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Rating Methodology by Sector

Leasing

This article is intended for so-called general leasing companies and auto leasing companies, excluding rental companies and construction equipment rental companies. (Note)

1. Business base

(1) Characteristics of the industry

(i) Business Size

The size of the leasing business tends to be strongly affected by the amount of private capital expenditure and is also influenced by the trends in companies' transfer of production offshore, frameworks for accounting and taxation, and customer preferences. Customers largely comprise domestic companies and government offices, in which large and middle-sized companies account for a large part, except in the area of vendor finance. The volume of leasing alone in the leasing business was 7.9 trillion yen in fiscal 2000 and 2005, with the highest amount in recent years but the figure has continued to decline since fiscal 2006. The volume of auto leasing is affected by business trends, trends in the sales of new automobiles, and business cycles, which has been repeatedly increasing and decreasing depending on the fiscal year. In an effort to understand the trends of the entire leasing market, information is garnered from leasing statistics (Japan Leasing Association), field study reports on specific service industries (Ministry of Economy, Trade and Industry), corporation statistics, statistical surveys of orders received for machinery (private demand, excluding ships and electric power), and other studies. The trends in the auto leasing market are determined by using the statistics of the number of automobiles under auto leasing agreement prepared by the Japan Automotive Leasing Association (JALA), the number of new automobiles sold (Japan Automobile Dealers Association/Japan Mini Vehicles Association), the number of used cars whose registration is new, moved, or changed (JALA), and other information.

(ii) Competitive situation

Competitors of leasing as one of the methods of financing capital expenditure include bank loans and companies' funds on hand (internal reserves). Meanwhile, the competition within the leasing industry itself is fierce, and the industrial structure has continued to fragment for an extended period. An increasing number of mergers and acquisitions, however, has resulted in a concentration of businesses in large leasing companies and increasing gaps between the large companies and small and medium companies. Even among the large leasing companies, the differences in the sizes of the top five companies and the others have been increasing. The statistics of the Japan Leasing Association

reveal a decreasing number of companies to be surveyed. Domestic capital expenditure has not been growing in recent years, and the competition for the limited market has been intensifying, causing the lease rates to decline. Auto leasing is also experiencing an increase in the business size gap, in terms of the number of automobiles leased, and a similar concentration in large companies, resulting in intensified competition. For a number of companies, the competitive situation will be analyzed based on the changes in the markets shares over the medium- and long-term, cumulative market shares, and the Herfindahl coefficient using the statistics of Japan Leasing Association.

(iii) Business base and background

Large leasing companies, in many cases, are not independent entities, but have companies that have supported their establishment, including banks, trading companies, manufacturers, and distributors, and are using the business flow and customers of such supporting companies. Many of the auto leasing companies that lead the industry are affiliated with large leasing companies or large trading companies. Other auto leasing companies, though not large, include those operating inside their customers' companies and independent auto leasing companies based on the local communities.

(iv) Customer base and business methods

Bank-affiliated leasing companies are often overlapped with the banks' corporate customers and their sales network in terms of target, allowing them to excel in area sales and business with closely affiliated companies within their groups. Trading company-affiliated and manufacturer-affiliated leasing companies tend more to engage in sales finance along the flow of sale of goods. Some trading company-affiliated leasing companies are doing business focusing on the pre-owned value and resale value of leaseholds and operate along the property value chains rather than area sales. Because the competition among leasing companies is fierce in material procurement over a relatively long period of time, the rates are often determined through competitive bids. As a result, customer loyalty and the connection between leasing companies and their customers are often not as strong as those of companies with their main banks and lead managing underwriter. On the other hand, auto leasing companies operate in areas in which they continuously provide services, such as with maintenance contracts. In such an area, the connection between auto leasing companies and their customers, in some cases, is strong.

(v) Regulations

Leasing is a business that does not require a license, and there are no legal barriers and regulations. Unlike banks, no government support can be expected in the leasing business. In contrast, leasing can be characterized by its close connection with accounting standards and tax laws, and changes in the accounting or tax systems may significantly affect the leasing preferences of customers and the product design of leasing companies. Japan's lease accounting standards were changed to the

current ones in the fiscal year that began on April 1, 2008, in which the volume of leasing business in fiscal 2008 decreased year on year by 15.3%, leasing capital expenditure by 14.2%, and private capital expenditure by 5.6%. The difference between the decrease in private capital expenditure and the decrease in leasing capital expenditure increased to 8.6 percentage point. Japan is considering the introduction of International Financial Reporting Standards (IFRS) in fiscal 2012. If introduced, mandatory adoption is said to begin around fiscal 2014 or 2015. Further, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board are considering the treatment of leasing, and the results will have to be paid close attention to.

