

Revisions of Rating Methodologies by Sector "Retail" and "Railroad"

Japan Credit Rating Agency, Ltd. (JCR) hereby announces that it has revised rating methodologies by sector "Retail" and "Railroad."

The revisions do not alter the framework, concept, treatment, or other details of the methodologies. Descriptions in the methodologies have been revised to reflect recent trends and other factors in the explanation of industry characteristics that form the backgrounds of the methodologies, or to make the explanation of the concept easier to understand. Therefore, there is no impact on individual ratings.

The revised rating methodologies will be posted on the page of "Rating Methodologies: Corporates" (https://www.jcr.co.jp/en/rrinfo/meth_corp/) of JCR's website.

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JCR publishes its press releases regarding the rating actions both in Japanese and in English on the same day. In case that it takes time to translate rating rationale, JCR may publicize the summary version, which will be replaced by the full translated version within three business days. (Regarding Structured Finance products, JCR only publicize the summary version in English.)

Rating Methodology by Sector

Retail

This rating methodology is primarily applicable to multi-store retail chain operators such as supermarkets, convenience stores, home improvement centers, and electronics retail stores, excluding mail-order businesses. In addition, there are some cases where this rating methodology may not apply partly to department stores, which essentially function as “space rent” businesses rather than conducting their own sales under tenants’ single-store operating method.

1. Business base

Retail is basically a domestic industry, making it largely influenced by domestic consumer trends. However, when examining individual companies, there are companies that achieve growth in performance regardless of macro consumption and industry trends. Therefore, while macro consumption and industry trends are considered in the rating assessment, JCR considers characteristics of each company's business model, competitive advantages, risk characteristics, and other factors.

(1) Characteristics of the industry

(i) Market overview

Many companies in Japan’s retail industry primarily operate in domestic market. Some have expanded into overseas markets, but few have reached a point where their overseas operations significantly contribute to overall performance. Consequently, retail companies are highly susceptible to domestic trends of business, employment, income, demographics, etc. Although some companies benefit from inbound demand, but fluctuations in exchange rates can reduce this demand, impacting their performance in some cases.

With overall consumption expected to shrink over the long-term associated with the decline in the total domestic population, retail industry as a whole is positioned as a mature industry. However, as the aging population and declining birthrate progresses, consumption structures and consumer behaviors are to be significantly changing from the past, while traditional consumer markets are shrinking, there are some new markets that are expanding such as markets targeting the elderly.

Looking at the history of retail, the central players in the market have shifted from department stores to general merchandise stores, and then to convenience stores, showing the rise and fall of different business categories. Furthermore, specialty clothing stores, electronics retail stores, and drugstores have also increased their presence. Additionally, demand for e-commerce (EC) is growing, and there are multi-store retail chain operators who are focusing on their EC businesses.

As described in the above, within the retail industry itself, growth stages vary by business category. Consequently, JCR incorporates not only macro consumption trends but also market trends by business category in the individual evaluations.

(ii) Competitive situation

In the retail industry, excluding convenience stores, degree of market oligopoly by top companies is not particularly high, resulting in a situation where excessive number of stores operate and compete, often termed “over store.” However, anticipating market contraction due to population decline, particularly in regional areas, restructuring such as management integration, led by major companies, is progressing.

Under such circumstances, local chain operators maintaining high market share in specific regions also exist. When such local chain operators in a specific region expand their areas into neighboring areas, there are cases where competition with leading local chain operators in those regions intensifies.

Furthermore, rise of specialty store business categories, such as specialty clothing stores, electronics retail stores, and drugstores, has led department stores and general merchandise stores to lose their market shares in part of their categories to these specialty stores. Competition is intensifying not only within the same business category but also across different business categories.

JCR confirms changes in the competitive situation of each company and focuses on their effect on the business base in the medium- and long-term.

