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Rating Methods by Sector

Warehousing

1. Business base

Warehouse companies primarily combine a warehousing business with distribution, including associated operations such as transportation along with real estate rental using the redeveloped sites previously used for warehouses. Because of the characteristics of risks and cash flow, which vary between the distribution business and the real estate rental business, ratings take into account the rating methods for land transportation and real estate.

(1) Characteristics of the industry

(i) Market overview

The key determinant of the state of the warehousing business is the volume of domestic distribution. The distribution volume is linked with domestic economic conditions, and the earnings of warehousing business are vulnerable to economic trends. From a long-term perspective, distribution volumes have generally reached their ceiling, given the maturity of the domestic economy and the overseas shift of distribution. Still, the controlled area for public warehouses is tending to increase. This reflects changes and diversification in distribution needs. Owners of goods are seeking warehouses that help improve their distribution efficiency, warehouses are becoming larger, and distribution centers are moving from harbors to inland and suburban areas. Meanwhile, demand for the outsourcing of distribution functions to reduce distribution costs is also increasing. JCR believes that potential for moderate market growth remains in the warehousing business, achieved by meeting customer needs.

In addition to warehousing, warehouse companies operate land transportation, port transportation, air cargo transportation, customs clearance agency, and other businesses. While all of these businesses are also influenced by economic trends, medium- and long-term market trends vary. Land transportation is affected by sluggish domestic distribution, and each company is attempting to deal with the situation by increasing the transportation of freight stored in their own warehouses. Port transportation faces a harsh business environment with the decline in the international position of Japanese ports. Meanwhile, air cargo transportation is enjoying increasing demand for international cargo and an upward trend in the volume of transportation.

Real estate rental is influenced by the office building market, which has become a stable source of income based on the relatively stable amount of rents received over the long term.

(ii) Competitive situation

With the exception of special operations such as refrigerated warehouses, barriers to entry in the warehousing market are low, and the industry is characterized by a large number of small and midsize players. The drive by customers to reduce their distribution expenses has rapidly gathered momentum and inventory has been reduced in the late 1990s, causing a decline in the capacity utilization ratio of warehouses. This has resulted in increasing downward pressure on storage fees and intensifying competition over cargo among companies in the same industry. In the late 1990s, the earnings of large warehouse companies experienced a significant decline. These companies have streamlined their existing distribution centers and have built new warehouses or rebuilt existing ones. In addition to storage, they have restored profitability by aggressively adopting distribution processing activities such as packaging and increasing the handling of freight with higher added value to better serve customer needs. Although the situation that small and midsize warehouse companies face is more difficult than that of larger companies, their stable customers help sustain the business and to this point there has been no increase in industry reorganization. By acquiring companies with strength in land, overseas, and air cargo transportation rather than other warehouse companies, large warehouse companies are attempting to obtain operational soft infrastructure and expertise, increasing their collective strength as distribution companies.

The real estate rental business develops sites previously used for warehouses, located close to harbors and rivers that in the past played key roles in distribution. These properties are often less popular as office locations than the properties of general real estate companies. Therefore, downward pressure on rents tends to be high when the economy slows.

(iii) Cost structure (profit structure)

Warehouse fees are divided primarily into storage fees and stevedoring charges. Although each has established a fee structure, market prices are lower than that. The stock-type business—largely storage of warehouse freight with low labor costs—used to contribute substantially to earnings. However, changing customer needs and rising demand for reduced distribution costs have resulted in lower storage fees, which have led to an increased reliance on flow-type operations such as warehousing as well as shipping and distribution processing. These activities, however, entail higher labor costs, making it difficult to control overall costs. Losses are likely to result, particularly at the start of the business, although they are generally recouped over time. Warehouses with extensive distribution processing and other activities must be examined in terms of their individual earnings.

Warehouse companies respond to shortages of storage space due to increased freight by renting nearby storage space. Meanwhile, a space that has become vacant due to decreased freight is, in many cases, rented out for a fee to owners of goods who are entrusted to handle their goods themselves. While having the benefit of responding flexibly to changes in distribution volumes, the former entails large rent payments and profitability is not high. In some cases, therefore, the details of transactions must be reexamined and construction of a new warehouse must be considered. Renting out a space, on the other hand, generates earnings effects similar to that of real estate rental. Especially when the entire warehouse building is rented out, it must be analyzed as a business similar to real estate rental, as the cost structure differs from that of the general warehousing business.

Compared with warehousing, the real estate rental business enjoys high profitability and earnings stability despite the heavy burden of depreciation. Yet, since reduced rent and increased vacancies directly affect earnings, efforts to prevent the capacity utilization ratio of properties from falling and to avoid a reduction in rental rates are necessary in maintaining the rental income.

