Roundtable with Management

Roundtable Participants

Yoshinari Hara, President and CEO, Daiwa Securities Group Inc.
Akira Kiyota, President, Daiwa Securities SMBC
Teruwo Hatano, President, Daiwa Asset Management
Tatsuhiko Kawakami, President, Daiwa Institute of Research

Gentlemen, I would like to start off by thanking you for making the time to talk with us this morning. In this session, we would like to concentrate on matters of strategic interest for the Group as a whole and for its individual companies.

I would like to start with a general question, therefore. Looking back at the financial year just ended, what would you regard as the most significant events? Perhaps I could ask President Hara to start off.

Hara
Our principle management policy was to establish the Daiwa Securities Brand. I would like to discuss this in more detail later. Other than this, strategic decision making last year involved revisions made to our medium-term management plan and the exceptional write-downs we elected to take on our real estate holdings.

Our medium-term management plan was produced at the beginning of FY 2000 and covers the three years to March 2003. Under the original plan, we set ourselves three targets—to achieve a sustainable return on equity of 15% or more by the end of the plan period, to achieve a credit rating of single-A or better with major credit-rating agencies, and to achieve a doubling in the level of retail client assets under custody to 28.3 trillion yen. During FY 2001, we recorded a loss due to the above-mentioned real estate write-offs; endured a credit-rating downgrade; and although Daiwa alone of all the big three brokers managed to increase retail assets under custody, the balance fell woefully short of initial targets due to the effect of declining valuations. Consequently, it is perhaps an understatement to say that we failed to make progress in meeting our financial goals.

However, the only one of the three targets we changed was the one pertaining to retail client assets under custody. The other two, relating to return on equity and to credit rating, remain unchanged. The reason that we changed the target relating to client assets is that the original target has proved to be too much a reflection of the direction of the general securities markets and too little a reflection of the results of our own efforts.

For the final year of our three-year management plan, we have decided to introduce a more appropriate measure of our ability to attract retail client assets. Our revised target is to attract new retail client assets under custody of 2.9 trillion yen unadjusted for valuation effects during FY 2002.

As for the real estate valuation write-downs, these were incurred due to our decision to dispose of these holdings in order to concentrate managerial and financial resources to our securities-related businesses. We also wanted to be ahead of the curve, especially in light of our upcoming listing on the NYSE, which requires us to use impaired value accounting, and to avoid having too wide a gap between our Japanese and U.S. GAAP figures. Under Japanese GAAP, impaired asset accounting is scheduled to be fully implemented from the fiscal year ending March 2006. This write-down thus represents the final act in a series of steps we have taken over the last several years to improve the quality of the Group's balance sheet.

You say that it remains your goal to achieve a 15% return on equity and a single A or better rating from the credit rating agencies by March 2003. How realistic are these goals, especially the achievement of a single A credit rating?

Hara

That is a good question. It seems that the major credit rating agencies are quick to downgrade but slow to raise ratings. Consequently, it will not be such an easy target to achieve. Perhaps the best way to state the goal is to achieve a corporate structure worthy of a single A rating by the end of the year since we have little control over how and when our actual situation will be reflected in the views of the agencies. This is not to say, however, that a two-point upgrade is out of the question. Our internal forecasts call for a "V-shaped" economic recovery during the current financial year. If these prove to be correct, we could well experience a sharp recovery in profitability, in which case a sizable upgrade might be achievable.

Playing devil's advocate, what would happen if you were wrong and there was no recovery this year? What is the chance of another downgrade in the credit rating for the Group as a whole and for Daiwa Securities SMBC? What would be the effect of such a downgrade if it occurred? I would like to address this question jointly to President Hara and to President Kiyota.

Hara

From a Group point of view, the biggest contributor to the ratings downgrade was the low level of profitability in the retail securities company. Our wholesale securities company, headed by President Kiyota, still turned in a reasonable profit, albeit well down from FY 2000. Last year was among the worst years ever for our retail securities operation. Nevertheless, we have now reduced SG&A costs in that company to the point where we could break even in a similar market while still remaining fully prepared to take advantage of any upturn. As a result, I see little need for a further decline in our rating. Indeed, I see cautious grounds for optimism.