(iii) Cost structure

Retail is a labor-intensive industry, where labor costs in general constitute the largest expense item within SG&A expenses. Retailers operating chain stores, in particular, require massive manpower for tasks like cashier operations, merchandise display, and in-store processing. However, amid a declining population, labor shortages are worsening, leading to increased labor cost burdens. Against this backdrop, retailers are advancing initiatives like introducing self-checkout and semi-self-checkout systems and establishing process centers to reduce in-store operations. Promoting labor-saving measures is important, and JCR focuses on trends in the labor cost ratio.

Furthermore, as a process industry with numerous stores, proportion of fixed costs related to facilities, such as depreciation expenses and rent, is relatively high. JCR confirms whether rising fixed costs like labor costs and rent will push up the break-even point and squeeze profits, as retailers promote store expansion.

(2) Key factors in market position and competitiveness

(i) Market position

Within the retail industry, some business categories or companies even with large sales scale are seeing their earnings strengths declining due to changes in the external environment. Current sales scale or ranking does not necessarily lead to their competitive strength.

Some companies hold low national market share but hold high market shares in specific regions. For food

supermarkets, product assortments reflecting regional characteristics are important for gaining consumer support. Even with low sales volume or national market share, strong competitiveness within specific regions can be highly valued in some cases.

(ii) Competitiveness of existing stores

For companies operating chain stores, strength of their business base and basis for earnings strength are derived from competitiveness of existing stores. JCR therefore evaluates whether a retail chain operator has a comparative advantage or lags behind by comparing and analyzing the year-on-year changes in sales of existing stores against the industry average and those of competitors. Furthermore, by breaking this down into factors such as the number of customers, sales per customer, average sales per item, and the number of products sold, JCR confirms what factors are driving changes in the sales, whether the company is losing its ability to attract customers due to intensifying competition, whether the changes are due to price competition, or whether they are the result of changes in the company's product strategy.

(iii) Merchandising skills

In retail, differences in earnings strength arise from the effectiveness of product appeal, pricing strategies, and sales promotional methods. After understanding characteristics of merchandising policies such as competitive strength by product category, differentiation through price appeal or customer services, and sales promotions like EDLP (Everyday Low Price) strategies, flyer-based special sales, and point giving, JCR will focus on whether these are appropriate strategies given consumer trends and each company's specific situation.

Furthermore, reducing cost of goods purchased is important factor for enhancing price competitiveness and gross profit margin. In recent years, many retail chain operators have leveraged economies of scale with the expansion of retail operations to develop private brand products, selling items at lower prices and higher gross profit margins than national brands. JCR confirms the private brand product development strategy, sales performance, and contribution to gross profit margin improvement.

(iv) Store strategy

For retailers operating chain stores, store openings and renovations of existing stores are important strategies. Chain store theory suggests that store openings through dominant method, which is concentrating stores in specific area, offers advantages in logistics efficiency and increasing customer awareness. Furthermore, renovating aging stores is necessary to improve competitiveness of existing stores. Through store formats, store networks, logistics systems, future expansion plans, and existing store renovation strategies of individual companies, JCR examines the impacts on business base and earnings strength by region.

On the other hand, chain retailers often have unprofitable stores due to worsening profitability from changes in the trade area environment or delays in achieving profitability after the new store openings. For unprofitable stores, which carry impairment risks in the future alongside deteriorating performance, JCR confirms the company's store closure criteria and individual stores' response policies to assess their medium-to-long-term

impacts on earnings strength.

(v) Group capacity

Some relatively large retailers have multiple business categories or affiliated companies such as those for credit card business within their group. In such cases, JCR places emphasis on whether synergies between business categories within the group are functioning, or whether synergistic effects exist with related businesses. Furthermore, with limited growth prospects in the domestic market in recent years, an increasing number of retailers are strengthening their overseas expansion. JCR evaluates overseas business promotion plans and their impact on profit and financials to confirm whether the group as a whole can strengthen its business base over the medium to long term.

