

## Rating Methodology by Sector **Land Transportation**

This rating method (the “Rating Method”) applies to land transportation companies that mainly operate the following businesses in Japan: i) Business-to-Business Logistics (“special loading motor truck transportation”); ii) door-to-door delivery; and iii) third-party logistics (“3PL”). Along with their respective businesses, many land transportation companies also operate other businesses. For this reason, the following mainly indicates the common concepts while appropriately addressing the points that should be focused according to the characteristics of respective businesses.

### **1. Business base**

Many land transportation companies mainly operate businesses in Japan. Some companies operate businesses overseas, but many of their businesses are from overseas operations of customers who have business transactions with them in Japan. In general, logistics is a non-core business that does not create value for customers and is easily targeted for improving efficiency. Therefore, it is important for land transportation companies to ensure the proposal ability to optimize the customers’ logistics that contribute to an improvement in efficiency of the entire supply chain, and to secure information systems and logistics networks to execute those proposals.

#### (1) Characteristics of the industry

##### (i) Market overview

Land transportation business is basically a domestic demand-oriented industry and is often highly linked to domestic economic conditions. However, it is important to understand the characteristics of the industry to which customers belong, and then to monitor the trends along with the macroeconomics. For the land transportation companies mainly engaging in special loading motor truck transportation business that consolidate cargos collected from numerous unspecified shippers onto a single truck, the impact on the cargo handling volume and others caused by fluctuations in customers' business performance and other factors are checked. For companies mainly engaging in 3PL business that take on contract work and comprehensive logistics operation of customers often have stronger ties with customers compared to operators of special loading motor truck transportation and door-to-door delivery. Therefore, JCR will pay attention to the impact of customers’ performance trends and management policies on land transportation companies in particular. In order to improve logistics quality and transportation efficiency, an advantage in the system perspective is also important to handle overall operations of customers. Therefore, JCR will also check the system-related investment status. For companies engaging in door-to-door delivery business, the most delivery destinations are individual residences. For this reason, it is more important to check the status of transportation efficiency

compared to that of operators of special loading motor truck transportation and 3PL.

(ii) Competitive situation

In any of special loading motor truck transportation, door-to-door delivery and 3PL businesses, there are limited number of operators that can flexibly and promptly respond to logistics needs of major customers on a nationwide basis. Since competitions within this situation are unavoidable, competitive situation and the changes are checked through understanding business relationship with customers and others. In 3PL, there is a tendency to maintain long-term stable business relationships with specific customers, and this creates relatively high entry barriers. Since differences in abilities of making proposals to customers often influence acquisition of new customers and receiving new business from existing customers, JCR ensures the situation of development of new customers and entry of other companies to existing customers' business through understanding the logistics operations offered and system investment status of each company.

(iii) Cost structure

The land transportation industry is a process industry and also a labor-intensive, and proportion of fixed costs tends to be high. The main costs are labor, vehicle hiring, and fuel costs. Vehicle hiring costs are variable costs to cover seasonal fluctuations in freight transportation volumes through outsourcing, but in reality, companies tend to carry excess capacity in off-peak periods securing a transportation capacity in line with busy seasons. Therefore, it has strong nature of a fixed cost. With respect to labor costs, JCR will also examine the impact on costs associated with improving working conditions to secure drivers.

(2) Important factors in market position and competitiveness

(i) Market position

Companies operating special loading motor truck transportation that have established own nationwide logistics network have increased the density of their logistics networks through cooperating with companies for hiring vehicles and concluding business partnerships with peers. This helps to mitigate the impact of seasonal fluctuations and improve transportation quality, such as increasing the on-time delivery rate. Door-to-Door delivery requires an even finer logistics network than that for special loading motor truck transportation, but the market is in a state of oligopoly since only a limited number of companies can operate the business on a nationwide basis. However, since some e-commerce operating companies organize small-scale logistics companies and carry out part of the delivery services, JCR will check the impact of these. As for outsourcing and 3PL, the entry barriers are high, and the share for each major customer is relatively stable. However, there are cases where companies mainly operating special loading motor truck transportation business and door-to-door delivery offer proposals combing their businesses with 3PL services to customers. Therefore, it is important to grasp the fluctuations in shares within a customer and the status of acquiring new business to understand any changes in the competitive status.

