Q&A Session at Explanatory Meeting for Investors and Analysts for the Fiscal Period Ended January 2019 (FP 31) Held on March 15, 2019 (Summary)

【Q&A】

＜Questioner A＞

(Question: A-1) In regard to the significance of property replacement and future investment intentions, can we recognize that the disposition of retail facilities and the acquisition of offices represents your desire to grow internally, targeting the upside of rents?

Are properties solely used as residences being added to target properties as part of a policy to expand investment opportunities and integrate internal growth?

(Answer: A-1) The replacement of TOKYU REIT Kiba Building with Lucid Square Ebisu was primarily about disposing a property located outside of our focused investment area and acquiring a property near Shibuya which is within our focused investment area. The property replacement was decided upon comparing room for future internal growth.

The property replacement scheduled on March 28 with Tokyu Corporation is an exchange of an office in Shibuya and the co-ownership interest of Tokyu Bancho Building with a retail facility in Shibuya. The leasing market is in good shape for both offices and retail facilities in Shibuya, and there are barely any vacancies. While KALEIDO Shibuya Miyamasuzaka is close to the station, it is located in a spot that is one street in from the main street, Meiji-dori Street, and upon considering future investment for renovation, etc., it is thought that it is currently near its upper limit for rent levels.

On the other hand, although Shibuya Dogenzaka Sky Building is farther from the station than KALEIDO Shibuya Miyamasuzaka, new contracted rents continue to rise, and as current tenants' rent levels are lower than market value, it was determined that prospects for internal growth were larger with upward rent revisions.

Although both properties were in the Shibuya area which is within our focused investment area, the exchange was made based on considering room for growth between retail facilities and offices.

We are currently preparing to revise our management guidelines which would enable us to acquire properties solely used as residences. In November 2017, we acquired Maison Peony Toritsudaigaku, a complex that includes residences and retail facilities located just outside of Toritsu-Daigaku Station on the Tokyu Toyoko Line, and we have recognized that residences near stations along the Tokyu Line have high potential. Currently, we cannot acquire properties unless the properties are complexes with residential and retail functions, so we are making a revision to include properties solely used as residences, expanding the possibilities of property acquisitions in the Shibuya area and Tokyu Areas.

(Question: A-2) You have been able to fill vacancies without downtime when tenants move out of offices, but will office demand continue to be healthy in the Shibuya area? Please inform us of any risks.

(Answer: A-2) The current status of office leasing is continued high occupancy, and the market conditions are healthy enough whereby successive tenants can be decided upon in a short time after tenants move out. In particular, free rent periods have shortened, and recently there have been virtually no free rent periods for offices in the Shibuya area. These conditions have continued for two years, and we see no signs that this will change.

As for the impact that the mass supply of office buildings between 2018 and 2020 might have, high-grade offices that are opening by 2019 are practically at 100% occupancy, and this has not impacted secondary vacancies at Grade B buildings owned by TOKYU REIT, so we expect this situation to continue for quite some time.

(Question: A-3) Where do you think the current status lies on the “Surf Plan?” Moreover, could you tell us about your outlook on the future, potential signs of change, and your forecast for market tendencies?

(Answer: A-3) Although we are clearly in the sales phase of the “Surf Plan,” looking at trends over the last two to three years, it is unclear when the sales phase will end, or when real estate prices will fall as we approach the next acquisition phase. However, our current thought process has proceeded under the premise that the sales phase will last until at least 2020, and we have positioned TOKYU REIT’s investment actions during the sales phase by conducting both the “Surf Plan” and the “Capital Re-investment Model” in our focused investment areas with our sponsor as indicated on page 21 of the Financial Results Presentation.

<Questioner B>

(Question: B-1) Will property replacements centered on utilizing exchanges and reduction entries continue in the future as the replacement strategy?
In terms of property acquisitions, will you continue to proactively acquire properties that can expect future upsides, even if current yields are low, such as was the case with Shibuya Dogenzaka Sky Building?

