CFO Small Meeting - Main Questions and Answers

2024.12.05

TOKYU CORPORATION

* Please note in advance that this is not a transcription of the entire Q&A session, but a brief summary prepared by the Company.

<u>Meeting Summary</u>

Date December 5, 2024

Speakers

Hirohisa Fujihara, Director and Senior Managing Executive Officer

Kyosuke Toda, Executive Officer and Manager of Finance & Accounting Strategy Headquarters

Hiroaki Nishimura, General Manager of Accounting Group of Finance & Accounting Strategy Headquarters

Main questions and answers

Q1. In the current Three-year Medium-term Management Plan, ROE target is 8%, in part because it is hard to increase ROE while holding upfront investments in redevelopment projects. Looking beyond the plan to 2030, do you expect that ROE will increase to a higher level from the current 8% target? Is there an update on the Long-term Management Initiative announced in FY2019?

A1. There are upfront investments in the development stage, but after the openings of the properties, there will be profit contributions to various businesses, not just the real estate business, so we believe we can aim for improved ROE. Moreover, ROE 8% is just a minimum target, and higher results should be aimed by accumulating profits in each business. Regarding our Long-term Management Initiative, the company is not yet in a position to give a bullish forecast due to the significant damage during the COVID-19 pandemic. Personally, I think it is possible to achieve the target metrics laid out in the Long-term Management Initiative by capitalizing on further improvements in the business environment in addition to the rapid recovery seen recently, and I do not believe it will be necessary to revise the target figures.

Q2. **Are there any updates on the cash flows that were presented in the current Three-year Medium-term Management Plan?**

A2. **Growth in revenue has been steady, but costs and construction expenses have also risen as expected. Although various expenditures are being incurred ahead of time, including rising labor costs and investments in the refurbishment of existing properties, they are being steadily passed on to rents and ADR, etc.**
As a result, there is no major change to our overall sense of free cash flow, and similarly, interest-bearing debt has not veered far from our initial forecasts.

(From IR manager)

This time, we have only updated the numerical targets in the Medium-term Management Plan and no changes to the content of the plan. Regarding the numerical figures, the increase in the interest-bearing debt level of about 11 billion yen at the end of FY2026 reflects only partial adjustments such as 40 billion yen in treasury share acquisitions and the acquisition of Tokyu REIT investment units, while target operating cash flow increased due to revised profit. In other words, there is no change to investment cash flow or the scale of asset sales from the previous plan. As we will release earnings forecasts for FY2025 in May next year, we should be able to provide updates at that time.

Q3. **Despite declaring a target payout ratio of 30% in the medium- to long-term, it seems that the dividend increase of 1 yen per share at the time of the second quarter results release is overly cautious. What is your approach to dividends?**

A3. **There are no changes to the approach announced in FY2019 with the Long-term Management Initiative to aim for a payout ratio of 30% by 2030, but there is debate about what yield it should be raised. Our performance is currently good, but with many uncertain elements such as changes to the external environment including labor shortages, careful decision-making is needed. In particular, it is important to determine dividend levels while taking into account future investment plans and growth strategies. As with dividends, we want to make appropriate capital allocations, including labor costs. While this is my personal view and not a commitment, over the course of the next medium-term management plan I hope that we can achieve a payout ratio of 30%, and we intend to steadily raise the level of dividends going forward.**

Q4. As for the share buybacks, I believe that reducing the number of shares that had increased through the Group reorganization is one purpose. As mentioned previously, you plan to acquire the remaining 30 million shares and this time acquired 24 million of them. If the remaining 6 million shares are acquired, you will clear this goal. What would be the goals and intentions after that?

A4. Regarding the buybacks, as you said, we have set the benchmark of buying back the issued shares we overshot due to the past Group reorganization, and we have been carrying out these acquisitions on a large scale since the previous fiscal year. Our intention is to eliminate the effects of the diluted share value for our existing shareholders from before the Group reorganization. By achieving this at an early stage, we will enter a phase where we can carry out more strategic buybacks with the aim of improving ROE and EPS in the future.
This time we have made purchases in the market in addition to ToSTNet-3 with that intent. The future purchase volume has not been set clearly as it depends on trends in the stock price and other factors. Speaking personally, I would like to increase EPS, a key management index, from its current level of about 130 yen to 150 yen or 180 yen in the future, and also aim for a market capitalization of around 2 trillion yen, so I would like to act flexibly if there is a chance.