(vi) Business volume and asset structure

More than a half of the business volume and assets of major leasing companies comprise leasing and installment transactions, which generate stable income over a long period of time. Even after the end of the initial lease period, a transaction called re-leasing is often repeated several times for several years. While this will no longer be recorded as part of the business volume and asset balance, it does support the income. In contrast, the weight of the form of loans (finance) in both volume and asset balance has been gradually increasing in the recent five to ten years. This consists of various transactions, such as those similar to leasing, factoring, non-recourse loans, corporate credit for companies, LBO finance, and mezzanine loans. Some companies have been attempting to cover the decrease in leasing and installment transactions with loan transactions in recent years.

(2) key factors in market position and competitiveness

The effect of a position in the industry, market share, and business scale on competitiveness is evident in areas such as small lease (including vendor finance), auto leasing, and rentals. Meanwhile, areas such as proposal-based and issue-solving leasing, large transactions, and non-recourse finance require composition and examination procedures in each case, and bargaining power in purchasing does not work effectively. For this reason, economies of scale are difficult to find in cases beyond than a certain volume. Rather, in wholesale-style sales, the degree of handling needed in each case requires a certain cost regardless of the amount of money. While differences in size and efficiency are evident between large companies and small and medium companies, a comparison among large leasing companies reveals the business base, fund-raising capacity, management policy, and the presence of support from shareholders, including information sharing, as the factors that differentiate their competitiveness, rather than the business size. Transactions with large and medium companies often involve competition with banks or other financial institutions in addition to competition among large leasing companies. The competitive edges in such cases are the ability to make proposals based on the characteristics of the property and the offering of total solutions in addition to fund-raising capacity and low lease rates. Leasing companies have a slight advantage in the area of finance that takes into account the value of goods and recycling and disposal after use, and the market is likely to be further divided

between leasing companies and banks.

The operating base is assessed based on the major channels and the strength of the power to control the channels, the number of customers and the level of distribution of the customers, strengths and weaknesses in each operation area, and other factors. Whether risk is worth the return is related to the strength of the operating base, which is an important factor in considering the business continuation.

(3) Management

JCR focuses on factors such as (i) the manager composition and management stability and autonomy, (ii) each company's strengths and weaknesses in view of opportunities and threats in the business environment (SWOT analysis), and (iii) the corporate governance. With the decrease in the volume of leasing business in recent years, the direction of management has become increasingly diversified and globalized. A certain amount of capital, human resources, and information is often required, and the balance between risk and return and the balance with resources within individual companies must also be paid attention to.

2. Financial base

(1) Capital adequacy

JCR examines whether the equity capital is adequate in both aspects of quality and amount for the risk taken. The factors to be examined include, in the aspect of amount, the thickness in view of the absolute amount and the amount of risk and, in the aspect of quality, the level of dependence of capital on the tax effect, a limited period, or security with a possibility of redemption (hybrid securities) and the level of capital adequacy ratio. The level and details of the risk will be examined by referring also to information and indicators (changes in UL, EL, etc.) that reflect the details of major business and assets, operating base, and improvement in the method of enterprise risk management in recent years.

Key financial indicators:

- ■ Capital adequacy ratio
- ■ Debt equity ratio
- ■ Measured amount and surplus of risk capital
- ■ Capital adequacy ratio after adjustment of deferred tax asset and capital adequacy ratio after adjustment of goodwill

(2) Asset quality

JCR examines the asset turnover (average life), percentage of operating assets in view of liabilities (debt coverage ratio of assets), level of distribution of debtors and credit, bad debt ratio, ratio of bad debt write-offs, collection ratio, the presence of unrealized loss, adequacy of reserves for bad debts, and other factors. In qualitative aspects, the channels of acquiring assets behind the numeral values and the control of the channels, sales positions, credit policy, credit management, credit collection system, and

other factors are considered. While the cost of credit from traditional finance leases is normally limited to a very small value, the cost of credit from non-recourse loans and real estate-related finance sometimes becomes a relatively large amount. This needs to be analyzed based on the details of the assets.

