



NEWS RELEASE

No.2001-A-006
March 2, 2001

Ratings Methodology to Japanese REITs

Responding to the advent of Japanese real estate investment trusts (J-REITs), which became possible through a revision of the Securities Investment Trust Law, the Tokyo Stock Exchange formally established a J-REIT market on March 1. By doing so, it created a place for the trading of J-REITs, which are a financial product new to Japan and which offer liquidity based on small lots. Investment firms (toushi-houjin), which are the primary purveyors of company-type trusts, have the option of increasing yields on the equity portions of these trusts by raising debt, and can issue bonds for this purpose. R&I will rate the creditworthiness of these debt instruments.

To obtain funds for investment, investment firms themselves may raise whole amounts by selling equity. They may then invest these funds in the subordinated portion of real estate-backed securities. Another possibility is for SPCs to issue CMBSs backed by nonrecourse loans to investment firms. A traditional-style approach is used in rating such real estate-backed products and CMBSs.

An investment firm, in contrast to the general SPCs that issue real estate-backed securities, is an active going-concern that invests in real estate. Consequently, the rating of debt issued by an investment firm requires an approach similar to the one used in the case of an ordinary real estate firm. However, in the case of an investment firm listed on a major exchange, which must hold more than 50% of its investment assets in rental properties not planned to be sold within 1 year, the scope of business activities is much more limited than that of an ordinary company. Therefore, when rating investment firm debt, R&I will likely take two approaches – one used for real estate firms and another used for real estate-backed securities.

Evaluations of creditworthiness are based primarily on examinations from 3 major perspectives – asset quality, investment policies, and financing strategy. The setting of appropriate covenants to reduce non-transparent risk borne by investors is also an important consideration. Furthermore, the points emphasized during a ratings evaluation will differ depending upon the timing of the evaluation. An evaluation performed when an investment firm is established will emphasize different points from one performed around the time of an offering, or one performed several years after a trust has been established. In the particular case of an evaluation performed at the time of an offering, it is important to focus attention not only on the real estate portfolio, but also on whom its managers are. Once a trust has accumulated a track record, the focus of attention shifts to management ability and performance.

The ideas expressed here will be appropriately updated as necessary.

(Narumi Takahashi, Structured Finance Department)