2. Financial base

(1) Earnings strength

While retailers can easily increase sales by opening new stores, foundation of their earnings strengths ultimately lies with existing stores. To measure earnings strength of those existing stores, JCR places emphasis on year-on-year changes in sales of existing stores as an important indicator. Except for some manufacturing retailers, retailers that primarily purchase goods from wholesalers and sell them to their customers generally do not exhibit high profitability such as operating margin. However, many maintain relatively stable profit levels compared to other industries. For companies in their growth phase, many experience a decline in operating margin as sales scale increases, even if they maintained high profitability when sales scale was small. Therefore, JCR will pay attention not only to the most recent level of operating margin but also to its long-term trend.

When evaluating the core business' earnings strength, JCR confirms trend in operating income. Additionally, JCR places emphasis on efficient profit generation from invested assets.

Key financial indicators:

- Year-on-year changes in sales of existing stores
- Operating margin
- Operating income
- Return on assets (ROA)

(2) Cash flow generation capability

In retail, cash flow patterns vary depending on the business categories. In businesses like food supermarkets that daily receive cash flow, turnover difference funds, which are funds generated due to longer payable conversion period than accounts receivable conversion period, increase cash flow generation capability. In contrast, businesses with a long inventory turnover period, such as home improvement centers, require working capital, resulting in a reduced ability to generate cash flow. There are also business categories where EBITDA and cash flow from operating activities are relatively larger than operating income as seen in cases of general

merchandise stores operating large shopping centers, which incur a large amount of depreciation expenses. JCR assesses debt repayment capacity after understanding these differences in patterns of cash flows generated by business type.

It is desirable that retailers operating chain stores reinvest the profits generated from existing stores in new stores. In reality, however, investment in new stores is often made through external financing. In this case, JCR confirms whether the invested capital is properly generating cash flows and is being recovered within a certain period of time.

Retailers often use leasing in opening new stores. For operating leases, if the lease assets are highly essential assets in operating business and have an impact on the balance sheet, JCR also considers adjusted financial statements reflecting this. Additionally, if the group operates financial businesses such as credit card companies or banks, interest-bearing debt related to these operations may also be adjusted in some cases.

Key financial indicators:

- Cash flow from operating activities
- EBITDA
- Ratio of interest-bearing debt to EBITDA
- Ratio of interest-bearing debt to cash flow from operating activities

(3) Safety

Stores that remain unprofitable for a certain period will be subject to impairment accounting assessments and subsequently record impairment losses. In the retail industry, impairment accounting assessments are basically conducted for each store, meaning new stores subject to impairment losses arise nearly every fiscal year. Particularly when the company's performance deteriorates, the number of stores triggering impairment accounting increases in a spiral pattern, significantly impacting the financials.

In the retail industry, promptly closing unprofitable stores is an important option for restoring performance. Furthermore, on a retail company's balance sheet, items like inventory and security deposits other than tangible fixed assets account for a relatively high proportion. Sufficient equity capital is necessary to withstand losses associated with evaluation as unprofitable stores, store closures, and inventory disposal, and JCR places importance in the adequacy of equity capital.

Furthermore, expanding retail operations requires continuous capital investments, including new store openings and renovations of existing stores. JCR confirms whether the company is being able to maintain the financial condition essential for smooth financing.

Key financial indicators:

- Impairment loss
- Shareholders' equity
- Equity ratio
- Debt equity ratio

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Rating Methodology by Sector

Railroad

This rating methodology is applicable to major private railway companies and JR passenger railway companies. In addition to transportation business centered on railway business, each company is engaged in related business such as real estate, retail, and hotels. Given the strong linkage between railway companies' transportation businesses and related businesses, the rating approach outlined below focuses primarily on railway business while also referring to related businesses as appropriate.

