STANDARD & POOR'S

Structured Finance

J-REIT Rating Report

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Nomura Real Estate Office Fund Inc.

New Rating
Corporate Credit Rating
A/Stable/A-1

Rationale

On July 8, 2004, Standard & Poor's assigned its 'A' long-term and 'A-1' short-term corporate credit ratings to Nomura Real Estate Office Fund Inc. (NOF). The outlook on the long-term rating is stable.

Major Rating Factors

Strengths

- The highly conservative structure of Japanese Real Estate Investment Trusts (J-REITs);
- NOF's above-average business position, measured external growth strategy, relatively conservative financial profile and financial policy;
- A high-quality portfolio of office properties, which generates a stable income stream; and
- The expertise of the asset management firm, Nomura Real Estate Asset Management Co. Ltd. (NREAM).

Concerns

- The J-REIT market's relatively short track record; and
- Single property concentration risk due to a relatively limited portfolio mix.

A corporate credit rating (or issuer credit rating) represents Standard & Poor's current opinion of an obligor's general creditworthiness, or the creditworthiness of an obligor with respect to a particular debt security or other financial obligation. In other words, its overall ability to meet its financial obligations. This opinion focuses on the obligor's capacity and willingness to meet its financial commitments as they come due. A rating is not a recommendation to buy or sell any securities or stocks issued by NOF.

This rating report is based on information as of July 8, 2004.

Rating Analysis

Rating approach for J-REITs.
Standard & Poor's published its rating approach for J-REITs in May 2001, in an article entitled "Rating Policy for Japanese Real Estate Investment Trusts." The above rating has been assigned in accordance with the approach outlined in this article.

Credit characteristics of a J-REIT corporation.
J-REIT corporations are governed by various sets of legal requirements under the Investment Trust Law, which was revised in November 2000. The business purpose of J-REIT corporations is limited to the acquisition, holding, and selling of cash-flow generating properties. The entities are prohibited from engaging in other business and are subject to strict disclosure requirements. J-REIT corporations are required to outsource all aspects of their real estate investment and asset management functions to an external asset management company. They are also prohibited from having their own office or hiring employees. As a result, although they carry a corporation name, in essence they are more like Special Purpose Companies (SPC), similar to those used in securitization transactions. Hence, the operations of J-REIT corporations are likely to be more predictable than those of public corporations. Under the current interpretation of the Investment Trust Law, J-REITs may be precluded from engaging in development projects, which sets them apart from REITs in other countries, such as U.S. REITs or Australian Property Trusts. In general, development projects give REITs the opportunity for future income and growth, but at the same time expose them to construction risk and completion risk.

Corporate credit ratings.
Standard & Poor's rating analysis of J-REIT corporations takes into account two major aspects of a given company: its business profile and its financial profile.

In assessing a J-REIT corporation's business profile, Standard & Poor's evaluates its operating strategy and management policies by considering its market position, asset quality, diversification of assets in its portfolio, stability of cash flow, and investment strategy.

In assessing a J-REIT corporation's financial profile, Standard & Poor's evaluates its financial health by considering its financial strategy, profitability, capital structure, cash flow protection, and financial flexibility.

Business Profile

Business foundation and market position.
Established in August 2003 and listed on the Tokyo stock exchange in December 2003, NOF currently ranks as one of the largest J-REIT corporations in terms of asset volume and market capitalization. All of the invested properties are

Table 1
Sponsorship breakdown of NOF and NREAM

	Nomura Real Estate Development	Others	Total
Ownership of NOF			
# units	10,414	174,236	184,650
% shares	5.6%	94.4%	100.0%
Ownership of NREAM			
% shares	100.0%	0.0%	100.0%

office buildings (office fund). The company's sponsor is Nomura Real Estate Development Co. Ltd. (not rated), and the company owns a 5.6% interest in NOF, as well as 100% of Nomura Real Estate Asset Management Co. Ltd. (NREAM), the asset manager of NOF.

While these sponsors do not have a direct relationship with NOF's management, their credit standing plays an important role in determining NOF's credit quality, as they are closely involved in the business operations of NOF through the provision of human resources, real estate expertise, and funding support. Standard & Poor's conducted a comprehensive analysis of various aspects of the sponsors, including their real estate management capabilities, credit profiles, and commitment to NOF, which are reflected in the ratings on NOF.

