Nomura Real Estate Residential Fund Assigned 'A+/A-1' Ratings

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TOKYO (Standard & Poor's) July 18, 2007--Standard & Poor's Ratings Services today assigned its 'A+' long-term and 'A-1' short-term corporate credit ratings to Nomura Real Estate Residential Fund Inc. (NRF). The outlook on the long-term rating is stable.

The ratings reflect NRF's relatively strong business position and its conservative financial policy and profile. NRF owns a highly diversified real estate portfolio, which comprised 91 residential properties as of June 30, 2007. The portfolio has a high occupancy rate and generates stable cash flow. NRF selects properties chiefly in the Tokyo metropolitan area, and targets tenants with stable demand. Its operations are supported by its sponsor's real estate development and management capabilities, as well as its brand recognition. The company has a conservative capital structure and high financial flexibility. Nevertheless, Standard & Poor's has some concerns over NRF's profitability levels.

The ratings also take into consideration the unique structure of Japanese real estate investment trust (J-REITs) compared with REITs rated by Standard & Poor's in other global markets, which restricts management from pursuing certain high-risk activities, such as ground-up development, to safeguard investors.

NRF was established in August 2006 and was listed on the Tokyo Stock Exchange in February 2007. There are now 41 listed J-REITs, of which eight specialize in residential properties. In terms of its asset base based on purchase price, NRF is currently the fifth largest J-REIT that invests in residential properties. Nomura Real Estate Holdings Inc. (NR) is the sponsor of NRF's asset management company, Nomura Real Estate Asset Management Co. Ltd. (NREAM). Moreover, group company Nomura Real Estate Development Co. Ltd. (NR) owns 18.36% of NRF. NREAM established NRF after NREAM was licensed by the Financial Services Agency to conduct changes in its business methods under the Investment Trust Law. NREAM accumulated substantial J-REIT management skills by managing Nomura Real Estate Office Fund Inc. (A/Stable/A-1), and achieved high recognition in the J-REIT market. Standard & Poor's regards NREAM's management expertise as being fully applied to the establishment, listing, and operation of NRF.

Standard & Poor's also believes that NRF's growth potential is not limited by the fact that it has only one sponsor, since third parties developed about 82% of its acquired residential properties. Moreover, third parties provide NRF with adequate information on properties. Additionally, the sponsor has a certain track record regarding the real estate leasing business for residential properties, having managed a private fund for five years, and employees who operated the private fund have transferred to NREAM.

As of June 2007, NRF owned a portfolio of 91 residential properties consisting of 4,339 units (including 12 stores) with a combined value about ¥70.4 billion, based on purchase price. The properties are mainly located in the Tokyo metropolitan area, with others located in Sapporo, Sendai, Nagoya, Osaka, and Fukuoka. NRF targets a stable and well-balanced portfolio through the acquisition of residential properties under three brands: PROUD FLAT, which was developed by Nomura Real Estate Development, and PRIME URBAN and URBAN STAGE, which were created by other developers. Units smaller than 30 sq. meters account for about 82% of the company's portfolio. The company mainly targets single occupiers and households with dual income but no kids (DINKS) that can afford monthly rent of up to ¥150,000. NRF's portfolio includes PROUD FLAT Sumida Riverside (Shinkawa, Chuo-ku, Tokyo), PRIME URBAN Monzen-nakacho (Monzen-nakacho, Koto-ku, Tokyo), and URBAN STAGE Kachidoki (Kachidoki, Chuo-ku, Tokyo). These properties are located in highly convenient areas within commuting distance from central Tokyo, and are highly competitive.

NRF strategically limits its investments to residential properties, focusing on those for rent. Standard & Poor's regards residential properties as generally generating more stable cash flow than other types of properties. This is mainly because they have a diverse range of tenants, high substitutability, and rent levels whose fluctuations are limited amid changes in the economic climate. The company's strategy is to focus its investments in the Tokyo metropolitan area (more than 70% of the portfolio), as well as three other major metropolitan areas, and other major cities around the country, including designated ordinance cities. About 92% of NRF's portfolio is currently concentrated in the Tokyo metropolitan area (about 82.3% in the 23 main wards, about 9.7% in other areas). Standard & Poor's does not view asset concentration in Tokyo as a concern because Tokyo has the largest and most liquid real estate market in Japan, and firm demand is expected due to an increase in the number of households living in the capital.

Risks related to damage caused by earthquakes are limited on the whole, with the Probable Maximum Loss (PML) ratio of the portfolio properties settling between 3.0 and 19.1%. Although the average age of the properties is low at about seven years, the portfolio includes some properties that are somewhat old, with about 9.2% built over 20 years ago. The company will be challenged to maintain and improve the competitiveness of these properties. On the property management front, NRF aims to boost operational efficiency by selecting property management firms that best match the regional characteristics and target tenants of each property. The average occupancy ratio as of May 2007, based on end tenants, was relatively high at 95.4%, generating stable cash flow. NRF's portfolio is highly diversified, with the top four properties accounting for about 12.5% of the total portfolio value and the top 10 accounting for about 25.3% as of June 2007, which benefits the company in terms of credit quality.

NRF aims to expand the asset size of its portfolio somewhat aggressively to ¥300 billion by March 2013, implying an annual growth rate of about 28%. However, this is a rough timeline and the company plans to take its capital structure into consideration when planning acquisitions.

Management plans to maintain the average debt-to-capital ratio between 35% and 45% (a maximum of 60%), which is conservative when compared with other J-REITs specializing in residential properties. NRF plans to issue equity in a timely manner when debt-to-capital levels reach around 45%, depending on property acquisitions, and is looking to stabilize its financial leverage. NRF's debt-to-capital ratio (interest-bearing debt/(interest-bearing debt + unitholders' capital; Standard & Poor's definition) for its first fiscal year (ended May 2007) was about 43%. The company has a relatively sound financial profile and its debt repayment terms are dispersed through 2015. Its estimated EBITDA interest coverage will be around 6x, and its funds from operations (FFO) to total debt ratio is expected to be between 7% and 8%. NRF's portfolio profitability measures are somewhat low compared to those of other J-REITs holding different types of properties, with an average ROA of around 4.1% to 4.3% estimated going forward. Such measures are expected to decline as other new and high-quality properties, including PROUD FLAT, are incorporated into the portfolio. Future organic growth is viewed as limited to some extent, since NRF specializes in residential properties and rent on such properties only rises moderately. As stated previously, Standard & Poor's has some concerns over NRF's profitability levels.

NRF has ample liquidity at hand, and the company's long-term and short-term fundraising capabilities do not represent a cause for concern in respect of near-term debt repayments or portfolio expansion. The company has established favorable relationships with 12 major financial institutions and has high financial flexibility through unsecured financing.

The outlook on the long-term rating is stable. The company will generate stable income by maintaining relatively high asset quality and a conservative financial profile. This will be achieved by obtaining its sponsor's support in expanding its property portfolio. Debt-to-capital ratios will likely remain in the aforementioned range, with fluctuations remaining marginal due to the company's diversified asset portfolio specializing in residential properties.

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