Nippon Accommodations Fund Inc.
35th Period (March 2023 – August 2023) Investor Presentation
Q&A

Q NAF's financial results appear to be firm. My question concerns costs. Faced with the possibility that restoration and marketing costs may rise in the future, for example, what measures do you plan to implement and what are your strategies toward controlling costs?

A While it is true that restoration costs are on an upward trend, transactions are conducted on a stable basis at prices that fall within a certain range over a reasonably long period of time with various sponsor group suppliers. In this manner, steps are taken to control costs so that extreme increases do not occur. Of course, we recognize the need to closely monitor cost trends going forward. We will work to curb costs by utilizing the procurement capabilities of our sponsor group as a whole. Occupancy rates are currently on an upward trajectory and conditions throughout the leasing market are favorable. In light of these circumstances, it is unlikely that marketing costs will continue to rise. Rather than unnecessarily extending vacancy periods by focusing excessively on increasing rents, we believe that engaging in appropriate leasing activities will help increase occupancy and thereby improve NOI. Accordingly, we will endeavor to control marketing expenses by engaging in leasing activities that appropriately address the needs of the market by area.

Q While recognizing that the percentage change at the time of tenant turnover is strong, I believe that amount of key money received has a significant impact on NAF's profit and loss. What is your strategy toward key money received going forward?

A Key money is also an important source of revenue. With market trends beginning to strengthen, the rate of key money received is gradually increasing. Higher rates of key money received for single type units were especially marked in the 35th period. While trends are subject to overall market conditions, we will work closely with leasing companies to capture key money in areas and for unit types where inquiries are firm.

Q The lease contracts for the three hotels acquired in this instance are all on a fixed rent basis, with a remaining period of 13 years. As such, there are no contingencies that serve as a hedge against inflation. I suspect that these properties were acquired with the expectation of stable cash flows. Taking into consideration the external environment, including inflation, what were your intentions when acquiring the three hotels and what is the possibility of acquiring additional properties with similar stable cash flows?

A NAF has set a cap of 10% on hospitality facilities as a percentage of the total portfolio. With the ratio at 5% prior to the recent acquisitions, there is still room for additional purchases. As an investment corporation that focuses mainly on rental apartments, acquiring hospitality facilities helps to not only supplement stability, but also allows us to better grasp trends in the investment environment and market by product. We recognize that fixed rents do not hedge against inflation. By the same token, given the high volatility of hotels, a fact that became abundantly clear during the COVID-19 pandemic, we look to acquire certain properties with fixed rents or a high proportion of fixed rents to ensure a steady stream of revenue as opposed to addressing inflationary concerns.

Q Do you intend to acquire more hotels in the future guided by your 10% cap on hospitality facilities? Or, do you view the acquisition of hotels as a supplementary initiative, amid the difficulties in acquiring rental apartments? Moreover, during the last Investor Presentation, you mentioned that NAF would on the one hand adopt a cautious approach toward the acquisition of properties while still exploring acquisition opportunities in the future. What then is your appetite toward acquiring rental apartments?

A As we have mentioned, NAF has set a hospitality facility acquisition cap of 10% as a percentage of the total portfolio. While there is still room for additional acquisitions, we are not looking to intentionally pursue the acquisition of more hospitality facilities in the future. As far as the Investment Corporation's investment criteria is concerned, we examine whether the asset is consistent with existing properties managed and provides an adequate yield. Should a hospitality facility meet these criteria, we will take steps to take advantage of any acquisition opportunities as they arise. We did not acquire hotels in this instance because of the difficulties encountered in purchasing residential properties. The decision was based on NAF's capacity to acquire hospitality facilities at this time and the attractiveness of each property as an investment. Turning to its investment policy toward rental apartments, NAF maintains a cautious approach to avoid negatively impacting the portfolio through unnecessary acquisitions amid an environment in which prices are high. Meanwhile, we will continue to acquire properties, including residential and other properties, that contribute to NOI and EPU growth. Accordingly, our policy to acquire quality properties that become available remains unchanged.

Q NAF's LTV ratio on a book value basis is slightly above 50%. Taking into consideration the accumulation of unrealized gains, the Investment Corporation's LTV ratio on a market value is extremely low in the 30% range. Taking the aforementioned into consideration, there appears to be a considerable difference between the LTV ratio on a book and market value. As far as NAF and its principal financial institutions are concerned which LTV ratio value basis plays a more important role?

A It would appear that lenders focus on NAF's LTV ratio on a book value basis while conscious of the market value. We also believe that managing the LTV ratio on a book value basis is basic to and an important prerequisite in the Investment Corporation's financial management.

Q As far as new rents are concerned, the percentage change in rent at the time of tenant turnover has risen to 4%. What are your thoughts on the future direction? Will the percentage continue to increase, and if so for how long?

A The Tokyo metropolitan area is enjoying a robust upswing in the inflow of people. We believe this trend will continue until this inflow reaches the levels recorded between 2018 and 2019 when market conditions were extremely favorable. Accordingly, we expect rents will also continue to rise.

