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JCR Solicits Public Comments on Revisions to Rating Methodologies by Sector “Leasing” and “General Construction”

Japan Credit Rating Agency, Ltd. (JCR) is considering revisions to the rating methodologies by sector “Leasing” and “General Construction” as described below, and solicits opinions on the proposed rating methodologies.

1. Outline

JCR is considering revising its rating methodologies by sector "Leasing" and "General Construction," as described in the attachment. The purpose of these revisions is to make the rating more transparent by measures such as changing the content of the descriptions and revising the key indicators.

2. Future Plans

JCR solicits public comments on this matter. Comments will be accepted by e-mail to "Contact Us" on JCR website until December 20. JCR plans to finalize these rating methodologies in about one or two months. There will be no existing individual ratings that need to be reviewed.

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Attachment

Draft for Public Opinions

Rating Methodology by Sector

Leasing

This rating methodology applies to leasing companies in Japan. JCR applies this rating methodology with the necessary changes in the indicators for analysis to overseas leasing companies, based on laws, accounting system, financial administration in which these entities are located.

1. Business base

(1) Characteristics of industry

Leasing companies are financial service providers that provide long-term credit to corporations, and they also have the character of asset managers involved in the possession, maintenance, and disposal of leased assets. Leasing companies provide services that involve various factors, such as systems, taxation, and accounting.

(i) Market size and growth potential

The size of the domestic market, which is the main focus of each company, is relatively large. Japan's leasing transactions, which were born in the 1960s, have become deeply entrenched in the development of economic activity, centering on domestic companies, over half a century later, and the need for leasing is expanding to a wide range of products, starting with information and communications equipment, and including automobiles and industrial machinery.

The volume of new leasing transactions in Japan has shrunk to just over half of its most recent peak level. While it is difficult to expect sustained expansion of existing businesses, leasing companies are creating new earnings opportunities through expansion of range of products handled, support for distribution channels, provision of services, participation in business operations in fields such as real estate development and renewable energy, and overseas business development.

(ii) Competitive situation

The leasing industry is highly competitive. While the volume of domestic leasing transactions has been sluggish, the number of players in the leasing industry has continued to decline over the long term, but the number is still high. In particular, in the traditional finance lease business, it is difficult to differentiate itself from other companies, and there is also competition with bank lending, so profitability tends to decline. On the other hand, there are cases where relatively high profitability is secured in services with maintenance that can be differentiated, and in business investment-type businesses.

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(iii) Regulations

There is no impact from regulations such as licenses and special laws when entering the market. Leasing companies use their flexibility as a financial service provider that creates service value by combining various factors such as system, taxation, and accounting as their strength.

(2) Market position and competitiveness

Whether or not a company has been able to build a strong market position and competitiveness is extremely important when assessing creditworthiness, as this will have a significant impact on future earnings capacity. In addition to the market position and competitiveness of the core business, JCR pays attention to the diversity of the business portfolio for leasing companies.

When assessing the market position and competitiveness of the core business, JCR evaluates factors such as the customer base and the superiority of products and services. Leasing companies often have strong ties with banks, trading companies and manufacturers, and one of the key points is whether they can make full use of the management resources of these closely-tied groups or companies, including the network, know-how and human resources, as well as the customer base. Group-wide proposals and the like are an important factor in enhancing market position and competitiveness, and there are many cases where they lead to a deeper customer base and establishment of stable business relationships with customers. In terms of superiority of products and services, JCR is focusing on the provision of comprehensive solutions. As customer needs diversify, it will be important to discover new areas of business, as well as to improve their ability to make proposals to solve each issue. Based on these factors, JCR evaluates the scale of transaction volume and operating assets, as well as stability and growth potential of earnings.

