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## Ratings On Japan's Nomura Real Estate Office Fund Affirmed At 'A-/A-2'; Outlook Stable

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**OVERVIEW**

- NOF is a Japanese REIT specializing in office buildings.
- Japan's sluggish office building market continues to constrain NOF's profitability, but higher occupancy rates in the J-REIT's portfolio and property acquisitions have helped its earnings to an extent.
- NOF's portfolio cash flow is unlikely to decline substantially in the midterm because of the J-REIT's relatively strong business position and the relatively high quality of its portfolio.
- We have affirmed our 'A-' long-term corporate credit and unsecured debt ratings and our 'A-2' short-term credit rating on NOF. The outlook on the long-term rating is stable.

TOKYO (Standard & Poor's) Sept. 7, 2012--Standard & Poor's Ratings Services today said that it has affirmed its 'A-' long-term corporate credit and unsecured debt ratings and its 'A-2' short-term credit rating on Nomura Real Estate Office Fund Inc. (NOF). The outlook on the long-term rating on NOF is stable.

The ratings on NOF reflect its relatively strong business position, backed by its sponsor's real estate management and development capabilities; the high quality of its sizable portfolio of office properties; and its adequate liquidity on hand and relatively high financial flexibility. At the same time, the ratings are tempered by weak portfolio profitability and interest coverage indicators, owing to the slow recovery of the office leasing market, which continues to constrain rental revenue; the portfolio's large unrealized

losses, which diminishes its financial buffer; a debt-to-capital ratio slightly above the range set under its financial policy; and its properties' high average age.

As of the end of the 17th six-month fiscal term (ended April 30, 2012), NOF owned a portfolio of 51 office buildings nationwide, though primarily in the Tokyo metropolitan area, with a total purchase price of about ¥375.4 billion. We view a substantial decline in NOF's cash flow as unlikely in the midterm, due to the high quality of the properties in its portfolio. Nevertheless, NOF's cash flow has faced downside risk. In the second half of 2010, NOF's largest tenant reduced the rent for the sublessee of one of the J-REIT's major properties, NRE Tennozu Building (Shinagawa Ward, Tokyo; purchase price: about ¥33.1 billion). Thereafter, the sublessee evacuated some of its subleased space. Although the master lessee concluded a lease agreement with a new sublessee, effective October 2011, to fill the vacated portion of the building, we believe it will take time for NOF's profits to recover.

The average occupancy rate of NOF's portfolio stood at about 97.1% as of the end of the 17th fiscal term, improving year-on-year from a recent, term-end low of 93.8%. However, rents in the office leasing market continue to fall, and the overall flow of tenant departures has not stopped. In NOF's case, the single tenant fully occupying NOF Surugadai Plaza Building (Chiyoda Ward, Tokyo; accounts for about 1% of the total net rentable area of NOF's portfolio) is scheduled to vacate the building in May 2013. Accordingly, we see the status of NOF's leasing activities and earnings profile as key factors for its credit quality.

In terms of external growth, the J-REIT aims to expand its portfolio to ¥500 billion in the midterm. It plans to continue selective property acquisitions and replacements by utilizing its sponsor's property sourcing pipeline, while considering its debt level. For example, in the 17th fiscal term, NOF acquired from its sponsor three properties, including PMO Akihabara (Chiyoda Ward, Tokyo), for a total purchase price of ¥7.7 billion. The J-REIT supports its earnings to a degree by steadily, albeit gradually, expanding the size of its asset portfolio.

NOF aims to maintain its debt-to-total asset ratio at between 35% and 45% (as defined by NOF), which is a conservative level. As of the end of the 17th fiscal term, NOF's 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 49.2% (46.1% based on NOF's definition), which is slightly higher than the cruising range set under NOF's financial policy. The portfolio's unrealized losses (the difference between the portfolio's appraisal value and book value at the end of a fiscal term) represented about 9.8% of book value. Although the increase in unrealized losses is decelerating, the situation is a reversal from when the portfolio had unrealized gains under strong market conditions. NOF's weak profitability and interest coverage indicators make it likely, in our view, that the J-REIT's financial standing will take time to completely recover, amid the subdued office leasing market.

We assess NOF's liquidity as "adequate." We believe NOF has sufficient liquidity sources for the 18th fiscal term (ending Oct. 31, 2012)--including liquidity on hand and funds from operations (FFO)--to cover uses--such as debt repayments, capital expenditures, and dividend payouts. Outstanding cash and deposits totaled about ¥26.7 billion as of the end of the 17th term. Following a ¥10 billion reduction in June 2012, NOF's current committed credit lines total ¥30 billion, all of which are unused. The J-REIT maintains good relationships with many financial institutions, allowing it to secure refinancing loans with relative ease, among other benefits. NOF also has relatively high financial flexibility, given that all of its debt is unsecured.

The outlook is stable. Although business conditions for NOF remain challenging, we believe that its portfolio cash flow is unlikely to decline materially from current levels in the midterm, underpinned by its high-quality portfolio. We may consider raising our ratings on NOF if we see an increased likelihood of improvement in its profitability, debt-to-capital ratio, and interest coverage indicators, and if signs of recovery in the office leasing market emerge. Specifically, we may consider an upgrade if its ratio of FFO to interest-bearing debt exceeds and remains above 7.5% or so, and if its debt-to-total asset ratio (as defined by NOF) falls and stays below 45%. On the other hand, we would consider lowering our ratings if NOF's ratio of FFO to debt fell and remained below 5.5%, or if its debt-to-total asset ratio remains above 55% and appears unlikely to improve.

#### RELATED CRITERIA AND RESEARCH

"Key Credit Factors: Global Criteria For Rating Real Estate Companies," June 21, 2011

"Principles Of Credit Ratings," Feb. 16, 2011

"Rating Policy For Japanese Real Estate Investment Trusts," May 9, 2001

#### RATINGS LIST

Ratings Affirmed

Nomura Real Estate Office Fund Inc.

	Ratings
Corporate credit rating	A-/Stable/A-2
Unsecured J-REIT bonds*	A-

\*The above 'A-' rating on NOF's J-REIT bonds refers to its series 1, 2, 4, and 6 to 9 J-REIT bonds (total issue amount: ¥39.5 bil.). NOF has already redeemed its series 3 and 5 bonds.

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