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Rating Methodology of J-REIT

(This report is an English translation of the original report in Japanese.)

1. Summary of R&I's rating approach

(1) Separate a REIT's creditworthiness into "operating stability" and "financial stability" and evaluate each component.

(2) Evaluate the stability of the REIT's operations, mainly by examining the following points.

- Quality and stability of the properties held (regions, uses, property sizes, years since construction, title and rights-related issues, earthquake proofing, occupancy rates, etc.)
- Portfolio diversification (property diversification, tenant diversification, regional diversification, use diversification, etc.)
- External growth policy (policy concerning investment in new properties and ability to execute the policy)
- Internal growth policy (policy concerning maintenance and enhancement of the value of properties held and ability to execute the policy)
- Measures to prevent conflicts of interest with the sponsor

(3) Evaluate the stability of the REIT's financials, mainly by examining the following points.

- Prepare projected financial statements for several periods to understand the medium-term projected range of LTV as defined by R&I
- Cash flow level and interest coverage ratio
- Procurement duration
- Collateral margin, diversification of funding sources, diversification of maturities

(4) To determine the final Issuer Rating, R&I closely examines "operating stability" and "financial stability."

2. Evaluation of operating stability

Because J-REITs are restricted institutionally almost entirely to real estate rental operations, the majority of operating risk is concentrated in the "risk the portfolio asset value or cash flow will decline" (portfolio stability). Accordingly, R&I investigates each rating factor, including the quality and stability of the properties held, from the perspective of risk evaluation.

Specifically, R&I receives data concerning the properties held (property list, appraisal reports, engineering reports, market reports, rent rolls, etc.) and performs an independent evaluation of each property. This includes an on-site inspection of the leading properties. Together with the divergence between the R&I evaluation values and the acquisition prices, which serves as an important means for verifying the suitability of the acquisition prices, R&I uses the calculation of substantive LTV as defined by R&I and the medium-term projection of cash flow levels in its evaluation of financial stability as described below. R&I simultaneously seeks an understanding of the characteristics and diversification of the current portfolio from the property data.

Moreover, because the current portfolio is not static, and its composition will change as the asset management company acquires additional assets or sells properties at its discretion, R&I investigates a REIT's external growth policy and internal growth policy by means such as interviews conducted with the asset manager.

- Quality and stability of properties held (regions, uses, property sizes, years since construction, title and rights-related issues, earthquake proofing, occupancy rates, etc.)

This is the most important rating factor for evaluating REIT operating risk. The ability of the properties held to generate cash flow steadily over the medium to long-term, and maintain their value, is extremely important for maintaining creditworthiness.

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- Regions: R&I investigates the strength of demand in the key investment regions and factors such as the dominance of the property locations within the regions. If many of the properties held are located in areas where demand is strong, with relatively excellent locational conditions within the regions, R&I can evaluate the properties to be capable of generating steady cash flow over the medium to long-term and maintaining their value.
- Uses: R&I focuses on factors such as substitutability of the tenants considered to be the investment target, the liquidity of the property market, and property management risks. In general, attracting follow-up tenants or disposing of a property will be comparatively easy if assets are in large-scale rental or property markets, such as office buildings or residential properties. On the other hand, the number of tenant candidates for properties such as hotels or suburban commercial facilities is limited, and these property markets are still developing. Nevertheless, for these uses as well, if the properties are highly competitive as shops and are managed by an influential property management firm, and rents are set in a range that makes it possible to cover the expense burden from earnings generated from the shops, R&I can judge the investment risk to be mitigated.
- Property sizes: In the case of office properties and suburban commercial facilities, large-scale properties generally are considered to have a competitive edge. Certainly there also are instances where properties such as small-scale office buildings with strong demand from store-related tenants, or community-type commercial facilities with strong local ties, are highly competitive even though small or medium-sized, and such properties must be evaluated individually.
- Years since construction (equipment and fixtures level): Because recently completed properties are assumed to be superior in attracting tenants, and the quality level of their equipment and fixtures also is comparatively high, R&I will investigate factors such as the distribution of portfolio properties by number of years since construction, or the average number of years since construction of the portfolio. If properties such as office buildings, urban commercial facilities or rental properties aimed at non-Japanese residents have been renovated appropriately, however, R&I will note the properties may be able to maintain their competitiveness regardless of the number of years since construction.
- Title and rights-related: Sectional ownership rights or common ownership of title normally decrease the liquidity of property transactions and restrict freedom of control. Therefore it is preferable for the percentage of sectional ownership or common title properties in a portfolio to be low, and when the principal properties include properties with sectional ownership rights or common ownership title, R&I will scrutinize the degree of risk from factors such as how the sectional ownership percentage and title relationship are set, and the creditworthiness of the other owners.
- Earthquake proofing: R&I judges the degree of earthquake risk based on factors such as the Probable Maximum Losses (PML) for the individual properties, or the portfolio PML taking into consideration regional diversification.
- Occupancy rates: R&I verifies the current occupancy circumstances and past changes in occupancy for each property. If the number of tenants is small, however, it is easier for a REIT to maintain a high occupancy rate, and the evaluation must be made in conjunction with a review of tenant diversification.