Q5. In the process of buybacks, your treasury stock has swelled, but do you plan to cancel these shares in the future?

A5. When the current buybacks are completed, treasury stock will exceed 5%, and we are discussing our future strategy internally. Carrying the discussion forward, we intend to cancel the shares upon the completion of the buybacks in this fiscal year, but to what degree we will cancel shares has yet to be determined.

Q6. Regarding the procurement of interest-bearing debt, what methods do you see as appropriate under the current environment? There is an example of other company in the same industry procuring interest-bearing debt using convertible bonds. What is your view on this, including cost aspects and other concerns?

A6. Our financing policy depends on market conditions, but it is important to raise funds through a combination of direct and indirect financing. The current balance of corporate bonds appears to me close to the limit of our financing capacity, and it feels risky not to leave any room for further issuance. We have also secured capacity for instruments such as commercial paper, but we need to act cautiously. With regard to indirect financing, considering that banks have increasingly reorganized over the past 30 years, it is preferable to adopt a well-balanced financing position. For the convertible bonds we issued in the previous fiscal year, we were able to raise funds with virtually zero-coupons, but in the future we will research various means of financing and take the appropriate action based on circumstances.

Q7. What do you consider to be appropriate asset volume? Do you have any future vision for five or ten years down the road in this regard?

A7. Our balance sheets comprise enormous fixed assets centered on real estate for leasing, supported by a large amount of interest-bearing debt. To ensure a healthy balance sheet that allows us to make appropriate investments when future investment opportunities arise, we want to avoid supporting our real estate with massive debt. In the future, our total assets could grow to around 3 trillion yen, but interest-bearing debt should preferably be around 1 trillion yen, and a D/E ratio of around 1x is ideal. We would also like to maintain the interest-bearing debt-to-EBITDA ratio, which is a benchmark for financial soundness, at around 5x. This is not an issue when economic conditions are positive, but we are mindful of not increasing interest-bearing debt to a level that would cause us difficulties when responding to emergencies such as a rapid economic deterioration. This is something we are discussing at a slightly longer-term scale such as 2030. For the meantime, we have major investment projects such as the redevelopment of Shibuya, in addition to the losses in operating cash flow over the three years of the COVID-19 pandemic, and we are placing an emphasis on making steady progress. Over this period, we see an increase in interest-bearing debt as unavoidable, and the current level will continue for a certain period.

Q8. To what degree do intend to invest in human resources going forward?

A8. Since our businesses are wide-ranging it is difficult to give a uniform answer, but we do intent to increase human investment in general. For example, this spring we increased the wages of employees in the public transportation business 7-8%, but as this is a labor-intensive business, we need to raise wages two more times by roughly the same amount as this spring. It is important to grow revenue in conjunction with the investment, and, by simple calculation, a revenue increase by around 15% is necessary to keep pace with wage growth.

Q9. With the sharp rise in construction costs, what specific initiatives are you pursuing to improve return from its redevelopment projects and mitigate risks such as delays in construction schedules?

A9. From the perspective of construction risks, it is important to not only secure general contractors but also sub-contractors. As we operate the railway business along with the real estate business, we have relationships with companies in such areas as air conditioning, electricity, and sanitation, and this allows us to proceed with constructions using approaches such as separate contracting. We are working to mitigate risks by internalizing the construction management functions traditionally provided by general contractors. The decline in yield due to a sharp rise in construction costs is undeniable. For commercial facilities or offices, once lease contracts are signed, the terms of the agreement cannot be revised for some time thereafter, so how we manage it is important. With recent improvements in the business environment, there is growing momentum internally to revise rents upwards, including for existing properties.

Q10. Are there any potential changes to future redevelopment projects? In particular, do you expect any changes to the intended use or schedule for the SHIBUYA UPPER WEST PROJECT?

A10. There are no major changes to the SHIBUYA UPPER WEST PROJECT. It is a joint project with the LVMH Group. Their high-end brands have extremely high potential, and we are also maintaining good communication with them. The operator of the hotel has already been decided, and we are proceeding in that direction. It seems the schedule could possibly slip by six months to a year, but the project is proceeding without any changes to the plan itself. As there are many residents in the surrounding area, we want to ensure steady progress.

Q11. What is your policy on utilizing unrealized capital gains from real estate?