(Answer: B-1) The property exchange with our sponsor in March was an exchange transaction, and the reduction entry of Article 50 from the Corporation Tax Act applies. The conditions under which reduction entries can be applied are that both the property acquired and disposed in the exchange have been owned for one year or more, the difference arising from the exchange of property must be within a margin of 20 percent, that the assets were not acquired for mutual exchange, etc., and exchanges must meet all criteria for reduction entry to apply, making it highly difficult.
On this occasion, these conditions were met during a meeting with the sponsor, enabling us to conduct reduction entry based on the regulations of the Corporation Tax Act, but if reduction entry could not be applied, we could have accumulated reserve for reduction entry, giving us the option of internal reserve.
Moreover, cap rates are declining in the current market situation, and acquiring properties with cap rates that exceed market rates is extremely difficult. However, because we make decisions upon assessing prices, including elements for internal growth for rent levels in the medium to long term, in addition to current cap rates, as a result, even if the cap rates are low at the time of acquisition, we sometimes consider property acquisitions when we believe that rent levels and cap rates could be increased in the medium to long term.

(Question: B-2) Could you explain any developments or changes in thinking from the previous briefing in terms of revising rents at QFRONT, insofar as possible?

(Answer: B-2) As the lease agreement period expires in December 2019, we are currently negotiating the rent level and contract type. We are continuing discussions in order to decide upon the rent level, in addition to thinking about what the lessor and lessee can do to improve the value of QFRONT, including its location.

(Question: B-3) I have heard that occupancy rates are high for other REITs and that tenant turnover is extremely low, but it seems as though tenant turnover occurs frequently at TOKYU REIT. Is this actually the case?

Moreover, without a free rent period, relocation needs decline and tenants stay fixed, causing rent increases to occur only during renewals. Is this enough to anticipate a certain level of ratio of rent increase?

(Answer: B-3) The tenancy turnover status is as shown on P12 of the Financial Results Presentation, and it includes all expected move-outs in the future as well as expected successive move-ins.

While the area of tenant turnover was large in the Fiscal Period Ended January 2018 (FP 29) because of overlapping move-outs at Setagaya Business Square and Tokyu Toranomon Building due to tenants' own reasons, and because successive tenants moved in after a short period of time, Setagaya Business Square's occupancy has stabilized, and it is expected to have a 100% occupancy rate at its offices by next year. Moreover, the turnover of a tenant who had leased four floors at Tokyu Toranomon Building was another large factor.

Move-ins and move-outs for the Fiscal Period Ended January 2019 (FP 31) are all relocations that have arisen from tenant needs to congregate their offices or expand their scale at Setagaya Business Square, TOKYU REIT Shinjuku 2 Building, Tokyu Bancho Building, and Lucid Square Ebisu. Although there were tenants who moved out as they could not meet the requirements of upward rent revisions, we were able to fill their spots with a short period of downtime, securing levels on par with market rent.

＜Questioner C＞

(Question: C-1) While unrealized gains for TOKYU REIT Kiba Building, disposed of in the Fiscal Period Ended January 2019 (FP 31), were entirely distributed as gain on sale, and unrealized gains for KALEIDO Shibuya Miyamasuzaka, scheduled to be disposed of in the Fiscal Period Ending July 2019 (FP 32), will undergo reduction entry as properties acquired through exchange utilizing the exchange reduction policy, is there a distribution policy for when unrealized gains are realized during property disposition?

(Answer: C-1) In the sales phase, property exchange was prioritized rather than simple sale, and gain on sale occurred as a result. In the process of replacing properties, if the criteria for reduction entry are met for exchange, we will prioritize reduction entry through exchange. However, when the criteria are not met, we will accumulate reserve for reduction entry, resulting in internal reserve. With internal reserve through reserve for reduction entry, we will consider the provision amount in reserve for reduction entry based on the future usage of reserve for reduction entry, as the possible provision amount in reserve for reduction entry changes based on the constraints of reversal.

