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# Real Estate Development Projects

## 1. Overview of target products

Securitization of real estate development projects is a type of future flow securitization that relies on cash flow generated in the future, in which investors provide funds for the development of condominiums and office buildings in the form of debt and equities. As opposed to conventional real estate securitization that applies to properties such as office buildings that already exist, this is a scheme that applies to properties that have not yet exist and to procure their funds, such as that for land acquisition and/or payment for contractors, through a bankruptcy-remote special purpose vehicle (SPV). Securitization of real estate development projects can also be regarded as project finance for real estate.

## 2. General scheme

### (1) Condominium for Sale

As cited in the example in which a specific purpose company (TMK) acted as an SPV, TMK uses funds obtained by issuing specified corporate bonds and/or loans to purchase land for a building construction site. The TMK also signs a contract for the building construction with a contractor and makes an advance payment for the construction and partial payment for the facilities. The TMK deposits the balance left after subtracting the land price, advance payment for construction, and initial expenses from the acquired funds. This deposit is maintained as a cash reserve to pay for costs including expenses during the construction, a certain amount of redemption funds, interest on specified corporate bonds and/or loans, a contingency for earthquakes.

In the sales operation, the sales agent sells real estate lots based on the contract for distribution between the sales agent and the TMK. And the agent signs a real estate sales agreement with the property purchaser.

The TMK redeems the specified corporate bonds and/or loans using the payment for the property from the purchaser.

### (2) Earning properties for rent, office, etc.

TMK uses funds obtained by issuing specified corporate bonds and/or loans to purchase land for a building construction site or to redeem existing debt. The repayment date is to be set for corresponding to a certain construction and leasing period and the TMK redeems the specified corporate bonds and/or loans utilizing the proceeds of disposing the properties or refinancing.

3. **Key points in rating**

I. **Case of the Condominium for Sale**

(1) Risk at the stage of construction

(a) Contractor's credit downgrade

An important point is whether the contractor is equipped with adequate experience and ability to construct the building. If the credit standing of the contractor is poor and there is some concern of accomplish that project, to enhance credit, insurance for bond performance from a nonlife insurance company is taken out with the issuer as the insured or a commitment line is established with a financial institution. This covers any additional expenditure for construction if the construction work must be taken over by another contractor. It should be noted that to appoint the "Back-up Contractor" from the beginning is desirable.

(b) Insolvent of the construction payment

When the Real Estate Development Projects are securitized, the money will be paid at the time of delivery after the completion of building, except for the deposit from the purchaser. So, in many cases, the provision usually is to be made that the construction payment should be subordinated to the specified corporate bonds, or senior loans, except for advance payment. It should be noted that, in addition to this case, when the Sale price are to be less than the assumed level and the possibility of the shortage of the construction payment are raised, the scheme should be set not to interfere the redemption of senior debt by the additional capital injection from the sponsors, or committed loan from the junior lenders.

(c) Growth in construction payment

There is a risk of payments to the contractor increasing from the initial agreement (cost overrun risk). To prevent this, the construction contract must put a limit on such a cost and specify that the payment for any inevitable increase in cost is to be paid within the reserved money, or is subordinate to the specified corporate bonds, or senior loans.

(d) Significant delay and cancelations of construction contract due to force majeure.

Generally, in the construction contract, if the contractor is forced to interrupt their business to a certain time period due to force majeure, the contractor can cancel the contract and then is exempted from their obligations. As a countermeasure of this situation, while giving consideration to the length of a grace period, if the contractor can resume the business objectively, the contractor is oblige resume the construction in accordance with the contract.

(e) Development contractor's credit downgrade

The development contractor provides advisory services based on the property development agreement for: the selection, inspection and purchase of land; product planning, including decisions on the type of product specifications and the basic plan of the building; acquisition of permits and licenses; measures for neighboring residents; selection of the construction contractor; and matters related to other building construction and associated property development. As a contingency for when the development contractor becomes unable to carry out the development operation, the asset management contractor is to take over the advisory services for the TMK.

(f) Soil contamination

If environmental research finds that the soil is contaminated, appropriate treatment must be provided in advance.

