

Nomura Real Estate Residential Fund Inc.

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Major Rating Factors

Strengths:

- The highly regulated nature of J-REITs
- A relatively strong business position backed by the real estate management and development capabilities of its sponsor
- A highly diversified residential property portfolio, which ensures less volatile rental income than other type of assets and generates stable cash flow

Corporate Credit Rating

A/Stable/A-1

Weaknesses:

- A high debt-to-capital ratio, despite its conservative financial policy, as well as low interest coverage ratios and profitability-related measures
- A certain degree of unrealized losses in its portfolio
- A relatively large proportion of older properties in its portfolio

Rationale

Nomura Real Estate Residential Fund, Inc. (NRF; A/Stable/A-1) has a midsize asset portfolio among Japanese real estate investment trusts (J-REITs) specializing in residential properties. The REIT has a relatively strong business position in the J-REIT market, backed by brand recognition and the real estate management capabilities of its sponsor, Nomura Real Estate Holdings, Inc. (NR). NRF's real estate portfolio is highly diversified, and the weighted average portfolio property age is low. The occupancy rates of properties in its portfolio are sound, given that NRF acquires properties selectively, targeting tenants who can provide sustainable demand. NRF pursues a conservative financial policy.

Conversely, NRF's credit quality has been undermined by the following risk factors: (1) Although the REIT's debt-to-capital ratio has somewhat improved as a result of the equity issuance conducted in December 2009, it remains high despite its conservative financial policy, and its interest coverage ratios and profitability-related measures remain low; and (2) the REIT has a certain degree of unrealized losses (the difference between the appraisal value and the book value of the portfolio at the end of the fiscal term). Although its liquidity at hand is somewhat weak due to its status as a J-REIT specializing in residential properties, NRF has maintained adequate financial flexibility, as all of its interest-bearing debt is unsecured.

Outlook

The outlook on the long-term corporate rating is stable. This reflects Standard & Poor's Ratings Services' expectation that NRF will be able to generate stable earnings because: (1) It owns a well-diversified portfolio of relatively high-quality properties with sound occupancy rates; and (2) the declines in occupancy rates and rents in the residential leasing market appear to have come to a halt. The ratings on NRF may come under downward pressure if the REIT's financial indicators remain weak or further deteriorate. In contrast, for us to consider upgrading NRF, a clear improvement in its financial indicators must materialize, and we would need to see the

REIT's debt-to-capital ratio decline to the conservative level set out in its financial policy.

Credit Characteristics Of J-REITs

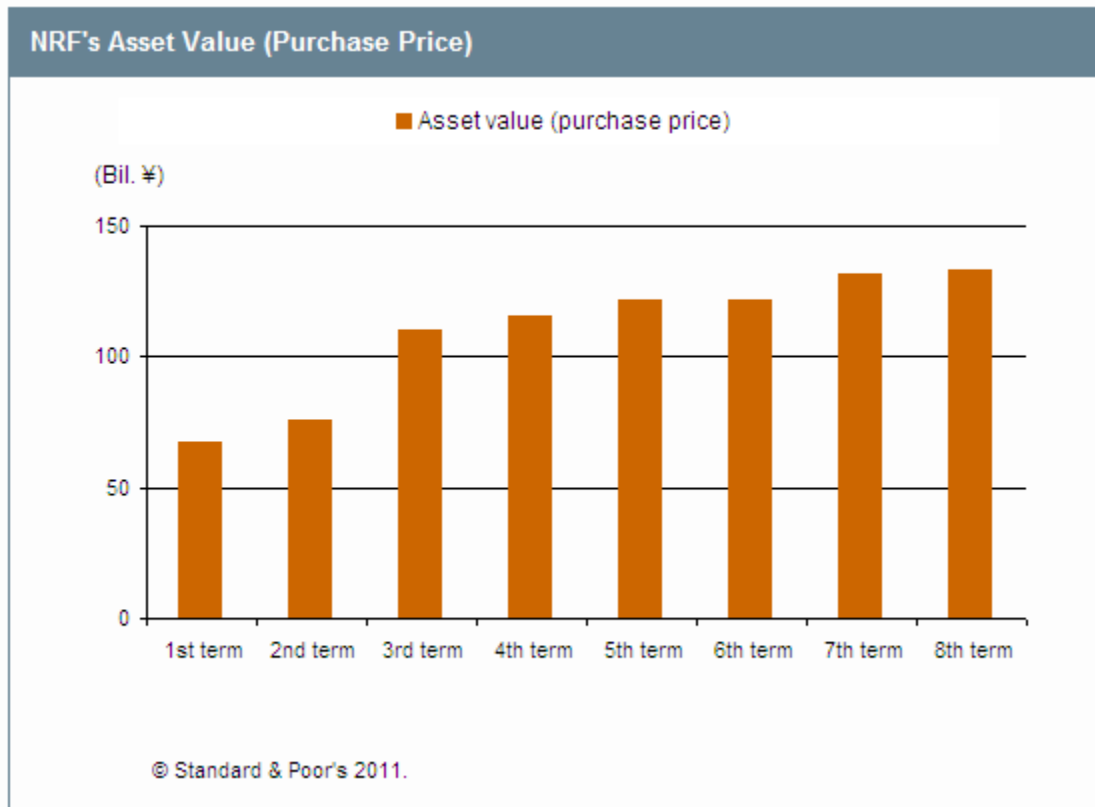
J-REITs are investment corporations established under the Investment Trust and Investment Corporation Law. J-REITs' scope of business is limited to the acquisition and operation of real estate and beneficial interests backed by real estate that generate stable cash flows. J-REITs are not allowed to conduct any other business. With regard to the operation and management of real estate and beneficial interests backed by real estate, J-REITs are obliged to outsource this work to external investment trust management companies ("asset management companies") with legal licenses, and are not allowed to hire employees. For this reason, J-REITs are practically treated as asset holding companies. As such, the operations of J-REITs are likely to be more transparent and the associated risks are likely to be more predictable than those of public corporations, such as real estate companies.