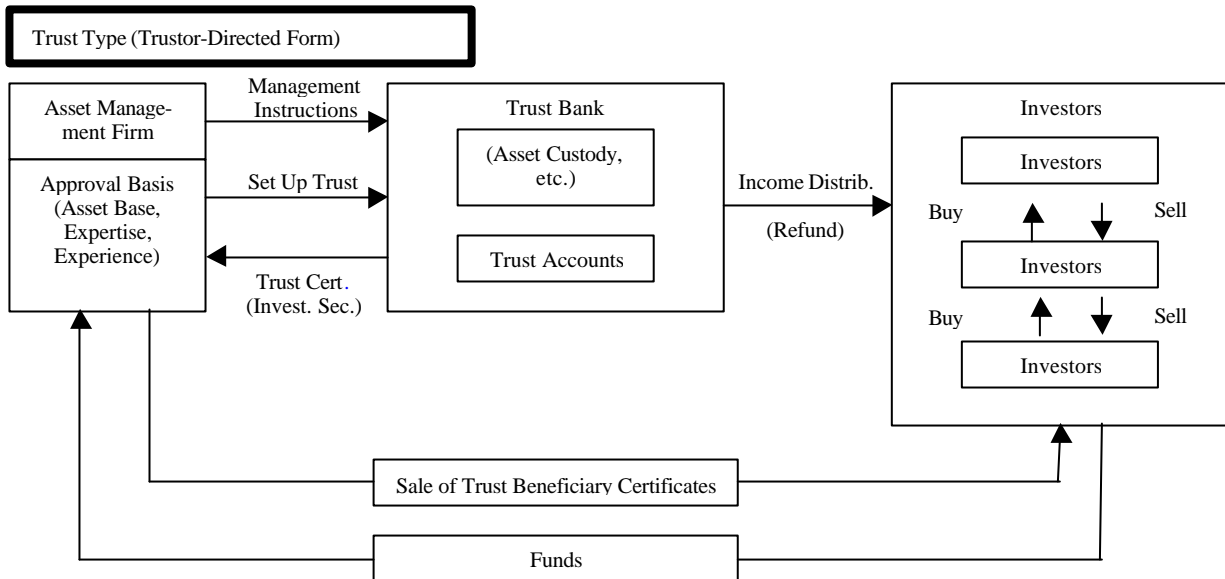
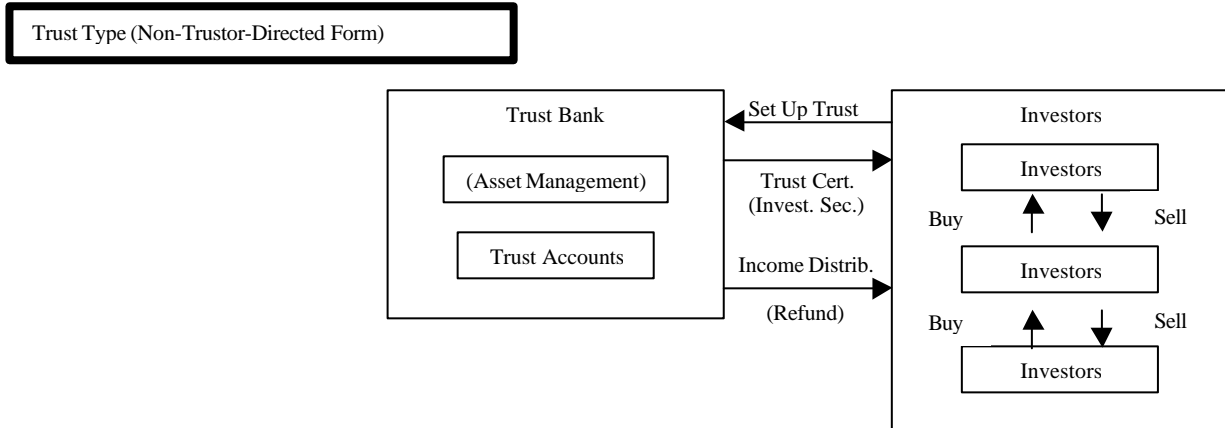
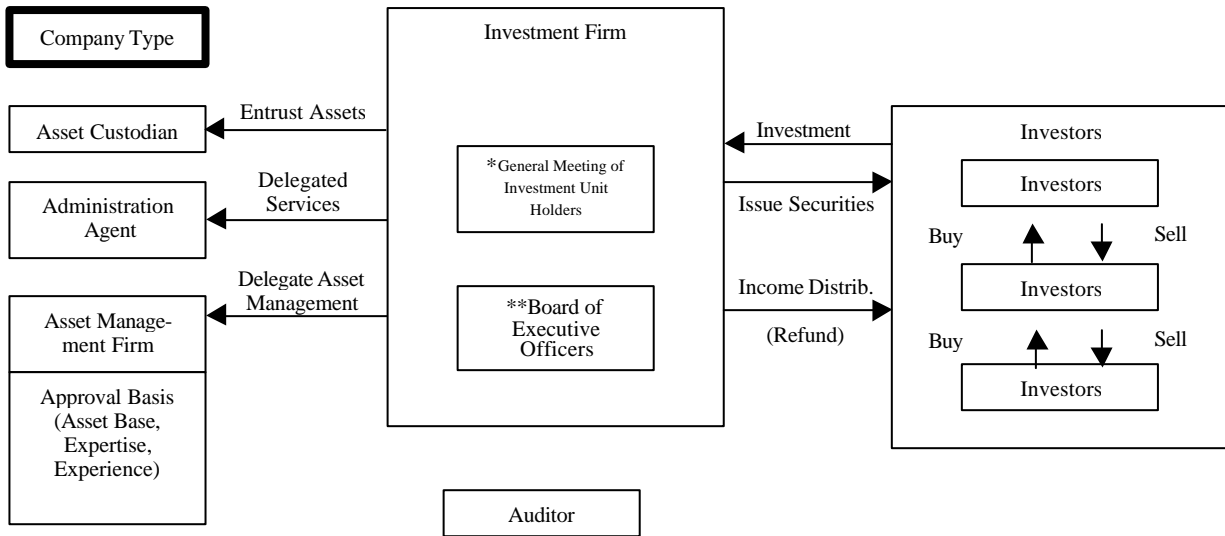
1. Revision of the Securities Investment Trust Law

The most important feature of the revision of the Securities Investment Trust Law, which took effect in November, was an expansion of its focus to include more than just securities. This opened the door to the creation of real estate investment trusts (J-REITs). Because J-REITs are required to distribute more than 90% of distributable income, in exchange for their tax-favored status, they are regarded as a new “middle risk/middle return” financial product that will focus on current period income gains.

