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Investment Funds

1. Scope of this methodology and its relations with other methodologies

(1) Scope

This rating methodology covers investment funds as asset management type collective investment scheme, in which funds collected from a number of investors are pooled, and then asset managers invest in various companies and assets according to a certain investment policy and return interest, dividends and proceeds from sale of assets to investors.

(2) Obligations to be assessed

Ratings on investment funds cover obligations to repay loans and/or bonds owed by investment funds. Ratings also cover arrangements for repayment regarding trust beneficiary rights and/or investment in partnerships deemed as redemption obligations (hereinafter collectively referred to as "obligations"). While rating is basically assessment of the certainty that the principal and interest payments will be made as initially agreed, it also may be assessment of the certainty that the amount equivalent to the principal of the trust beneficiary interest or the partnership investment will be paid in full by the expiration date if it is reasonable to totally assess the outcome of the investment in terms of the principal redemption and dividends.

The type of rating assigned to an investment fund is basically an individual debt rating. However, the issuer rating may be assigned to an investment fund that can be substantially regarded as a going concern raising funds on a continual basis.

(3) Relations with other methodologies

This rating methodology provides general rules for ratings of investment funds as asset management type collective investment scheme. Investment funds can be classified into public and private funds, listed and unlisted funds in terms of form, and traditional investments and alternative investments in terms of investment strategy, and so on. Alternative investments include real estate investment funds, private equity funds, mezzanine funds, and commodity funds as well as hedge funds that make full use of various investment methods, such as derivatives. Japan Credit Rating Agency, Ltd. (JCR) may individually establish a rating methodology for a certain type of investment funds. The assessment of each investment fund is referred to this methodology and the individual methodology. The same applies to investment funds that invest in securities and loans backed by cash flows from specific assets, such as housing loans and real estates.

2. Framework

Investment funds shall be assessed on the basis of portfolio analysis, financial analysis, and fund management capability analysis as well as assessment of complementary elements such as information availability and related parties.

In portfolio analysis, JCR assesses the ability of the portfolio to generate cash flows, stability of asset values, and the possibility of incurring losses, based on the actual portfolio and investment policies set forth in advance by the management, such as investment strategies, types of investments, and investment styles. In financial analysis, JCR assesses the sufficiency of funds for debt repayment based on prescribed financial targets, covenants, and actual financial conditions. In fund management capability analysis, JCR assesses whether the fund manager can maintain the soundness of portfolio and financial position over the medium to long term, through process such as interviews with the related parties.

3. Portfolio analysis

(1) Concept

JCR places emphasis on estimates of investment performance and portfolio disposal value during the investment period if the investment fund relies on refinancing backed by cash flows or asset values from investments to repay the debt to be rated. For the purpose of assessing the certainty of debt repayments, the analysis focuses on stability rather than profitability.

(2) Investment performance and portfolio characteristics

In the first step of portfolio analysis, JCR assesses the market environment surrounding investment, the historical track records, asset quality of the portfolio, and portfolio diversification. JCR then estimates expected return, volatility and correlation. For investment funds that invest in loans and bonds, JCR estimates the default rate and the recovery rate for individual investments. Based on these estimates, JCR assesses the resilience of the fund for debt repayments by calculating investment performance according to the probability of occurrence determined for each rating level. The check points in this process are as follows.

(i) Market environment

JCR confirms the following matters mainly according to the asset type in order to capture risk factors.

- Indicators related to investment performance
- Supply and demand conditions in the market
- Trends of the market participants and the investors' attitudes
- Financial policies of the central banks

- Legal and tax systems (including revisions)
- Outlook on foreign exchange rates (if investment target is in the different currency from procurement funds)

(ii) Historical track record

JCR scrutinizes the historical track records, such as asset price movements, for investments or similar assets. This enables JCR to grasp the average level of profits and volatility in normal times as well as performance trends in times of recession and stress events like the Lehman Shock.

(iii) Asset quality

In the analysis of asset quality, JCR assesses the advantage or risk/return characteristics of the asset held by the fund among the asset types to be invested in. For example, in the case of real estate, liquidity in a stress phase may differ depending on the location advantage and the specifications of buildings. Also in the case of equity investment in venture enterprises, there may be a certain gap between risk and return depending on the stages such as the seed stage at startup or the late stage at which IPOs are expected.

