

## Structured Finance Ratings & Research

Rating: **A+/Stable/A-1**

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### Japan Retail Fund Investment Corp.

#### Rationale

On Sept. 28, 2004, Standard & Poor's Ratings Services assigned its 'A+' long-term and 'A-1' short-term corporate credit ratings to Japan Retail Fund Investment Corp. (JRF). The outlook on the long-term corporate credit rating is stable.

The rating reflects JRF's above-average business position and conservative financial profile and financial policy. The company is currently the third-largest Japanese real estate investment trust fund (J-REIT) based on its purchase price, despite its relatively small portfolio (20 properties). JRF owns a high-quality portfolio of retail properties, and its sponsors have strong real estate expertise and brand recognition. The company has a conservative capital structure, and solid coverage measures supported by above-average profitability. These strengths are partly offset by concerns regarding tenant and property concentration risk.

Due to the historic use of Hoshokin liabilities to finance the development of certain portfolio assets, over 50% of JRF's net operating income is currently encumbered, which effectively subordinates unsecured creditors and necessitates a one-notch differential between the corporate credit rating and the implied rating for senior unsecured notes. Therefore, the rating on any unsecured note issue would be rated 'A', one notch lower than the corporate credit rating.

The ratings also take into consideration the unique structure of J-REITs compared with REITs rated by Standard & Poor's in other global markets, which restricts management from pursuing certain higher-risk activities, such as ground-up development, to safeguard investors.

JRF was established in September 2001 and was listed on the Tokyo stock exchange in March 2002. Currently there are 14 listed J-REITs, and JRF ranks third largest in terms of assets (on a purchase price basis). The company is the first retail REIT established in Japan, and invests solely in the retail sector. The company's sponsors are Mitsubishi Corp. (A-/Stable/A-2) and UBS AG (AA/Stable/A-1+). The two companies own 5.0% of JRF, as well as 100% of Mitsubishi Corp. UBS Realty, the asset manager of JRF.

As of August 2004, JRF owned a portfolio of 20 retail properties nationwide. The properties have a total net rentable area (NRA) of 247,577 tsubo and are occupied by 308 tenants. The portfolio value amounts to ¥182.5 billion based on Standard & Poor's underwriting value, which is about 97% of the total appraisal value and 98% of the total purchase price. Of 20 properties, 13 are suburban retail properties anchored by retailers Ito-Yokado (AA/Stable/A-1) and Aeon (A-/Stable/-). The remaining seven are urban retail properties, one single-tenanted property occupied by Tokyu Hands (N.R.) and six multi-tenanted properties.

Geographically, about 43% of the portfolio is invested in Tokyo and the surrounding Kanto area, and 57% in regional cities, including Sapporo, Sendai, Aichi, Osaka, Nara, and Fukuoka. Standard & Poor's does not regard asset concentration in Tokyo as an immediate negative factor, given the centralization of both political and economic functions, which makes the real estate market the largest and most liquid in Japan. With regard to earthquake risk, the probable maximum loss (PML) of each property within the portfolio ranges between 0.8%-14.8%, so the aggregate portfolio risk is somewhat limited. The average property age is 6.5 years, which is considered young. Most of the properties are well located and maintained, and many have been refurbished before JRF's acquisition in order to meet the latest consumer demands. As of the end of August 2004, the average portfolio occupancy rate was approximately 100%, and portfolio rent levels were consistent with submarket rents as well as the sales volumes being achieved, mitigating exposure to near-term declines in rental income.

There is tenant concentration risk in the portfolio, as Ito-Yokado and Aeon contribute about 50% of the portfolio's annual rent income. This revenue concentration is not an immediate concern because Ito-Yodado and Aeon have strong retail expertise supported by high credit quality. There is also a degree of asset concentration risk in the portfolio, with Nara Family SC comprising 16.8% of the total portfolio value. However, this single asset concentration risk is not a major concern, because the property is achieving high sales volume and currently holds a unique competitive position in the submarket in Nara. Moreover, both tenant and asset concentration risks are expected to decline modestly over time, as JRF acquires more properties.

JRF's strategy is to enlarge its portfolio at a moderately aggressive pace, aiming to reach ¥400 billion by March 2007. This is considered to be generally in line with its rated J-REIT peers. Up to the target year, the company will pursue a policy of investing 40%-60% of its portfolio in the Tokyo and Kanto areas and the remainder in regional cities. JRF is expected to continue investing 100% of its portfolio in retail properties.

JRF's management expects to maintain a conservative capital structure, with a debt-to-capital ratio averaging between 40%-50% (including Hoshokin as debt). To fund future property acquisitions, JRF anticipates a strategy of timely equity issues to stabilize its leverage, as illustrated by public equity issues in March 2003 and March 2004. JRF's quality portfolio produces a stable rental revenue stream. Cash flow protection is strong, with the company's debt-service coverage ratio (DSCR) expected to remain above 3x on average, using Standard & Poor's conservative stressed constant interest rate of 6%. EBITDA interest coverage, based on currently attractive financing costs, is expected to remain at approximately 12x. The

total amount of Hoshokin liability repayment varies from year to year, which may result in volatile coverage measures. However this concern is mitigated because the DSCR using actual interest rate and including Hoshokin liability (both principal and interest) as fixed charge is expected to remain at least 2.5x.

## *Liquidity.*

JRF's liquidity is solid, with long- and short-term credit available to meet the company's near-term debt maturities as well as expand its portfolio. In addition, retained internal cash flow from operations after dividends provides coverage for the company's capital expenditures, which are expected to be manageable (retained internal cash flow is estimated to be ¥3.6 billion over the next 12 months). As of July 2004, JRF had approximately ¥6.8 billion in cash and cash equivalents, sufficient to cover immediate operating expenses including security deposit and Hoshokin liabilities. JRF's financial flexibility is considered high, reflecting its established bank relationships with major financial institutions. With more than 50% of the company's net operating income encumbered, the rating on any unsecured note issue would be rated 'A', one notch lower than the corporate credit rating.

## **Outlook**

JRF's diverse and high-quality asset portfolio should provide a stable income stream and sustainable profitability, despite the current asset concentration. With the support of its sponsors, JRF is expected to maintain a conservative financial profile. Although JRF's leverage may vary as its portfolio grows, it is expected to remain in the moderate range indicated.

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