Asset quality

As of May 2004, NOF owns a portfolio of 16 office buildings. The aggregate acquisition value is about ¥137.3 billion, and the total appraisal value is ¥137.4 billion. The aggregate net rentable area is 57,159 tsubo, and there are 271 tenants, which shows good diversification. The REIT's office buildings, as represented by Shinjuku Nomura Building, the largest property in the portfolio, generally benefit from attractive locations in their respective sub-markets, sound building structures, and facilities with strong resistance to earthquakes. The majority of the buildings are highly occupied with tenants with sound credit profiles. Standard & Poor's believes that the good condition and appropriate maintenance of NOF's assets reflects the high property management capabilities of NREAM.

Legal ownership of property

NOF owns 12 assets in the portfolio under a fee simple ownership structure. The remaining four properties are held under other contract types, including condominium ownership and co-ownership. Partly owned assets are generally less liquid than properties held under a fee simple structure. These assets comprise a relatively low proportion of NOF's portfolio and are within an acceptable range. In addition, NOF plans to increase its stakes in these properties over time, while balancing the portfolio.

Age of buildings and maintenance

The average age of the buildings is relatively old (within the rated J-REIT comparative universe), at 21 years, although the properties are well maintained. Most of NOF's assets were built after 1981, when a new construction code with more stringent anti-earthquake standards was introduced. The exceptions are Shinjuku Nomura Building (built in 1978), Itopia Nihonbashi Honcho Building (built in 1961), and Nomura Real Estate Hiroshima Building (built in 1976). However, all three of these buildings have structural appraisal reports that verify that their level of earthquake resistance is as good as for properties built under the new standards. In addition to seismic reinforcements, the entrance, interior, electric capacity, central supervisory system, and fire protection facilities of the Shinjuku Nomura Building were refurbished, and individual air conditioning systems introduced, during 1993 to 2002 at a total cost of ¥13.8 billion. Improvements to the Itopia Nihonbashi Honcho Building include renovations of exterior walls, entrances, rest rooms, the installation of new light fixtures, raised floors, and individual air conditioning systems between 1996 and 2003, at a total cost of ¥3.1 billion.

In general, all the properties are well maintained with appropriate capital expenditures. Some properties are equipped with office OA floors and individual air conditioning units. Some of the properties in regional areas do not have OA floors, but the management company is willing to supply these facilities if demand rises.

Occupancy rate/Rent levels

Most of the assets in the portfolio have above-average occupancy rates for their respective markets, with average occupancy at approximately 93.5% as of March 2004. It is important to note that this level of occupancy has been achieved with rental rates that are in line with market rent levels. Standard & Poor's assessed the actual rent paid to NOF by the respective tenants by examining the rent roll for each property, and determined that the rent levels were consistent with sub-market rents.

In Japan, it is still common practice for lease agreements to expire in two years, with tenants allowed to vacate the premises by giving six months notice. Therefore, property owners in Japan are exposed to higher rent reduction risk caused by the economic environment, compared to owners in western countries, where long-term fixed rent lease agreements are common. However, Standard & Poor's believes that NOF has limited exposure to such risk, as its properties have above-average occupancy rates, with rents consistent with sub-market levels. This good performance is attributable primarily to the high quality of the portfolio assets and NOF's high leasing capability.

Diversification and stability

NOF's portfolio, though relatively small by number of assets, has generated high and stable cash flow. While the portfolio is well diversified in terms of tenants, property concentration risk is a slight concern.

Property type/geographic diversification.
The portfolio consists of 16 office buildings spread nationwide. The geographic location of the properties is appropriately weighted to the Kanto region, especially to Tokyo. The geographic breakdown in terms of acquisition value is as follows:

Central Tokyo: about 71.3%
Suburban Tokyo: 15.2%
Others: 13.5% (Osaka, Kobe, Hiroshima, and Utsunomiya)

NOF's geographic concentration in Tokyo is mitigated by the size and liquidity of the Tokyo real estate market, given that both economic and political functions are centralized in the city. Therefore, Standard & Poor's does not regard asset concentration in Tokyo as an immediate negative factor.

Property value diversification.

