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## Research Update:

# Ratings On Japan's Frontier Real Estate Investment Corp. Affirmed At 'A+ / A-1'; Outlook Stable

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## Research Update:

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## Overview

- FRI is a J-REIT that specializes in retail properties.
- Despite continued severe competition in the retail industry, long-term lease contracts keep cash flow from its property portfolio stable, and new acquisitions have diversified the portfolio.
- We expect FRI to generate mostly stable revenue and maintain the high quality of its property portfolio.
- We have affirmed our long- and short-term ratings at 'A+/A-1'. The outlook on the long-term rating remains stable.

## Rating Action

On Feb. 12, 2013, Standard & Poor's Ratings Services affirmed its 'A+' long-term corporate credit and senior unsecured debt ratings and 'A-1' short-term rating on Frontier Real Estate Investment Corp. (FRI). The outlook on the long-term corporate credit rating remains stable.

## Rationale

FRI is a Japanese REIT (J-REIT) that specializes in retail properties. The ratings on FRI reflect its strong business position in the J-REIT market, underpinned by the real estate development and management capabilities and the brand recognition of its sponsor, Mitsui Fudosan Co. Ltd. (BBB+/Stable/A-2); its high-quality real estate portfolio, which mostly consists of properties rented out under long-term leasing contracts that generate stable cash flows; and its relatively conservative financial policy and high financial flexibility. The ratings, however, are tempered by continued, intense competition in Japan's retail industry. In addition, FRI's profitability has been declining slightly. FRI also bears portfolio concentration risk in terms of both its top-tier properties and tenants.

FRI had a real estate portfolio consisting of 27 retail properties, including three plots of land with fixed-term leaseholds for commercial use ("sokochi"), with a total acquisition value of about ¥245.8 billion, as of the end of the 17th six-month fiscal term (ended Dec. 31, 2012). FRI's portfolio is geographically well diversified and incorporates various types of assets, primarily large suburban shopping centers, as well as urban retail buildings and outlet malls. Despite continued, severe competition in the retail

industry, FRI's cash flow remains stable because its portfolio comprises mostly properties that are highly competitive in their respective submarkets and has a 100% occupancy rate on a master lease basis. In addition, FRI has been steadily pursuing external growth through property acquisitions by taking advantage of its sponsor's property-sourcing pipeline. Specifically, the J-REIT acquired three properties in 2012. In 2013, it acquired Ikebukuro Square (Toshima Ward, Tokyo; purchase price: ¥20.4 billion), a newly developed retail facility in central Tokyo.

FRI's portfolio has a degree of concentration in top-tier properties, with the top four properties accounting for about 36% of the total portfolio value as of the end of the 17th term. The portfolio also bears tenant concentration risk, with FRI's four largest tenants providing about 70% of the J-REIT's total rental revenue as of the end of the 16th term (ended June 30, 2012). However, in our view, the competitive locations of FRI's properties mitigate these concentration risks. Also, the properties are rented out under long-term contracts to highly competitive tenants with high credit quality, such as Aeon Retail Co. Ltd., and they generate stable cash flows. In addition, we expect this concentration risk to continue to decline modestly over time, as FRI acquires more properties. Portfolio profitability remains relatively high, although it has declined slightly compared with previous levels, owing to the J-REIT's acquisition in recent years of urban retail buildings at slightly lower yields than that of its existing portfolio.

FRI plans to maintain its debt-to-total assets ratio (as defined by FRI; includes security deposits and hoshokin liabilities) between 40% and 50%, in an effort to achieve stable external growth in the near term. Due to recent debt-funded acquisitions, FRI's debt-to-total assets ratio was about 49.6%, slightly higher than previous levels, and its debt-to-capital ratio [interest-bearing debt including hoshokin liabilities/(interest-bearing debt including hoshokin liabilities + total net assets, as defined by Standard & Poor's] stood at about 46.8%, as of the end of the 16th term. However, we expect FRI's debt ratios to improve moderately because it has since completed equity offerings totaling ¥20.5 billion and acquired two properties. The ratio of funds from operations (FFO) to debt is likely to stay between 12% and 14% over the next one to two years. As of the end of the 17th term, the J-REIT had diversified its debt maturities through 2020, indicating a relatively conservative debt profile and capital structure.

## **Liquidity**

FRI's liquidity is "adequate," as defined in our criteria. We expect FRI to have sufficient sources of liquidity--including liquidity on hand and FFO--for the 18th fiscal term (ending June 30, 2013) to cover its uses of liquidity--such as debt repayments, capital expenditures, and dividend payments. As of the end of the 16th term, the J-REIT had about ¥13 billion in cash and deposits; as of Feb. 12, 2013, it has committed credit facilities of ¥17.0 billion, all of which were unused. We view the J-REIT's financial flexibility as high, because it has maintained solid relationships with multiple major Japanese financial institutions and all of its interest-bearing

borrowings are unsecured. FRI has pledged some of the properties in its portfolio as collateral for hoshokin liabilities, but we do not consider this to be a risk factor at present, given that the outstanding balance of its hoshokin liabilities is small relative to the amount of total assets.

## Outlook

The outlook is stable. Standard & Poor's expects FRI to generate mostly stable revenue from its high-quality properties rented out under long-term lease contracts, backed by its sponsor. We continue to regard the following as key factors for FRI's credit quality: business conditions in the retail industry, the degree of asset and tenant concentration in FRI's portfolio, the portfolio's profitability, the J-REIT's debt ratios, and its cash flow metrics. Competition in the domestic retail industry remains severe, and we see little likelihood of raising the ratings on FRI because we expect the J-REIT to maintain its debt-to-total assets ratio at the current cruising level for the time being in an effort to achieve stable external growth. Conversely, the ratings on FRI could come under downward pressure if debt-funded acquisitions weaken its debt profile and capital structure, or if its portfolio cash flow declines due to tenant moves or other factors, pushing up its debt-to-total assets ratio to around 55%. We may also consider a downgrade if the FFO-to-debt ratio falls and stays below 10%.

## Related Criteria And Research

- Key Credit Factors: Global Criteria For Rating Real Estate Companies, June 21, 2011
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- Rating Policy For Japanese Real Estate Investment Trusts, May 9, 2001

## Ratings List

Ratings Affirmed

Frontier Real Estate Investment Corp.

Corporate Credit Rating A+/Stable/A-1

Frontier Real Estate Investment Corp.

Senior Unsecured A+

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