Ratings On Nomura Real Estate Office Fund On CreditWatch, Nomura Real Estate Residential Fund Affirmed After Merger News

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- The three Japanese REITs (J-REITs) of the Nomura Real Estate group have reached an agreement to merge into a new J-REIT that they plan to establish on Oct. 1, 2015.
- Based on the J-REITs' merger announcement, we are placing our ratings on Nomura Real Estate Office Fund (NOF) on CreditWatch with positive implications.
- We are also affirming our long- and short-term corporate credit ratings on Nomura Real Estate Residential Fund (NRF). The outlook is stable.
- We will resolve the CreditWatch status on the ratings on NOF after the merger plan receives approval at unitholders' meetings and when there are clearer prospects of the merger progressing as planned. We expect to raise the long- and short-term ratings on NOF to the same level as our anticipated ratings on the new J-REIT.

TOKYO (Standard & Poor's) May 27, 2015--Standard & Poor's Ratings Services today said that it has placed its long- and short-term corporate credit ratings on Nomura Real Estate Office Fund Inc. (NOF) on CreditWatch with positive implications. We also affirmed our 'A/A-1' ratings on Nomura Real Estate Residential Fund Inc. (NRF). Our outlook on the long-term corporate credit rating on NRF is stable. The rating actions on NOF and NRF follow the announcement by the three listed Japanese REITs (J-REITs) sponsored by Nomura Real Estate Holdings Inc. (hereafter, the "three J-REITs of the Nomura Real Estate group")--Nomura Real Estate Master Fund Inc. (NMF), NOF, and NRF--that they have agreed to merge into an investment corporation (hereafter, the "new

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J-REIT") that they plan to establish through consolidation on Oct. 1, 2015. We will resolve the CreditWatch status on the ratings on NOF after the merger plan receives approval at unitholders' meetings and when there are clearer prospects of the merger progressing as planned. We expect to raise the long- and short-term corporate credit ratings on NOF to the same level as our anticipated ratings on the new J-REIT. Although we plan to review the potential impact of the merger on our ratings on NRF, we did not place these ratings on CreditWatch because we currently believe the likelihood of our changing the ratings is low.

NOF's properties will account for roughly 45% of the new J-REIT's portfolio (based on its projected acquisition value). The high average age of NOF's properties, NOF's relatively weak profitability, relatively large unrealized losses (appraisal value less book value) on its portfolio, moderately high debt ratios, and relatively weak cash flow measures have constrained our assessment of NOF's business and financial risk profiles. However, we believe the merger will ease the negative impact of these factors on the new J-REIT's business and financial risk profiles. Meanwhile, NRF's properties will account for about 20% of the new J-REIT's portfolio. We view NRF's extremely well diversified, high-occupancy residential portfolio with inherently stable rental revenue as a strength in its business risk profile, and we expect these properties to help diversify the new J-REIT's assets and stabilize its profitability. We also expect the merger to ease the impact of NRF's financial weaknesses, such as its continued high debt ratios, on the new J-REIT's financial risk profile. NMF's business and financial strengths lie in the steady cash flow from its long-term contracts and highly profitable logistics and retail properties, slightly conservative debt ratios, and favorable cash flow measures. However, its tenant concentration risk is slightly high and its ability to grow internally through higher rent levels is limited, constraining its business profile, in our view.

Based on our views on the business strengths and weaknesses of the three J-REITs, we believe the new J-REIT 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 the new J-REIT to generate steady rental revenue from its large, diversified, and relatively high-quality portfolio (total projected acquisition value of about ¥800 billion). In addition, we believe the new J-REIT will be able to respond 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.

We expect moderate improvement in rental revenue from existing properties, particularly office properties, as Japan's property leasing market recovers. But profitability is likely to remain mostly flat at slightly weak levels because of a moderate increase in property prices for new acquisitions. Therefore, we expect the expanded portfolio scale, asset diversification, and improved business flexibility of the new J-REIT to offset NOF's slight business weaknesses. As a result, we expect to carry our "strong" assessment (the second highest of six possible categories) of NRF's business risk profile over to the new J-REIT.

In assessing the financial risk profile of the new J-REIT, we incorporate our view that it will maintain favorable interest coverage measures and relatively high financial flexibility. NOF's and NRF's debt-to-total assets ratios are moderately high relative to their respective financial policies, constraining our assessments of their financial risk profiles. But NMF's debt ratios stand at slightly conservative levels and its cash flow measures are favorable, which we believe will somewhat mitigate the slightly weak financial standing of NOF and NRF. We expect post-merger EBITDA interest coverage to remain favorable, reflecting the new J-REIT's strong relationship s with financial institutions. The new J-REIT's portfolio will likely carry a certain amount of unrealized gains, which will act as a cushion in its financial operations. However, moderately high debt ratios relative to the diversified mix of assets in its portfolio and slightly weak cash flow measures constrain our assessment somewhat. Accordingly, we expect to assess the financial risk profile of the new J-REIT as "modest," the second highest of six possible categories.

We will resolve the CreditWatch status on our ratings on NOF after the merger plan receives approval at unitholders' meetings and when there are clearer prospects of the merger progressing as planned. Upon resolving the CreditWatch status, we will examine the new J-REIT's business and financial risk profiles, growth strategy, and financial policy. When we resolve the CreditWatch status, we expect to raise the long- and short-term ratings on NOF to the same level as our anticipated ratings on the new J-REIT.

We are affirming our current ratings on NRF. The outlook is stable. We expect NRF's diversified and relatively high quality portfolio to continue to support its steady cash flow. However, we may review the outlook on NRF when clearer prospects emerge of the merger progressing as planned and after we examine the new J-REIT's business and financial risk profiles, growth strategy, and financial policy.

RELATED CRITERIA AND RESEARCH
Related Criteria
- Key Credit Factors For The Real Estate Industry, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013

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