The top four properties in the portfolio represent about 61.3% of the total acquisition value. Shinjuku Nomura Building (Shinjuku-ku, Tokyo) currently comprises 28.2% of asset value, followed by Itopia Nihonbashi Honcho Building (Chuo-ku, Tokyo, 15.0%), Tennozu Parkside Building (Shinagawa-ku, Tokyo, 10.8%), and Isuzu Shiba Building (Minato-ku, Tokyo, 7.3%). Other assets comprise between 1.4% and 5.5 % of the total acquisition value. There is concentration risk in the portfolio in terms of value, with the largest property, Shinjuku Nomura Building, accounting for 28.2%. However, the building's strong competitiveness among high-rise buildings in the Nishi Shinjuku area, backed by its highly diverse tenant structure, with 89 tenants as of March 2004, and high occupancy rate of 95.6% somewhat offset this concern. In addition, concentration risks will fall as NOF pursues external growth and increases the properties in its portfolio. (In June 2004, NOF purchased Seiwa Shinjuku Building for ¥2.3 billion, bringing its office-building portfolio to 17).

The portfolio has 271 tenants in total. The largest tenant and top 10 tenants in the property in the portfolio represent about 4.2% and 24.6% of total NRA, respectively. Tenant diversification is also high.

Standard & Poor's Underwriting Value

Standard & Poor's underwrote the individual cash flows and property values for all the properties after conducting onsite inspections of the top 14 buildings in NOF's asset portfolio of 16 properties. Based on its results, Standard & Poor's assessed the total portfolio value as being about ¥133.9 billion. The purpose of Standard & Poor's underwriting was to confirm that NOF had acquired these assets at reasonable prices. Standard & Poor's underwriting value was 97.6% of NOF's acquisition cost, and about 97.5% of its portfolio appraisal value. As the discrepancies between Standard & Poor's and NOF were within 3%, Standard & Poor's concluded that NOF's purchase cost was at an appropriate level.

Standard & Poor's used a direct capitalization method (DCM) to underwrite NOF's portfolio. Individual property values using DCMs are obtained by dividing stabilized net cash flow (NCF) over the next few years by a cap rate. The cap rate is defined as the investor's required rate of return on a particular asset. The rate is derived by adding a risk premium specific to each property—such as location, property age, building structure, legal ownership status, or marketability—and a risk premium specific to Japan's real estate market to the risk free rate. Standard & Poor's applied cap rates ranging from 5.25%-7.0% (5.25% for the Shinjuku Nomura Building) upon underwriting NOF's portfolio. The weight average cap rate on the portfolio is 5.98%.

Operating Strategy / Management

Investment strategy

NOF's investment strategy is to invest in high-quality office and retail properties throughout Japan.

Asset type: Maintains investments in office properties (100%).

Geographic diversification: Will invest 60%-80% of its portfolio in assets in central Tokyo, and 20%-40% in other regions, including suburban Tokyo.

Investment style:
Mainly invests in a “buy and hold” style, under which it holds assets over the long term.

Development projects.
Has no intention to invest in development projects that carry construction and completion risks.

Property age:
Invests primarily in buildings constructed after 1981 under the new construction code. Otherwise, will acquire properties with a PML of less than 20% and similar seismic resistance and structural characteristics to those constructed under the new code.

Target yield:
Invests in office buildings maintaining portfolio NOI yield of between 6.0% and 6.5%.

Property size:
Invests in properties with a total building area of more than 3,300 sq. meters (equivalent to about 1,000 tsubo).

Internal growth strategy

NOF intends to examine potential cost reductions, such as changing vendors, including cleaning and security firms. It will also consider outsourcing vendors in bulk, if it determines there is room to reduce administrative costs after reviewing the expense structure of all properties. In addition, NOF expects to increase rent revenue by leasing up those properties that are currently performing below the sub-market average occupancy level. In terms of utility costs, NOF examines the appropriate volume, terms, and unit price for each property at the time of contract renewal and tries to reduce basic charges. It also aims to reduce administrative costs by 3%-5% in total by the end of April 2005, and has already achieved some reduction in electricity costs and management dues for condominium ownership.

External growth strategy

NOF aims to increase the size of its portfolio by 1.35x to ¥200 billion from the current ¥147.9 billion (Standard & Poor’s underwriting value) by the end of April 2006. The company will need to acquire new properties worth ¥26.0 billion each year to achieve its goal. This translates into a growth rate of 16% on an annual basis, which is considered moderate. In general, if a J-REIT’s external growth rate is aggressive, the company may face difficulty in maintaining its leverage at a constant level in the course of its property acquisition, debt financing and equity issue (i.e leverage control), as J-REITs remain highly dependent upon external sources of capital to fund their growth. This could lead to a more volatile capital structure and an increase in the overall financial risk of the company. NOF’s conservative growth rate is reassuring in this respect. Standard & Poor's believes that the company's external growth strategy is attainable, given the volume of potential acquisition properties that it is exposed to on a regular basis.