Business Profile

As of the end of November 2010, NRF owned a portfolio of 144 residential properties consisting of 7,609 units for lease with a combined value about ¥133.4 billion, based on purchase price. In December 2009, NRF raised funds through a public share offering and acquired four properties, using the pipeline support of its sponsor. The total purchase price was about ¥9.98 billion. In June 2010, NRF sold its property URBAN STAGE Tennocho (Yokohama, Kanagawa Prefecture; sales price of ¥140 million) and newly purchased two properties, including URBAN STAGE Yoga (Setagaya Ward, Tokyo; purchase price of ¥1.15 billion), by replacing some of its assets. NRF has generated external growth in the past year, mostly through property acquisitions, by using the funds that it raised through the equity issuance and by replacing assets, while giving careful attention to its debt-to-capital structure. However, Standard & Poor's regards the continued high unrealized losses in NRF's portfolio as a risk factor for the REIT's credit quality, despite the fact that such unrealized losses have been shrinking slightly. These unrealized losses may also further raise the REIT's leverage ratio based on the appraisal value of the portfolio, thereby weakening NRF's financial buffer. Given all these factors, Standard & Poor's intends to continue monitoring the level of unrealized losses.

Meanwhile, in the J-REIT market, sentiment in the equity market has been eased to a certain degree, as the Bank of Japan's (BOJ) Asset Purchase Program, which is aimed at purchasing various financial assets under the BOJ's monetary easing policy, extended its purchase targets to J-REIT investment units (shares). NRF's investment unit price currently hovers around ¥450,000, which is below the ¥630,000 level of its initial public offering. However, the unit price is recovering moderately. In addition, the REIT maintains favorable relationships with major financial institutions, as well as financial flexibility. As such, Standard & Poor's expects NRF to maintain its financing capability for the foreseeable future.

Chart 1



NRF limits its investments to the residential sector, focusing on leased properties, and it makes investment decisions after positioning rent levels, rail access, and commuting time as central factors in its property selection and investment process. NRF acquires properties selectively, targeting tenants who can afford to pay monthly rents of below ¥100,000 or between ¥100,000 and ¥150,000, as well as tenants that are less vulnerable to economic fluctuations, thereby maintaining stable leasing demand. NRF targets a stable, well-balanced portfolio through the acquisition of residential properties under three brands: PROUD FLAT, which comprises properties developed by Nomura Real Estate Development (NR), and PRIME URBAN and URBAN STAGE, which comprise properties developed by other developers. The REIT's investment strategy focuses on the Tokyo metropolitan area--Tokyo, Kanagawa, Chiba, and Saitama prefectures--which contains more than 70% of NRF's portfolio based on purchase price. Property investments as of the end of November 2010 consisted of about 87% in the Tokyo metropolitan area and about 13% in other regional areas (Sapporo, Sendai, Nagoya, Osaka, and Fukuoka). This breakdown is in line with NRF's investment strategy. To secure properties in good condition that allow for stable leasing demand, NRF also considers investments in properties that are not yet in operation. However, NRF makes it a rule to follow the requirements it set for purchasing such properties to avoid development-related risks.

