Main Q&A at the 30th Fiscal Period Earnings Announcement

Date and Time: 15:30-16:30, January 21, 2021 (Thursday)

Presenter: Toshio Fukushima/President and Representative Director

Daiwa Real Estate Asset Management Co. Ltd.

*Questions are presented in sequential order.

Q1. How do you view the fact that the occupancy rate for the fiscal period ended November 2020 (30th fiscal period) was 1% higher than the assumption? Furthermore, what is the factor for the increase?

(Answer)

We believe that it is the result of focusing on leasing as an entire company, such as by increasing the personnel for leasing. In addition, various campaigns implemented ahead of other companies were also successful.

Q2. You said dividends for the fiscal period ending November 2021 (32nd fiscal period) is forecast to be 13,900 yen, which is higher than the actual dividends for the fiscal period ended November 2020 (30th fiscal period), but we understand repair costs have been reduced as an effort to control costs. What kind of impact will the cost control have on dividends in or after the fiscal period ending November 2021 (32nd fiscal period)?

(Answer)

Dividends are assumed to be fully paid while controlling costs, but there is some construction work, etc. that has been postponed as understood. We believe that it is important to overcome the fiscal period ending May 2021 (31st fiscal period) which is most susceptible to the impact of the cancellation of lease contacts due to the COVID-19 crisis and the fiscal period ending November 2021 (32nd fiscal period) when recovery from such impact will be seen in order to realize a situation in which we can intend to maintain and improve dividends while implementing construction work that has been delayed to the fiscal period ending May 2022 (33rd fiscal period) or after.

In addition, Nihonbashi-Bakurocho 1-Chome Development Project is assumed to contribute to revenue after approximately two years from now, and such amount can be accumulated. We will not change our stance of aiming to maintain and improve dividends so long as the office market does not significantly change in a negative way.

Q3. Please tell us about your future portfolio strategy. Is qualitative improvement through property replacement and reconstruction, etc. your basic policy?

(Answer)

We take pride in the fact that we have smoothly improved the quality of our portfolio over the past seven fiscal periods as mentioned on page 25 of the presentation material. We believe that the final issue is the handling of two properties, namely Daiwa Ginza, which complies with outdated standards for earthquake resistance and is currently occupied by the asset management company, and Daiwa Ginza Annex, which also complies with outdated standards for the resistance, standing adjacent to Daiwa Ginza. Although there are no clear methods that can be implemented immediately, we will make efforts to improve the quality of our portfolio by using various methods including property replacement and reconstruction which we have experienced until now.

Q4. As you said you secured more personnel for leasing, what exactly did you do?

(Answer)

First, the asset management company sought to reduce the number of personnel in the management team as the office market before the outbreak of the COVD-19 crisis in the previous year was stable and the area subject to cancellation was far smaller than usual at the Investment Corporation. We intended to strengthen leasing by substantially having two more personnel as a result of the transfer of a staff member who has experience conducting AM business of offices from a different department in addition to the cancellation of the transfer at the timing when the impact of the COVID-19 crisis started to be seen.

Furthermore, we made economically beneficial proposals such as the granting of incentives to leasing companies and PM companies and free rent to candidate tenants in addition to the increase in personnel, and refilled vacancies at an early stage.

Q5. The period-end occupancy rate is forecast to reach the 95% range in the fiscal period ending May 2021 (31st fiscal period), and the 95% range is equivalent to the level of occupancy rates in 2012 and 2013 at Daiwa Office Investment Corporation (DOI) when looking at page 14 of the presentation material. We thought the vacancy rate of offices was 8% to 9% in 2012 and 2013, so we now have the impression that the future occupancy rate of DOI is underestimated when based on the current vacancy rate of offices, which is 4.5%. How do you view the forecast of vacancy rates from a medium- to long-term perspective?

(Answer)

As for the occupancy rate for the fiscal period ending May 2021 (31st fiscal period), the nominal occupancy rate upon the budget compilation is 95.7% as described on page 6 of the presentation material, but we believe that we can secure a substantial occupancy rate of 97.8%. The 270 million yen that is expected to be used as expenses to respond to various factors attributable to the COVID-19 crisis such as the failure to collect 160 million yen of uncollected rent and the occurrence of contingencies to tenants has become a factor pushing down the nominal occupancy rate.