#### (ii) Customer base

To grasp the situation of the customer base, JCR monitors the customers, transaction status and revenue contribution on a continuing basis, not only for outsourcing and 3PL business operators where the relationship with the customers is relatively strong, but for operators of the special loading motor truck transportation and door-to-door delivery, to check the stability of transactions with customers. Where the degree of dependency on specific customers is high, JCR also checks the impact of fluctuations in the customers' business performance and changes in their management policies. Furthermore, JCR understands the status of expansion of customer bases through acquisition of new customers and the receiving new projects from existing customers.

#### (iii) Transportation quality

Transportation quality primarily indicates the ability to respond to diversifying and becoming more complex needs of customers including overseas development such as punctuality in delivery, cargo security, flexible responses to the nature and amount of goods, and other factors. Believing that maintaining high transportation quality would win confidence of customers and secure competitive advantages over industry peers. JCR checks measures of respective companies for increasing transportation quality, their progress and outcomes.

#### (iv) Infrastructure

The infrastructure broadly consists of a logistics network (logistics bases and transportation / delivery routes) and a information system. Drivers including those in subcontracted transportation service providers are also included in infrastructure. Since not all infrastructure needs to be owned by a company itself where transportation quality required by the customer is satisfied and maintained, JCR checks situation of logistics network construction including usage of subcontracted transportation service providers and collaboration with peers who operate in other areas and their effectiveness. Information system is significant infrastructure to maintain transportation quality and increasing customers' logistics efficiency. For this reason, JCR checks situation of costs required for maintaining and expanding logistics network and the future outlook as well as status of strengthening the system.

#### (V) Cost competitiveness

While it is considered difficult to continuously reduce labor costs related to drivers and vehicle hiring cost in the situation where maintaining/expanding logistics network is required in order to secure transportation quality, JCR will pay attention to the initiatives that absorb cost increases through improving transportation efficiency and advancing automation of logistics facilities as well as their outcomes. As for transport efficiency, JCR will check not only efforts made by a company, but also joint efforts made with peers such as joint transportation. It is also important to understand the cost reduction situation in indirect departments through promoting an improvement in operational efficiency.

## 2. Financial base

### (1) Earning capacity

To understand the order intake situation, a trend in net sales is checked. At that time, it is necessary to understand factors causing increase and decrease in net sales by analyzing the following situations: acquisition of new customers, expansion of domains where orders come from existing customers and price revisions. To grasp the progress in improvements in transportation efficiency and operational efficiency including indirect departments, ensure increase and decrease in major items under operating expense as well as the factors causing such situation at the same time of paying attention to the levels and changes in operating profit and operating profit margin.

Key financial indicators:

- Net sales
- Operating income
- Operating profit margin

### (2) Cash flow generation capacity

Land transportation companies continuously implement measures such as strengthening logistics networks and system investments to enhance their responsiveness to customer needs. To understand the status of returns on past capital investments and M&As, EBITDA, which indicates cash flow generation capability, is checked. Furthermore, by grasping free cash flow, the difference between operating cash flow and investment cash flow, the presence or absence of external financing associated with investments is ensured. To conclude the following items, JCR checks the trend in interest-bearing debt/EBITDA ratio and the outlook: whether the interest-bearing debt at present is excessive compared to EBITDA, which indicates cash flow generation capability, whether a company is making progress in reducing a financial burden relative to cash flow through gaining the initially anticipated EBITDA, and the balance between future investment plans and cash flow generation capacity.

Key financial indicators:

- Cash flow from operating activities
- Free cash flow
- EBITDA
- Ratio of interest-bearing debt to EBITDA

### (3) Safety

An investment burden increases to respond to the needs of customers, resulting in a possibility of creation of a higher burden on financials. In addition, there may be a situation where asset value of logistics facilities may decline or loss may need to be recorded in relation to renovation of existing logistics facility. Therefore, a considerable financial resilience will probably be required. For this reason, the sizes and trends in interest-bearing debt and equity capital are checked together with conducting analysis on the levels and trends in debt-

equity ratio and equity ratio to ensure the current situation of the financial structure and outlook. Furthermore, JCR will also check the status of lease-related obligations.

Key financial indicators:

- Interest-bearing debt
- Shareholders' equity
- Debt equity ratio
- Equity ratio

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