NRF had seen adverse economic conditions stemming from the 2008 financial crisis drag down occupancy rates of properties in its portfolio to unprecedented levels, and it took some time for the REIT to lease new properties. Nevertheless, the rates recovered to as high as 96% as of the end of October 2010, generating stable cash flow. This was made possible by targeting tenants who can provide sustainable demand and by working closely with property management firms to map out and implement leasing strategies. Standard & Poor's views the cash flows from

residential properties to be generally more stable than those from other types of properties, given the higher tenant diversity, relative ease in searching for alternative tenants, and smaller fluctuations of rents against changes in economic conditions compared with other property types.

NRF saw limited change in the rents of properties in its portfolio, as about 94.8% of all its residential properties that had renewed lease contracts in the seventh fiscal term (the six-month period ended May 31, 2010) maintained their rent levels at previous levels. NRF's portfolio is extremely well diversified. The top four properties account for about 10% of the total portfolio value, and the largest property accounts for only about 2.7% of the entire portfolio. As these facts illustrate, there is only limited concentration risk in terms of real estate values (as of the end of the seventh fiscal term). NRF's tenant diversification is also high, with 7,609 units for lease in the portfolio. NRF's rents, which are less affected by economic fluctuations, and its highly diversified portfolio support the REIT's credit quality. Under NRF's investment strategy, the investment amount per property must be less than 30% of the total investment amount of the portfolio. In addition, the REIT targets properties with 100 units or less that can be leased relatively quickly. Therefore, Standard & Poor's expects that this diversification is unlikely to decrease substantially going forward.

The weighted average age of the properties in the portfolio is low, at about 7.7 years. On the other hand, properties of 20 years or older accounted for about 11% of the entire portfolio (as of the end of the seventh fiscal term). NRF has so far renovated or repaired older properties as necessary so as to satisfy the needs of tenants. However, it is our view that maintaining and improving the competitiveness of the older properties is one of NRF's key challenges, as facility obsolescence due to aging cannot be avoided for residential properties, and this may affect the competitiveness of the properties. Indeed, the REIT plans to carry out further renovation and repair work under a schedule that avoids concentration of such activities in certain time periods. The REIT is able to do so, backed by the strengths of its diversification in terms of property age and portfolio, while taking its cash flow into consideration.

NRF holds fee simple ownership and 100% condo ownership of 142 properties out of a total of 144 properties. The proportion of fee simple ownership and 100% condo ownership is very high. Thus the likelihood of this ownership structure affecting the REIT's liquidity is limited. Properties in NRF's portfolio are covered by fire insurance and general liability insurance on an as-needed basis. According to NRF's official report, the probable maximum loss (PML) of the properties ranged from 0.9% to 14.9% as of the end of the seventh fiscal term.

Given the characteristics of NRF's portfolio, such as the diversity of its tenants and property locations, the selection of property management companies is considered important for efficient operations and for the prompt commencement of leasing activities. Regarding property management, NRF typically selects the most appropriate property management companies by examining its properties' localities and target tenants, and strives to improve operational efficiency through reductions in property management expenses. At the same time, NRF has pursued steady internal growth, such as high cash flows, and has achieved this by increasing its properties' values by renovating shared spaces at these properties. Standard & Poor's believes it is necessary for operators of residential properties to take measures to steadily reduce expenses and improve cash flow, given the small upside in rents when economic conditions fluctuate. Tenant management duties are carried out by property management companies that also serve as master lessees. NRF has introduced the master lease system to all of its owned properties.

NRF's asset management company, Nomura Real Estate Asset Management Co., Ltd. (NREAM; NR), established Nomura Real Estate Private REIT, Inc. (NPR; NR) in March 2010. Accordingly, NREAM became an asset

management company that has operational headquarters where it manages three J-REITs: (1) Nomura Real Estate Office Fund Inc. (NOF; A/Negative/A-1), specializing in office properties; (2) NRF, specializing in residential properties; and (3) NPR, an unlisted J-REIT. To start management of these three J-REITs, NREAM established an adequate operational framework to avoid conflicts of interest. Given this, we believe the establishment of NPR is unlikely to have a great impact on NRF's management approach.

