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Ratings On Japan's Nomura Real Estate Residential Fund Affirmed At 'A/A-1'; Outlook Stable

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OVERVIEW

- NRF is a Japanese REIT specializing in residential properties.
- NRF's portfolio has sound occupancy rates and small fluctuations in rents, and generates stable cash flows.
- We expect NRF to continue to generate steady cash flows, given its well-diversified real estate portfolio.
- We have affirmed our 'A' long-term corporate credit and unsecured debt ratings and our 'A-1' short-term credit ratings on NRF. The outlook remains stable.

TOKYO (Standard & Poor's) Sept. 11, 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-1' short-term credit ratings on Nomura Real Estate Residential Fund Inc. (NRF). The outlook on the long-term corporate credit ratings remains stable.

NRF is a Japanese REIT (J-REIT) that specializes in residential properties. The ratings on NRF reflect its relatively strong business position in the J-REIT market, supported by the real estate management and development capabilities and brand recognition of its sponsor, Nomura Real Estate Holdings Inc. (not rated). We also consider NRF's well-diversified real estate portfolio, which mainly comprises residential properties with small rent fluctuations and generates stable cash flows, as a positive factor for its

credit quality. On the other hand, NRF's high debt-to-capital ratio, its somewhat low interest coverage ratios and profitability measures, and a degree of unrealized losses in its portfolio constrain the ratings.

As of Aug. 31, 2012, NRF's portfolio comprised 153 residential properties for lease (8,917 total rentable units) worth about ¥150.6 billion based on total purchase price. NRF's properties and tenants are extremely well diversified, which we believe supports the J-REIT's credit quality. In our view, residential properties generate more stable cash flows than other types of properties, because they have a high degree of tenant diversification, their tenants can be easily replaced, and their rent levels are little affected by economic fluctuations. Indeed, NRF's rent levels have been broadly stable without large volatility. The occupancy rate of its portfolio has been high, standing at 96% as of July 31, 2012, with its properties generating stable cash flows in general. In addition, NRF replaces assets by selling properties with declining competitiveness and operational efficiency while acquiring more competitive properties to increase and maintain the profitability of its portfolio.

NRF raised about ¥7.2 billion in equity capital in December 2011, when its investment unit (equity share) prices were somewhat sluggish. It also purchased eight properties for a total purchase price of about ¥15.1 billion, funding the acquisitions with the equity it raised as well as additional bank loans. Although NRF further diversified its portfolio, the J-REIT's debt-to-capital ratio did not improve, owing to less-than-expected funds raised through the above equity offering as a result of volatility in the capital markets. NRF has a conservative financial policy of maintaining its ratio of debt to total assets (as defined by NRF) at 35%-45%. However, NRF's debt-to-capital ratio [interest bearing liabilities including hoshokin liabilities/(interest bearing liabilities including hoshokin liabilities + total net assets), as defined by Standard & Poor's] stood at about 54% (53.1% based on NRF's definition of debt to total assets) as of the end of the 11th fiscal term (ended May 31, 2012), which is relatively high compared with the J-REIT's conservative financial policy. Meanwhile, NRF's interest coverage indicators and profitability measures have been somewhat low. Furthermore, although the unrealized losses (the difference between the portfolio's appraisal value and book value at the end of a fiscal term) in its portfolio have improved slightly due to the purchase of new properties, the unrealized losses remain high, thereby weakening NRF's financial buffer. Standard & Poor's views these three factors as risks to NRF's credit quality. Nevertheless, in our view, NRF's enhanced profitability, stemming from its new property acquisitions that the December 2011 equity offering largely funded; its unchanged, conservative financial policy; and its track record in raising equity capital, partially mitigate these risks. Given that NRF's debt-to-capital ratio has remained high for several fiscal terms, Standard & Poor's expects NRF to take two to three years to restore its financial base to the levels it set in its conservative financial policy.

NRF is actively extending maturities of its debt to strengthen its financial base. The debt's average residual period was about 2.5 years as of May 31,

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2012. The J-REIT is also trying to equalize payment amounts of each fiscal term. As a result, NRF's debt profile has improved, in our view.

Standard & Poor's assesses NRF's liquidity as adequate. We believe that NRF's liquidity sources--including liquidity on hand and funds from operations (FFO)--will likely cover its liquidity uses for the 12th fiscal term (ending Nov. 30, 2012)--such as capital expenditures and dividend payouts. NRF maintains favorable relationships with many financial institutions, enabling it to secure refinancing loans with relative ease, among other benefits. NRF also maintains financial flexibility because all of its borrowings are unsecured.

The outlook on NRF's long-term corporate rating is stable. We expect NRF to continue to generate largely stable cash flow, given its well-diversified portfolio of relatively high quality properties; its continued, stable occupancy rates; and the small fluctuations in rent. To raise the ratings on NRF, we would need to see a clear improvement in NRF's financial indicators. In particular, we would need to see the J-REIT's debt-to-total assets ratio decline to near the range of its conservative financial policy. Nevertheless, given its current, slightly-high debt-to-capital ratio, we see the likelihood of an upgrade as limited for the foreseeable future. In contrast, we will consider lowering our ratings on NRF if we see continued weakness in NRF's financial standing, such as a high likelihood that its ratio of FFO to debt will decline and remain under 6% or its debt-to-total asset ratio (based on NRF's definition) will rise to 56% or more and stay at that level.

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 Residential Fund Inc.

| | Ratings |
|---------------------------------------|--------------|
| Corporate credit rating | A/Stable/A-1 |
| Unsecured J-REIT bonds series 1 and 2 | A |

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