In terms of diversity of business portfolio, JCR checks the status of revenue sources other than the traditional asset business (finance leases, installment sales, and loans). Leasing companies also handle assets that are developed globally, such as aircraft, engines, ships, and containers. In addition, they are expanding their business domains to include business development and operation, such as renewable energy and real estate development. In many of these areas where they have diversified, they have been able to maintain profitability. In addition to the breadth of their business areas, JCR also looks at the strength of their customer bases in the regions where they operate, competitiveness of their diversified businesses, and other factors, and evaluates the degree of diversification of their business portfolios and the extent to which it contributes to the stabilization of earnings capacity.

(3) Management strategy and governance

Management strategy and governance have a significant impact on the direction of the business base, and therefore can be factors that either reduce or increase risks. With regard to management strategy, JCR evaluates whether the company has been able to formulate and implement a management strategy that takes into account the business environment. In addition, after confirming the risk-taking policy, JCR looks at whether the company is paying attention to the balance between risk and return. Regarding governance, JCR checks the

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status of the corporate governance system, such as the board of directors, management control system, risk management, and internal controls such as compliance.

2. Financial base

(1) Earnings capacity

Earnings capacity is important for absorbing losses arising from each risk and accumulating internal reserves. However, it is important to note that the business portfolios of leasing companies are very distinctive for each company, and there are differences in the balance of risk and return. In assessing the company, JCR uses ordinary income before and after deducting bad debt related expenses. JCR also checks whether the company can absorb bad debt related expenses and financial expenses by the fundamental profit even when they are stressed. In addition, JCR also assesses the level and stability of profitability, ordinary income and net income.

For profitability, JCR focuses on ROA. JCR uses profit such as ordinary income before and after deducting bad debt related expenses for the numerator. The denominator is total assets or operating assets. In doing so, JCR makes adjustments as necessary, such as adding the off-balance sheet receivables such as off-balance sheet guarantees.

In addition to quantitative aspects, JCR also places importance on stability and diversity of earnings. While profitability of traditional domestic asset businesses is not particularly high, it can generally be evaluated as being highly stable. Many lease contracts have relatively long terms, and after the contract expires, it is possible to expect transactions such as re-leasing. The fact that leasing companies can rely on the underlying assets in addition to business cash flow of the lessee as the source of investment recovery is the background to the stability. On the other hand, even if there are businesses with high earnings volatility due to factors such as effects from gains on sale of assets or impairment losses, JCR confirms whether diversification of earnings sources has progressed and whether volatility is controlled for the business portfolio as a whole.

Key financial indicators:

- Ordinary income, Ordinary income before deducting bad debt related expenses
- Overhead ratio
- ROA

(2) Asset quality

Deterioration in asset quality is directly linked to an increase in bad debt related expenses, which in turn leads to a deterioration in business performance. JCR checks the trend of bad debt losses relative to operating assets to see whether the company has been able to control the quality of its assets for the past performance. JCR pays attention not only to bad debt related expenses arising from credit risk, but also to impairment losses, etc. arising from asset risk such as price fluctuations in operating assets and investment risk.

In terms of qualitative aspects, JCR focuses on credit management system. JCR checks credit management policies, conservativeness of write-offs and provisions, and receivables management and collection systems. In addition, since risk of concentration in specific areas can have a significant impact on management of leasing

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companies in times of environmental deterioration, JCR checks whether there are any problems with degree of concentration in asset classes with large fluctuations in profitability and asset prices, balance of industries and regions of credit recipients, and composition of major credit recipients.

Key financial indicators:

- Bad debt related expenses, impairment losses, etc. relative to operating assets
- Ratio of non-performing receivables

(3) Capital adequacy

Capital adequacy is important as a final buffer against realized risk. In assessing capital adequacy, JCR focuses on the equity ratio. For the numerator, JCR adjusts as necessary items such as goodwill, deferred tax assets, and equity securities against shareholders' equity. For the denominator, JCR considers making adjustments, such as including off-balance sheet assets such as securitized receivables and off-balance sheet guarantees in total assets, in addition to operating assets, etc.