For the seventh fiscal term, NRF posted about ¥4.3 billion in operating revenue and about ¥1.4 billion in net income, marking a slight increase from the previous fiscal term. This was partly due to the positive effect from its property acquisitions. NRF had a return on assets (ROA) of around 4.1%, a return on equity (ROE) of around 4.7%, and a return on investment (ROI; net operating income (NOI)/purchase price) of around 5.2% as of the end of May 2010. As these figures illustrate, NRF's portfolio profitability measures are low compared to those of other J-REITs holding different types of properties. Nonetheless, the NRF has so far maintained stable profitability, as rents of residential properties fluctuate within a smaller range than those of other types of properties when economic conditions change. The ratio of EBITDA to rental revenue stood at the generally stable level of about 63.9% (see table 1).

Financial Profile

NRF pursues a conservative financial policy. The REIT aims to maintain its ratio of debt to total assets at a conservative level, within a range of between 35% and 45% on average, or 60% at maximum. Meanwhile, the REIT's ratio of debt to capital, according to Standard & Poor's criteria definition (interest-bearing debt including hoshokin liabilities/interest-bearing debt including hoshokin liabilities + total net assets), was still high despite its conservative financial policy, standing at about 53.6% as of the end of the seventh fiscal term. However, its debt-to-capital ratio, which had remained high since the financial crisis in the autumn of 2008, has declined somewhat, and the possibility that the ratio will further deteriorate has abated. This is because the REIT raised about ¥8.0 billion through an equity issuance in December 2009 and has already repaid some of its debt, using its cash on hand. NRF says that it will adhere to its conservative financial policy. To this end, the REIT intends to lower its debt-to-capital ratio to a level that is closer to that set under its financial policy, through prudent property acquisitions, including property exchanges, and more efficient cash management.

As of Sept. 30, 2010, NRF's long-term debt accounted for 73% of its total debt, about 75% of which carries fixed interest rates. The REIT's total debt also has an average residual period of about 1.9 years and maturities that are diversified until 2017. Although debt maturities appears to be concentrated from 2010 to 2012 (see chart 2), Standard & Poor's believes NRF will likely continue financing as steadily as ever, given that the REIT maintains its favorable relationships with major financial institutions.

NRF's relatively high-quality portfolio ensures a stable rental revenue stream. Cash flow protection measures have somewhat improved, as its debt-to-capital ratio declined as a result of the equity issuance in 2009. EBITDA interest coverage stood at about 4.7x, while the ratio of funds from operations (FFO) to debt was about 6% as of the end of the seventh fiscal term (see table 1). On the other hand, NRF's current coverage ratios are lower than those we assumed at our first ratings action on the REIT, and these lower ratios have become a risk factor for its credit quality. Nonetheless, Standard & Poor's expects NRF's coverage ratios to moderately improve going forward, given that the REIT is determined to lower its ratio of debt to total assets to a level closer to that set out under its conservative financial policy.

Liquidity and financial flexibility

NRF has favorable business relationships with 16 major financial institutions. As such, we believe NRF's liquidity at hand and ability to finance long- and short-term funds raises no issues over the REIT's immediate repayment of debt and payment of funds needed for operations, including security deposits. NRF maintains financial flexibility, as its borrowings are all unsecured.