As for the gain on sale from TOKYU REIT Kiba Building, there was no limiting amount for reserve for reduction entry under tax laws, so we distributed all of the gains on sale. As for KALEIDO Shibuya Miyamasuzaka, because all of the criteria for reduction entry through exchange were met, we conducted reduction of the book value of the properties acquired through exchange.

As for gain on sale, we will prioritize internal reserve through reduction entry or reserve for reduction entry, and have a policy of distributing portions that cannot be retained internally.

(Question: C-2) In the property exchange with the sponsor, it was mentioned that the reason for disposing KALEIDO Shibuya Miyamasuzaka was because future room for growth was limited as rent levels approached their upper limit, but does this suggest properties with contracted rents at or above new market rents will be targeted for sale?

Which properties in the portfolio might be candidates for sale?

(Answer: C-2) We do not decide to dispose of a property simply because its rent levels are reaching their upper limits and room for future growth is limited. We will continue to possess properties if the property value could be improved through value-added work and proactive leasing. When considering disposition of a property, we not only look at rent levels, but also look at the area in which it is located, the age of the building, and investment amounts for expected repair work in the future.

Moreover, sales activities are not our utmost priority. Instead, our current policy is to improve quality without changing the scale of our portfolio through property replacement.

＜Questioner D＞

(Question: D-1) It was explained that property replacement will be the main scenario going forward under the premise that the sales phase will continue to 2020, but is there a possibility to adopt an investment strategy that aims for major external growth apart from property replacement as a means to newly challenge investing into properties solely used as residences given the current relatively healthy investment unit prices?

(Answer: D-1) Until 2020, property replacement will be a priority, and we will not be aiming for major external growth.
The recent move to make it possible to acquire properties solely used as residences is to expand the possibilities of property acquisition in our focused investment areas such as Shibuya and the Tokyu Areas, and this is an extension of the change made in 2017 that brought down our minimum investment amount from 4 billion yen to 1 billion yen.
Property acquisition in Shibuya and the Tokyo Areas is difficult, but utilizing the property information possessed by the Tokyu Group, we are anticipating acquisitions of retail facilities and residences of 1 billion yen or more in front of and around stations along the Tokyu Line, and hope to continue property acquisition in a profitable manner by including properties solely used as residences in our investment target.

(Question: D-2) What levels for cap rate are you anticipating for properties solely used as residences?

(Answer: D-2) While cap rate depends on location, the cap rate for Maison Peony Toritsudaigaku acquired in November 2017 is 3.9%. As such, we anticipate cap rates between 3.5% and 3.9%.

＜Questioner E＞

(Question: E-1) If you subtract property and other taxes that are not recorded from expected DPU of 2,950 yen in the Fiscal Period Ending January 2020 (FP 33), DPU levels are likely to continue at a similar level. In such a case, will you consider future DPU to be at around 2,900 yen? Will you continue to have an optimistic outlook considering development in internal growth, or will you be more conservative by considering unexpected risks in the future?

(Answer: E-1) As for stable DPU levels from the Fiscal Period Ending January 2020 (FP 33) onward, we believe that the EPS in the Fiscal Period Ending January 2020 (FP 33) will be the lower limit at 2,888 yen. In the Fiscal Period Ending January 2020 (FP 33), there will be large quantities of irregular repair and maintenance costs due to external wall renovation work at TOKYU REIT Shinjuku 2 Building. On this occasion, we expect DPU of 2,950 yen as we anticipate similar amounts of reversal of reserve for reduction entry, but it indicates the stable DPU level assuming no renovation work for external walls.

Although sudden tenant move-outs could be considered a future risk that is not included in our financial forecast, we also have not included upward rent revisions that will be negotiated in the future. As such, even if we take the view that tenant move-outs and upward rent revisions are both possible, the stable DPU level is likely to be around 2,950 yen.