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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 structured finance can be taken in rating for it. On the other hand, evaluations on a J-REIT need to 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 asset management company (asset manager, hereinafter referred to as “AM”), causing AM’s management capability (including the collaboration with the sponsor (who is the shareholder of AM)) 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. Characteristics of J-REITs in light of Rating Viewpoint

(1) Comparison with SPC

Although a J-REIT does not have 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. On the other hand, 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[1] 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

[1] 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.

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, it is not reasonable that a criterion in rating for structured finance by loan-to-value ratio ("LTV") is applied directly to the J-REITs.

In case of J-REITs, governance by the investors as equity holders is clearly defined under the Investment Trust Act and 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) 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 mainly that the real estate leasing business can generate stable earnings compared with other businesses, and there are cases where JCR assigns a relatively higher rating to a real estate leasing 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 possibly similar to those in earnings of the real estate leasing companies.

In the real estate leasing companies, transitions of financial indicators reflect their management capacity in properties and financing in their long histories, and qualitative evaluations can be made based on these indicators. In the case of J-REITs, it may be difficult to make qualitative evaluations similar to those in the case of the real estate leasing companies, because their business histories are relatively short. JCR considers, on the other hand, that it may be 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. Additionally, the collaboration with the sponsor may be evaluated to complement these negative factors.

Financial 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. JCR thinks the financial soundness etc. of J-REITs, however, is relatively high at the moment.

In addition, evaluation on the point that there is a limit on implementation of development business in J-REITs 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 has various risks inside. 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[2].

On the other hand, in evaluations on J-REITs, a point working as a negative factor is that J-REITs cannot accumulate net income because they need to distribute almost all of their earnings to the investors for the purpose of clearing requirements for dividend deductibility, while corporate can accumulate net income 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 should be basically used for repair and/or renewal expenses for their properties, they cannot accumulate capital as buffer for creditworthiness of its debt. 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 that good relations with creditors to mitigate the refinancing risk has an impact on equity finance and then debt finance subsequently, is one of its characteristics.

## 3. Rating Methodology

As described above, 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. And JCR considers that 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 J-REITs' 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, JCR thinks that analysis of the present portfolio is important because these pieces of property are central part of the portfolio for the time being. Additionally, JCR thinks that confirmation on whether or not the present portfolio's composition is consistent with the J-REITs'

[2] 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, depending on the legal interpretations, there are cases where it invests in buildings which have high expectancy of ensuring tenants at the time of delivery after completion of construction, or where it reconstructs buildings which are deteriorating.

investment policy or management policy is a point in making a prediction of the portfolio performance in the future.

(i) Property Valuation

In property appraisal, JCR scrutinizes each piece of property and then grasps total value of the properties in the entire portfolio by summing up each piece of property. Specifically, JCR scrutinizes, appraised value after conducting site survey on major properties and hearing with AM and 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.

Furthermore, JCR examines the values of major properties including NCF to be generated stably in the medium term and validity of cap rate of each property, taking into account the market situations of area, predominance of each property, and spec of the buildings.

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 case where it acquires property at a relatively high price, it is concerned that its capacity to acquire properties including AM's routes for obtaining information on properties through their due diligence system. And the verification about prevention of the transaction which may include conflict of interest is needed if the property has been acquired from sponsor.

(ii) Quality and Competitive Strength of Portfolio

JCR evaluates quality and competitive strength of portfolio by factors such as geographical conditions, size of buildings, structure, age, content of facility, ownership form, content of tenants' attribution and contract, rent or occupancy rate, and cost per *tsubo* (3.31 square meters), through evaluation of each piece of real estate property. In these evaluations, a point of view whether or not the J-REITs can maintain quality and competitive strength of portfolio not only at the moment but also in the future is required, examining factors causing changes in the submarket such as development plan in the vicinity in the future. 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 the form of ownership other than full ownership, JCR is concerned that, in case where an owner cannot make a decision on replacement of its management company with another company or a repair by itself owing to relations with other sectional owners or co-owners, sectional ownership or co-ownership may become factors to constrict internal growth of J-REITs or can cause default risk or difficulty in disposing of properties as a result of default of other sectional owners or co-owners. 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.