・ Portfolio diversification (property diversification, tenant diversification, regional diversification, use diversification, etc.)

To the extent portfolio diversification is effective, the size of any decline in asset value as a whole or size of any decrease in cash flow can be mitigated. Property diversification, tenant diversification, regional diversification and use diversification are considered to be the primary types of diversification, and R&I investigates the key factors for each category.

- Property diversification: R&I looks mainly at the degree of concentration for the leading properties. When a high degree of concentration is found, R&I looks at the competitiveness of the properties in detail. Needless to say, however, the quality and stability of the properties is of primary importance, because diversification of the properties is not meaningful if the competitiveness of the properties is low.
- Tenant diversification: When the number of tenants is limited, R&I analyzes the creditworthiness of the key tenants and the possibility of such tenants vacating the property (details of the leases and importance of said property for the tenants). R&I considers investments that rely entirely on

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the creditworthiness of current tenants to be risky, however, and will combine its analysis with an investigation of other factors such as (1) the possibility of substitute tenants renting space in the property, (2) the earnings level that can be assumed in such a situation and (3) the need for additional investment accompanying a tenant substitution.

- Regional diversification: When properties are concentrated in a specific region, the risk of a change in cash flow will increase because the REIT is more easily affected by the market trend in that region. In the case of Japan, however, the scale of the economy in the Tokyo metropolitan area dwarfs that of any other region, and R&I does not believe the concentration of properties in the Tokyo metropolitan area is a cause for concern. In addition, the fact the benefits of regional diversification will vary depending on use should be noted. For office buildings, for example, given a situation where head office functions are concentrated in Tokyo, diversified investment in local areas will be restricted to some degree, but commercial facilities can be established comparatively widely in locations boasting strong commercial districts, and even if the investment percentage in regional cities is high, this alone cannot be deemed reason to arrive at a negative evaluation.
- Use diversification: Diversification of property use is considered to contribute to portfolio stability because the factors affecting asset value and cash flow tend to differ depending upon property use. On the other hand, to the extent property use is diversified, property management can be anticipated to be more difficult because investment decision points or management procedures will vary greatly according to each use. Therefore R&I does not judge indiscriminate diversification of properties by use to be advantageous in and of itself.

・ External growth policy (policy concerning investment in new properties and ability to execute that policy)

Because a rating fundamentally assumes the characteristics of the current portfolio will not change greatly in the future, REITs should disclose their investment criteria as clearly as possible. The more specific the investment criteria, the better the future prospects of the portfolio. Because frequently the investment criteria normally disclosed are written somewhat abstractly in order to not hinder flexible investment decisions, however, R&I will evaluate the external growth policy through means such as interviews with the asset management company and analysis of the investment results achieved to-date.

In addition, it is important that REITs basically make investments on the assumption of long-term property ownership. Certainly, reviewing the portfolio through the external growth process and selling properties with the intent of improving the portfolio quality is desirable. When a REIT has declared from the beginning a policy of seeking capital gains through short-term property turnover, however, R&I must consider the fact operating results will be affected more easily by real estate market price fluctuations.

A REIT that boasts an excellent information network and strong property sourcing capabilities can improve its portfolio quality or achieve diversification by acquiring numerous high-quality properties. Conversely, if a REIT lacks strong sourcing capabilities, the danger of the REIT not adequately diversifying its portfolio, purchasing properties at unduly high prices or acquiring inferior quality properties increases.

Recently, conclusion of purchase agreements in which building completion is a condition precedent, or the technique of investing equity in an SPC responsible for development work and obtaining preferential acquisition negotiation rights, have been utilized frequently with the objective of securing newly-constructed quality properties. When such techniques are adopted, it is necessary to confirm what types of policies are in place to address the risks originating in the development work (construction completion risk, tenant leasing risk, asset value fluctuation risk). Furthermore, management that limits the percentage of the portfolio accounted for by development projects to a certain level is preferable.

The sponsor (used in this report in the sense of the asset management company's shareholders) will have an important influence on the external growth policy, through means such as supplying human resources and know-how to the asset management company or by donating property, offering agency servicing and providing information. Therefore the sponsor's business development capabilities in the real estate sector and the strength of such cooperation must be adequately considered.

