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# Japanese Real Estate Investment Trust (J-REIT)

## 1. Overview

The Japanese Real Estate Investment Trust or J-REIT is subject to various regulations including regulations on sphere of business in law and outsourcing of its operation. It can positioned as similar to a SPC, which is used in the composition of securitization products, in form, because it relies basically on a portfolio consisting of its real property owned by it for its future debt repayment. Therefore, rating methodology for structure finance can be taken in rating for it. However, evaluations on a J-REIT should be made based on the premise that it is a going concern, because its properties are replaced with other properties unlike in the case of a static SPC and a time limit for its investment is not set. In particular, investment skill depends on experiences, knowledge and know-how of an investment trust management company (asset manager, hereinafter referred to as “AM”), causing AM’s management capability to have a significant impact on credit capability of debt. Therefore, it is necessary to rate a J-REIT as a going concern real estate leasing operational company, thinking of the J-REIT as a vehicle and the AM as a one unit.

JCR has a policy to determine a rating for a J-REIT, effectively employing rating methodology for structured finance and that for operational company (corporate), and at the moment thinks of content of portfolio consisting of its properties held by it and AM’s management ability as the important elements for a rating determination.

## 2. Introduction

Real estate was allowed as one choice of investment products into a collective investment scheme by Act on Investment Trusts and Investment Corporations (“Investment Trust Act”), which became effective in November 2000. JCR has already made public its opinions on the rating as “Rating Methodology on Real Estate Investment Fund (J-REIT)” in March 2001.

Subsequently, the first investment equities of the two J-REITs, “Japan Real Estate Investment Corporation” and “Nippon Building Fund Inc.” were listed on the Tokyo Stock Exchange in September 2001, and then new J-REITs have been listed successively thereafter. The 15 J-REITs, of which 14 on the Tokyo Stock Exchange and 1 on the Osaka Securities Exchange, have been listed to date in total, reaching 1 trillion yen in terms of total market value of investment equities. JCR now gives an explanation on point of view on rating for J-REIT afresh, based on the market trend and progress of investment corporations in the past. In addition, JCR has a policy to rate a J-REIT for its senior debts[1]

[1] Senior debts denote dated obligations, which are not subordinated to other general obligations in payment hierarchy. There are cases where ratings on individual bonds differ from ratings on senior debts depending on subordination, conditions of collateral and guarantee and contents of financial covenants.

and individual debts (bonds or loans).

Although uses of the properties held by J-REITs currently listed on a stock exchange center on offices, portfolios have a variety of different types such as the ones specializing in each of offices, commercial facilities or residential properties, or composite type of portfolios consisting of offices, residential properties, commercial facilities and hotels, which are combined together. Although the J-REITs with a variety of characteristics will emerge in the future as shown by the expected listing of a J-REIT specializing in logistics facilities, JCR considers that the point of view on rating for J-REIT described in this report can apply to these cases above.

Under the Investment Trust Act, investment forms such as Investment Trust Managed under Instructions from the Settlor or Investment Trusts Managed Without Instructions from the Settlor are available in addition to investments by investment corporations, which are well-established as J-REITs, this report describes point of view on rating for investment corporations of J-REITs. J-REIT denotes investment corporations afterward in this report.

## 3. Characteristics of J-REITs in light of Rating Viewpoint

(1) Comparison with SPC

Although a J-REIT does not have complete bankruptcy remoteness as seen in the case of a SPC used in the composition of securitization products, JCR considers that it can be positioned as similar to SPC, because their investments are restricted under the Investment Trust Act, etc., and there are no employees and all administrative works including deskwork and asset management & custody are outsourced. However, J-REITs differ greatly from SPCs in that J-REIT's real estate portfolios change depending on AM's discretion. In addition, in case of J-REITs, appropriations of funds from asset sales[2] for discretionary debt repayment and also for new asset purchase are left to the AM's discretion, unlike the case of SPCs where rules on distribution of funds from their asset sales are remarkably clearly defined in general. Therefore, although there is no room for different opinions on a view that real estate owned by J-REITs is a ground for their future debt repayment for the J-REIT's creditors basically, it should be kept in mind that the present portfolio does not necessarily underpin the repayment in substance, depending on AM's investment strategy and management policy.

JCR therefore considers that although methodology for structured finance can be applied to the present portfolio analysis such as evaluations on properties, a criterion in rating for structured finance by loan-to-value ratio ("LTV") cannot be applied directly to the J-REITs.

It can be pointed out that in case of J-REITs, governance by the investors as equity holders is clearly defined under the Investment Trust Act and that J-REITs are greatly differ from SPCs in that the investors can control J-REITs through a general meeting of investors in terms of changes to the certificate of incorporation and dismissal of AM, etc.