(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

Portfolio with not only multiple properties but also high diversification of cash flows from individual properties (including the number of tenants per a property) and of property values is generally stable in its cash flows. In cases where cash flows and property values are not diversified well, there is a possibility that fall in cash flows from specific properties can lead to significant decreases in cash flows from the overall portfolio. In such cases, there is also a possibility that flexible property sale may be inhibited because sale amount of such specific properties can become so large.

■ 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 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 in terms of quake resistance of each property.

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 of economy in Tokyo, causing geographic diversification to work as a negative factor in current situation. JCR judges the portfolio value in an integrated manner by examining competitive strength or competitive advantage of each piece of property in its area, AM's or PM's expertise in its area, the role in J-REITs' portfolio, 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 logistic properties, office, commercial facilities, and to hotel, although it quite 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. Concerning with other type of property, there are cases where JCR may judge that risk is relatively low, 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 concern that stronger degree of diversification may decrease efficiency in property management.

■ Tenant Diversification

The more diversified the portfolio is with many tenants and attributes including their industries, the less the portfolio 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 and share of tenants, conditions of contract, creditworthiness, and termination time of lease contract in addition to the degree of the concentration. Exit risk of tenants from the headquarters building, important business base (including logistics) or stores generating high income will become lower, so grasp of each usage is necessary in some cases.

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

There are some J-REITs which invest in development projects as a means of acquisition of real property in a situation of intensified competition for acquisitions of excellent real estate. It's not very conceivable in general that J-REITs acquire real estate even at risks for completion delay/cost overrun but it's possible that they may get exposed to some market risks in the case of delivery immediately after the completion or they may bear some risks to rebuild properties they already own. 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 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. With regard to mezzanine/equity investments by each of J-REITs, such investment has been seen as a means of acquisition of excellent real estate same as in the case of development projects currently. As these investments are ones with market risk related to real estate being condensed even if each investment costs small, and therefore it is necessary to watch closely impairment risk of financial standing, JCR judges degree of risk that these investment may have an impact on the portfolio as in the case of the development projects.

In cases of an open-ended investment corporation, when real estate appraisal value falls rapidly owing to deterioration of real estate market, it is likely that requests for refund on investment equity by investors will increase rapidly and that LTV based on market value will rise. In light of these concerns, it is preferable that JCR can value marketability of properties for the reasons that the properties are not limited to a specific use or portfolio is well diversified for the open-ended investment corporation particularly, although these factors can apply to a J-REIT as necessary factors.

(2) Analysis of AM's Management Capacity

JCR places emphasis on analysis of AM's management capacity, along with portfolio analysis, in rating for J-REITs. JCR examines primarily AM's management and financial policy, and its capacity including previous results to carry out these policies. As many elements of management capacity are incorporated into the rating as qualitative factors as time advances, reflecting the actual performance, there are some cases where JCR evaluates conservatively, if there is uncertainty about the AM's management performance. 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 disregarded 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/diversified 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 is required of PM. Although fee is always required to be reduced in recent years due to intensified competition among PMs, JCR thinks it is necessary to select and assign a PM who carries out adequate services which can maximize earnings through improvement of tenant satisfaction by setting up an incentive scheme for example, other than property management services "with low price and poor quality."

AM's management policy is a foundation for the rating of J-REITs. And it is important to examine closely whether or not the AM has ability to carry out its management policy and to check their performance in the past. All-around property management capacity including maintenance and management of property and adequate replacement of assets with other 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. Especially, 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 and raises funds for purchase by way of loans in terms of flexibility. Therefore, it is necessary to lower the leverage ratio by capital increase at the appropriate time, and it is important that it can maintain a stable leverage level by adequately controlling balance between debt and equity finances for external growth. In such case, it is probable that records of capital increase in the past will become an element for making an evaluation. However, whether or not it can implement a capital increase smoothly depends on market conditions to a large degree. In general, JCR thinks an AM is required to make a decision on financial management at a good time in consideration of market conditions through the interaction with the market participant by way of tireless IR efforts.

