STANDARD & POOR'S

Structured Finance

J-REIT Rating Report

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Nippon Accommodations Fund Inc.

New Rating
Corporate Credit Rating A+/Stable/A-1
Outlook: Stable

Rationale

On Dec. 25, 2006, Standard & Poor's Ratings Services assigned its 'A+' long-term and 'A-1' short-term corporate credit ratings to Nippon Accommodations Fund Inc. (NAF). The outlook on the long-term corporate credit rating is stable.

Major Rating Factors

Strengths

- The highly regulated nature of Japanese Real Estate Investment Trusts (J-REITs);
- NAF's strong business position and relatively conservative financial policy;
- High-quality property portfolio, which generates stable cash flow;
- The strong real estate development and management capabilities of NAF's sponsor, Mitsui Fudosan Co. Ltd. ; and
- The real estate expertise of NAF's asset-management company, Mitsui Fudosan Accommodations Fund Management (MFAFM).

Concerns

- Property concentration risk.

Outlook

The outlook is stable. NAF's portfolio of high-quality assets should generate stable income despite its asset concentration risk. With the support of its sponsor, NAF is expected to maintain the high quality of its assets and a relatively conservative financial profile as its portfolio grows. Although NAF's debt-to-capital ratio may fluctuate as it pursues acquisitions of properties, it is expected to remain within a moderate range.

A corporate credit rating (or issuer credit rating) represents Standard & Poor's current opinion of an obligor's general creditworthiness, or the creditworthiness of an obligor with respect to a particular debt security or other financial obligation. In other words, the rating represents the company's overall ability to meet its financial obligations. This opinion focuses on the obligor's capacity and willingness to meet its financial commitments as they come due. A rating is not a recommendation to buy or sell any securities or stocks issued by NAF. This rating report is based on information as of Dec. 25, 2006. However, some 'unaudited' provisional accounting figures for the second term, published in January 2007, are used. Corporate credit ratings in this report are indicated as 'long-term/outlook/short-term'. N.R. denotes 'not rated'.

Rating Analysis

Rating approach for J-REITs.

Standard & Poor's published its rating approach for J-REITs in May 2001, in an article titled "Rating Policy For Japanese Real Estate Investment Trusts". The above rating has been assigned in accordance with the methodology outlined in that article.

Credit characteristics of J-REITs.

J-REITs are governed by various sets of legal requirements under the Investment Trust Law, which was revised in November 2000. The business purpose of J-REITs is limited to the acquisition, holding, and selling of cash-flow generating properties. The entities are prohibited from engaging in other business and are subject to strict disclosure requirements. J-REITs are required to outsource all aspects of their real estate investment and asset management functions to an external asset management company. They are also prohibited from having their own offices or hiring employees.

As a result, in essence they are more like Special Purpose Companies (SPCs), similar to those used in securitization transactions. Hence, 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. Under the current interpretation of the Investment Trust Law, it may be difficult for J-REITs to engage in full-scale development projects, which sets them apart from REITs in other countries, such as U.S. REITs or Australian Property Trusts. In general, development projects provide REITs with an opportunity for future income and growth, but at the same time expose them to land risk, approval and licensing risk for development, construction risk, and construction completion risk, which may, in turn, increase the unpredictability of overall business risk.

Business Profile:

Business foundation and market position.

NAF was established in October 2005 and was listed on the Tokyo Stock Exchange in August 2006. Currently, 40 J-REITs are listed, of which seven are J-REITs that specialize in residential properties. In terms of portfolio size based on purchase price, NAF ranks third among the seven J-REITS that focus on residential properties. The sponsor of NAF's asset manager, Mitsui Fudosan Accommodations Fund Management (MFAFM), is Mitsui Fudosan Co. Ltd. (BBB/Positive/A-2), which has a 5.8% investment in NAF. Having only one sponsor has not limited the company's ability to grow, as the sponsor has a proven track record in developing residential properties. Moreover, 13% of NAF's current portfolio consists of properties developed by third parties.