(iv) Portfolio diversification

In the analysis of portfolio diversification, JCR examines the number of investments, asset types, geographical areas, and industries, as well as the degree of concentration on specific investments. Generally, large investment funds are likely to be positively evaluated in terms of profitability and portfolio stability, because the larger the investment, the higher the degree of diversification, and the greater the cost-bearing capacity required for funds procurement and fund management.

(v) Default rate and recovery rate

When the fund’s investment assets are loans or bonds, synthetic CDOs rating methodology shall be used to assess the portfolio. Specifically, in cases where JCR ratings have already been assigned to the borrowers assumed for the model portfolio of the fund, the default rate shall be assigned by referring to the long-term issuer ratings given to the borrowers. If no credit rating is assigned by JCR, JCR determines a presumable default rate based on a shadow rating by an industry analyst in charge of the reference entity. JCR also adopts the following methods other than shadow rating.

- Estimation of a default rate using JCR’s Corporate Default Rate Estimation Model.
- In cases where a rating is assigned to the borrower by other credit rating agency, JCR maps rating by such credit rating agency to JCR’s rating.
- Use of originator’s internal rating and estimated default rate, or default rates calculated from outside credit scoring models.

In some cases, JCR may estimate the recovery rate in the event of default of the borrower based on such factors as the recovery performance of similar investments, the status of collateral setting, estimates by other rating agencies, and scoring models by the originator.

(3) Disposal value

The disposal value of the fund's investment assets used in portfolio analysis largely depends on liquidity of investments in the market. Thus, JCR assesses the value assuming that the fund may be forced to dispose of them under time constraints. For unlisted equities, real estate, ships, aircraft, and other asset types for which it is difficult for JCR to observe the value in a timely and objective manner through the markets, expert valuations shall be used if appropriate. However, conservative valuations may be conducted considering the possibility that uncertainties may be involved.

(4) Stress test

In portfolio analysis, JCR identifies risks based on historical average returns, volatility, and correlations. JCR also conducts sensitivity analysis based on stress scenarios assuming deterioration in the market environment is conducted to confirm the resilience of the portfolio and fund's financial strength.

JCR may conduct analysis dividing the funds' investment period into the initial investment period, the execution period, and the payback period. This is because the size of the portfolio is relatively small during the initial investment period and the payback period, and the diversification is not sufficiently secured.

4. Financial Analysis

(1) Concept

Investment performance of investment funds is generally volatile. In financial analysis, JCR assesses whether an investment fund is adequately resilient to fluctuations in investment performance and is able to secure funding for debt repayments. Increased leverage through debt financing increases the risk associated with fluctuations in investment performance, and thus the degree of leverage and its control are important in the analysis. In addition, from the viewpoint of the debt repayment certainty, the strength of the financial management systems related to liquidity that enables sufficient funds to be provided at the repayment date are also important.

(2) Leverage

Leverage analysis focuses on the ratio of assets to liabilities as indicators of financial soundness, such as LTV (Loan to Value) and the overcollateralization ratio. Some investment funds are prescribed contractually to suspend dividends to equity investors, to compulsorily repay debts through a cash sweep, to dispose of collateral, and to take other measures when they violate a certain level of LTV. In such a case, the analysis is based on the assumption that the investment fund is managed to meet the trigger requirements. The appropriate LTV level for each fund should be set according to the volatility of its investment performance. The appropriateness of the LTV level is judged by considering asset type, asset quality and the diversification of the portfolio.

(3) Liquidity

Liquidity analysis focuses on financial arrangements and management policies for liquidity, such as the provision of cash reserves for debt repayment and funds management expenses, financial covenants using indicators such as DSCR to measure the sufficiency of the fund's cash flow for principal and interest payments, and the shape of maturity ladders in debt repayment. Financial creditworthiness of the lenders and the liquidity providers may be an important assessment point when financial support from financial institutions can be expected including the establishment of credit lines (commitment lines), based on good business relationships with the financial institutions, strong lender formation, etc., and when proceeds from additional capital calls to the equity investors can be allocated to liquidity enhancement with a strong constraint. However, even if a funding structure is regarded as having a diversification effect in normal times, there is a possibility that the correlation between the parties concerned will rapidly increase in the event of large market fluctuations like the Lehman shock. Therefore, the analysis also assumes that the lenders and the providers of liquidity enhancement may also face financial difficulties simultaneously with the drastic deterioration of the portfolio.