[2] It should be noted that gain on sale is distributed to the investors as the current-period earnings due to the nature of J-REITs.

(2) Comparison with Corporate

As a J-REIT invests its moneys primarily in real estate which generates earnings at the moment, analysis as a corporate can be made by comparing it with a real estate company with real estate leasing business as it main business. JCR values that the real estate leasing business generates stable earnings compared with other businesses, and there are cases where JCR assigns a relatively higher rating to a real estate company in comparison with other industries, although its earnings power itself is low relative to other industries. The characteristics in earnings of the J-REITs will be similar to those in earnings of the real estate leasing companies.

In the real estate leasing companies, transitions of numerical values in the financial statements reflect their management capacity in properties and financing in their long histories, and qualitative evaluations can be made based on these numerical values. In the case of J-REITs, on the other hand, it is difficult to make qualitative evaluations similar to those in the case of the real estate leasing companies, because their business histories are short. JCR considers, however, that it is easy to estimate the J-REITs' future earnings because their investments are basically leasing properties with track records and additionally their higher transparency of business relative to corporations because of their higher level of disclosure together can offset the negative factors such as short business history partly.

Financial stability and soundness are required of a real estate leasing business as premises for evaluations on earnings stability, because the real estate leasing business is susceptible to changes in the real estate market conditions and changes in the interest rates. The financial stability of J-REITs, however, is relatively high at the moment.

In addition, as there is a limit on implementation of development business in J-REITs, evaluations on this point is important. Ratings on real estate companies tend to be conservative during a time where they make development investments aggressively, because while real estate development business may generate large earnings, it will raise various risks. One of the sharp risks inherent in the real estate business is reduced in the J-REITs, because they do not carry out development business per se. Their restraining power against business risk is high relative to general corporations[3].

Furthermore, in evaluations on J-REITs, a difference working as a negative factor is that J-REITs cannot accumulate retained earnings, distributing almost all of their earnings to the investors for the purpose of clearing requirements for dividend deductibility, while corporate can accumulate earnings as retained earnings. Therefore, as cash flow, which can become funds for debt repayment, is limited to their depreciation expenses for J-REITs, and their depreciation expenses are basically used for repair expenses for their properties, they cannot accumulate capital as buffer for creditworthiness of its debt.

[3] It should be noted that although each J-REIT in its management policy does not engage in development projects in which it acquires land per se and then constructs a building, there are cases where it invests in buildings to be delivered after completion of construction or buildings with high expectancy of ensuring tenants, depending on the legal interpretations.

This point is a great difference in drawing a comparison between J-REIT and corporate in terms of capacity to redeem debt, and J-REITs' debt redemption must be dependent on refinance or sale of properties. As these points, of course, seem to be recognized by each corporation of the current J-REITs and it is important to have a stable financial base in order to refinance on an ongoing basis, each J-REIT tries to maintain a financial structure as conservative as above the LTV stipulated in the certificate of incorporation. Its keeping an eye on cyclicality in finance, meaning good refinancing has an impact on equity finance and then debt finance subsequently, is one of its characteristics.

## 4. Rating Methodology

As described above, JCR considers that although rating methodology for structured finance can be applied to J-REITs, because J-REITs as investment vehicles have characteristics similar to those of SPCs and basically their properties held by them are grounds for debt repayment, importance of rating analysis as a going concern corporate is high in analyses of AM's management capacity and financial analysis, taking into consideration significance of AM's discretion in management. JCR discusses below approaches in the rating to the portfolio analysis, analysis of AM's management capacity and financial analysis, on which JCR focuses its attention in the debt ratings for J-REITs.

### (1) Portfolio Analysis

In rating for J-REITs, JCR places emphasis especially on cash flow generation capacity of their real estate portfolios and their stability, and makes an analysis of quality of properties in the portfolio, competitive strength and degree of diversification at length. In making an analysis of portfolios, JCR does the analysis, applying rating methodology used in structured finance products backed by multiple pieces of real property. In case of J-REITs, although content of portfolio will change due to new acquisitions or sale of real estate, analysis of the present portfolio is important because these pieces of property are central part of the portfolio for the time being. Additionally, confirmation on whether or not the present portfolio's composition is consistent with the J-REITs' investment policy or management policy will be a point in making a prediction of the portfolio performance in the future.