(2) Important factors in market position and competitiveness

(i) Market position

Warehouses are divided into private warehouses (those of manufacturers that store their own freight) and public warehouses (those operated by warehouse companies), with private warehouses the majority. While the public warehouses owned by warehouse companies are part of their distribution function, their positions in the distribution market are low. A large number of companies operate public warehouses, and even large warehouse companies own only several percent of the controlled areas. This limits the ability of even a large warehouse company to influence the distribution market and other companies.

(ii) Customer base

The warehousing business of storing important raw materials and products of customers tends to last a long time once customer trust has been gained. JCR examines the major customers and the conditions of transactions with them, growth potential of the major customers, and profitability of storage freight. Particularly when major customers comprise a large part of sales, the credit rating of such customers must also be taken into consideration.

(iii) Ability to respond to customer needs

Although relations with customers tend to be for the long term, cases in which competitive bidding is regularly requested are also increasing. The ability to meet customer needs is essential also to avoid simple price competition. JCR examines companies' ability to respond to customer demand for facilities, distribution processing, and other activities. In particular, a business in which the warehouse company takes charge not only of storage, but the entire distribution of the customer, tends to last longer, and is assessed as a stable income source.

The ability to handle different types of freight must also be analyzed to respond to new demands for outsourcing. JCR surveys the details of facilities, the ability to attract freight, and the operational expertise needed to handle high value-added freight such as the storage of pharmaceuticals and documents.

(iv) Location

Warehouses are located close to ports and harbors, where there is a concentration of import and export freight, or else they are near highway interchanges that play important roles in inland transportation. While there is often a concentration of warehouses of multiple companies in these areas, needs for distribution centers have been changing. It is important then to examine whether companies have many of their warehouses in locations with long-term potential.

Location is also an important factor in assessing the medium- to long-term earnings of real estate rental properties created through the redevelopment of former warehouse sites. Although the locations are often less favorable than those of the properties of large real estate companies, the properties are often relatively large as the former sites of warehouses. Taking advantage of this feature, data centers and office buildings that can be used in part as distribution facilities have been constructed. Warehouse companies also try to enter into the rental agreements in longer term in an attempt to prevent vacancies and reduced rental rates.

Many warehouse companies plan to permanently use their land rather than selling it, and JCR needs to check for any scope for the redevelopment of their sites. Land with the potential for future redevelopment is analyzed in terms of the development schedule, amount invested, and profit plan.

(v) Overseas business development

Warehouse companies lag other distribution companies somewhat in overseas expansion. The continuous relocation of the production bases of domestic manufacturers overseas, however, requires that warehouse companies also need the ability to handle overseas distribution. Strengthening this ability not only protects the domestic customer base, which is expanding overseas, it also helps acquire new customers. Still, many companies have only just begun serious overseas development. Therefore, rather than the contribution of overseas business to earnings, JCR looks at the conditions of overseas subsidiaries, the locations of warehouses, synergy through acquisitions or capital alliances with overseas companies, the strengthening of relationships with domestic customers, whether such activities facilitate the acquisition of new customers, and other factors.

2. Financial base

(1) Earnings strength

The segments of warehouse companies are divided chiefly into real estate rental business and distribution business. Because of the varying profit characteristics between the real estate rental and distribution businesses, JCR predicts the level of profit stability of the company based on the profit contribution made by each segment. The distribution business can be divided into warehousing, land transportation, port transportation, and other operations, each of which has different profit characteristics. Analyzing the earnings power of each operation and its weighting within the distribution business to verify the stability of distribution business profits is a prerequisite for segment profit analysis.

Key financial indicators:

- Operating income
- Profit contribution by segment

(2) Cash flow

Both the distribution and real estate rental businesses are based on a business model of recovering investment funds through long-term stable cash flow. The repayment ratio is calculated from the amount of interest-bearing debt, EBITDA, and other indicators, which is monitored for changes. However, because the distribution and real estate rental businesses have different profitability and payback periods, changes in yields must also be learned from factors such as EBITDA and the asset size of each business.

If a new investment is made, the estimated yield is confirmed based on EBITDA, asset size, and other factors for each property to ensure the scheduled progress of investment recovery. The effect of the property on overall EBITDA and asset size is also analyzed.

Key financial indicators:

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

(3) Safety

Both warehousing and real estate rental properties require a large initial investment. Interest-bearing debt rises rapidly when making this investment, and this may reduce the performance of financial ratios. With a business model of long-term recovery, progress in recouping the investment is confirmed while estimating the future financial structure based on financial policies. The level of improvement is also considered in the rating.

Many warehouse companies are retaining unrealized profits even after the enforcement of the Land Revaluation Law. JCR compares the actual financial ratios taking these unrealized profits into account.

Key financial indicators:

- Interest-bearing debt
- Shareholders' equity
- Debt equity ratio
- Equity ratio

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