The occupancy rate for the fiscal period ending November 2021 (32nd fiscal period) before taking into consideration the expenses for responding to the COVID-19 crisis slightly decreased to 96.1%, and such assessment of the occupancy rate is very conservative given the move-out of a major tenant at Daiwa River Gate and the trend of another major tenant whose move-out has been suggested from before, although we have not yet received a cancellation notice.

As for the 5,000 tsubos of space which will become vacant in the fiscal period ending May 2021 (31st fiscal period), both downtime and free rent are viewed very conservatively compared with the previous year, but the occupancy rate is forecast to recover significantly in the fiscal period ending May 2022 (33rd fiscal period) if the move-in of new tenants progresses smoothly. We do not view the occupancy rate with excessive caution.

Q6. What is the outlook for the current rent gap? Furthermore, how did it change from the end of the previous fiscal period?

(Answer)

We recognize that there is still a rent gap overall. However, we feel that it is decreasing from the previous fiscal period as expected. The rent gap was in the lower half of the 10% range in the previous fiscal period, and even though it is slightly below 10% in the current fiscal period, it comes as no surprise.

Q7. In the fiscal period ended November 2018 (26th fiscal period), you changed the management fee system to that more closely linked to management results. Is there any plan to change the system going forward given the impact of the COVID-19 crisis?

(Answer)

As for management fees, in the fiscal period ended November 2018 (26th fiscal period), we changed the fee rate of Management Fee III linked to management results from 2% to 3.5%, while halving the fee rate of Management Fee I linked to the balance of assets under management from 0.1% to 0.05%. We do not intend to frequently change our idea on management fees based on the management status, and we will probably maintain the current system for the time being. Increases and decreases in the amount of management fees at the asset management company are linked to “how dividends are increased,” corresponding to Management Fee III. Therefore, we recognize that the portion progressing in the same direction as investors will remain unchanged.

Q8. In the current portfolio, 80.5% of the properties are located in the five central wards of Tokyo. Do you intend to increase the percentage of properties in major regional cities in the future?

(Answer)

Originally, it was never in our minds to not invest in major regional cities. Up until now, we have considered acquiring properties in various locations including Sapporo, Sendai, Nagoya, Osaka and Fukuoka, and as of now are already engaged in talks for some properties. While it is obvious that we invest mainly in the five central wards of Tokyo, we would also like to invest in major regional cities if such opportunities arise.

Q9. As for Nihonbashi-Bakurocho 1-Chome Development Project, we have the impression that the NOI yield of 4.1% during the normal operation period is low when taking into consideration the fact that development risks are taken. How did you arrive at your decision for the acquisition?

(Answer)

As to the point of whether the yield of 4.1% is low or high, it is certainly a bit low when based on the current investment unit price including the implied cap rate of the portfolio, but we believe that the acquisition was made at an appropriate yield when considering that it is a new project located above a station.

In addition, with regard to the acquisition of existing properties, we recognize that the NOI yield of most properties is in the 3% range at the time of acquisition and exceeds 4% over the medium to long term through repeated rent increase. On the other hand, we believe that it is an extremely reasonable investment from a medium- to long-term perspective as the yield of the development property will reach 4% or more immediately after completion if vacancies are filled as scheduled, although there will be a loss of revenue for two years.

As for development risks, we have developed a system for our management company as well as a system that can control risks to a significant extent by receiving support from external experts.

Q10. We believe your plan is to compensate for the revenue decrease associated with the replacement of two properties in operation with the development site whose revenue will occur beforehand with internal reserves, but what are you going to do with the loss of revenue until the completion of the development property? Will you continue to reverse internal reserves and allocate them?

(Answer)

As of now, we intend to push up the loss of dividends until the development property reaches a normal operation level by effectively utilizing cash on hand, such as by acquiring multiple new properties, repaying loans and buying back shares, but such plan has not been determined upon the budget compilation. However, we believe that it is possible to follow up by using any method.

If the loss of dividends cannot be covered even by adopting the above methods, we will also consider reversing more than 1 billion yen of internal reserves through the sale of Daiwa Shimbashi 510 and Daiwa Kyobashi and use it to cover the loss. The amount is estimated to be enough even when the loss is covered with internal reserves in order to maintain 13,900 yen of dividends for a limited period of approximately two years until the completion of the development property.