Table 1: Sponsorship breakdown

(Dec. 31, 2006)

Sponsors	NAF	NAF	MFAFM	MFAFM
	# of units	% shares	# of shares	% shares
Mitsui Fudosan	6,600	5.82	6,000	100.00
Other	106,880	94.18	0	0.00
TOTAL	113,480	100.00	6,000	100.00

Although the sponsor is not directly involved in NAF's management, its credit standing plays an important role in determining NAF's credit quality, as the firm is closely involved in the business operations of NAF through the provision of human resources and real estate expertise. Standard & Poor's conducted a comprehensive analysis of the sponsor, assessing its real estate development and management capabilities, credit profile, and commitment to NAF. These factors are reflected in the ratings on NAF. As shown in Table 1, NAF's units are also held by investors other than the sponsor.

Asset quality

NAF's current real estate portfolio, featuring 27 properties located mainly in the 23 wards of Tokyo, consists of 2,758 leasing units and has a total purchase price of ¥101.4 billion as of December 2006. The properties have good locations, a low average age, and good leasing conditions, providing support to NAF's credit profile. The portfolio is diversified in terms of unit type, comprising single, family-type, and large leasing units, with a focus on comparatively high-demand compact units. The 27 properties include high-quality, competitive properties located in high-demand and convenient residential areas, such as the Okawabata Apartment communities, located in a large-scale complex in the River City 21 development area (Tsukuda, Chuo ward), Park Axis Ochanomizu Stage (Yushima, Bunkyo ward), Park Axis Nihonbashi Stage (Kakigaracho, Nihonbashi, Chuo ward), and Park Axis Shirokanedai (Shirokanedai, Minato ward).

Age of buildings and maintenance

The weighted average property age is about six years, which is considered low. All of the properties were built after

1981, when a new construction code with more stringent anti-earthquake standards was introduced. In addition, when excluding Okawabata Apartment communities built in 1988-1989, the weighted average property age is about 1.5 years, since the majority of other properties are very new. All the properties are well maintained and equipped with facilities that meet present-day tenant needs.

Occupancy rate/Rent levels

As of the end of December 2006, the portfolio's average occupancy rate, based on end-tenants, was high at 96.6%, which is above the market average. Standard & Poor's assessed the actual rent paid to NAF by the respective tenants by examining the rent rolls for each property. Based on this, Standard & Poor's determined that the current rent levels are in line with sub-market rents. These favorable performances have been achieved based on the high quality of properties as well as strong leasing capabilities of NAF's property manager.

Legal ownership of property

Of the 27 assets in the portfolio, 25 are held under a fee simple ownership. The remaining two account for about 31% of the total acquisition value. The Okawabata Apartment communities are held under co-ownership, and Park Cube Ichigaya under condo-ownership with less than 100% ownership. Both of the properties are considered to be almost as marketable as the properties under fee simple ownership.

Diversification and stability

NAF's portfolio has concentration risk in specific properties. Nevertheless, stable rent revenue is expected from highly occupied and high quality properties, given that NAF's cash flow is diversified over a number of tenants.

Property type/geographic diversification.

As part of its strategy, NAF limits its investments to residential properties. In general, Standard & Poor's considers residential properties to have more stable cash flows compared with other property types. This is due, in general, to high tenant diversification, the relative ease in finding new tenants, and relatively low fluctuations in rents during economic cycles. NAF's investment target area is the metropolitan area of Tokyo and major ordinance-designated cities, with the company aiming to keep allocating more than 80% of its portfolio investments to properties located in the 23 wards of Tokyo. Currently, properties located within the 23 wards make up about 95.5% of the portfolio, which is in line with its investment policy. Standard & Poor's does not regard asset concentration in Tokyo as a credit concern, given that Tokyo has the largest and most liquid real estate market in Japan, and that solid demand for leasing is expected with the increasing number of households in the capital.

Diversification of property value

The portfolio has asset concentration risk, with the Okawabata Apartment communities comprising 29.3% of the total portfolio value. However, this risk is mitigated by such factors as good tenant diversification at the property, high occupancy rates, stable cash flows, and high competitiveness in the submarket. Asset concentration risk is expected to decline modestly over time, as NAF acquires more properties.

