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Rating Methodology by Sector

Real Estate

1. Business base

In the real estate industry, while property sales and brokerage business do not necessarily require a high market position to be competitive, leasing business and large redevelopment projects offer advantages to large companies ranked high in the industry, and the current rankings are unlikely to change easily. When observing this industry, JCR focuses on financial capacity, proportion of stable leasing business, and competitiveness of the assets of leasing business in addition to such rankings.

(1) Characteristics of the industry

(i) Market overview

Because of its social importance and public nature, Japan's real estate industry is subject to various laws and regulations, including the City Planning Law, Building Standards Act, Building Lots and Buildings Transaction Business Law, and real estate taxation, to eliminate uncontrolled development and real estate speculation. Any company rating analysis needs to adequately take into account the trends in these laws and policies.

Forms of entry include the leasing of real property, such as office buildings and commercial facilities; sale of real property, such as condominiums and houses; brokerage of real estate buying, selling, and leasing; and property management of office buildings, condominiums, etc. In recent years, the Special Purpose Company Law (SPC Law) has been improved, resulting in an expansion of the securitization market, such as the establishment of the J-REIT market and increase in private placement real estate funds, and progress in the financial commercialization of real property. Such new businesses as asset management have been created, and the business sphere has grown larger.

Real estate business handles immovable assets and traditionally holds direct dealings between a seller and a buyer. Unlike stock trading, the absence of an open market makes the business more like a local industry, with a complete domestic market. As noted above, however, the financial commercialization of real estate has been increasing in recent years, causing an increase in funds flowing in from overseas investors.

In general, the industry is affected by domestic business fluctuations, and the level of volatility varies among the subsectors. The market of short-term turnover business, such as sale of condominiums, is highly variable, and business is unstable. Meanwhile, real estate leasing business capable of earning long-term, fixed leasing income is considered stable and predictable.

Not only the domestic population, but also the working population is expected to decrease as the birthrate declines and the population ages. Medium- and long-term trends in the demand for such properties as condominiums and office buildings, therefore, must be monitored. High growth in the domestic real estate industry is thus unlikely, and entry to overseas markets is expected to become an important management strategy going forward.

(ii) Competitive situation

Entry barriers are thought to be relatively lower than in other industries. Even individuals are able to enter the market if financing is available and the appropriate real estate license for buying, selling, and trading land and buildings, acting as a proxy, or brokering leasing properties has been obtained. In particular, real estate brokerage business, with its low funding requirements and community-based business, allows a large number of individual entries. The entrants range from the aforementioned individuals as well as housing dealers and property lessors to general real estate companies operating in multiple categories.

The real estate leasing industry comprises numerous long-established general real estate companies, which have owned properties in good locations since the time of lower property values. In new development projects, they maintain a highly competitive edge with their development capacity, financial strength to withstand financial burden, and tenant appeal. Meanwhile in condominium sales business, while brand power and product planning capabilities are important, property locations and selling prices are more important in terms of competition. Any advantage based on company size and brand power, therefore, is not necessarily absolute, and competition develops for each individual property. High market volatility, however, results in an increase in new entrants when the market booms. When the market is sluggish, on the other hand, small and medium-sized companies whose finances are unstable tend to be ousted from the market, and continuing this business is considered difficult unless they are companies mainly dealing in stable income businesses such as real estate leasing or companies backed by sponsors.

(iii) Cost structure

While the cost structure varies in each subsector, the industry generally carries a heavy burden of fixed cost. The proportion of depreciation cost is large in the business of real estate leasing, and companies operating subleasing face heavy real estate rent. Because most such costs are determined by the start of a project, ensuring adequate revenue is more important in terms of profitability than controlling costs. The cost structure of property sales business largely consists of direct costs, such as the cost of land and construction. Like leasing business, most of the cost is fixed when a project starts, and thus, the success of the project depends on how much it cost to purchase the property and how quickly it can be sold so as to avoid the effect of changes in market conditions.

(2) Important factors in market position and competitiveness

(i) Market position

Each business in the real estate industry competes individually in each area or property, and particularly property sales and brokerage business do not necessarily require a high market position to be competitive. In public tenders for large redevelopment projects, large companies having rich experience and expertise in development that are ranked high in the industry have a more competitive edge. The market positions of such large companies have been achieved through their long histories, and they are unlikely to be taken over by smaller companies.

(ii) Finance capacity

Other than those of real estate broker and some other businesses, projects require a large amount of funds, including the cost of land and construction, which is difficult to be paid with the company's own funds. Project periods exceed two years, even for housing developments with their relatively short time frames, while large projects, in some cases, continue for more than 10 years. In addition, the periods for investment recovery can be several decades for leasing business, and, thus, the availability of long-term, stable external financing is key to maintaining the management base and competitiveness. When the market is stagnant, in particular, financial institutions tend to tighten their loan restrictions, and reduced fund availability has caused a series of bankruptcies in the past. The financial capacity of each company, including its relationships with financial institutions and financing structure from normal times, must be carefully monitored.

(iii) Business structure

In general, the market of short-term turnover business, such as sale of condominiums, is highly volatile, and stable cash flow is difficult to achieve. In contrast, real estate leasing and management businesses capable of earning long-term, fixed rent and fee income maintain stable cash flow. Increasing the cash flow and component ratios of these businesses will, therefore, improve the company's resilience to the risk of market fluctuations and facilitate future cash flow stability. JCR therefore thinks these are important factors.

(iv) Leasing asset portfolio

Whether the asset portfolio will reduce risk so as to improve the cash flow stability of real estate leasing business is observed. Whether a portfolio not influenced by particular properties has been developed must be taken into consideration. While asset diversification is necessary to a certain extent, potential demand in regional cities is thought to be low and business risk is considered high. Having a large number of competitive properties or being able to develop new properties in areas with high potential demand, such as the five wards of central Tokyo (Chiyoda, Chuo, Minato, Shinjuku, and Shibuya) is viewed as a requirement for improving the competitiveness of the asset portfolio.

2. Financial base

(1) Cash flow

The ability to generate cash flow, the funds for debt redemption, is important. Not only the cash flow level, but its sources also need to be examined. Cash flow generated in real estate leasing business is relatively stable, and, conversely, cash flow from asset or housing sales is highly susceptible to external environment factors and, thus, considered unstable. JCR also monitors trends in cash flow, taking into account the balance with financial aspects, such as interest-bearing debt.

Key financial indicators:

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

(2) Safety

The real estate industry often requires large capital expenditure. Real estate leasing and property sales businesses, in particular, need to pay a large amount of funds to acquire land for development. Such purchases are rarely made using the companies' own funds, but require external financing. The ability to maintain adequate income levels and financial safety to obtain smooth financing, therefore, is considered to cause disparities among companies. Especially, increasing the level of equity capital is thought to create a buffer against the risk of asset degradation.

Key financial indicators:

- Operating income
- Ordinary income
- Shareholders' equity
- Interest-bearing debt
- Equity ratio
- Debt equity ratio
- Unrealized profit on assets held

(3) Financing structure

As previously noted, in this industry in which a large amount of external funds is acquired for property development, the quality and flexibility of financing is likely to significantly affect future business development and is crucial when the business environment deteriorates. For instance, whether long-term financing has been made for assets with a long period of investment recovery must be confirmed. If the term of redemption has expired when the business environment is deteriorating, refinancing may become difficult. The ratio of secured debts and level of margin for additional collateral are also likely to cause differences in future financing and, therefore, must be observed.

Key financial indicators:

- Margin for additional collateral

■ Secured debts
■ Ratio of unsecured debts
■ Ratio of long-term to short-term borrowings

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