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Ratings On Nomura Real Estate Residential Fund Affirmed

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TOKYO (Standard & Poor's) Sept. 11, 2008--Standard & Poor's Ratings Services today affirmed its 'A+' long-term and 'A-1' short-term corporate credit ratings on Nomura Real Estate Residential Fund Inc. (NRF). The outlook on the long-term corporate credit rating remains stable.

The ratings reflect NRF's relatively strong business position and its conservative financial policy. NRF owns a highly diversified portfolio of residential properties with moderately good leasing conditions. The portfolio has a low average age, and it generates stable cash flow. NRF's sponsor is Nomura Real Estate Holdings Inc. (NR). NRF's operations are supported by the sponsor's real estate development and management capabilities, as well as brand recognition. NRF targets tenants with stable demand, and selects its investment properties accordingly. The company maintains a conservative financial policy and a certain degree of financial flexibility, although these strengths are partially offset by a relatively aggressive pace of external growth and a decline in its financial indicators resulting from an increased debt-to-capital ratio.

NRF was established in August 2006 and was listed on the Tokyo Stock Exchange in February 2007. As of the end of May 2008 (third six-month fiscal term), NRF owned a portfolio of 131 properties, consisting of 6,487 leasing units (including 25 stores/offices). The total value of these properties is about ¥110.3 billion, based on purchase price. NRF's strategy is to limit its investments to residential properties, focusing on those for rent. The company

mainly targets single occupants and households with dual incomes but no kids (DINKS) that can afford monthly rent of less than about ¥100,000 and between ¥100,000 and ¥150,000. NRF is actively engaged in property acquisitions. In its second six-month fiscal term (ended Nov. 30, 2007) and third six-month fiscal term, the company acquired 42 properties (with a total acquisition price of about ¥43.3 billion), including PRIME URBAN Meguro Ohashi Hills (in Meguro Ward, Tokyo; acquisition price of about ¥3.58 billion) and PROUD FLAT Kamiooka (in Konan Ward, Yokohama, Kanagawa Prefecture; acquisition price of ¥2.77 billion).

Standard & Poor's regards residential properties as investments that generate more stable cash flows than other types of properties. This is mainly because residential properties have a diverse range of tenants, high substitutability, and rent levels whose fluctuations are limited amid changes in the economic climate. NRF's policy is to focus its investments (more than 70% of the portfolio) in the Tokyo metropolitan area (Tokyo, Kanagawa Prefecture, Chiba Prefecture, and Saitama Prefecture). As of the end of the third six-month fiscal term, about 88.3% of NRF's properties were located in the Tokyo metropolitan area, and about 11.7% in other major cities (Sapporo, Sendai, Nagoya, Osaka, Fukuoka). This is in line with NRF's investment policy.

Excluding some properties that are still seeking leasing contracts, the average occupancy rate of NRF's portfolio was generally high at 93.9% at the end of the third six-month fiscal term. As previously mentioned, NRF's portfolio is highly diversified. The top four properties account for about 10% of the total portfolio purchase price, which benefits the company in terms of credit quality. Although the weighted average age of the properties is low at about 6.7 years, the portfolio includes some properties that are somewhat old, with about 10% of the properties built more than 20 years ago. It will be a challenge for the company to maintain and improve the competitiveness of these properties.

The market for J-REITs' (Japanese real estate investment trusts) investment units and debentures is still undergoing a correction as domestic and overseas debt and capital markets have been unstable. Despite turmoil in global financial markets, NRF issued equity between February 2008 and March 2008. It was NRF's first equity issuance since its listing in February 2007. Under NRF's conservative financial policy, it aims to maintain its debt-to-capital ratio (interest-bearing debt/total assets) at between 35% and 45% (cruising level), or at a maximum 60%. During its February-March equity issuance, however, NRF could not reach its targeted debt-to-capital level due to a decline in investment unit prices. In addition, due to NRF's relatively aggressive external growth strategy, the debt-to-capital ratio stood at about 53% (according to Standard & Poor's definition: $\text{interest-bearing liabilities} / (\text{interest-bearing liabilities} + \text{shareholders' capital})$) as of the end of the third six-month fiscal term, somewhat above the cruising level set under the company's financial policy. The debt-to-capital ratio may remain above cruising level (35%-45%) until the capital markets recover and this partly raises concern about the company's credit quality. However, this concern is mitigated to some extent by: 1) the company's highly diversified portfolio, which consists of residential properties with relatively high occupancy rates, generating stable cash flow; and 2) the solid relationships that NRF maintains with several financial institutions, enabling the company

to maintain a certain level of liquidity. Since NRF's current leverage is relatively high, the company pursues property acquisitions through careful selection, using ways such as a warehousing function that is currently being considered by its sponsor and so on.

As of the end of the third six-month fiscal term, long-term debt accounted for about 70% of NRF's total debt, with debt repayment terms dispersed through 2015. Its EBITDA interest coverage was about 5.5x, and its funds from operations (FFO) to total debt ratio was about 5.7%. Both indicators have declined, pointing to the company's somewhat high financial leverage. NRF plans to monitor market trends and issue equity in a timely manner, in an effort to stabilize its financial leverage. With return on assets (ROA) of about 4.3%, NRF's portfolio profitability measures are somewhat low compared with those of other J-REITs holding different types of properties. Meanwhile, NRF's EBITDA margin (EBITDA/real estate rental revenue) is relatively high at about 65.5%.

Due to NRF's solid business relationships with 14 major financial institutions, NRF's liquidity at hand and long-term and short-term fundraising capabilities do not represent a cause for concern with respect to near-term debt repayments or the ability to cover immediate operating expenses, including security deposit liabilities. NRF's financial flexibility is moderately high, reflecting all interest-bearing liabilities from financial institutions on an unsecured basis.

The outlook on the long-term rating is stable. The company will generate stable income through its diversified portfolio of relatively high-quality real estate. Since the company has somewhat high financial leverage, Standard & Poor's will especially monitor its debt-to-capital ratio, cash-flow protection, and profitability levels. We see little likelihood of a rating upgrade for the time being. Meanwhile, the rating on NRF may come under downward pressure if the debt-to-capital ratio remains high and other financial indicators, such as cash flow protection, remain low, or if the company finds it hard to maintain its conservative financial policy.

RATINGS AFFIRMED

Long-term corporate credit rating: A+
Short-term corporate credit rating: A-1
Outlook on the long-term rating: Stable

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