1. Business base

When rating railway companies, while JCR checks stability of cash flows from the railway business, which is a highly public infrastructure business, JCR evaluates each business individually for related businesses based on rating methodology applicable to the industry, to which such business belongs, and then conducts an assessment on a consolidated basis. In the assessment on a consolidated basis, JCR places emphasis not only on the evaluation of individual businesses and realization of synergies among them but also on changes in overall corporate risk associated with changes in the business portfolio.

(1) Characteristics of industry

(i) Market overview

Excluding the pandemic period, the number of railway passengers carried has generally remained steady. However, the impact of declining birthrate and aging population is unavoidable in the medium to long term. Due to the nature of the railway business as a domestic infrastructure industry, it is strongly influenced by regional factors (demographics, economic conditions, modal share, etc.). Consequently, companies are implementing measures to increase the resident population along their lines and to boost the exchange population through initiatives like revitalizing tourism resources in response to the declining birthrate and aging population. There are also efforts seen to enhance convenience and increase appeal of areas along the lines by expanding direct through-service operations with other railway companies' lines.

Regarding related businesses (real estate, retail, hotels, etc.), operations are often developed around major railway terminals and areas surrounding railway lines, with primary objectives being improvement of convenience for residents along the lines and enhancement of ability to attract customers of station facilities. Consequently, transportation business and related businesses are closely related. Therefore, for related businesses, JCR places emphasis not only on the standalone profit of each business but also on the realization of synergies between the railway business and these related businesses. Furthermore, when a company promotes overseas expansion in real estate or hotel businesses, JCR assesses not only profit performance but also regional risk diversification and risk mitigation status for each project.

(ii) Competitive situation

Railway business is a licensed business with approval from the Minister of Land, Infrastructure, Transport and Tourism required under the Railway Business Act. Entry barriers are high due to factors such as substantial capital required for extensive infrastructure development, long-term nature of capital recovery, and need for advanced train operation expertise. While competitors of private railways and JR conventional lines are buses and private cars, modal share varies by region, leading to the different competitive situations. Furthermore, since competitions among private railways and those between private railways and JR companies vary by region, JCR confirms the competitive situations and their impacts on the number of passengers carried for each major line.

Regarding the Shinkansen operated by JR companies, there is competition with aircraft. However, considering travel time and frequency of services, JCR judges that the Shinkansen maintains a significant advantage over aircraft within their operating areas.

(iii) Cost structure

While railway business is a typical process industry, having (a) extensive railway networks, (b) numerous station facilities and railway cars, and (c) advanced train operation systems, the train operations require significant manpower. Given these business characteristics, JCR checks status of labor cost reductions through measures such as improving efficiency of station operations, implementing one-man operation, promoting DX (digital transformation), and implementing re-employment of retirees to secure personnel, in addition to checking utilization rates (i.e., changes in the number of passengers carried). Since the railway industry is a regulated industry, flexibility in fare adjustments is essentially low. However, as recent revisions to the regulations have made it easier to pass on increased costs to fares, JCR confirms each company's implementation status and outlook for raising upper limits of the fares, as well as the impact on railway business profits.

(2) Important factors in market position and competitiveness

(i) Market position

Railway companies obtain relatively stable cash flow centered around railway in each region, backed by factors such as expectation of a certain level of use and high barriers to entry. However, in the railway business, length of routes does not bring about high competitiveness, rather, maintaining many unprofitable routes carries risk of causing reduction of transportation efficiency. Therefore, JCR understands the population along the lines and checks progress and results of initiatives to improve railway transportation efficiency, including addressing unprofitable routes.

(ii) Environment along the railroad lines

The business development of each railway company is indivisible from the economies along the railway lines. Whether core railway business and related businesses can maintain stable cash flow generating ability going

forward depends significantly on the ability to attract customers and future potential of major railway terminals and tourism resources along the lines, as well as the characteristics, demographics, and development trend of the surrounding areas connected by the railways. Therefore, JCR analyzes in detail the surrounding environment and each company's initiatives by railway line and incorporates the competitiveness of each line into the evaluation.