Tenant composition

The portfolio has 2,758 leasing units, and tenant diversification is very high. Mitsui Fudosan is a master lessee for Okawabata Apartment communities, and Mitsui Fudosan Housing Lease Co. Ltd. (MFHL: a 100% subsidiary of Mitsui Fudosan) conducts tenant management and relevant operations as a master lessee for the remaining properties.

Insurance/Earthquake risk

All the properties in NAF's portfolio are covered by fire insurance and general liability insurance. According to seismic reports submitted to Standard & Poor's, the probable maximum loss (PML) of the properties ranges between 4.9%-12.0%, indicating limited aggregate portfolio risk.

Standard & Poor's Underwriting Value

Standard & Poor's underwrote the individual cash flows and property values for 13 properties after conducting onsite inspections of 15 properties (accounting for about 81% of the entire portfolio based on purchase price) out of the 27 properties in the portfolio.

The purpose of this underwriting was to confirm that NAF had acquired these assets at reasonable prices. The discrepancies between Standard & Poor's underwriting value and NAF's purchase prices were within a reasonable range. Standard & Poor's adopts a Direct Capitalization Method for property underwriting, by which the net cash flow (NCF) that a property is expected to generate for the next few years on average is divided by a cap rate to determine the property price. The outlines of the core properties can be found at the end of this report.

Operating Strategy / Management

Investment strategy

As part of its strategy, NAF limits its investments to residential properties. NAF categorizes rental housing, student dormitories/student apartments, serviced apartments, housing for senior citizens, and company houses as "accomodation assets". The company plans to invest mainly in rental housing, based on a principle of mid- to long-term holding. NAF's investment area is the metropolitan area of Tokyo and major ordinance-designated cities, with the aim of keeping more than 80% of its portfolio investments within properties located in the 23 wards of Tokyo. In principle, NAF invests in properties that satisfy the new anti-earthquake standard (in compliance with the revised construction code in 1981), or properties with structures at the same level of the standard. Investment size per property is ¥1 billion or more in principle. If the PML is larger than 20%, seismic insurance coverage is considered. NAF plans to purchase properties for which stable rental revenue is ensured. In principle, NAF does not invest in properties under development. However, the purchase of such properties may be considered if risks for completing the building, and delivery and securing of tenants are judged to have been minimized.

Internal growth strategy

Through collaboration with Mitsui Fudosan group, NAF plans to promote the branding of Park Axis and Park Cube series and improve tenant services. NAF conducts property management and maintenance by utilizing the group's know-how, aiming at improving the efficiency of operations, reducing costs, increasing rents, and improving occupancy rates. In addition, NAF will create appropriate repair and maintenance plans, with the aim of improving the value of properties and sustaining internal growth.

External growth strategy

Based on an agreement regarding the "provision of real estate information and advisory services" with Mitsui Fudosan, NAF focuses on stable and ongoing acquisition of "accommodation assets" owned and developed by Mitsui Fudosan. In addition, NAF aims at solid external growth by purchasing competitive and good quality properties by utilizing property information collected at Mitsui Fudosan and the wide information networks of group companies, including Mitsui Real Estate Sales Co. Ltd. (N.R.), as well as MFAFM's own information gathering routes.

NAF is aiming to enlarge its portfolio by ¥300 billion, or 10,000 residential units, by 2010-2011. This represents an annual growth rate of about 25%, mirroring the general pace of growth among other J-REITs. However, the company is not focused solely on expanding the size of its portfolio, taking into consideration the overheating of the real estate market. NAF will use Mitsui Fudosan group's network to expand further into major ordinance-designated cities in the future, as well as in Tokyo. Although NAF's leverage may increase over the course of its property acquisitions, NAF is expected to carry out appropriate leverage control through timely equity issuances.

Property management

NAF outsources property management and tenant leasing operations to MFHL. MFHL contracts management operations of over 30,000 units, including property management of other J-REITs' residences. MFHL has gained ample experience since its establishment in 1986. In addition, MFHL utilizes a wide rental and brokerage network through Resident First, a wholly owned subsidiary, as well as the strong building management capabilities of group company Mitsui Fudosan Housing Service Co. Ltd. (N.R.). Standard & Poor's believes that property management by MFHL and group companies contributes to stable cash flow from NAF's portfolio.