Legal revisions made room for one company-type and two trust -types of asset management schemes. Under the company-type of asset management, an investment firm (toushi-houjin), as defined by the Securities Investment Trust Law, holds assets and delegates management to an asset management firm (one managing investment trusts). Under this form of asset management, corporate governance devices such as an general meeting of investment unit holders (akin to a shareholders' meeting held by a corporation) and a board of executive officers (akin to a board of directors) are employed. Among the trust forms of asset management, the trustor-directed form has the asset management firm providing management instructions to the trust bank that has been entrusted with the assets. Under the other trust form of asset management, which came into being under the recent legal revision, the trust bank manages assets under its sole discretion. This form is referred to as the non-trustor-directed form. All of these group investment schemes are legal under the Securities Investment Trust Law. Legal provisions protecting those who have invested in such schemes have been put in place and listing on the TSE is possible.

An additional noteworthy point is that investment firms who include in their bylaws (akin to articles of incorporation) a provision not to redeem investment units (akin to shares in a corporation) at the request of investors, may not only borrow funds but also issue bonds. For the foreseeable future, R&I will focus on bonds and loans (together referred to as “debt” hereafter) as the subjects of ratings.

NEWS RELEASE



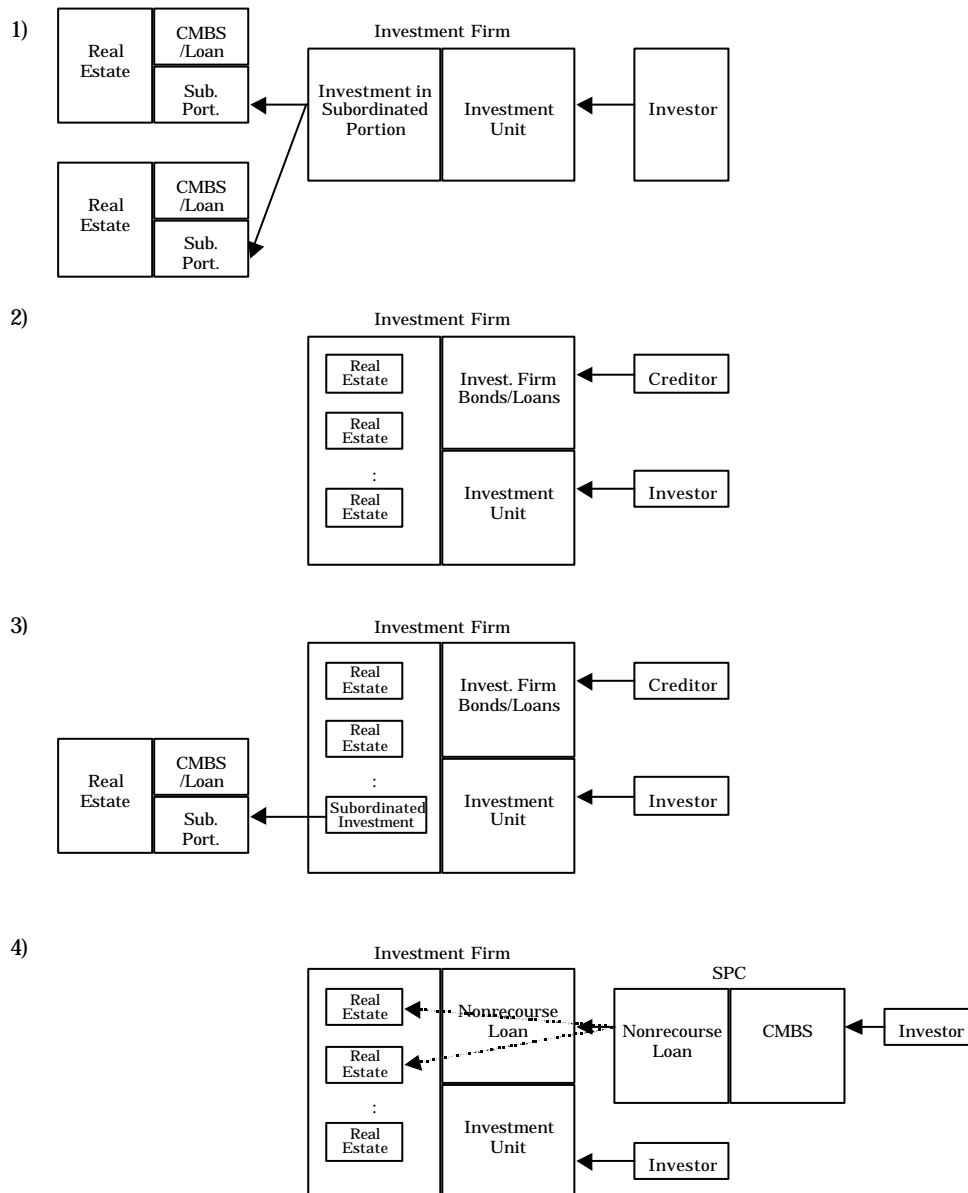
Source: FSA homepage

2. Anticipated Structures

R&I anticipates that investment firms (toushi-houjin) will use the following 3 structures to gather and invest funds. The first is one in which the investment firm secures all funding by selling investment units, and then invests funds in the subordinated portions of investment products backed by real estate (or trust certificates) or nonrecourse loans. In the second, the investment firm either takes out loans from a financial institution, or issues bonds, and then uses the funds to invest directly in real estate (or trust certificates). The third structure is a hybrid of the first two.

When an investment firm pledges real estate or trust certificates as collateral for nonrecourse loans that it takes out from a financial institution, the financial institution may turn around and sell the nonrecourse loans to a general SPC (Special Purpose Company), which may then use them to back a CMBS (Commercial Mortgage Backed Securities) issue. Real estate-backed products like this would be rated using traditional evaluation methods.