Property management

Currently, NOF outsources property and leasing management for its 16 properties to Nomura Real Estate Development Co., Ltd., Nomura Building Management Co., Ltd., Itochu Urban Community, The Dai-ichi Building Co., Ltd., and Ikoma TBM K.K. Some of these companies are also sponsors of NOF, or affiliates of its sponsor companies, which raises concerns over conflicts of interest. NOF recognizes this issue and has introduced a criteria and procedure for property manager evaluation to increase transparency in selection and assessment of property managers. NOF intends to continue to disclose PM compensation by property. The company also expects that the PM appraisal system will help raise the quality of property management and reduce costs.

Insurance/Earthquake risk

Fire and general liability insurance is attached to all assets. According to the seismic report provided by NOF, both the portfolio PML and arithmetic average PML of all properties are low, at around 7.5% and 11.9%, respectively. Nomura Fudosan Osaka Building has the highest PML, at 19%, and others range between 5% and 17%.

Conflicts of interest

Under the J-REIT system, a company's entire operation must be outsourced to third party companies, which tends to increase the potential for conflicts of interest between J-REIT corporations and third parties. Standard & Poor's confirmed that NOF has introduced adequate measures to mitigate these potential conflicts. For instance, NOF's compliance committee consists of two external experts, one of which is a lawyer, to ensure appropriate "checks and balances" by third parties. In addition, NOF ensures that the acquisition value is set lower than the appraisal value when purchasing properties from its related entities. NOF also ensures that properties are rented to its related entities at market value and that they enter into fixed tenant agreements, while disclosing the contracts. Furthermore, NOF has adopted an agreement with NREAM and the property managers under which their fees are performance-based. Through this arrangement, NOF has succeeded in aligning the economic interests of the third parties with those of investors.

Dividend Policy and Growth Strategy

According to Japanese tax law, in order to be exempt from paying corporate tax, a J-REIT corporation must distribute more than 90% of its distributable profit to the unit holders as dividends. Compliance with this rule is one of NOF's policies. As a result, J-REIT corporations such as NOF cannot retain a great a deal of profit internally, and have to rely on external borrowings or equity issues to increase their asset bases and achieve external growth. Internal growth strategies are likely to involve plans to maximize portfolio cash flow, either by increasing monthly rents or by reducing operating costs through efficient management of properties. However, companies like NOF, which already have high-quality assets with stable cash flows, may face some constraints on potential for internal growth.

Financial Profile

Standard & Poor's examined NOF's leverage and capital structure, in terms of both its loan-to-value (LTV) ratio and its debt-to-capital ratio. The debt-to-capital ratio is based on the book value of assets, which appears on NOF's balance sheet, while the LTV ratio is based on Standard & Poor's underwriting value of the properties.

Debt-to-capital ratio= interest bearing liabilities (long-term loans + short term loans + debentures) / total capital (interest bearing liabilities + shareholder's capital).

LTV Ratio = interest bearing liabilities (long-term loans + short term loans + debentures) / (Standard & Poor' s underwriting value of property portfolio – outstanding balance of security deposits).

The LTV ratio is based on Standard & Poor's underwriting value, and therefore reflects the market value of the portfolio. The security deposit was excluded from the denominator, because for J-REITS, it is not always common practice to set aside such liabilities in an escrowed reserve account in cash. For NOF, which fully sets aside the security deposit liability in cash in an escrow account by each property, there is no need to subtract the security deposit in the above calculation.

Financial policy

NOF's financial policy is relatively conservative. The company's management expects to maintain a debt-to-capital ratio averaging between 35% and 45%. The company intends to flexibly raise equity along with the purchase of new properties to stabilize the leverage ratio, and is likely to maintain the leverage at the projected level given its conservative growth rate. NOF's commitment to maintaining its leverage was recently demonstrated through a public offering in May 2004 (issued ¥20.5 billion additional equity). As a result of this capital increase, total debt to capital declined to 39.4% from 45.5% in April 2004. However, Standard & Poor's acknowledges that this recent equity issuance was facilitated by the current favorable investor appetite for the company's stock. Future issuances may be more challenging, in a declining share price environment.