In addition, degree of margin of equity relative to risk is also checked. The extent to which risks such as credit risk, asset risk and market risk based on stress scenarios can be covered by equity capital, future profits, etc. is evaluated. For asset classes with large fluctuations in profitability and asset prices, JCR pays attention to the balance between their exposures and equity capital.

Key financial indicators:

- Equity ratio
- Degree of margin of equity relative to risk

(4) Liquidity

For non-bank financial institutions such as leasing companies, fundraising is equivalent to purchasing goods, and has a significant impact on business continuity. If concerns arise about fundraising due to changes in the business environment or a deterioration in business performance, this can become a constraint on maintaining and expanding operating assets. JCR checks the fundraising structure and looks at the stability of fundraising and the status of financial costs.

More specifically, JCR looks at liquidity on hand, composition of financial institutions with which the company does business, status of transactions with each financial institution (amounts borrowed, terms and conditions, overdrafts, commitment lines, etc.), status of setting collateral, approach to covenants, status of cash management by the parent company and group companies, diversity of fundraising methods (CP, corporate bonds, securitization of receivables, etc.), fundraising structure (balances between long-term and short-term financing, indirect and direct financing, and fixed-rate and variable-rate financing), and diversification of debt repayment dates (whether there is any concentration of large repayments at specific times).

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Key financial indicators:

- Liquidity on hand
- Direct financing ratio, short-term financing ratio

(5) Risk management system

JCR checks whether risk management is being carried out from an integrated perspective in response to the diverse risks faced by leasing companies, including the methods and assumptions used. When the business domain and regions of operation are extensive, the risks faced are diverse and can become complex, so the importance of appropriately identifying and controlling these risks increases.

In integrated risk management, it is difficult to make simple comparisons between leasing companies because the amount of risk recognized differs depending on the methods and assumptions used. For this reason, it is also important to evaluate how management perceives its own risk-taking situation and whether it can link this to the formulation of management plans and capital policies. Even if the company has excellent risk management, this is unlikely to have a positive impact on its creditworthiness, while in cases where there is significant room for improvement in the risk management system, this could be a negative factor.

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Attachment

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Rating Methodology by Sector

General Construction

Business model of general construction (general contractor) industry is to receive orders for construction work in bulk from the client, and to complete the work while coordinating specialized contractors, etc. The range of players is wide, from major contractors with annual sales of over 2 trillion yen, known as "super general contractors," to small- and medium-sized enterprises. This rating methodology is applied to general contractors of a listed scale, and does not cover specialized contractors for electrical, air conditioning, telecommunications work, etc.

1. Business base

The general construction industry is essentially an industry driven by domestic demand. It undertakes building construction and civil engineering works related to social infrastructure and living infrastructure that are essential to people's lives. It is unable to create demand on its own and is affected by government construction investment, private housing investment, and private non-housing investment. In general, companies are classified into tiers such as major (super), second-tier, and midsize companies, according to their sales scale. As it is difficult to differentiate between companies in the same tier, competition tends to intensify during periods of declining demand. In rating assessment, JCR places emphasis on factors such as strength of competitiveness that can allow steadily winning orders even during periods of declining demand.

(1) Characteristics of industry

(i) Market overview

According to the Ministry of Land, Infrastructure, Transport and Tourism, domestic construction investment amount in FY2023 was 71 trillion yen. After peaking at 84 trillion yen in FY1992, it halved to 42 trillion yen in FY2010, but has since continued to increase. It is thought that domestic construction investment will remain steady over the medium term. In the building construction sector, investment is expected to be made in urban redevelopment, logistics facilities, and factories related to semiconductors and electronic devices. In the civil engineering sector, investment is expected to be made in response to the strengthening of national resilience and the aging of infrastructure.

