7	7.2	7.8
EPU	2,579	2,597	2,586	2,667	2,952
DPU	2,580	2,520	2,560	2,667	2,952
FFO Payout ratio (%)	79.4	80.0	82.9	82.8	82.8
AFFO Payout ratio (%)	79.4	80.0	82.9	82.8	82.8
FFO per unit	3,250	3,149	3,090	3,221	3,565

Source: Company, Astris Advisory (estimates)

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