(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 (equity or debt), disposition of properties (including property replacement through mutual transaction), provision of human resources to AM, assumption of property management services. Although these involvements can be positive factors in terms of support for J-REIT or AM, it is necessary to check the influence and conflict of interest by its substantial involvement.

For the financial assistance, it is to be studied whether the sponsor can meet needs for loans (including the establishment of commitment lines) or capital increase in a case where the market situation hampers the J-REIT's debt or equity financing. There have been only limited examples of such cases, however. Meanwhile, in light of provision of human resources to AM, support in the form of temporary transfer of staffs with experiences and know-how in real estate management from sponsor is of importance for management of a J-REIT, which requires various kinds of knowledge. Given that these staffs will return to the sponsor in a personnel rotation at some future time, how such negative aspects are addressed may need to be taken into consideration. Attention should be paid to the management's stance for how the AM accumulates and imparts know-how.

As for assumption of PM services, in case that sponsor's benefits are large in terms of compensation, 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 the previous conditions of properties that they once possessed, as there is a chance that conflict of interest may occur such as 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, JCR thinks acquisition of property owned by sponsors must be watched the most. Information on properties and preferential acquiring chance of properties from sponsors are considered supporting factors for J-REITs' external growth to a certain degree. On the other hand, it is necessary to check fully whether or not J-REITs acquire 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, portfolio's NOI yield and ROA (return on asset) are important profitability indicators to evaluate a J-REIT as a going concern. It should be noted that NOI yield may tend to be high in a case of a portfolio that consists of properties with relatively high risk such as a lack of liquidity. In this context JCR sees it important to make evaluations based on whether the J-REIT generates incomes worth the risk involved in the owned assets and also on the stability of the entire portfolio's cash flows.

LTV is important factors as indicators for financial stability and the timely payment for principal amount of the debt. Based on current level of LTV etc., JCR evaluates how much buffer the J-REIT has in preparation for various changes to be made to the real estate market. 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.

JCR grasps LTV as a proportion of total debt amount to the total assets with book value or market value, etc. It is necessary to pay attention for the LTV calculation in case that security deposit and/or guaranty money are not reserved in the form of cash. JCR checks consistency of the LTV with an LTV level on an ongoing basis set by J-REIT and AM, and in particular, JCR watches closely LTV control through equity and debt finance when acquiring properties.

JCR also checks DSCR and/or ICR as an indicator for a metric for certainty of interest payment and principal repayment and refinance during the term.

Since an open-ended investment corporation is required to refund investment equity to the investors by requests from them, it is necessary to assume a risk that its LTV may rise due to procurement of funds for such refund by way of borrowings. While volatility of equity price for investors is low for an open-ended investment corporation because net asset value of the investment equity is calculated based on real estate appraisal value for it unlike in the case of a J-REIT, there will be a possibility that more requests for refunds on investment equity than assumed may be made in a phase where real estate appraisal value, which is a base for calculation for the net asset value, and other decline significantly due to events such as rapid decline in real estate market despite the fact that the equity investments originally are intended for investors with buy-and-hold strategy. Prior treatments such as setting of upper limit on amount of refund during a certain period are necessary to control risk of a rapid rise in LTV to a certain extent.

It is necessary to watch closely whether or not an open-ended investment corporation secures relatively liquid properties that can be sold for a relatively short period of time during a period from requests for refund by investors to the actual implementation of such refund as well as approaches towards an ensuring of asset liquidity, actual performance of cooperation with sponsor, feasibility of such cooperation for the future, etc. on the part of AM.

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