In addition, mainly major and second-tier companies are strengthening their overseas expansion. However, in the past, there have been cases where construction projects have become unprofitable and large losses have been recorded. Therefore, it seems that the issue overseas is to generate stable profits by developing business, focusing on their areas of expertise, and promoting localization.

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(ii) Competitive situation

The number of major players has not changed significantly since the 1990s.

Competition often takes place among players in the same tier such as among major players and among second-tier players, or between players of close tires such as between major players and second-tier players and such as between second-tier players and midsize players. During periods of expanding demand, construction capacity of upper tiers is limited (demand is larger than supply), so there are cases where lower-tier players can win orders for larger-scale construction projects than that they would receive in normal periods. On the other hand, during periods of declining demand, there is room for construction capacity, so upper-tier players win orders for smaller-scale construction projects than that they would receive in normal periods, more intensifying competition for lower-tier players.

(iii) Cost structure

The business model of general contractors is to receive orders for construction work in bulk from the client, and then to outsource the majority of that work to specialized contractors and other partner companies. There are many outsourcing costs (including outsourced labor costs) and material costs that are variable costs, and few fixed costs. Thanks to this flexible cost structure, although there are fluctuations in the amount of work carried out from fiscal year to fiscal year, there is almost no chance of operating losses unless there is unprofitable work. Furthermore, outsourcing costs are affected by balance of supply and demand for labor, etc., while material costs are affected by market conditions, etc., but the higher the tier, the more likely the economies of scale can work.

(2) Important factors in market position and competitiveness

(i) Market position

A multi-tiered structure with major companies at the top can be seen. There are large differences among the tiers in terms of sales, technical strength, mobilization strength, and name recognition, and the higher the tier, the stronger the competitiveness. In rating assessment, JCR understands the tier to which a company being rated belongs, and then checks how differentiation is carried out within the tier and how competitive advantage is built.

(ii) Business structure

Demand trends and competitive situations for building construction and civil engineering works differ. In general, building construction work, which is often private sector construction, is less profitable and has greater earnings volatility. On the other hand, civil engineering work, which is often public sector construction, is relatively more profitable and has less earnings volatility. In addition, since the number of competitors is limited in marine civil engineering work, which has high barriers to entry, it is often more profitable than land civil engineering work.

In addition, many of the rated companies also operate real estate businesses. Real estate business can be

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broadly divided into two categories: leasing of offices, condominiums, etc., and development of condominiums, logistics facilities, etc. Leasing is considered to contribute to stabilization of earnings if there are no problems with location or rent setting. On the other hand, while development is a factor that adds to earnings as long as market conditions are strong, there is a concern that if market conditions worsen, there will be valuation losses and losses on sales, so JCR pays particular attention to status of real estate assets related to development.

JCR evaluates stability of earnings while confirming business composition of building construction, civil engineering, real estate, etc.

(iii) Customer base

Customers have different investment appetites. JCR evaluates customer base by understanding the main customers and their attributes (private companies, public organizations, industry, region, construction content, etc.). Technical strength and mobilization strength discussed in the following sections are important for maintaining and strengthening the customer base.

(iv) Technical strength

Technical strength is essential for creating a workpiece that customers want. In the construction industry, there are no standardized products, and each workpiece is made to order. Therefore, it is essential to have a technical strength to create a workpiece according to predetermined specifications, budgets, and construction periods, and it is also necessary to make customers aware of such technical strength.

JCR checks the specific construction track record of the company and evaluates whether it has a technical strength for similar construction work.

(v) Mobilization strength

As construction industry is a labor-intensive industry, manpower that can be mobilized has a direct impact on earnings. If the company has strong mobilization strength, it can increase the volume of construction work it undertakes, but if it has weak mobilization strength, it will not be able to increase the volume of construction work, and this will become a bottleneck for the earnings growth. The number of people working in the construction industry is decreasing year by year, and in the future there is a possibility that differences in the mobilization strength can lead to differences in earnings among companies. For this reason, JCR pays attention to the initiatives that the company is taking to maintain and strengthen its mobilization strength.