A11. Our properties that have significant unrealized capital gains are mostly mixed-use properties, which lack liquidity and are difficult to sell. Our Medium-term Management Plan incorporates asset sales of 70 billion yen, and we need to consider favorable ways to sell these assets. The sale of property is not for the purpose of realizing the unrealized capital gains, but to control the balance sheet and interest-bearing debt. We will consider both selling assets and the control of interest-bearing debt while also factoring in the utilization of Tokyu REIT.

Q12. Regarding operational concession contracts, I believe that Tokyu's expertise in property management can be leveraged. How will you expand business revenue?

A12. For airport operation, we are collaborating with various companies. We are working while being selective in terms of geography, size, and risk management. The synergies among our Group companies are also important. For example, for Todoroki Park, one of the aims was to provide business opportunities to Group companies. As Todoroki is served by Tokyu's railway line, we expect to be able to leverage our resources extensively and produce synergies.

Q13. Tokyo Metro Co., Ltd. went public. With the aim to grow its real estate business, it is considering real estate development with a focus on the areas around its stations. I know that Tokyu already has a deep relationship with Tokyo Metro through mutual railway interconnectivity. Are you planning any involvement with Tokyo Metro in the real estate business going forward?

A13. Tokyo Metro is one of our essential partners. As you mentioned, we have railway interconnectivity. As for real estate, they own prime properties including Shibuya, and we have developed Shibuya Mark City, Shibuya Scramble Square and other projects on a joint basis. The fact that Tokyo Metro is now publicly listed does not mean a major change in how we collaborate with them.

Q14. In your briefing on the second quarter financial results, you explained that the reason for the rise in real estate vacancy rate was due to the tenant switch at some Shibuya property. Have the next tenants been decided? In terms of the rental terms, can we assume they are more favorable than before?

A14. For offices in Shibuya, as many of the tenants are IT firms which are cash rich, they desire long-term contracts. This result in opportunity losses during inflation periods or rising interest rates. There are cases where large IT tenants have vacated office buildings and replaced. Tenant turnover takes six months, but comparted with 2018, the rents of the new tenants have risen by 15% over five years. In other words, we have escalated rents by 3% a year, which is roughly equal to new rents in Shibuya. We could secure rent increases at the pace of inflation. For real estate leasing, we are working on aggressive negotiation and shortening the lease terms. Note that the property that caused the higher vacancy rate has a prospective successor tenant. We refrain from sharing details of individual contracts, but overall rent level is expected to grow in the future.

Q15. In the materials on the second quarter results, there was a downturn in the inbound sales in Shibuya in August and September. Was it a temporary effect from yen getting stronger? Please give details of the most recent conditions.

A15. In addition to the forex impact from the temporary yen appreciation over the summer, weather factors such as the extreme heat also played a part. We have not obtained accurate figures for the recent retail performance, but the Hotel Business was very well in October, driven by inbound demand. We think we can expect high level performance in the retail business as well.

Q16. Many railway operators found it difficult to grow in railway after the COVID-19 pandemic and aim to expand their real estate businesses. What will be the strength of Tokyu Corporation, as a group which also operates a railway business, over dedicated real estate developers?

A16. Our strength is that we go beyond the development and operation of real estate, because in real estate we can run other businesses such as department stores, supermarkets, and hotels. Dedicated real estate developers rely on rents for a return on their investments, so even if operators perform well, it goes no further than increased percentage rents. In our case, we also handle some of the operation, so each company secures appropriate profit and also contributes to the Real Estate Business through percentage-based rent. In a current environment where the number of customers rises due to inbound demand, etc., there is a positive cycle that, as the profitability of each business rises, fixed rents plus variable rents also contribute to the results of the real estate leasing business. As for the railway business, although big events like line extensions are not expected, third parties are also pursuing development in the Tokyu line areas in addition to our own efforts, and this contributes to the Transportation Business in the form of growth in the population and users. This business model is a major driver of our recent upward revisions to forecasts, and we will continue to aim for this kind of comprehensive enhancement of value.

Q17. Please describe the impact of the wheelset issue at Tokyu Railways.

A17. Although having contracted wheelset assembly work externally, proper checks of the work were not performed on the Tokyu side, and this was the cause of the issue. We are taking a multi-faceted approach by making changes to the operation to ensure that the work is not completely entrusted to contractors and amending contracts in line with the changes. In addition, as some of the data was falsified, we are making system modifications and developing mechanism to ensure that falsification itself can never occur, as part of thorough action to prevent recurrences. Outsourcing occur in other businesses besides the Railway Business, we will allocate appropriate resources to respond.