Kiyota
As President Hara has noted, a further downgrade is unlikely. However, were there some further deterioration I do not think that it would affect our short-term trading operations. On the other hand, there could well be some impact on our operations dealing with longer-term instruments, for example derivatives.

It has now been three years since the former Daiwa Securities moved to a holding-company structure and formed a close relationship with the former Sumitomo Bank, currently the Sumitomo Mitsui Banking Corporation. Looking back, I wonder if I might ask President Hara and President Kiyota to comment on developments over the last three years.

Hara
In general terms, I think I would point to two main developments that I believe have gone well for the Group.

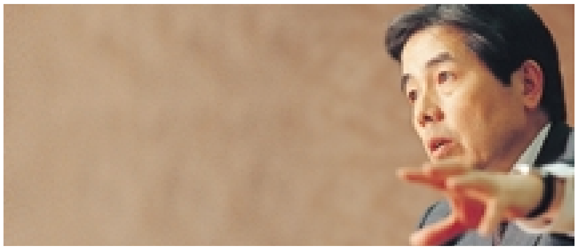
The first is the clear pickup in efficiency that has been made possible by adopting a holding-company structure. The benefits of separating the retail and wholesale securities companies have become increasingly evident as each company has been able to focus on its own area of specialization.

The second element of our strategy with which I am well pleased is the evolution of our corporate branding project. I should stress that the focus of the project is inward-looking rather than outward-looking. We wish to establish a common corporate culture across the Group, with the customer at the very center. Although this will be a lifelong quest for improvement, initial indications are that we have at least laid the foundations for a strong corporate culture.

Kiyota
I would point to synergies with the Sumitomo Mitsui Banking Corporation. While such synergies have maybe not lived up to the most aggressive of our initial expectations, we have, in fact, since inception of Daiwa Securities SMBC, managed to build on the depth and breadth of corporate relationships and available skill sets with visible result. For instance, during FY 2001 we were the clear leader in straight bond underwriting for the first time ever. The same benefit is evident in our new business operations - structured finance, derivatives, and mergers and acquisitions. I would also point to the huge success our Derivatives and Structured Financial Products Department has had with its innovative Enman-Sai structured bond as an example. It is even true in our IPO operations, where we ranked number one last year on the three markets for emerging companies, although second overall. Mandates awarded due to referrals through the SMBC network, for example,

have doubled over the last year. Our relationship with the bank has had a beneficial effect in many different areas of our business, therefore. The one area in which we have yet to see results is the area of equity underwriting, where we hoped that access to the networks of the merged bank would open up opportunities for us. This has not happened to date and is the single biggest disappointment we have.

Turning now to the retail securities company, Daiwa Securities Co. Ltd., I would now like to ask President Hara, in your capacity as president of this company, to comment on the role of the branch network in Daiwa's retail marketing strategy. After all, with one of Japan's most successful call centers and Internet brokerages in the Group, why does Daiwa need such a widespread physical presence? Would it not make more sense to scale back the branch network to cover the major metropolitan centers only and to rely on the call center and the Internet for the rest? Would this not represent a major cost saving?



Hara

Actually, if anything, we believe that our current network of 126 branches is about the minimum size we need to function effectively. The reason is that in addition to servicing retail clients, the branches also have the duty to service local companies, foundations, and financial institutions. Since these are attractive targets for us, in light of the upcoming end to blanket bank deposit insurance and a subsequent shift of funds into securities markets, the branch network clearly has an important role to play. In addition, while there clearly is demand in the market for price-driven, low-cost, speculation-oriented brokerage services, those are not the areas we wish to emphasize or find most attractive. Rather, our Daiwa Call and Daiwa Net packages are intended to promote responsible accumulation of risk assets for economically sound reasons. For this sort of approach, the branch-office network is indispensable and offers all customers a physical point of access. The Saturday openings we started last October has made it easier for people to stop by our branch offices. We hope to expand our client base by fully utilizing our physical presence.