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- Internal growth policy (policy to maintain and enhance the value of the properties held and ability to execute that policy)

Managing properties efficiently, attracting tenants with favorable terms and carrying out renovation work when necessary are indispensable for maintaining and improving property values. Therefore, creating circumstances in which a REIT will manage the properties efficiently and effectively while cooperating closely with the property management (PM) company is necessary. Systematizing management in preparation for growth in the number of properties and number of tenants also is considered an effective approach.

When a REIT holds properties for which facilities management is assumed to be comparatively difficult, such as commercial facilities and hotels, a high level of knowledge and experience is needed in order to maintain competitiveness. For example, even if the REIT has consigned management to a prominent property manager, the probability the earning capacity of the properties will be affected if the property manager is replaced must be assumed.

Just as in the case of the external growth policy, the sponsor's presence will have a substantial affect on the internal growth policy, and therefore R&I will sufficiently consider the sponsor's business development capabilities and strength of cooperation in the real estate sector.

- Measures to prevent conflicts of interest with the sponsor

A sponsor will have many instances for dealing with a REIT during the REIT's various phases, including property purchases and sales or mediation, the provision of information, tenant mediation and receipt of consignment of PM activities. Consideration must be given to conflicts of interest at such times. These include selling the sponsor's inferior quality properties to the REIT at high prices, and placing priority on attracting tenants to the properties owned or managed by the sponsor. The possibility of the sponsor blindly expanding the size of assets to increase asset management fees also cannot be ignored.

On these points, R&I will confirm whether the conflict of interest risk is mitigated by examining factors such as the content of the sponsor's own rules for preventing conflict of interest, the aggressiveness of information disclosure, the asset management company's shareholder structure, the sponsor's investment percentage in the REIT, and the structure of the asset management fees. Additionally, R&I will confirm the appropriateness of the acquisition prices for properties purchased from the sponsor.

- The image of a REIT with "very high" operating stability is provided below.
  - Many of the properties held are highly competitive and are expected to generate stable cash flow over the medium to long-term.
  - The concentration of specific properties or tenants is comparatively low and the portfolio is reasonably diversified.
  - The REIT can be expected to maintain or improve portfolio quality and diversify the assets because the investment criteria are clear and property acquisition capabilities are excellent.
  - The REIT has prepared the capacity to efficiently manage the properties, attract new tenants and implement planned, large-scale renovations as necessary to ensure the existing property values are maintained and improved.
  - Measures to prevent conflicts of interest with the sponsor have been adequately established.

3. Evaluation of financial stability

Because they are obligated institutionally to distribute over 90% of available earnings as dividends, it is difficult for J-REITs to retain earnings and accumulate capital. On the other hand, because the LTV will increase through the process of acquiring properties with borrowed funds, managing a REIT by increasing capital at the appropriate time, reinforcing equity capital and lowering the LTV is extremely important. A J-REIT also must simultaneously build a strong financial base that can withstand a rise in interest rates or deterioration of the finance environment while continuing to ensure appropriate cash flow corresponding to the risk of the portfolio.

R&I projects medium-term operating results and changes in financial structure based on materials submitted from the asset management company, the results of interviews with management, historical earnings information and other information, and based on its projections evaluates the stability of the financial structure from factors such as LTV level, cash flow level, interest rate sensitivity and liquidity.

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・ Understanding the medium-term projected LTV range

When evaluating financial stability, R&I prepares projected financial statements for about three years into the future while referring to materials such as the medium-term asset management plan submitted by the asset management company. In its projections, R&I especially emphasizes the future change in the LTV. Most REITs have established a target range for LTV under normal circumstances, although the definitions are not necessarily uniform. R&I uses a uniform calculation formula to analyze the divergence between the property acquisition price and R&I's assessed value, or the substantive LTV considering deposits and guaranty money excluding cash reserves.

While reducing LTV through a capital increase will improve the creditworthiness of the debt, there is a potential this will result in dilution or a decrease in dividends for the equity investors. Depending on the circumstances, there also is a possibility the interests of the debt investors and the equity investors will be at odds with regard to the LTV level. Accordingly, this demands a strong intent on the part of the management team to maintain sound finances and not opt for easy share price maintenance measures, and when R&I judges such intent is not strong in light of its interview findings and past operating results, R&I will assume a more conservative (higher) LTV level forecast.

Apart from the numerical LTV level, R&I takes account of factors such as the share in the equity market and the past record of capital increase in order to address the company's readiness of capital increase.