Key financial indicators:

- Delinquency rate
- Depreciation ratio
- Cost of credit in comparison to operating assets
- Cost of credit in comparison to periodical accounting of profit and loss

(3) Earnings capacity

The income stability, return on assets, and cost structure are analyzed. A breakdown between stable income and volatile income is one of the analysis methods; however, revenue from re-leasing fees, non-interest rate revenue (service fees), and revenue from leasing, installment, and loans are examined based on the past results and future prospects. For leasing companies, the gross profit on sales before the deduction of cost of funds and before depreciation (gross profit) will be the focus, rather than sales, which will be the starting point of an examination that will be followed step by step by gross profit after the deduction of the cost of funds, operating income, ordinary income, net income, and the relationship between profit/loss and cost at each stage. The return on assets (ROA) used will be that calculated using total assets and operating assets as the denominator and gross profit before and after the deduction of cost of funds, ordinary income, and net income as the numerator. While a guarantee obligation is added in some cases, the guarantee obligation of leasing companies, in many cases, is not a large amount. For companies with a small business volume and when a decrease in business volume continues, the distance to the break-even point of each individual company will also be a focus.

Key financial indicators:

- Indicators per employee (volume of business, balance of operating assets, and profit/loss)
- Overhead ratio (OHR) (Selling, general and administrative expenses excluding bad debt-related expenses/gross profit)
- ROA
- Profit rate (profit/sales), gross margin

(4) Liquidity and responsiveness to market risk

It is noteworthy that fund-raising for leasing companies is comparable to purchasing raw materials for manufacturers, which is an important factor directly connected not only to the revenue but also to management stability and reliability. Leasing companies are characterized by the use of leverage and the absence of a plan for income-based repayment for debt redemption. Debt redemption of leasing companies at normal times uses refinancing and securitization in addition to free cash flow as the fund

sources. Therefore, stability of transactions with financial institutions for efficient refinancing and CP rollovers, the level of surplus financing capacity in preparation for a temporary disruption in the market for direct financing, and contingency plans must be taken into consideration. JCR examines the balance between long-term and short-term financing, fixed and floating interest rates, and direct and indirect financing. Factors such as the structure of lending financial institutions, the composition of the means of direct financing (SB, CP, securitization of receivables, etc.), level of interest rates on borrowings, collateral provided, and the concept and conditions of covenants are also studied to determine whether appropriate financing is carried out in view of stability and cost of financing.

As for long-term financing, JCR checks for any specific time in the future when a large amount of funds must be repaid (repayment bumps) by focusing on the repayment and redemption schedules. If such a time is scheduled, a financing policy in preparation for such occasion (collateral policy, too, if necessary) must be confirmed.

If there are any syndicated loans or securitization of receivables to which covenants are attached, the possibility of a future conflict and arrangement in the event of such conflict will be investigated. If the possibility of a conflict is considered to be high, the plan for the preparation for and responses to the conflict and its practicability will be examined.

Market risks include fluctuations in interest rates, foreign exchange, and stock prices, of which the risk of interest rates is particularly high. In addition to gap analysis, interest rate risk management using VaR and Bp sensitivity has been increasing. Each company's position and changes in these indicators are observed in a time series and cross section in combination with changes in market volatility.

The asset value of a subject property is focused on as in the case of operating leases. Financing that is not fully paid off during the initial term of agreement carries residual value risk (risk of fluctuations in the remaining price). JCR pays attention to the level and percentage of risk exposure in view of such residual value risk, risk management method, and the conditions of the exit market.

Key financial indicators:

- VaR
- Matching ratio
- Level of short-term liquidity
- Short-term debts vs. short-term liquidity and balance of commitment line
- Direct financing ratio and short-term financing ratio

(Note) Individual companies are analyzed based on multiple perspectives, including capital adequacy, asset quality, management, earnings, liquidity, sensitivity to market risk (CAMELS), operating base (franchise value), and parent-subsidiary relationships (support) in addition to such external factors as the business environment. The order, importance, and levels of assessment weight are not related, and a comprehensive judgment is made based on multifaceted examination and these aspects. Similar to the way the balance between risk and return is emphasized, these factors are also connected to one

another for additional analysis.

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