Profitability

First fiscal term (ended April 2004) results:
Income was generated by a portfolio of 15 properties, comprising 12 properties, which the company purchased soon after it was listed, and three properties, which it purchased additionally within the term. EGI (effective gross income) was ¥4,531 million and NOI (net operating income) about ¥3,350 million. Net profit was about ¥1,526 million, with net profit per unit at ¥10,274.

Second fiscal term (ended October 2004):
Income estimates are based on 17 properties. EGI is estimated at ¥6,600 million, NOI at about ¥4,434 million, net profit about ¥2,381 million, and net profit per unit ¥12,900.

ROA (per annum) based on end-of-term data was 2.8% for the first term and is expected to be 3.0% in the second term. ROE (p.a.) was 5.2% for the first term and is expected to be 5.0% in the second term. Since NOF's policy is to distribute more than 90% of its distributable profit, the ROE should approximate the return on investment at the property level, as expressed by the cap rate, although it depends on the leverage level. NOF's target portfolio NOI cap rates are 6.0%-6.5%. This level is equivalent to a high 5% to low 6% range in the NCF cap rate. Standard & Poor's underwriting cap rate for all the properties is 5.98% on a weighted average basis. The ROE level mentioned above is reasonably consistent with those cap rates.

Capital structure

NOF's capital structure is currently conservative, although leverage levels could increase temporarily as the company pursues debt-financed acquisitions. The company's capital structure after the capital increase in May 2004 consists of ¥92.168 billion in equity, ¥50.5 billion in unsecured long-term loans, and ¥10.5 billion in unsecured short-term loans. Its leverage ratio (total debt to capital) is conservative at 39.4%. These debt instruments are attractively priced, which supports the company's very strong coverage measures to a moderate extent.

NOF's targeted debt-to-capital ratio, ranging between 35% and 45%, translates into an LTV ratio of 37% to 47%. An LTV ratio of this range is considered extremely conservative, since it satisfies the leverage levels required for the 'AA' and 'AAA' rated segments of standard CMBS transactions, which involve perfect bankruptcy remote SPC structures. However, the bankruptcy remoteness of J-REIT corporations is considered imperfect and weak compared with that of SPCs used in CMBS transactions. Also, J-REIT portfolios are not as static as CMBS pools, since J-REITs are likely to buy and sell properties over the long term. These factors may place certain constraints on the rating level of a J-REIT corporation in comparison to the ratings achievable in a CMBS transaction.

Cash flow protection

NOF has a well-diversified portfolio with above-average occupancy rates, which produces a stable rental revenue stream. Cash flow protection is strong, with the 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 on currently attractive actual financing costs, is 10x. The DSCR using actual interest rates and including common dividends as a fixed charge is expected to remain above 1.35x on average. The company is expected to maintain a strong debt servicing ability, even if future interest rates rise.

Liquidity at hand

NOF's liquidity at hand and short- and long-term funding capabilities are high, resulting in a solid servicing ability. In addition, retained earnings after dividend payments are sufficient to cover necessary capital expenditures for property maintenance and renovations (estimated at about ¥2 billion of retained earnings for a year from April 2004). As of the end of April 2004, NOF had cash and deposits of about ¥18.2 billion, enabling the company to make short-term payments related to its operations, including the repayment of security deposits.

Financial flexibility

NOF's financial flexibility is considered high, reflecting its established bank relationships with 19 financial institutions. The company's bank borrowings are all unsecured and none of its properties are encumbered. Standard & Poor's J-REIT rating analysis includes a review of loan agreements to examine any financial covenants or triggers, which may severely constrain an issuer's financial flexibility. Standard & Poor's identified several restrictions and triggers embedded in NOF's loan agreements, but concluded that none of these covenants are likely to materially affect the company's financial flexibility.

Outlook: Stable

NOF's diverse and high-quality asset portfolio should provide a stable income stream and sustainable profitability, despite the current asset concentration. With the support of its sponsors, NOF is expected to maintain a conservative financial profile as the company pursues acquisitions at a relatively modest pace. Although NOF's leverage may fluctuate as its portfolio grows, average leverage is expected to remain in the moderate range indicated.

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