Conflicts of interest

Under the J-REIT system, a company's entire operation must be outsourced to third party companies, which tends to increase the potential for conflicts of interest between J-REITs and third parties. Through an interview with NAF management, Standard & Poor's confirmed that the company introduced adequate measures to mitigate these potential conflicts, as follows:

1. For transactions with related companies, including the sponsor, with which conflict of interests are most a concern, a voluntary rule is established for acquisition or sale of properties, leasing, and property management;
2. Review and approval are required at a compliance committee that requires attendance by two external specialists, for transactions with sponsor-related parties; and
3. Acquisition prices exceeding property appraisal values from independent property appraisers are not allowed for property acquisitions from sponsor-related parties.

Financial Profile

Standard & Poor's examined NAF's leverage and capital structure in terms of both its debt-to-capital ratio and its loan-to-value (LTV) ratio, based on financial data provided by the company.

The calculations are as follows:

Debt-to-capital ratio = interest bearing liabilities (long-term loans + short-term loans + debentures + Hoshokin liabilities)/total capital (interest bearing liabilities + shareholders' capital).
LTV Ratio = interest bearing liabilities (long-term loans + short-term loans + debentures + Hoshokin liabilities)/(Standard & Poor's underwriting value of property portfolio – outstanding balance of unreserved security deposits).

The LTV ratio is based on Standard & Poor's underwriting value, and therefore reflects the market value of the portfolio. Security deposits are excluded from the denominator if the security deposits from tenants are not separately set aside in cash in an escrow account. In the case of retail properties, it is common for the owners of the properties to fund construction costs via Hoshokin liabilities paid by tenants for a certain period of time, regardless of the leasing agreement period. Hoshokin liabilities, which bear interest and are repaid according to a payment schedule, have similar characteristics to debt liabilities. For this reason, they are included in the numerator as liabilities when calculating the debt-to-capital ratio and the LTV ratio. With respect to NAF, the security deposit liabilities (provisional value) that are not set aside are excluded from the denominator in the calculation of the LTV ratio.

Financial policy

NAF's financial policy is relatively conservative. MFAFM's management expects to maintain the company's debt-to-capital ratio (interest-bearing debt/total assets) at an average of 40% to 50%, or at a maximum of 60%, which is a relatively conservative level. To fund future property acquisitions, NAF anticipates a strategy of timely equity issues aimed at stabilizing its leverage. Regarding its dividend policy, NAF plans to allocate 100% of its distributable income as dividends. Expected dividends per unit for its second fiscal term (ended February 2007) stood at ¥17,551, and the investment period yield for the expected dividends based on unit price at December 2006 was about 2.2% per annum.

Profitability

For the second fiscal term (provisional settlement of accounts of April – November 2006), NAF posted about ¥2.8 billion in NOI (net operating income) and about ¥1.3 billion in net income. For the second fiscal term (April 2006 – February 2007), NOI is estimated at about ¥4.1 billion, and net income at about ¥2.0 billion. For the provisional settlement of accounts for the second fiscal term, annualized ROA was 4.5% (4.9% if listing costs are excluded), and ROE was 4.8% (5.6% if listing costs are excluded), which was slightly lower than at other property-type-focused J-REITs. This reflects NAF's high quality portfolio and relatively conservative leverage standards.

Capital structure

NAF's capital structure is relatively conservative. The company's capital structure in the provisional settlement of accounts for the second fiscal term consisted of about ¥61 billion in equity, ¥30 billion in long-term debt (accounting for 70.6% of total debt), and ¥12.5 billion in short-term debt (accounting for the remaining 29.4%). All borrowings are unsecured, which mitigates refinancing risk, and debt maturities are diversified through 2013, mainly by long-term borrowings. NAF recorded a debt-to-capital ratio (according to Standard & Poor's definition) of about 40.5% at the provisional settlement of accounts for the second fiscal term. MFAFM's management expects to maintain an average debt-to-capital ratio of 40%-50%, or a maximum of 60%. (Refer to 'Financial Policy' section)

Cash flow protection

NAF's relatively new and high-quality portfolio ensures a stable rental revenue stream. Backed by its solid financial profile, the company's EBITDA interest coverage, based on attractive current financing costs, is expected to remain between 6x and 7x. The ratio of funds from operations (FFO) to total debt is expected to remain at 6%-10%. Coverage measures may be affected by moderate hikes in interest rates. However, Standard & Poor's does not regard this as a specific concern due to the high ratio of long-term fixed-rate debt.

