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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 condominium 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

① 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. In some cases, to appoint the "Back-up Contractor" from the beginning is required.

② 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.

③ 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 is required to put provisions which limit such a risk 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.

④ 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.

⑤ 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.

⑥ Soil contamination

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

⑦ 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.

⑧ 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

① Sales 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.

② Sales activities

An important point is whether the sales representative is equipped with adequate experience and ability to perform sales representation. JCR uses documents and interviews to confirm the sales representative's experience and its sales strategies/advertising methods/sales activity policy for projects.

(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. An important point is whether the contractor's creditworthiness for performing duties is strong enough to be rated, for which the contractor's work record in constructing buildings that are similar to the projected building is considered. It is desirable that some structural arrangements should be made to cover risks of a certain degree of delay in construction.

(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 due to uncompleted leasing activity. In this respect, it is necessary to determine whether risks of the property' depreciation, as a result of long-term vacancy after the completion, are reduced to a certain range. For this, JCR before the completion examines the location and other potential of the development site and how project managers plan/promote their leasing strategies during the construction, and also verifies the validity of the level of scheduled rents.

(3) Risk to ensure the funds for repayment

The followings generally apply in cases of the securitization of real estate development projects:

- There is no rent income after a property is completed and until it is leased to a tenant, including rent-free period if stipulated in the contact. In a case where additional construction payment is required, funds need to be raised through additional ABL or additional investments from the sponsors.
- Scheduled payments (taxes and public dues, administration cost, payment of interest, etc.) are procured by ABL or the investment of sponsors in advance, and the funds are reserved.
- In the leasing period after the completion when the property as an ordinary income property gains rents, it is generally agreed that surplus cash flow after paying related expenses/interests are used for dividends to the preferred equity investors. The dividend payment, etc. will be suspended when preset LTV, DSCR, etc. is triggered.
- It is provided that some events such as unexpected cost increase and performance trigger should be addressed by the sponsors' additional investments or other arrangements.
- Concerning with the procedure of refinance or disposition of the properties, the detailed provisions are set in contracts concerned corresponds to the scheduled period. Addition to that, so called "tail period" shall be set for a certain period of time.

It is necessary to determine whether these arrangements and effectiveness thereof reduce risks to ensure the funds for repayment to a certain range.

(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 on the premise that the building is completed. (In this regard, in a case where pre-completion refinancing is scheduled, the DCF method is also adopted according to schemes.)

The rating is basically determined by multiplying the appraised value mentioned above by LTV ratio used in rating real estate securitization. JCR considers the following factors for LTV as necessary - risk factors related to the development; how the parties involved in the scheme are committed to the development project; the project's social significance; and severalty of each project.

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 parties

Contractor, sales agent, development contractor, etc.

(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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Japan Credit Rating Agency, Ltd.
Jiji Press Building, 5-15-8 Ginza,
Chuo-ku, Tokyo 104-0061, Japan
Tel. +81 3 3544 7013, Fax. +81 3 3544 7026