Chart 2

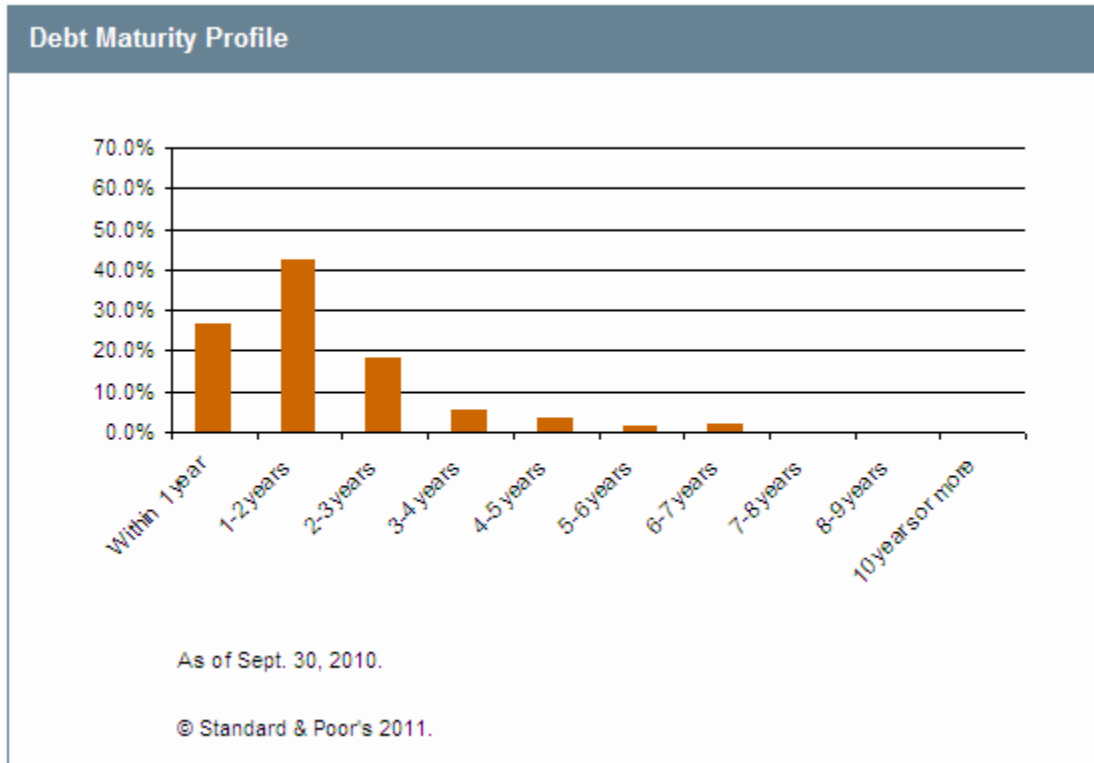


Table 1

Property Portfolio And Major Financial Indicators				
Fiscal term (FT)	7th	6th	5th	4th
Term ended	May 31, 2010	Nov. 30, 2009	May 31, 2009	Nov. 30, 2008
Rating history (as of end of FT)	A/Stable/A-1	A/Stable/A-1	A+/Watch Neg/A-1	A+/Stable/A-1
Number of properties (as of end of FT)	143	139	139	134
Rentable area (sq m, as of end of FT)	210,962	196,394	196,314	186,862
Occupancy rate (as of end of FT)	95.2%	92.8%	93.1%	94.4%
Total purchase price (mil. ¥)	131,463	121,483	121,483	115,940
Unrealized losses (vs. book value)	-10.4%	-11.5%	-8.5%	-4.4%
NOI (mil. ¥)	3,301	3,125	3,138	3,039
Net income (mil. ¥)	1,387	1,319	1,346	1,369
EBITDA (mil. ¥)	2,761	2,633	2,649	2,560
FFO (mil. ¥)	2,174	2,055	2,090	2,064
Total debt (mil. ¥)* (including "hoshokin" liabilities)	73,046	70,976	72,996	67,236
Total net assets (mil. ¥)	63,186	55,089	55,116	55,139

Table 1

Property Portfolio And Major Financial Indicators (cont.)				
ROA	4.1%	4.1%	4.2%	4.2%
ROE	4.7%	4.8%	4.9%	5.0%
ROI	5.2%	5.1%	5.3%	5.4%
EBITDA/Rental revenue	63.9%	66.5%	65.8%	67.2%
Debt-to-capital ratio* (including "hoshokin" liabilities)	53.6%	56.3%	57.0%	54.9%
EBITDA interest coverage	4.7x	4.6x	4.7x	5.2x
FFO/Debt *(including "hoshokin" liabilities)	6.0%	5.8%	5.7%	6.1%

*Standard & Poor's definition: Debt-to-capital ratio (including "hoshokin" liabilities) = interest bearing liabilities (including "hoshokin" liabilities) / (interest bearing liabilities + total net assets)

Ratings Detail (As Of January 31, 2011)*

Nomura Real Estate Residential Fund Inc.

Corporate Credit Rating A/Stable/A-1

Corporate Credit Ratings History

02-Sep-2009	A/Stable/A-1
29-May-2009	A+/Watch Neg/A-1
17-Jul-2007	A+/Stable/A-1

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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