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Ratings

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Research Update:

Nomura Real Estate Master Fund Inc. Ratings Affirmed After Announcement Of Merger With Top REIT Inc.; Outlook Stable

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Overview

- Nomura Real Estate Master Fund (NMF) has concluded a deal to merge with Top REIT on Sept. 1, 2016.
- We believe the impact of the merger, if realized, on NMF's credit quality would be within the tolerances of our current ratings despite the slightly weaker business base and financial standing of Top REIT. This is because the expanded scale would strengthen NMF's market position and the improved diversification of assets and their geographic locations would help stabilize revenues.
- We are affirming our 'A' long-term and 'A-1' short-term corporate credit ratings on NMF. The outlook on the long-term corporate credit rating remains stable.

Rating Action

On May 26, 2016, S&P Global Ratings affirmed its 'A' long-term and 'A-1' short-term corporate credit ratings on Japan-based Nomura Real Estate Master Fund Inc. (NMF). The outlook on the long-term rating remains stable.

Rationale

The affirmations follow the Japanese REIT's (J-REIT) announcement that it has concluded a deal to absorb Japan-based Top REIT Inc. on Sept. 1, 2016. We believe the impact of the merger, if realized, on NMF's credit quality would be within the tolerances of our current ratings despite the slightly weaker business base and financial standing of Top REIT. This is because the expanded scale from the merger would strengthen NMF's market position and the improved diversification of its assets and their locations would help stabilize revenues, in our view.

Top REIT's portfolio would be equivalent to about 15% of the assumed acquisition value of the merged entity's portfolio. Top REIT's portfolio carries concentration risk in its assets and tenants, the average property age is slightly high, and its profitability is somewhat low. However, we believe the merger would strengthen NMF's market position because it would expand NMF's scale via external growth with sufficient yields amid severe competition for acquisitions. We also expect NMF to further stabilize rental revenue from its diversified and relatively high-quality portfolio, which we expect will grow to over ¥900 billion (total assumed acquisition value). In addition, we believe NMF will leverage its nature as a diversified J-REIT and continue to use its sponsor's property sourcing pipeline to enhance its asset quality and scale by pursing external growth and replacing properties in its portfolio. We also continue to view as a strength the brand recognition and real estate management and development capabilities of its sponsor, Nomura Real Estate Holdings Inc. We believe the addition of Top REIT's portfolio, which generates sufficient yields, will slightly improve NMF's somewhat weak profitability. Accordingly, we continue to assess the business risk profile of NMF as strong.

In assessing the financial risk profile of NMF, we incorporate our view that it will maintain favorable interest coverage measures and relatively high financial flexibility. Top REIT's moderately high debt-to-total assets ratio (as Top REIT defines it) will likely push up NMF's post-merger debt ratios slightly. We expect NMF's moderately high debt ratios relative to its diversified portfolio and its slightly weak cash flow measures to continue to constrain our assessment of its financial risk profile somewhat. Nevertheless, we believe NMF will manage its debt levels in line with its financial policy in the medium term. Under its financial policy, NMF intends to maintain its debt-to-total assets ratio (as NMF defines it) at about 45% (40%-50%). We believe this corresponds to a debt-to-debt plus equity ratio on an undepreciated basis (debt / [debt + equity + depreciation]; our definition) of about 43% (38%-48%). Accordingly, we continue to assess NMF's financial risk profile as modest.

In our base-case scenario, we assume:

- NMF will merge with Top REIT on Sept. 1, 2016;
- NMF's total rental revenue will rise moderately, owing to an expanded asset scale and a marginal increase in rent levels;
- Its slightly weak profitability, including return on investments (ROI), will improve somewhat with the merger and will remain mostly flat thereafter; and
- NMF will control its debt-to-total assets ratio in line with its financial policy.

Based on these assumptions, we expect NMF's EBITDA interest coverage ratio to hover at about 8.0x-9.0x and its ratio of funds from operations (FFO) to debt to be about 7.5%-8.5%.

Liquidity

We believe NMF's liquidity is adequate and expect its sources of liquidity to exceed 1.2x its uses for the next 12 months.

Outlook

The stable outlook reflects our view that NMF will continue to generate steady rental revenue from its large, diversified, and relatively high-quality portfolio amid a moderate recovery of Japan's property leasing market.

Downside scenario

We would consider lowering our ratings if NMF's financial measures deteriorate, largely deviating from its financial policy and our projections, as a result of large property acquisitions funded with debt or weakened rental revenue. Specifically, we might consider a downgrade if the J-REIT's FFO to debt declined and stayed below 7.0% for a sustained period, and we saw this ratio as unlikely to improve.

Upside scenario

We might consider raising our ratings on NMF if we saw better prospects for improvement in its asset quality, profitability, debt ratios, and cash flow measures, and if we saw continued solid recovery in Japan's property leasing market. Specifically, we might consider an upgrade if we expected FFO to debt to exceed and remain above 9.5%. However, we believe the likelihood of an upgrade is currently remote, given NMF's slightly weak profitability measures and somewhat high debt levels.

Ratings Score Snapshot

Corporate Credit Rating: A/Stable/A-1

Business risk: Strong
- Country risk: Low
- Industry risk: Low
- Competitive position: Strong

Financial risk: Modest
- Cash flow/Leverage: Modest

Anchor: a

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria And Research

Related Criteria

- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Group Rating Methodology, Nov. 19, 2013
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Real Estate Industry, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013

Ratings List

Ratings Affirmed

Nomura Real Estate Master Fund Inc.	
Corporate Credit Rating	A/Stable/A-1
Nomura Real Estate Master Fund Inc.	
Senior Unsecured	A

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings public website at www.standardandpoors.com. Use the Ratings search box located in the left column.