#### (i) Property Valuation

In property appraisal, JCR assesses each piece of property and then assesses total value of the properties in the entire portfolio by summing up each piece of property. As a specific method for the evaluation of property, JCR assesses, in principle, JCR's appraised value after conducting site survey and hearing with property manager ("PM") together with close investigations of appraisal report, engineering report, earthquake risk report, environment risk report, market report, etc. based on rent roll or track record presented. JCR adopts capitalization method, in principle, as valuation method, and verifies the valuation using direct capitalization method, in which net cash flow ("NCF")[4] is discounted by cap rate or discounted cash flow ("DCF") method for properties with characteristic[5] NCF movements.

Property valuation amount JCR pursues is based on NCF to be generated stably in the medium term and cap rate, and differs from appraisal value aimed at valuation at the time of valuation.

It is important in property valuation to verify that a J-REIT acquires property at a proper market value worth the risk-return relationship in addition to valuation of the whole J-REIT's total properties and net operating income ("NOI"), which are used in valuation of LTV and debt service coverage ratio ("DSCR") in financial analysis. In case where it acquires property at a relatively high price, JCR is concerned about its capacity to acquire properties including AM's routes for obtaining information on properties and due diligence system and also concerned about conflict of interest if the property has been acquired from AM's sponsor.

(ii) Quality and Competitive Strength of Portfolio

In quality and competitive strength of portfolio, JCR makes an analysis from a point of view of whether or not the J-REITs can maintain quality and competitive strength of portfolio not only at the moment but also in the future, examining factors causing changes in the submarket such as development plan in the vicinity in the future, as well as by factors such as geographical conditions, size of buildings, structure, age, content of facility, ownership form, content of tenants, rent or occupancy rate, and cost per *tsubo* (3.31 square meters) through work of each piece of real estate property. As for the age, in particular, in case of old properties, JCR verifies whether or not large scale repair including renewal of facilities has been carried out for the buildings, whether or not the specifications for the buildings meet the needs of tenants, and whether or not there is a problem with quake resistance. As for ownership forms, as properties with condominium unit ownership or co-ownership other than fee simple may become factors to constrict internal growth of J-REITs in case where a unit owner cannot make a decision on replacement of its management company with another company or a repair by itself owing to relations with other unit owners or co-owners, JCR is concerned about default risk or difficulty in disposing of properties as a result of default of unit owners or co-owners in such cases. JCR judges degree of risk owing to ownership forms including the number of unit or co-owners, attributes, creditworthiness, proportion of co-owner's share, contents of certificate of incorporation or memorandum, and a likelihood of additional purchase.

4 NCF = NOI + returns from deposits and guarantees - capital expenditures (Capex).

5 For example, there are cases in which (1) it is difficult to assess a stable NCF because of large volatility; (2) long-term definitive term lease contract with a single tenant has been entered into; (3) rent is linked to revenue in case of commercial facilities or it is necessary to make an analysis of revenue and expenditure of business such as hotel; (4) demolition or reconstruction is scheduled and its probability is high.

(iii) Portfolio Diversification Degree

As size of assets increases, cash flow stability can increase due to diversification effect in general. JCR judges the portfolio diversification effect by making analysis of each of the following factors in an integrated manner.

■ Diversification of Cash Flow or Property Value

Portfolios with not only a large number of properties simply but also diversifications of cash flow or property value are considered stable in terms of cash flow in general. When concentration of cash flow or property value is high, cash flow of the overall portfolio can change widely as a result of drop in cash flow from specific properties, and there is a concern that high concentration can harm flexible handling in terms of property sale.

■ Geographic Diversification

Risk from deterioration in market or earthquake in specific areas can be mitigated, causing the cash flow to become stable, by diversifying areas where properties are located. Although there can be seen many portfolios of the currently listed J-REITs, in which properties are concentrated in central part of Tokyo or wider Tokyo metropolitan area, JCR does not necessarily consider that concentration of portfolios in central part of Tokyo or Tokyo metropolitan area is a negative factor in consideration of over-concentration of economy and industry in Tokyo or its amplitude of real estate market, assuming that the earthquake risk has been reduced. On the contrary, in case where investment proportion of local properties to the overall portfolio is high, there are often cases where markets in such local areas are stagnant as a result of the over-concentration in Tokyo, causing geographic diversification to work as a negative factor. JCR judges the portfolio diversification degree in an integrated manner by examining competitive strength or competitive advantage of each piece of property in its area, role in J-REITs, and risk-return relationship in addition to the proportion of properties in local area simply.

■ Diversification of Use

Diversification of use can make cash flow stable, because even if cash flow from properties for a specific use drops, properties for other uses can cover the drop.