(vi) Risk management capacity

The main business risk is an occurrence of unprofitable construction project. Unprofitable construction project occurs when additional costs are incurred due to events that were not anticipated at the time of receiving order, such as construction defects. In response to this, the company is working to curb unprofitable construction projects through measures such as (a) identifying risks before orders are received, (b) selecting orders based on profitability, and (c) implementing monitoring after orders are received. In recent years, there has been an

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increase in large-scale construction projects with long construction periods. If such projects become unprofitable, earnings will deteriorate over a long period of time, so JCR pays particular attention to progress of large-scale construction projects. In the past, there were cases where it became difficult to recover construction payments from a bankrupt emerging developer and a foreign government, so credit management for the client is also an important point.

It can also be said that holding real estate related assets that are subject to market conditions is a business risk. Among the rated companies, there are those who (a) bring land and other real estate to developers and other companies and receive orders for construction work, and (b) carry out condominium development and sales, real estate development of leasing buildings, etc. themselves. For these rated companies, in addition to an ability to assess business potential of individual real estate, it is also necessary to control balance of real estate related assets so that they can withstand financial difficulties even in times of market deterioration.

2. Financial base

(1) Earnings strength

In order to maintain and improve earnings strength, it is essential to strengthen competitiveness and risk management capacity. If the company has strong competitiveness, it can win orders on relatively favorable terms and earn excess earnings. If it has high risk management capacity, it can control an occurrence of unexpected expenses due to unprofitable construction projects, etc.

In order to estimate future earnings strength, it is essential to understand the timing at which the construction projects, for which the orders were received (order backlog), are recorded as sales and the assumed profitability of the projects at the time of receiving the orders. JCR evaluates the medium-term earnings strength by confirming the general situation of the construction projects, for which the orders were received, to the extent possible through interviews and other means.

Key financial indicators:

- Gross margin on construction revenues
- Amount of orders received
- Order backlog
- Operating income
- Net income

(2) Cash flow generation capacity

The company's ability to generate cash flow is an important factor in assessing its ability to repay debts. In general construction industry, there is a time lag between accounting profits recorded as construction projects progress and cash flows obtained. For this reason, in addition to the accounting profit, JCR also checks the level of cash flow and its sustainability.

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Key financial indicators:

- Operating cash flow
- Ratio of net interest-bearing debt before and after deducting working capital to EBITDA

(3) Safety

As mentioned in the previous section, there is a time lag between the accounting profit and cash flow in general construction industry. In particular, for large-scale construction projects with long construction periods, this time lag becomes even greater, and it is necessary to procure interest-bearing debt as working capital (notes receivable, accounts receivable from completed construction contracts + costs on uncompleted construction contracts - notes payable, accounts payable for construction contracts - advances received on uncompleted construction contracts, etc.) to bridge the fund gap. As the repayment source for such interest-bearing debt is the payments for construction projects, JCR pays attention to the payment capacity of the client.

From the perspective of medium-term debt repayment capacity, JCR places importance on balance of cash flow against interest-bearing debt. When confirming this balance, JCR also uses interest-bearing debt after deducting working capital, which is associated with construction projects mentioned above. JCR believes that working capital associated with real estate for sale and development projects in progress differs in nature from the fund gap associated with construction projects.

JCR confirms the actual amount of shareholders' equity as a risk buffer in the event of occurrence of unexpected circumstances. In addition, JCR also pay attention to the balances between shareholders' equity and (a) risk assets that are subject to price fluctuations and (b) interest-bearing debt (including interest-bearing debt after deducting working capital, which is associated with construction projects).

Key financial indicators:

- Net interest-bearing debt before and after deducting working capital
- Real estate related assets such as real estate for sale and development projects in progress
- Shareholders' equity
- Ratio of net interest-bearing debt before and after deducting working capital to shareholders' equity

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