With tax issues also to consider, it is unclear at this point what structures will emerge. However, below, we present methods for evaluating the creditworthiness of investment firms that have raised funding through bonds or loans.





NEWS RELEASE

3. Comparison of Japanese REITs, Real Estate-Backed Securities, and Real Estate Firms

The REIT was originally a business form that real estate firms in the U.S. used for its tax advantages. The actual substance of what these REITs did was nothing other than what real estate firms did. Investment firms (toushi-houjin), different from the general SPCs that issue real estate-backed securities, are going-concerns investing in real estate. Therefore, rating of the debt issued by these investment firms requires an approach similar to that used in the case of real estate firms operating as ordinary companies do.

However, in the case of an investment firm listed on a major exchange, which must hold more than 50% of its investment assets in rental properties not planned to be sold within 1 year, the scope of business activities is much more limited than that of an ordinary company. We may also see investment firms that engage in very little buying and selling of properties. In the extreme, it is even conceivable that there will be investment firms that simply hold the properties that they start with. In such a case, the investment firm would be practically the same as a general SPC. Therefore, when rating investment firm debt, R&I will likely take two approaches – one used for real estate firms and another used for real estate-backed securities.

Comparison of Japanese REITs, Real Estate Firms, and Real Estate-Backed Investment Products

	Real Estate Firm	Real Estate-Backed Investment Products	Japanese REITs
Managed as a company	Yes	No	Generally Yes
Tax-Advantaged	No	Yes	Yes
Business Activities	Real estate leasing/development	Mostly real estate leasing	Mostly real estate leasing (Stock mkt. listing requires that more than 50% of investment assets be in rental properties not planned to be sold within 1 year)
Targets for LTV / Equity Ratio	Many firms have low equity ratios	LTV – 70%	LTV – 50%
Asset Transparency	No (Unrealized profits/losses)	Depends on purchase price	Yes (Anticipated)
Asset Quality Changes	Yes	No	Yes
Going-Concern Characteristic	Yes	No	Generally Yes
Record of Management Performance	Yes	No (Management unnecessary)	No (Figures currently unknown)
Company History	Yes	No	No
Record of Performance with Current Assets	Yes	Yes	Yes
Debt Financing Method	Bank loans, corporate bonds (Unsecured, secured)	Nonrecourse loan (Secured), Corporate Bonds (Unsecured but valued as if secured)	?(Refer to anticipated structures)

4. Ratings Perspectives on Investment Firm Bonds and Loans

Investment firms (toushi-houjin) may use both secured and unsecured debt. Unsecured financing will be examined from 3 major perspectives – asset quality, investment policies, and financing strategy.