However, as JCR perceives that risk increases in the order of property from residential to office, commercial facilities, and to hotel, although it depends on conditions of location and building conditions of each piece of property. Therefore, undiversified portfolio in use does not necessarily lead to a negative rating decision in case where the portfolio consists of residential property or offices with superiority and relatively high competitive strength, even when the uses are concentrated in a specific area. In the commercial facilities, there are cases where risk is lower than the residential property or offices, depending on conditions of location, content of facilities, conditions of contracts with tenants, and creditworthiness of tenants.

Additionally, it should be noted that diversified use requires management expertise of AM for each use, and there is a chance that stronger degree of diversification may decrease efficiency in property management.

■ Tenant Diversification

The more diversified the portfolio is with many tenants and industries, the less the cash flow is susceptible to exit of a specific tenant or economic trend of a specific industry. As a result, risk of changes in the cash flow will become lower. When concentration of tenants is high, it is necessary to examine degree of effects on cash flow from the number of tenants, conditions of contract, creditworthiness, and termination time of lease contract in addition to the degree of the concentration. Exit risk from the headquarters building, important business base or stores generating high income will become lower.

(iv) Engagement in Development Projects or Mezzanine/Equity Investments in Real Estate Securitization Products

There are some J-REITs which show their policy to get engaged in development projects as a means of acquisition of excellent real property in a recent situation of intensified competition for acquisitions of excellent real estate. Although JCR cannot assume that J-REITs acquire real estate before completion of construction and then bear risk from non-completion of buildings as scheduled, they may accept delivery of real property immediately after completion and take a certain degree of market risk[6]. In this case, JCR focuses its attention on to what degree of proportion these investments can account for in the overall portfolio and judges degree of investment risk, carefully examining balance between risk and transfer price and possibility of completion of tenant recruitment by entering into the lease contracts after close investigation into content of contract of sale or content of stopping conditions.

Concerning the mezzanine/equity investments, although there are regulations on equity investments in other corporations in law or tax code, such investments can be made, provided that such investments are within the scope of these regulations. Although each of J-REITs takes conservative attitudes towards mezzanine/equity investments currently, it is probable that such investment can be carried out as a means of acquisition of excellent real estate as in the case of development projects. JCR considers that these investments are ones with market risk related to real estate being condensed and that they basically become a risk factor for changes in cash flow of portfolio.

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[6] There is a case of decision on acquisition of office building of "Shirokane 1-Chome Higashi District Class 1 Urban Redevelopment Project" by Nippon Building Fund Inc. as an example (completion was scheduled for November 2005 and delivery was scheduled for March 2006).

(2) Analysis of AM's Management Capacity

JCR place emphasis on analysis of AM's management capacity, along with portfolio analysis, in rating for J-REITs. JCR examines primarily AM's management policy and financial policy and its capacity to carry out these policies. Although many elements of management capacity are incorporated into the rating as qualitative factors as time advances, reflecting the actual performance, there are many points, on which JCR evaluates conservatively, because there is uncertainty about the AM's management performance at the moment. JCR considers that there are not a few elements in actual performance of sponsor of AM and its support to AM that can be taken into consideration in analysis of AM's management capacity, because the sponsor's involvement in AM cannot be ignored in terms of structure of J-REITs.

(i) Asset Management Policy and Capacity to Implement It

It is necessary to verify that by what policy AM manages J-REIT's portfolio first. JCR verifies AM's investment policy and its actual conditions such as whether it specializes in one use for its real estate or manages composite type of portfolio, or how it diversifies the portfolio geographically. JCR also verifies its approaches to PM because PM plays an important role in maintenance and improvement of value of each piece of real property and in realization of internal growth. Achievement of high occupancy rate by way of proper tenant leasing, cutback in management cost, formation of an effective renewal plan are required of PM. Although fee is always required to be reduced in recent years due to intensified competition among PMs, it is necessary to select and assign a PM who carries out adequate services which can maximize earnings by setting up an incentive scheme for example other than property management services "with low price and poor quality."

A wide variety of asset management forms can be assumed for J-REITs. AM's management policy will be a foundation for the rating. It is furthermore more important to examine closely whether or not the AM has ability to carry out its management policy. Although with many J-REITs drawing growth strategies at present, their ability to acquire properties including due diligence system is now being spotlighted, all-around property management capacity including maintenance and management of property and adequate replacement of assets with another assets will be required in order to increase efficiency in the portfolio management.

(ii) Financial Policy and Capacity to Implement It

JCR verifies AM's financial strategy including the ones such as its plan for borrowings or issue of investment corporation bonds, dispersion of maturities, handling of refinance risk including establishment of commitment line, and plan for capital increase. Verifications of several conditions including its aimed LTV, content of covenants, conditions of establishment of collateral are important.