(iii) Measures to improve the value of areas along railroad lines

As the market shifts from maturity to contraction, initiatives to minimize the impact of declining birthrate and aging population are important. JCR checks efforts and results aimed at enhancing the value of areas of the railway lines, including: (a) retaining residents along the lines, (b) attracting residents from areas along other companies' lines to the areas along its lines, and (c) revitalizing tourism resources along the lines and developing commercial facilities at key stations to increase the use of non-commuters.

(iv) Cost reduction in railroad business

In the railway business, companies have been promoting initiatives to improve operation efficiency, including reducing labor costs, decreasing the number of operating trains through revisions of timetables, and implementing one-person operation. They have been also promoting reductions of train operation cost through introduction of new energy-saving railway cars. While there are limits to cost reduction from the perspective of maintaining and improving safety, further reductions in fixed costs are unavoidable, given the medium- to long-term demand outlook. Each company has been ongoingly promoting fixed cost reductions, such as improving efficiency of station operations, and JCR will confirm the results of these efforts.

(v) Contribution of related businesses to profit and their synergy

Since room for profit growth in the railway business is limited from a long-term perspective, strengthening of related businesses is important. While stability of profits from the real estate leasing business is relatively high, retail and hotel businesses are susceptible to economic fluctuations and changes in consumer behavior. Therefore, if initiatives to strengthen related businesses are planned, JCR places emphasis on their content and investment scale. Since the development of related businesses is closely related to policies for enhancing the value of areas along the lines, it is necessary to pursue it with clear strategies, such as businesses that will expand profits, enhance brand image to differentiate the company from competitors or contribute to the convenience of residents along the lines, after identifying the characteristics of areas along the lines. JCR checks management policies shown in long-term visions and also development plans shown in medium-term management plans, and after analyzing the prospects for commercialization, progress of plans, financial impact, etc., JCR incorporates these factors into its assessment.

Financial base

(1) Earnings strength

JCR checks not only earnings strength on a consolidated basis but also cost structure of the railway business, profit/loss status of related businesses, and that of their sub-segments, if necessary. JCR places emphasis on operating margin to grasp progress of operational efficiency improvements, including those in indirect departments, on which each railway company is working. Given the large scale of assets held by railway companies and frequent reorganizations in business segments, JCR also confirms trends in extraordinary profit/loss items related to business restructuring.

Key financial indicators:

- Operating margin
- Extraordinary profit/loss items

(2) Cash flow generating ability

Since railway companies make investments to strengthen related businesses in addition to maintenance and renewal investments centered on the railway business, JCR checks the status and outlook for their cash flow generating ability to secure the investment funds. JCR places emphasis not only on consolidated cash flow generating ability but also on the trends in cash flows by business segment, such as the stable railway business and real estate leasing business. As external financing is often assumed for investments to strengthen related businesses unlike in the case of maintenance and renewal investments, JCR checks balance between cash flow generating ability and interest-bearing debt, a ratio, which indicates debt repayment capacity, and its trends.

Key financial indicators:

- EBITDA
- Ratio of interest-bearing debt to EBITDA

(3) Safety

Investments for development of areas along the railway lines, particularly redevelopment projects at major terminals, tend to become large investments and require extended development periods, making interest-bearing debt large. Therefore, JCR checks both the current status and outlook for both investment progress and trend in interest-bearing debt. Since risk tolerance of individual railway companies varies based on characteristics of areas along the lines and business portfolio, JCR also checks balance between interest-bearing debt and equity capital. There are cases where unexpired leasing fees on operating leases (off-balance sheet debts) under lease contracts are increasing for companies strengthening businesses like hotels. For companies with a large amount of unexpired leasing fees, JCR considers not only the on-balance sheet interest-bearing debt but also the repayment burden in the evaluation.

Key financial indicators:

- Interest-bearing debt
- Equity ratio

■ Debt equity ratio

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