Q11. Who are the major tenants that will move out of Daiwa River Gate in the fiscal period ending May 2021 (31st fiscal period), who are the major tenants scheduled to move out in the fiscal period ending November 2021 (32nd fiscal period), and what are the reasons for moving out? Furthermore, it seems that there are cases at buildings such as Daiwa Jinguemae and Daiwa Shinagawa North in which multiple small tenants moved out all at once. What is the backdrop for such movements?

(Answer)

There is no imbalance in the business types of these major tenants. As for the relocations, we discussed them with the tenants for more than a year, and we heard that these are to be extremely positive relocations for the purpose of integration and not due to the impact of the COVID-19 crisis.

We believe that major tenants at Daiwa Jingumae and Daiwa Shinagawa North coincidentally moved out in the same period. We believe this was due to coincidence rather than the characteristics of the buildings, as there are some buildings where tenants did not move out at all. Even when looking at the tenant composition, etc., tenant diversification is relatively effective in class B buildings owned mainly by DOI. Therefore, we believe that such phenomenon does not frequently occur.

Q12. Do you plan to replace assets with development properties again in the future?

(Answer)

We believe that we need to restrict the number of development properties that do not generate revenue for a certain period, and we do not assume to own multiple properties at the same time. In addition, no development properties have been decided as of now.

However, it is true that we are receiving more inquiries than before as such efforts have been announced via the website of DOI, etc. We believe that asset replacements will be conducted again if there are properties that contribute to the improvement of unitholder value and portfolio quality.

Q13. The occupancy rates of E SPACE TOWER and Daiwa Aoyama were 92.8% and 85.9%, respectively, as of the end of the fiscal period ended November 2020. Is there a prospect of recovery in the occupancy rates of these properties?

(Answer)

As the occupancy rates of E SPACE TOWER and Daiwa Aoyama are already expected to recover to the upper half of the 90% range and 100%, respectively, these properties are not included in properties subject to leasing improvement in “Properties Subject to Leasing Improvement in the Fiscal Period

Ending May 2021 (31st FP)" introduced on page 20.

Cancellations of lease contracts have not particularly increased in the Shibuya and Shinjuku areas. In the 31st fiscal period, there have been approximately 5,000 tsubos of vacancies, which is about twice the area in normal periods, but we feel that such vacancies do not concentrate in Shibuya and Shinjuku and have occurred at similar rates in each area based on the ratio of the portfolio.

Q14. You explained that maintaining occupancy rate will be prioritized over the rent increase. Is there a possibility that you will accept the requests for rent reduction, etc.?

(Answer)

The occupancy rate reached nearly 99% in the fiscal period ended November 2020 (30th fiscal period), including the increase in personnel for the AM team and strengthening of leasing. We believe that this is originally due to a large number of inquiries for class B buildings. We do not intend to ask tenants to continue occupying properties by going so far as to lower rents. However, depending on the rent level of the previous tenant at vacant sections, there may be some sections where occupancy will be prioritized even if rent decreases slightly.

Q15. You wrote "conservatively forecast" in the comment for occupancy rate before taking into consideration the impact of the COVID-19 crisis for each period on page 6 of the presentation material. Does this mean that tenants who are likely to move out have been factored in? Is there a possibility that this forecast will deteriorate after half a year?

(Answer)

Although move-outs by major tenants in the fiscal period ending November 2021 (32nd fiscal period) have already been decided, they may be postponed to the fiscal period ending May 2022 (33rd fiscal period) as the move-out dates have not yet been decided. However, the forecast is made based on the assumption that the move-outs will take place in the fiscal period ending November 2021 (32nd fiscal period) by making a conservative estimation. As for approximately 5,000 tsubos of area subject to cancellation in the fiscal period ending May 2021 (31st fiscal period), the free-rent period and downtime are assumed to be approximately twice as long as those before the COVID-19 crisis.

Potential cancellations have been factored in the budget as usual regardless of the COVID-19 crisis.

Q16. How do you forecast the change in receipt of advance cancellation notices on page 6 of the presentation material?

(Answer)

We believe that we were impacted by the COVID-19 crisis to a certain degree from April to July 2020, as expected. When excluding "cancellation by major tenants," which was originally scheduled for August, the area subject to cancellation remained within the scope of around 300 to 500 tsubos per month in general for half a year from August to December.

As of now, we have received only one cancellation notice in January 2021, and the situation has become stable. The asset management company is considering various items under the assumption that the situation will remain unchanged, and we recognize that it is difficult to forecast movements after February 2021 and that the situation is unpredictable due to the second state of emergency declared in January 2021.