J-REIT's leverage increases when it acquires new property, because it raises funds for purchase by way of loans ordinarily. Therefore, it is necessary to lower the leverage ratio by capital increase, and it is important that it can maintain a stable leverage level by adequately controlling balance between debt and equity finances for growth. In such case, it is probable that records of capital increase in the past will become an element for making a decision. However, whether or not it can implement a capital increase smoothly depends on market conditions to a large degree. In general, making a decision on financial management at a good time in consideration of market conditions is required.

(iii) Involvement of AM's Sponsor and Conflict of Interest

Involvements of AM's sponsor with J-REIT can be seen in the financial assistance, property sale, provision of human resources to AM, assumption of property management services. Although these involvements can be positive factors in terms of support for AM, it is necessary to check the degree of its real involvement and conflict of interest.

Evaluation on the financial assistances is made whether or not it can meet the needs of loans (including establishment of commitment line) or capital increase when J-REIT faces difficulty in debt or equity financing. On the other hand, sponsor's support in provision of human resources to AM is an important point at an early stage of inauguration of J-REIT. This could be a negative factor, however, because persons sent to AM from the sponsor are to return to it by personnel rotation. Thus, employees should be basically employees of AM itself other than workers dispatched from the sponsor. As for assumption of PM services, sponsor's benefits are large in terms of compensation, and there are many cases where sponsors become PMs. Although JCR does not see the sponsors' becoming PMs as a problem because they are familiar with such properties, as there is a chance that conflict of interest may occur in tenant leasing, JCR considers it necessary to verify preventive measures for avoiding the conflict of interest and also adequacy of level of compensation.

Concerning the conflict of interest, purchase of property owned by sponsors must be watched the most. Information on properties and purchase of properties from sponsors are considered supporting factors for J-REITs' external growth. On the other hand, it is necessary to check fully whether or not J-REITs purchase property at an appropriate price.

Although the creditworthiness of J-REIT's debt is not a direct reflection of that of sponsor, there will be a case in which it is necessary to make analysis of degree of sponsor's effects on AM's ongoing business activities when creditworthiness of the sponsor is extremely low.

(3) Financial Analysis

Major points in the rating in financial analysis are the following:

First, ROA (Return on Assets) might be an important financial indicator for profitability for evaluation of J-REIT as a going concern. Whether or not it generates earnings worth its property owned by it is a point in the evaluation, and cash flow stability is important above all, because ROA of portfolio consisting of properties with high risk may become higher. As another indicator for profitability, JCR verifies NOI return.

Ratio of equity capital to total assets, etc might be important factors as indicators for financial stability. JCR evaluates how much buffer the J-REIT has in preparation for various changes to be made to the real estate market.

JCR verifies LTV as an indicator for certainty of principal recovery. As described above, however, JCR does not think that a criterion in rating for structured finance by LTV can be applied directly to the J-REIT, because in comparison with structured finance projects in which property replacement is not made basically, and is static with time limit being defined, J-REIT's properties can be replaced with other properties at the discretion of AM, and therefore, it should be thought of as a corporate as a dynamic going concern. LTV is understood as a ratio of total debt to total property valuation amount, and JCR's valuation amount is used as the valuation amount in the calculation of LTV. The deposits and guarantees from tenants, which are not reserved in cash, are added to the total debt amount in the calculation of LTV. In addition, JCR pays attention to the expected level of LTV in the medium term, examining the adequacy of the J-REIT's target LTV level at normal time after verifying the movements of LTV in the past.

JCR also verifies DSCR as an indicator for a metric for certainty of interest payment and principal repayment and refinance during the term. DSCR equals NOI divided by annual debt service payments. JCR's NOI is used in the calculation of DSCR, and JCR adds a DSCR in a stress scenario, assuming a phase of interest rate rise, to the evaluation in addition to a DSCR obtained by the real debt service payment schedule during the term.

## 5. Conclusion

Skill or lack of skill in asset management can be thought of as having not come to the surface in the financial structure of each J-REIT to date excluding short-term changes in the financial indicators due to additional acquisition of properties or property sale, although differences may occur gradually as time advances. Given this current situation, JCR gives priority also to portfolio analysis and analysis of AM's management capacity while considering financial analysis as a basis.

As J-REITs are at present in growth stage where content of their portfolios can change every minute. Therefore, JCR considers it essential to monitor timely due diligence for each property acquisition or LTV level.

JCR intends to review the rating views described here in accordance with changes in the environment surrounding the J-REITs such as future economic trend, real estate market condition, system of laws or system of taxation.