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Main Q&As at the 31st Fiscal Period Earnings Announcement

Date and Time: 15:30-16:30, July 20, 2021 (Tuesday)

Presenter: Toshio Fukushima/President and Representative Director

Daiwa Real Estate Asset Management Co. Ltd.

*Questions are presented in sequential order.

Q1. You said that properties indicated under "Properties Subject to Leasing Improvement" on page 20 of the presentation material are large properties even in the portfolio of Daiwa Office Investment Corporation (DOI) and that their unit rents are high. I would like to know the leasing plans for each property. You also said that focus will be placed on occupancy rates, but do you have lowering unit rent or granting free rent in mind?

(Answer)

All of the properties that are subject to leasing improvement have budgets set with leeway including downtime and free rent.

First, concerning Daiwa River Gate, we have continuously conducted leasing activities for almost half a year by now, and tenant candidates who consider leasing the space always exist. However, the fact is that they require time to make decisions on concluding contracts, and a lease contract for 300 tsubos was concluded at last in July. Although there are tenant candidates who are currently considering leasing, they are also taking time to make decisions, so we made a conservative forecast regarding the downtime and free rent granted.

Although Shinjuku Maynds Tower is constantly engaging in negotiations with tenant candidates, the downtime and free rent are forecast more conservatively than usual upon budget planning as there are rumors that a lease agreement at a nearby large building will be terminated.

As for Daiwa Akasaka, although it is not as large as Daiwa River Gate or Shinjuku Maynds Tower, we forecast that the occupancy rate will drop to 70.9% as of the end of November 2021. Although the location is convenient with various ways to reach nearby Akasaka Station, one of the two minor ways is currently closed, and thus we are making a cautious forecast for leasing activities.

However, we will operate with the aim to secure dividends of 14,000 yen even when based on these assumptions.

Q2. During the explanation, you said that you will “shift to be aggressive anytime.” By this, do you mean pursuing rent increase, focusing on development, or making aggressive property acquisitions? I would like to hear a specific idea.

(Answer)

By saying “shift to be aggressive anytime,” I mean to improve rent to match the market rent without missing an opportunity when the rent gap shows a trend of widening in the future. In the 31st fiscal period, rent increases were achieved in B Class buildings although the range was smaller than before, and we intend to shift to be aggressive when signs of a widening rent gap appear again in the future.

Q3. You said that leasing activities for medium-sized sections are doing well. Is there a move among struggling large-scale buildings to lower unit rents and acquire tenants from medium-sized buildings?

(Answer)

I believe that S Class and A Class buildings are actually lowering their rents and acquiring tenants from medium-sized buildings. In DOI’s portfolio, Shinjuku Maynds Tower, E SPACE TOWER and other properties with relatively high rents such as those with unit rents higher than 30,000 yen are affected by such, and in fact a tenant replacement in an office section resulted in a decrease in rent. However, the core assets of DOI’s portfolio are B Class buildings with unit rents at around 15,000 yen to 25,000 yen. I believe it is unlikely that S Class and A Class buildings will divide their sections into smaller units and lower unit rents to this level, so B Class buildings are likely to stay steady.

Q4. Leasing activities for sections with high unit rents in large-scale building are struggling, but is that due to a temporary change in tenant demand? If the shift is structural, selling large-scale buildings might be an option. What are your thoughts on that?

(Answer)

We view the struggle of high-unit-rent sections in large-scale buildings as temporary. Corporate performance is polarized partly due to the impact of COVID-19, but our recognition is that it is relatively favorable as an overall average, and we believe that office demand will recover sooner or later. A large supply of high-class office buildings is scheduled for 2023, and developers are likely to aim for securing tenants even if they relax contract terms slightly. We think that it might take two or two and a half more years for such moves to settle.

Q5. How do you see the current transaction market and what is your future outlook?

(Answer)

The current transaction market has returned to the pre-COVID-19 state. In particular, for relatively new properties and large properties, sales agreements are concluded at cap rates even lower than pre-COVID-19, and we understand that a severe environment for acquisition continues. If DOI acquires a property at an unreasonably high price, the overall cap rate of the existing portfolio will fall.

Therefore, under the current transaction market, we understand that we have to take time and improve the quality of our portfolio through various efforts such as the Nihonbashi-Bakurocho 1-Chome Development Project (Bakurocho Development Project).

Q6. Concerning the partial amendments to the asset management guidelines announced simultaneously with the announcement of financial results, I would like to know your future policy on efforts for development projects.

(Answer)

As construction for the Bakurocho Development Project launched in October 2020 commenced in June 2021, we understand that the development risk of the project has decreased. Recently, we stated in the asset management guidelines that the upper limit of investment in development projects should be 10% for the following reasons.

We usually begin to consider rebuilding, replacing, or selling a property when it reaches an age of around 40 years. For DOI, whose sponsor is a securities firm group, we believe that efforts like the Bakurocho Development Project are very effective in terms of improving the portfolio quality and making the portfolio younger. Development itself takes roughly two to two and a half years from commencement to completion, but we are not considering launching two or three development projects simultaneously this time. Depending on the circumstances, we would like to consider launching another project at the stage when a previous project has progressed and its development risk is reasonably reduced, like in the case of the Bakurocho Development Project. Development projects in different phases might progress simultaneously. We made it clear in the asset management guidelines that even if these projects are to progress at the same time, investment should not exceed 10% of the overall portfolio.

Q7. I would like to know the target cap rate for acquiring development projects. Furthermore, how much difference exists between the cap rates of development projects and completed properties?

(Answer)

Development projects do not generate cash flows during their development, and there is a need to grasp the risks of market change. Based on these points, we would like to work so as to not have the pro forma cap rates of development projects be lower than the implied cap rates. We hope to engage in these projects in the future as well, while regarding the Bakurocho Development Project's cap rate of 4.1%-4.2% as a target cap rate for acquiring development projects.

As for existing properties, around 3.8%, which is the current implied cap rate, will be the base of judgement and the lower limit, although this depends on the property. If there is a good property, we would arrive at a decision after assessing its unique features including its location, size and age.