In fact, we have just started to introduce a wide-ranging restructuring of the branch network to concentrate on what we term "area marketing." For some time we have recognized that there are substantial differences between different geographical localities in terms of client type and demand for products. We have now grouped our branch network into semiautonomous "areas" and devolved far more responsibility for intra-area marketing to these areas. All areas will come under the control of a "mother branch," which will act as the local headquarters for area-oriented activities. Reporting to the mother branch may be 3 or even 10 other branches and sales offices. For example, in Tokyo 10 out of 50 branch offices will become mother branches, while in Osaka 2 out of 11 will be so appointed. Henceforth, the "area" will be the minimum geographical area with which the head office will be concerned. This will have a number of beneficial effects. For example, it will increase the critical mass of the local organization and allow them to take responsibility for a wider range of initiatives in marketing products and services in preparation for the complete lifting of blanket guarantees on bank deposits.

Again on the retail securities company, Daiwa Securities managed to squeeze its SG&A expenses relatively hard during FY 2001. Even so, there is some speculation that you could have done more. Would you care to comment?

Hara

We cut our SG&A expenses as hard as we sensibly could. For the year they fell by 10%. This was achieved without resorting to widespread layoffs in the retail company, which we regard as counterproductive. We could have cut more. I believe that certain of our competitors actually did so. However, our view is that the damage done to internal morale, the loss of institutional memory, and the necessity of ensuring adequate access to resources into a market upturn more than outweighed any potential short-term gain to our bottom line.

In summary, what are the major issues for the retail securities company during FY 2002?

Hara

As I have already mentioned, we would expect some flow of funds out of bank deposits into securities markets as historically safe bank deposits lose their guaranteed status. In addition, we need to cast our marketing net wider than in the past. On the product front, investment trusts continue to be the most important product as MMFs still offer a comfortable alternative to bank deposits, having much of the convenience and safety of bank deposits while providing exposure to the superior returns available in securities markets. In this respect, I should mention that Daiwa Asset Management bought for its own books eight issues of bonds with a face value totaling 143.6 billion yen from our MMF portfolio in February. While this has tied up shareholder's equity and increased investment securities on the balance sheet, it is intended to ensure the long-term credibility of Daiwa's MMF operations. This decision was made after careful consideration of the implications of this action. In addition to MMFs, we will emphasize foreign-currency denominated bonds and investment trusts investing in foreign bonds in light of the superior yields available in overseas markets. We must develop a range of medium-risk, medium return products that meet customer's asset management needs. Finally, of course, we will continue to rely on Daiwa Asset Management to achieve superior performance during the current year.

At this point, I would like to ask Mr. Hatano, President of Daiwa Asset Management, to comment on the challenges and issues you see for FY 2002.

Hatano

We completely restructured our operations in February 2002 to meet three major goals. In addition to the initiatives mentioned by President Hara, we embraced the following goals:

Firstly, we aim to enhance our core competency of fund management by integrating our investment management and research functions and bringing them into a common management framework.

Secondly, we will better articulate product strategies geared to the needs of the customer.

Finally, we need to improve the level of service extended to customers including a general improvement in the level of after sales support, the provision of help-desk functions, and so on.

Top priority in FY 2002 will be given to improving fund management performance, improving our research capability, developing an in-depth risk-management capability, and providing a high level of disclosure.

Turning now to the wholesale securities company, I would like to ask President Kiyota to comment on the major issues for your company as you see them.

Kiyota

I mentioned the positive developments earlier. However, clearly, the last financial year was also marked by a sharp downturn in our equity trading revenues. There is no doubt that the environment for the equity business was tough, but our poor performance is in reality the result of our failure to take advantage of the opportunities presented by companies unwinding their cross-shareholding positions.

Despite the disappointing revenue, our market share in the equity market remains high and our presence has by no means declined. To reflect this in profitability we have taken steps to coordinate more closely with our analysts at the Daiwa Institute of Research. We believe that the investor rating of our analysts will contribute to improving our bottom line.

Furthermore we have established a new division that cuts through the three product divisions Equity, Fixed Income and Derivatives, to better address our clients' needs. We are also considering an expansion in the number of staff to upgrade our trading capabilities.

We are working to take advantage of opportunities in the fixed income area provided by the lifting of blanket guarantees on bank deposits. Despite the aversion to credit risk during the second half of FY

2001, we have seen institutional investors shift funds from bank deposits to the securities markets.

