

# Japan Prime Realty Investment Corp.

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## Rationale

On Oct. 29, 2003, Standard & Poor's assigned its 'A-' long-term and 'A-2' short-term corporate credit ratings to Japan Prime Realty Investment Corp. (JPR). The outlook on the long-term rating is stable.

The rating reflects JPR's above-average business position and conservative financial profile. The company currently ranks as the third-largest Japanese real estate investment trust fund (J-REIT). It owns a high-quality portfolio of office and retail properties, and its sponsors have strong real estate expertise in Japan. JPR has a conservative capital structure, and solid coverage measures supported by above-average profitability.

The rating also takes 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.

These strengths are partly offset by concerns regarding the unseasoned market in which JPR operates, the company's relatively aggressive growth strategy, the relatively weak credit profiles of some sponsor companies, and tenant concentration risk in JPR's portfolio. In addition, the division of the company's investment strategy between office (targeted at 80% of investments) and retail (20%) investments may increase the complexity of managing the portfolio, especially given the higher operational risks typical for retail properties. However these concerns are offset to a certain degree by the limited proportion of retail properties within the portfolio, and by the diversification benefits expected from the presence of both office and retail properties. The company's current retail properties are well located and have a high sales volume, which further mitigates these subsector concerns.

JPR was established in September 2001 and was listed on the Tokyo stock exchange in June 2002. Currently it is the third-largest J-REIT in terms of market capitalization and portfolio volume. The company's sponsors are Tokyo Tatemono Co. Ltd. (not rated), Yasuda Mutual Life Insurance Co. (BBB+/Negative/A-2), Yasuda Real Estate Co. Ltd (not rated), Taisei Corp. (B+/Stable/--), and Sompo Japan Insurance Inc. (AA-/Negative/--). Between them, these companies own a

combined 19.5% of JPR, as well as 100% of Tokyo Realty Investment Management Inc., the asset manager of JPR.

As of today, JPR owns a portfolio of 32 properties, of which 28 are office buildings and four are retail properties. The current portfolio value amounts to ¥131.7 billion based on Standard & Poor's underwriting value, which is approximately 95% of the total appraisal value. The portfolio is well diversified by region and occupied by a solid tenant base, although some tenant concentration exists. Geographically, about 60% of the portfolio is invested in the Kanto region (40% in central Tokyo), and 40% in regional cities, including Osaka (18%), Fukuoka (6%), Nagoya (3%), and others. Despite the relatively high concentration in regional cities, the overall asset quality is strong, with an average age of 12 years, a current average occupancy rate of approximately 92%, and portfolio rent levels consistent with submarket rents. There is, however, a degree of tenant concentration risk within the portfolio, with Seiyu Ltd. (B+/Negative/--) comprising 20% of the total net rentable area, in two separate properties that are well located and generate above-average sales volumes. JPR's property concentration risk is not a major concern, with the largest-value asset, Kanematsu Building, comprising 11.7% of the portfolio value. Moreover, these concentration risks are expected to decline to a modest extent as the company acquires more properties.

JPR's strategy is to enlarge its portfolio at a relatively aggressive pace, aiming to reach ¥300 billion by December 2006. Up to the target year, JPR will pursue a policy of investing 80% of its portfolio in office assets and 20% in retail assets, while maintaining a geographic weighting of 60% in the Kanto area (including Tokyo) and 40% in regional cities.

JPR's management expects to maintain a conservative capital structure, with its debt-to-capital ratio averaging between 35% and the higher 40% range. However, leverage could periodically rise close to 50% as the company pursues its growth strategy by using debt to acquire additional properties. Following acquisitions, the company is expected to raise additional equity, returning its leverage to a more moderate range. JPR's recent public equity issues, as well as its sound investment criteria and underwriting procedures somewhat offset concerns over its capital structure. The portfolio diversity produces a stable rental revenue stream. Cash flow protection is strong, with the company's debt-service coverage ratio (DSCR) expected to remain above 2x on average, using Standard & Poor's conservative stressed constant interest rate of 6%. At present, EBITDA interest coverage, based upon currently attractive financing costs, is 10x.

### *Liquidity.*

JPR's liquidity is solid, with long- and short-term credit available to meet the company's near-term debt maturities as well as to 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. As of June 30, 2003, JPR had approximately ¥19.4 billion in cash and cash equivalents, sufficient to cover immediate operating expenses including security deposit liabilities. Despite the encumbrance of its portfolio's major holdings, JPR's financial flexibility is considered to be moderate, reflecting its established banking relationships and the benefits from having some sponsors with above-average credit profiles. However, with more than 50% of the company's net operating income encumbered, the rating on any unsecured note issue would be one notch below the corporate credit rating.

### **Outlook**

JPR's diversified and high-quality asset portfolio should provide for a stable income stream and sustainable profitability, despite modest exposure to the generally more volatile retail sector and some tenant concentration. With the support of its sponsors, JPR is expected to maintain a conservative financial profile as the company pursues acquisitions and portfolio growth. The rating anticipates that, although JPR's leverage may vary throughout this portfolio growth period, average leverage is expected to remain in the moderate range indicated.