Financial flexibility

NAF currently has ample liquidity, with long- and short-term credit available to meet the company's near-term debt maturities, as well as to expand its portfolio. As of November 2006, NAF had approximately ¥2.9 billion in cash and cash equivalents, sufficient to cover immediate operating expenses, including security deposit liabilities. NAF's financial flexibility is considered high, reflecting its established relationships with nine major financial institutions, from which it borrows on an unsecured basis.

Outline Of Top Assets

Okawabata Apartment communities: (1) River Point Tower; (2) Parkside Wings; (3) Pier West House

Address: 11-6-6, 3, and 2 (respectively), 1-chome, Tsukuda, Chuo-ku, Tokyo.
Structure/Construction completed:
(1) River Point Tower: March 1989, apartment building for lease with 40 floors above ground and two basement floors;
(2) Parkside Wings: July 1988, apartment building for lease with 14 floors above ground and two basement floors;
(3) Pier West House: April 1988, management office building with two floors above ground and one basement floor.
Public transportation access: About a six-minute walk from Tsukishima Station on the Tokyo Metro Yurakucho-line, and Toei Subway Oedo-line.

Ownership: Co-ownership for land and ownership for buildings
Purchase price: ¥29,696 million
Appraisal value: ¥29,700 million (Price as of the end of November 2005)
Net rentable area: 13,253 tsubo (As of the end of December 2006)
Occupancy rate: 94.1% (As of the end of December 2006)
Rentable units: 544
Comments: The properties have high visibility as part of the River City 21 development area. River City 21 is a former factory site beside the Sumida River developed by Mitsui Fudosan, the Tokyo Metropolitan Government, and the Housing and Urban Development Corp. The area is a residential district in central Tokyo with scarcity value, as well as good location and favorable living environment.

Although relatively old for a residential property, appropriate repairs and maintenance work have been carried out, and the property has upscale specifications and facilities that appeal to tenants. Access to the nearest station is good, and the neighborhood has convenient facilities, including supermarkets and medical institutions. The property is competitive, as it has attractive services and facilities such as a reception desk service, underground parking, sports club, and restaurants. One of the strengths of the property is the view from the high-rise River Point Tower and Parkside Wings, both adjacent to Tsukuda Park. The properties are well maintained and have had high occupancy rates since they were built.

Park Axis Ochanomizu Stage:

Address: 3-2-14, Yushima, Bunkyo-ku, Tokyo.
Completed: February 2006
Structure: Apartment building with 15 floors above ground
Public transportation access: A six-minute walk from Yushima Station on the Tokyo Metro Chiyoda Line.
Ownership: Fee simple ownership
Purchase price: ¥9,710 million
Appraisal value: ¥9,820 million (Price as of the end of April 2006)
Net rentable area: 3,638 tsubo (As of the end of December 2006)
Occupancy rate: 99.1% (As of the end of December 2006)
Rentable units: 324
Comments: A new, large property with high visibility and good access to multiple lines and stations. The property is a six-minute walk from Yushima Station on the Tokyo Metro Chiyoda Line and Suehiro-cho Station on the Ginza Line, as well as an eight-minute walk from Ochanomizu Station on the Marunouchi Line. The area has a mix of detached houses and apartment buildings, and a variety of educational and medical facilities. The area retains a taste of old-town Tokyo as the surrounding area includes historic sites such as the Yushima Tenjin and Kanda Myojin shrines.

The property provides services such as door deliveries by concierge, and 24-hour emergency response services that appeal to single-families and senior citizens. The property is expected to maintain strong competitiveness, backed by facilities that meet residents' needs, such as a well-lit, clean entrance, advanced security facilities, and floor-heating in every unit.

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