・ Cash flow level and interest coverage ratio

By dividing the stably anticipated NOI (net operating income) and NCF (net cash flow) calculated for the current portfolio by the total acquisition value, R&I can determine the portfolio yield (profitability) and verify the cash flow level based on these projected amounts.

Although R&I fundamentally emphasizes factors such as the extent to which cash flow will cover interest payments (interest coverage ratio), it also determines the earnings level after deducting costs such as depreciation and amortization expense, asset management fees and interest payments from NOI, and confirms whether dividends above a certain amount can be ensured.

R&I also performs stress tests, using items such as rental income, interest payments and LTV as variables to understand the ability of the portfolio to withstand a decrease in earnings because of deterioration in the real estate market or a rise in interest rates.

・ Procurement duration

Until now, J-REITs have benefited from a high so-called "yield gap," where the interest rate burden has been low compared with the high yields on real estate. The yield gap is expected to shrink in the future, however, as property yields fall and interest rates on debt climb. Therefore J-REITs probably will find it necessary to take steps to reduce their sensitivity to an interest rate increase, by restraining borrowings at low levels and moving to procure funds with longer maturities and fixed interest rates.

・ Collateral margin, diversification of funding sources and diversification of maturity dates

For REITs, whose internal reserves are restricted, debt typically is repaid by refinancing, because repayment funding sources basically are limited to refinancing or property sales, and time is needed in order to sell a property. This makes it important to create a flexible financial structure that will enable a REIT to respond even to a sharp deterioration in the finance environment.

For example, if the collateral margin is high, flexible funds procurement secured by the properties held probably will be possible. Diversification of funding sources and repayment dates also is effective for reducing related refinance risk.

・ The image of a REIT with "very high" financial stability is provided below.

- The average range of the substantive LTV understood by R&I is very low, at roughly 35-45%.
- Generates appropriate cash flow corresponding to risk, and has a very good interest coverage ratio level.
- Procures funds mainly with long maturities and fixed interest rates, and has reduced its sensitivity to an interest rate increase.
- Has established a sufficient collateral margin, and diversified both its funding sources and repayment dates.

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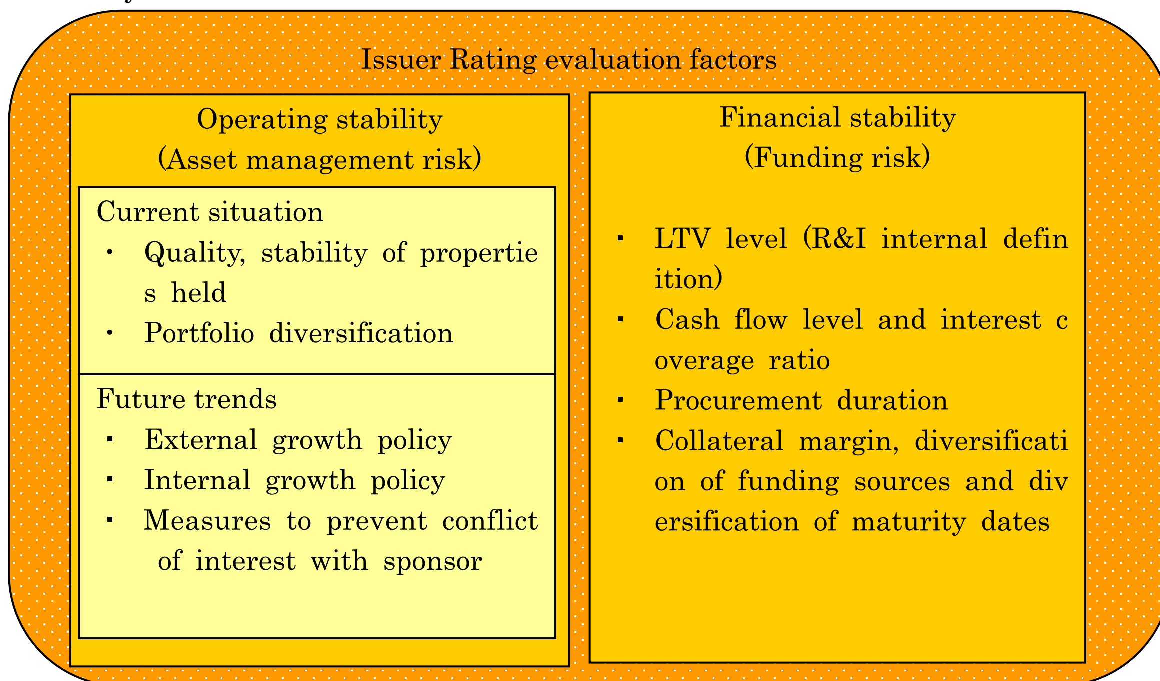
<Summary>



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