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Research Update:

Nomura Real Estate Master Fund Assigned 'A/A-1' Ratings Following Merger Of Three Nomura J-REITs; Outlook Stable

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Overview

- The three J-REITs of the Nomura Real Estate group merged to form Nomura Real Estate Master Fund (NMF) on Oct. 1, 2015.
- We are assigning our 'A' long-term and 'A-1' short-term corporate credit ratings to NMF. The outlook is stable. We are also assigning our 'A' rating to unsecured bonds that NMF succeeded from the three J-REITs.
- We are withdrawing our ratings on Nomura Real Estate Office Fund (NOF) after raising them by one notch to 'A/A-1' and resolving the CreditWatch status.
- We are withdrawing our ratings on Nomura Real Estate Residential Fund (NRF) after affirming them at 'A/A-1'.

Rating Action

On Oct. 1, 2015, Standard & Poor's Ratings Services newly assigned its 'A' long-term and 'A-1' short-term corporate credit ratings to Nomura Real Estate Master Fund Inc. (NMF). The outlook on the long-term rating on the Japanese REIT (J-REIT) is stable. NMF is an investment corporation that was established on Oct. 1, 2015, through the consolidation of three listed J-REITs sponsored by Nomura Real Estate Holdings Inc.-- Nomura Real Estate Office Fund Inc. (NOF), Nomura Real Estate Residential Fund Inc. (NRF), and the former Nomura Real Estate Master Fund Inc. (the former NMF). We also assigned our 'A' rating to unsecured bonds that NMF succeeded from the three J-REITs.

On May 27, 2015, we placed our long- and short-term corporate credit ratings on NOF on CreditWatch with positive implications and affirmed our long- and short-term corporate credit ratings on NRF, following the announcement of their planned merger. (We did not rate the former NMF.) As planned, in accordance with the merger, we today withdrew our long- and short-term ratings on NOF after raising them by one notch to 'A/A-1' and resolving the CreditWatch status. We also withdrew our long- and short-term ratings on NRF after affirming them at 'A/A-1'. In addition, we raised by one notch to 'A' our rating on NOF's unsecured bonds and resolved the CreditWatch status, and also affirmed our 'A' rating on NRF's unsecured bonds. As mentioned, NMF inherited these unsecured bonds and we maintained the ratings on the bonds at the same 'A' level.

Rationale

The corporate credit ratings and outlooks on NRF and NOF at the time of the withdrawals reflect the credit quality of the two J-REITs after the merger and equal our newly assigned ratings on NMF.

Meanwhile, we believe NMF will have a relatively strong business position, backed by the brand recognition and real estate management and development capabilities of its sponsor, Nomura Real Estate Holdings. We expect NMF to generate steady rental revenue from its large, diversified, and relatively high-quality portfolio (total projected acquisition value of about ¥800 billion, including planned property acquisitions). In addition, we believe NMF will be able to respond with agility to changes in business conditions, reflecting its nature as a diversified J-REIT and its sponsor's property sourcing pipeline, as it pursues external growth and replaces properties in its portfolio. However, profitability is likely to remain slightly weak relative to the diversified mix of assets in its portfolio because of a moderate increase in property prices for new acquisitions. Accordingly, we assess NMF's business risk profile 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. Meanwhile, moderately high debt ratios relative to its diversified portfolio and slightly weak cash flow measures constrain our assessment somewhat. 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 assess the financial risk profile of NMF as "modest".

In our base-case scenario, we assume:

- Japan's real GDP will grow 0.6% in 2015 and 1.3% in 2016;
- NMF's total rental revenue will rise moderately, owing to new property acquisitions and a marginal increase in rent levels;
- Profitability, including return on investments (ROI), will remain mostly flat at slightly weak levels; and
- NMF will control its debt-to-total assets ratio in line with its financial policy.

Based on these assumptions, we believe NMF's EBITDA interest coverage ratio will remain at about 6.5x-7.5x and its ratio of funds from operations (FFO) to debt will remain at about 7.5%-8.5% under normal operating and financing conditions.

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. NMF has relatively high financial flexibility, given that it maintains good relationships with many financial institutions and that all of its debt is unsecured.

Outlook

The stable outlook reflects our view that NMF will 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, 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 the J-REIT's ratio of FFO to debt to exceed and remain above 9.5%. However, we believe the likelihood of an upgrade is still 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

- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Corporate Methodology, Nov. 19, 2013
- Key Credit Factors For The Real Estate Industry, Nov. 19, 2013
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012

Related Research

- Ratings On Nomura Real Estate Office Fund On CreditWatch, Nomura Real Estate Residential Fund Affirmed After Merger News, May 27, 2015

Ratings List

New Rating; CreditWatch/Outlook Action

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

New Rating

Nomura Real Estate Master Fund Inc.	
Senior Unsecured	A