(g) Authorization risk

The general nonexistence of authorization risk must be confirmed. Permits for the overall design and building confirmation, therefore, must be obtained before issuing the specified corporate bonds or loans.

(h) Risk of earthquakes

Base on the Quake-resistance diagnosis report, the figure of PML should be checked at the completion and under construction in advance. Earthquake insurance is purchased and reserve funds, as measures against the risk of earthquakes, are deposited when issuing the specified corporate bonds or loans.

(2) Risk at the stage of Sales

(a) Sale agent's credit downgrade

The sales representative is liable for defects jointly with the TMK and provides the TMK with sales agency services. As a contingency for the credit downgrade of the initial sales agent, a substitute contractor is arranged. It should be noted that, the scheme need to be considered with that the substitute contract is triggered due to credit downgrade of the contractor, or substitute contract is canceled due to credit downgrade of the substitute contractor occur, as such.

(3) Assessment of total sales amount (i.e. expected recovery amount) and LTV

Total sales amount (expected recovery amount) is assessed based on data including market analysis. This is multiplied by the loan-to-value (LTV) ratio used for the rating in real estate securitization, which is the basic method of determining the ratings. In addition to the requirements as described above, Reserves may be required to be arranged as an additional credit supplement depending on the degree of construction risk and relocation.

## II. Case of the Earning properties for rent, office, etc.

(1) Risk at the stage of construction

The risk in the development project of properties exists whether the planned building will be completed at the scheduled time and specifications according to plan. In response to this point, JCR scrutinizes the contents of construction contract, the key-point of the project, etc., through the interview to the contractor, developer, as such.

(2) Risk at the stage of tenant leasing

It is important for the securitization of real estate development project that to examine how to manage the leasing risk because when the building is completed, there may be only few tenants. In response to this point, JCR scrutinizes the potential of development location, the planning and promotion of the tenant leasing by the project managers, and then judges the risk is reduced within a certain range.

(3) Risk to ensure the funds for repayment

Generally, for the securitization of real estate development project, such as the following clauses are added

- Until the beginning of the lease for the tenants after the completion, TMK has no income. So, if TMK shall pay additional cost, TMK needs the additional capital injection or loans.
- Scheduled payments (taxes and public dues, administration cost, payment of interest, etc.) are procured by the investment of sponsors, or specified corporate bonds and/or loans in advance.
- In the leasing period, surplus cash flow after deducting expenses(including payment of interest),are to be paid as dividend to equity holders. But, if the provision (LTV, DSCR, etc.) has been triggered, the dividend should be stopped.
- In the provision of the contract, sponsors must invest additionally in a certain situation (e.g. performance trigger, including unplanned payment).
- Concerning with the procedure of refinance or disposition of the properties, the detailed provisions are set corresponds to the scheduled period. Addition to that, so called “tail period” shall be set for a certain period of time.

(4) Appraised value of the properties and LTV

JCR scrutinizes the information (e.g. specifications of the building, assumed rent, cost of construction, etc.) received from stakeholders. And then JCR determine the assessed price by income capitalization approach (direct capitalization) through the assessment of the stabilized rent after the completion. This is multiplied by the loan-to-value (LTV) ratio used for the rating in real estate securitization, which is the basic method of determining the ratings.

## 4. Summary of documents required (primarily for condominiums for sale)

(1) Documents concerning land purchase

A certified copy of land registration, real estate appraisal report, and a report on the environmental research, etc.

(2) Documents concerning the building to be constructed

Design drawings, standard specifications, earthquake risk evaluation report, etc.

(3) Documents concerning sale of condominium
Sale performance of the sales agent, market research report, and status of the development of competitive properties, etc.

(4) Documents to describe the scheme overview
Scheme drawing, term sheet, and scheme participants, etc.

(5) Documents concerning the scheme participants

(6) Related contract of project
Contract of development consignment, construction contract, and contract for distribution, etc.

(7) Related Opinions
Legal opinion regarding the securitization, Tax/Accounting opinion (arbitrarily), etc.

**5. Related rating methods**

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