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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.

(iii) Regulations

There is no impact from regulations such as licenses and special laws when entering the market. Leasing

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

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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 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.

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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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