Q Turning to the Investment Corporation's borrowing costs, and as indicated by the "Long-Term Interest-Bearing Debt Maturity Ladder" that runs along the bottom half of page 17 of the Investor Presentation materials, the average interest rate for debt that is schedule to mature in the February 2024 36th period is a low 0.59% while rising to quite a high 1.12% in the August 2024 37th period. Meanwhile, looking at the Forecasts data on page 19, "Interest expenses, etc." are projected to climb 9 million yen in the 36th period compared with the period under review and 42 million yen in the 37th period compared with the 36th period. What are the factors that underpin this increase in interest costs in the 37th period compared with the 36th period. NAF plans to refinance a portion of its existing debt around the end of the 36th period and as such the effects of the increase in interest will emerge in the 37th period. Compared with the 36th period, interest rates prior to refinancing in the 37th period are higher. While the impact of higher refinancing rates should be less than compared with the 36th period, can we assume that profit and loss in the 37th period will be significantly affected compared with the previous period?

A That is correct. Calculations are based strictly on the timing of refinancing and as such a discrepancy is projected to emerge between interest rates prior to refinancing and the estimated increase in interest payable for each of the 36th and 37th periods.

* (Supplementary comment) Forecast interest payable is calculated on the assumption that will refinance the same amount of debt prior to repayment by the date of maturity for each individual loan that falls due on the date of repayment for each period. The repayment dates of long-term interest-bearing debt in the 36th period are concentrated around February 2024, the last month of the 36th period. As a result, the amount of difference between interest payable in the 36th period is relatively small compared with the previous period. Meanwhile, the refinancing of long-term interest-bearing debt in the 37th period is spread evenly. Accounting for the impact of the increase in interest on refinancing undertaken in the 36th period, together with the increase in interest associated with refinancing in the 37th period, the difference in the 37th period compared with the previous period is greater than the difference in the 36th period compared with the previous period.

Q Looking once again at the "Long-Term Interest-Bearing Debt Maturity Ladder" that runs along the bottom half of page 17 of the Investor Presentation materials, interest rates on borrowings that are scheduled to mature from the February 2025 period are quite low. As a result, the negative impact on earnings due to refinancing from this period may be significant. In light of an upswing in rents, will you be able to achieve dividend growth under this operating environment?

A Having procured funds at low rates of interest to date, we understand that refinancing at these previous interest rate levels will be difficult from the February 2025 period. When disclosing forecasts for each period going forward, we will look to set distributions while taking into consideration the recent upswing in base interest rates. As far as discussions with financial institutions are concerned, and despite the upward trend in base interest rates, there are no noticeable requests from lenders to increase the margins on debt interest rates. With this in mind, we assume that any increase in debt interest rates will mirror base rates of interest. NAF currently refinances interest-bearing debt to the tune of around 10 billion yen each period. Roughly speaking, an increase of 0.1% in the base rate will impact NAF's investment units by approximately 5 yen. By extension, an increase of 1% will increase costs by 50 yen per investment unit. Taking into consideration the current tight supply and demand balance in the rental apartment market and expectations that rents will continue to increase in the future owing to trends in population dynamics, we remain confident that the Investment Corporation is more than capable of absorbing an increase in debt interest rates of this nature.

* (Supplementary comment) The aforementioned example is provided as a matter of convenience since the repayments dates of loans prior to refinancing are to a certain extent spread out over the period. Should refinancing be carried out in a lump sum as of the beginning of the period, an increase in interest rates of 0.1% is estimated to have an impact of around 10 yen per investment unit.

Q Regarding NAF's acquisition of rental apartments by type, family and large type apartment are trending well. Trends in single type apartments are also expected to recover on the back of population dynamics in urban areas. What is your policy toward the acquisition of rental apartments by type?

A We believe that family and large type rental apartments will continue to face a low and depleted volume of market stock. On the supply side, returns on investment tend to decline as spacious floor plans are segregated into family and large type rental apartments. With this in mind, it is difficult for developers to take the leap toward development family and large type properties. Taking the aforementioned into consideration, it is not an easy task to purchase these types of rental apartment despite the desire to do so. In the event that family and large type properties become available, we would actively look to acquire. While it is true that single type rental apartments offer considerable potential, I believe that the Investment Corporation should carefully assess the competition as well as the winners and losers between properties within the micro-market of each area in which apartments are located. Having said this, NAF's policy is to avoid purchasing single type rental apartments solely on the premise that these types of properties are acceptable given that a significant portion of the population is made up of singles. We will focus on properties where product performance matches the market. This includes properties that are optimally positioned and that can solidly perform even under such circumstances as the COVID-19 pandemic.

NAF will not acquire properties simply because they are of the single type. Rather, steps will be taken to carefully select and acquire properties that are optimal for the market.

Q Turning to the “Effect of Value-enhancement investment in Private Area at Okawabata Apartment Communities” data on page 14 of the Investor Presentation materials, there was a substantial increase in the percentage change in rent at the time of tenant turnover for a number of individual factors in the 35th period. Even with this substantial increase, the average increase over the past six periods is about 20 to 30%. Will this upward momentum in rents continue into the future?

A The contracts for Okawabata Apartment Communities units that underwent value-enhancement investment and accordingly exhibited a high percentage change in rent at the time of tenant turnover in the 35th period were old. As such, the increase in rent eliminated the rent gap. Rents have also increased between 20 and 30% for other units at the time of tenant turnover. We believe that family and large type rental apartments will remain scarce and that the current upswing in prices for houses for sale in the Tokyo metropolitan area is reinforcing the growing demand for family type rental housing. Against the backdrop of robust trends in family and large type rental apartments, Okawabata Apartment Communities in particular is a rare family and large type apartment in the Tokyo CBD area and our flagship property. We expect that rents will continue to rise in line with the value of the property.

REIT Management Company: Mitsui Fudosan Accommodations Fund Management Co., Ltd.

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