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Rating for Open-ended Investment Corporation

Japan Credit Rating Agency, Ltd. (JCR) publicly announced rating methodology for "J-REIT" on June 1, 2012. JCR makes public this report on points complementary to the rating methodology for "J-REIT," following an assignment of a credit rating to an open-ended investment corporation for the first time.

1. Classification of Investment Corporations

Investment Corporations in accordance with Act on Investment Trusts and Investment Corporations (the "Act") are broadly classified into open-ended and closed-ended investment corporations. The listed investment corporations ("J-REITs") are all closed-ended investment corporations because J-REITs are required to be closed-ended investment corporations as a criterion for listing on Tokyo Stock Exchange, etc.

Major difference between open-ended and closed-ended types is while refund on investment equity can be made for open-ended type by request from investors, refund cannot be made for closed-ended type. The closed-ended type can ensure liquidity of the investments for investors because it is listed on securities exchange. Meanwhile, liquidity of investment equity for an open-ended investment corporation is lower than in the case of a listed J-REIT because an open-ended investment corporation is unlisted and conversion into cash for the open-ended investment corporation is limited to a refund on investment equity in accordance with certain rules and regulations and trading between counterparties among investors.

While a unit price (stock price) of a J-REIT changes on a daily basis, a unit price of an open-ended investment corporation does not change on a daily basis because net asset value of investment equity is calculated from real estate appraisal value for each accounting period.

Other major differences between open-ended investment corporations and closed-ended investment corporations are shown below.

	Open-ended Investment Corporation	Closed-ended Investment Corporation
Basis Act	the Act	the Act
Fund Procurement	Equity (private placement) and Bank Borrowing	Equity (Private placement and public offering), Bank Borrowing and Investment Corporation Bonds
Primary Investors	Institutional Investors	Wide range of Investors including Individuals
Supervisors	Financial Services Agency, Investors' Meetings and Supervisory Officers	Financial Services Agency, Investors' Meetings, Supervisory Officers and Securities Exchange (J-REIT)

It has been pointed out from before that investors cannot necessarily enjoy merchantability of a listed J-REIT as initially intended middle risk and middle return product sufficiently because a listed J-REIT is subject to changes in capital market strongly, causing volatility of unit price to increase. Meanwhile, there remains an issue for a private fund that performance is significantly affected by real estate market conditions during its period, which is normally 5 - 7 years.

JCR thinks that it is often the case that an open-ended investment corporation is planned as a stable and a long investment instrument that is less subject to influence of capital market and therefore can eliminate risk factors other than risk factors for real estate investments as much as possible because of its merchantability different from that of a J-REIT or a private fund, particularly, its suitability for needs of long-term investors, given the issues described above.

2. Points to be Watched in Assignment of Rating to an Open-ended Investment Corporation

(1) Refund on investment equity by request from investors

As described above, refund on investment equity can be made for open-ended investment corporation by request from investors. It is necessary therefore to assume a risk of rise in LTV owing to procurement of funds for such refund through borrowings.

Unlike in the case of a J-REIT, volatility of an open-ended investment corporation is considered low because its net asset value of investment equity is calculated from real estate appraisal value. However, when an event such as rapid fall in price of real estate market occurs and real estate appraisal value, on which calculation of the net asset value is based, falls sharply, it is likely that more-than-expected requests for refunds can be made despite the fact that an open-ended investment corporation is intended for investors holding investment equity for a long period of time. Therefore, it is necessary to take measures such as setting an upper limit on amount of refund for a certain period in order to curb a risk of sharp rise in LTV to a certain degree.

It should be watched also that whether or not an open-ended investment corporation has liquid property which can be sold for a short period of time during a period from request for refund to the actual implementation of refund, approaches by the asset management company for ensuring this liquidity, and actual performance on and future feasibility of cooperation with sponsor for this purpose.

(2) Trend in Real Estate Appraisal Value

As described above, it is increasingly likely that requests from investors for refunds will increase rapidly owing to rapid fall in real estate appraisal value arising from changes to real estate market conditions. There is also a risk of rise in LTV based on market value at the same time. As in the case of a J-REIT, it is desirable that portfolio of an open-ended investment corporation be well diversified, taking into consideration these risks. It is more necessary to watch stability of cash flows for not only a piece of real estate but also an entire portfolio through diversifications in terms of locations, tenants or purpose of properties.

While a stable investment can be expected for an open-ended investment corporation such as its ability to increase its capital based on the net asset value calculated from the real estate appraisal value for each investment property in a situation where a listed J-REIT has difficulty in procuring funds through equity finance owing to disorder and stagnancy of capital market, there are certain restrictions on sale of investment equity and request for refund for investors for their fund recovery. Based on the points above, JCR thinks it necessary to watch closely policy of asset management company for building a portfolio, arrangements for the building and policy for LTV control.

Shigeo Sugiyama, Takanori Akiyama

Japan Credit Rating Agency, Ltd.
Jiji Press Building, 5-15-8 Ginza, Chuo-ku, Tokyo 104-0061, Japan
Tel. +81 3 3544 7013, Fax. +81 3 3544 7026