1) Asset Quality (Real Estate Portfolio)

The most important point when it comes to asset quality is the amount of income that can be earned for each type of asset. R&I's evaluations cover issues such as conditions in the primary areas where properties are located, future competitiveness, current and future income-generating ability of primary properties (rent level compared to market rates, occupancy, etc.), distribution of tenants, and legal problems. R&I will also develop its own estimate of the value of primary properties, and examine the deviation of this value from the price and competitive conditions at the time of acquisition, and from the latest appraised value. We do this because relatively high prices paid for even prime properties may have negative future consequences for profitability and refinancing possibilities. Particularly for prime properties, R&I will apply the same type of detailed examination of asset quality that it uses in rating real estate-backed securities.

2) Investment Policies

The major difference between real estate-backed securities and J-REITs is that the asset quality of the latter will change as properties are bought and sold. Even if every property included in the original portfolio is analyzed, the portion of the portfolio comprised of these properties may gradually become only a small portion of a large portfolio, as investment activities go forward. On the other hand, it is unrealistic for R&I to analyze every new property that is acquired. Therefore, we will focus attention on the types of properties targeted for investment, the points that are evaluated by the J-REIT in making investment decisions, sale criteria, and other aspects of investment policies.

R&I also regards property maintenance policies as an important factor. Because of their tax-advantaged status, J-REITs will tend not to accumulate surplus funds. If this leads a J-REIT to use funds accumulated through depreciation, to invest in new properties, at the expense of maintaining existing ones, the existing properties may see their future competitiveness, as well as their values, decline. We also believe that J-REITs should have in place clearly defined criteria for hiring and firing property managers, who are responsible for managing and maintaining properties.

Investment firms will delegate management to third parties. The interests of an investment firm's investors will differ from those of the management firm's stockholders. R&I will determine whether or not investment firms have established policies to avoid conflicts of interest in the process of attracting tenants. Conflicts could come in the form of a management company focusing marketing efforts on properties owned by stockholders, or pressing the investment firm to acquire unnecessary properties, or acquire attractive properties at excessively high prices.

3) Financing Strategy

R&I will evaluate the proportion of debt that an investment firm plans to finance and the measures the firm has taken to counter risks involved in refinancing, as well as risks posed by interest rate hikes. R&I will also look for liquidity enhancement measures.

Additionally, we are concerned that a firm's issuance of unsecured debt may negatively affect future refinancings. Even if unsecured financing cannot be obtained, the presence of collateral may leave the door open to bank borrowings. Because of this, we believe that the amount of assets not pledged as collateral is a critical point.

4) Establishment of Appropriate Covenants

Since firms have no management track record when they begin operations, how closely they adhere to management policies cannot be given full consideration in evaluations. Therefore, the use of debt covenants can help to reduce non-transparent risk. Examples of debt covenants would

include requirements to maintain a certain LTV (Loan-to-Value ratio) and DSCR (Debt Service Coverage Ratio – cash flow as a multiple of interest and principal payments for one year), and a requirement to keep unsecured assets to a defined level.

However, in the end, debt is a tool for raising returns to holder's of investment units, and setting overly strict covenants to obtain better debt ratings may only have the effect of hindering growth in investment value. Careful attention is necessary in setting covenants.

5) Evaluation of Secured Debt

Secured debt used to obtain funds for investment may obtain higher ratings than unsecured debt, depending upon the collateral used and the proportion of debt covered. The reason for this is that the liquidation of collateral for the debt of investment firms, which are not corporations and not covered by the corporate reorganization law, can be accomplished relatively quickly.

The evaluation points discussed here will differ depending upon the timing of the evaluation. An evaluation performed when an investment firm is established will emphasize different points than will one performed around the time of an offering, or one performed several years after a trust has been established. In the case of firms that have just begun operations and have no track record, it is critical to focus attention not only on the real estate portfolio, but also on who its managers are. Once a trust has accumulated a track record, attention will shift to management ability and performance.