5. Fund management capability analysis

(1) Concept

In the analysis of fund management capabilities, JCR assesses the fund management ability of asset managers (AM), mainly in terms of judgment and management skills of investments, financial operation and governance structure. This assessment is based on the performance record of AM's fund management and the sponsor's related business.

(2) Judgement and management skill

Especially in the case of asset types such as unlisted stocks of venture companies or real estates, which are difficult to evaluate objectively and have high individuality, the construction of portfolio requires network and position in the relevant industry and the judgment skill of investments. Even after an investment is executed, for example, it is envisaged that the investment performance will be greatly influenced by whether or not, for example, step-in and support for investee companies whose performance is poor, property management to maintain property value, and risk hedging transactions such as those conducted by hedge funds are properly managed.

(3) Financial operation

As for financial stability, JCR assesses not only the financial covenants related to leverage and liquidity, but also disciplined and conservative financial management, and continuous funding capability based on good relationships with the lenders and the equity investors.

(4) Governance structure

In order to maintain stability of funds management throughout the investment period, it is necessary to have a proper governance structure in place and to secure personnel with sufficient knowledge and experience. It is desirable that discipline and transparency in the management system be appropriately ensured, such as process of investment decision-making, without being excessively dependent on a particular person, management of investment risks, compliance, and establishment of an independent committee on conflicts of interest with the stakeholders.

(5) Sponsor support

JCR can assess AM’s sponsor support positively, such as provision of investment opportunities, debt or equity financial support and the dispatch of personnel through the sponsor’s network and reputation, especially when the management of the investment funds is closely related to the sponsor’s business. Although it is necessary to pay attention to the monitoring system of conflicts of interest, there may be cases where the sponsor's related businesses and the expectations for sponsor support can be reflected in the assessment, even if the performance record as an AM is insufficient.

6. Other evaluation points

(1) Information availability

Publicly offered funds, such as J-REIT and listed infrastructure funds, can be assessed on the assumption that they generally disclose high levels of information and ensure transparency in terms of investment performance and fund management. On the other hand, in the case of investment funds targeting unlisted companies or privately placed investment funds without publicly available information including investment performance or fund management, the premise of assessment is that objective and reliable information can be sufficiently obtained from AM and other related parties, and when such information cannot be sufficiently provided, JCR may not assign a rating.

(2) Related parties

In assessing investment funds, not only the portfolio and financial position, but also credit, past performance and position in the industry of the parties involved in the funds, including equity investors, may be important assessment points for the rating.

For example, when equity investors and lenders judge to participate in investment funds, not only expectations regarding investment policies and methods, but also the credit and performance of AM and sponsors will be important factors in making decisions. Therefore, in order not to impair the credibility in the industry, it is expected that not only AM but also sponsors will be involved in the investment funds to a certain extent in order to achieve the objective investment results.

On the other hand, equity investors and lenders often cannot participate in promising investment funds without industry networks and credit. Considering this business practice, for example, financial stability expectations, such as meeting capital calls in line with initial commitments or continuing financial support even under poor investment performance, can be reflected positively to the rating on the basis of their credit and past performance.

7. Overall evaluation

As mentioned above, ratings for investment funds are comprehensively determined based on portfolio analysis, financial analysis, assessment of fund management capabilities, and on complementary factors such as available information and related parties. However, the types of investment funds vary, and the weights of each element differ depending on the type of investment funds.

For example, when there is a high correlation with markets such as listed stocks and public and corporate bonds, and when it is possible to assess risks using the large pool approach based on historical data on a large number of homogeneous pools of borrowers, or when it is possible to use the CDO approach to calculate the assumed loss for the entire portfolio based on default rates and recovery rates for individual loans, the emphasis may be placed on quantitative portfolio analysis and financial analysis using the stochastic and statistical approaches.

On the other hand, for private equity funds, which have a strong individuality of investment targets, and funds investing in highly specialized assets (vessels, aircraft, infrastructure assets, etc.), there may be large differences in investment results depending on the AMs' capabilities, and it may be difficult to appropriately assess investment risks through ordinary quantitative analysis. In such cases, the emphasis may be placed on the financial support committed by the related parties and on the assessment of the fund management capabilities based on the past performance and the credit.

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