Q18. About five years has passed since the split of the railway business. At this point, how do you assess the effects of the split both qualitatively and quantitatively?

A18. The greatest benefit was gaining quick approval for fare revisions in response to the COVID-19 pandemic. When the number of passengers carried dropped to two-thirds due to the pandemic, the large fixed costs that are characteristic to the business were brought into sharp focus, and this sense of urgency served as the driving force behind pursuing fare revisions ahead of the rest of the industry. If we had remained the former Tokyo Corporation an entity operating multiple businesses including real estate as before, it would have been difficult to move with this sense of speed, but with Tokyu Railways operating the railway business independently, the speed at which the business operated had increased. From the perspective of consolidation, various businesses are still pursued on a joint basis within the consolidated structure. Tokyu Corporation continues to operate various businesses, and we believe it faces challenges on the speed front compared with Tokyu Railways.

Q19. In terms of the business model you aspire to, in the Medium-term Management Plan you mentioned expanding demand areas and developing new domains. What are the businesses that show promise?

A19. Based on the premise that a rapid growth in demand is unlikely in Japan, our expectations lie in overseas business. We believe there are opportunities to take the kinds of businesses we operate in Tokyu line areas and roll them out overseas. In addition, we want to expand business areas that are not dependent on people's movements/traveling. The renewable energy and concession businesses we have been pursuing recently are examples. Regarding overseas businesses, the value of the assets we hold has unrealized gains over the time they were acquired. While there are risks as overseas businesses, we believe they have adequate potential.

Q20. With various risks including foreign exchange risks and country risks when operating overseas, what levels of assets and profit do you see as appropriate?

A20. Currently, the assets held by our overseas businesses total about 100 billion yen, which represents about 5% of our total assets. Considering foreign exchange risks and that overseas businesses will reinvest overseas, I personally believe that holding about 10% of total assets overseas as an upper limit is preferable.

Q21. From a long-term perspective with Japan's population on the decline, the number of private railways is large, and it seems likely that an industry reorganization will occur among railway companies in the Kanto region. How do you see the possibility of such a reorganization, and what are your views on whether Tokyu may take a proactive approach in this regard?

A21. This is my personal view, but even a so-called private railway actually operates a wide range of businesses, and they vary depending on regional characteristics and advantages in each area. There are businesses and areas that could benefit from expanding in size through integration, and then there are areas for which that is not necessarily the case. If an integration were to occur, it would increase the attention from capital markets, but I don't think it would be a simple thing due to the differences in each area and regional characteristics. On the other hand, for the businesses where there are advantages to integration, forming alliances is one possible approach. For example, there might be benefits to forming alliances for vehicle maintenance in the railway business.

Q22. Top management naturally presents united policies when presenting externally, but are there any differences in terms of priorities in internal discussions?

A22. My mission as CFO is appropriate balance sheet control, while profit and loss is the result of the efforts of each business. Tokyu Corporation does business across a wide range of domains, and due to differences in background, there are of course individual variations in philosophy among members of management. We engage in appropriate discussions that take it into account, and the direction is consistent in the output. For example, as mentioned earlier in the questions, there are ongoing discussions among top management about how to deal with capital markets including dividends, and how to give back to employees.

Q23. The Medium-term Management Plan includes pursuing business portfolio management. What progress has been made at this point, and can you give a clearer picture of which business lies where in the matrix?

A23. The matrix was created to organize our thoughts. But considering our business model, just because a particular business is underperforming doesn't mean we should withdraw from it. For example, theaters such as Bunkamura or Tokyu Theatre Orb may find it difficult to significantly increase earnings on a standalone basis, but they have a positive impact on surrounding businesses and our challenge is how to assess those synergistic effects. In the Medium-term Management Plan, we declared that we would pursue business portfolio management in greater depth than before. Rather than evaluating businesses on a standalone basis, we are proceeding the assessment by taking into account how customers use surrounding businesses in conjunction with them. In addition, in verifying Tokyu Corporation's business portfolio, we believe it is necessary to use regions in addition to businesses themselves as a basis for consideration. Once we have considered key regions, key businesses and where they fall in terms of priority in greater depth, we want to reflect those findings in future disclosures.