Elsewhere, the background is much more supportive. We became the leading underwriter of straight bonds for the first time, as noted earlier. We maintained our position of strength in structured products and derivatives and improved our market position in mergers and acquisitions. Our position in the equity IPO market also improved, as I noted earlier. I even have good news concerning our equity underwriting operations. Since the end of the last term, we have been appointed lead underwriter for the privatization of Japan Tobacco. As you may know, equity underwriting, particularly for large privatization-related issues, has recently been an area where we were relatively weak. Landing this issue has been a major cause for celebration, therefore. We are now in a position to aggressively pursue these deals.

Going forward, we seem to have all of the pieces in place to enable us once again to report acceptable levels of sales and earnings. The key will be to quickly restore the health of our equity sales and trading operations. Pretty much everything else is already headed in the right direction.

Incidentally, at this point I would like to mention that we at Daiwa Securities SMBC are exceptionally pleased that the analysts at the Daiwa Institute of Research have managed to improve their market standing so dramatically. As you may know, DIR's research strength has usually not been reflected in external perceptions. For example, in FY 2000 the company ranked only eighth in Japan according to the widely followed Nikkei Financial Daily rankings. I am pleased to say that in FY 2001 DIR ranked number three, a five-place improvement over the previous year. We hold high hopes that this success will feed through into our investment banking operations, where perceptions of analytical strength can be vitally important.

At this point, therefore, I would like to ask Mr. Kawakami, President of the Daiwa Institute of Research, to comment on this improvement in the analyst ranking. In addition, I would like to ask you to comment on any other developments of note.

Kawakami

The improvement in external perceptions of analyst strength came not so much from any change in our actual research apparatus. There were, in fact, surprisingly few changes to the type of research we produce or in our internal staffing. We did not change our research style, nor did we aggressively go out into the market and hire so-called star analysts. Rather, the improvement recorded is the result of our having adopted a more disciplined approach to research dissemination. In particular, analysts are now far more actively involved in discussing their work directly with end-consumers of our research such as portfolio managers. The indications are that such personal contact is highly valued and accounts for the major portion of the improvement recorded.

Apart from continuing the improvement in our research ranking, the major challenge I face as president of Daiwa Institute of Research, is to cope with ever-expanding demands on our systems development resources while maintaining a tight control on costs. One core strategy we have adopted in this respect is to outsource an increasing proportion of our systems development to China.

President Hara, I wonder if you could wrap up this roundtable for us by summarizing the outlook for FY 2002 and beyond for the Group as a whole?

Hara

Firstly, we want to lead the industry in developing and offering products and services. We understand that progress is not made by standing still and will require continual improvement in our internal processes. In this we are fortunate that the Daiwa Securities Group has always been innovative and treasured its pioneer spirit. Taking advantage of these skills, the Group will lead the industry in launching new products and services, thereby increasing the scope of its businesses and creating new opportunities.

Secondly, we will work to enhance synergies among Group companies. Maximizing Group corporate value is the ultimate goal of everything we do. Consequently, the Group will endeavor to increase competitiveness by enhancing synergies among companies and by promoting efficient operation.

By adhering to the above principles, we hope to provide enhanced long-term returns to shareholders.

As for the current financial year, clearly much depends on the state of Japanese securities markets. However, we are not simply waiting passively for an upturn to come. I feel very confident that the initiatives we have taken over the last several years, ever since the formation of the holding company and which we have discussed earlier, will eventually bear fruit. In the wholesale securities company, we have staked out market-leading positions in a number of promising business areas. Restoring the health of our equities operations there is clearly a challenge but one I think we will rise to. Meanwhile, the retail securities company has been restructured to garner maximum advantage from the changes we foresee happening in Japanese securities markets. We should be able to capture a large proportion of increased retail interest in securities once the markets turn. Overall, our operations are considerably more efficient than they were only a few years ago. Consequently, I think it is fair to say that we feel confident we will benefit in full from any upturn in our end markets. Recent indications are that the Japanese economy is in a mild upswing. At the very least, this should mean that the worst is behind us and, if projections for a “V-shaped” recovery do indeed turn out to be correct, there is every chance of a more pronounced improvement in our business.

Lastly, I would like to note that we aim to achieve an NYSE listing during the current year. With a foreign shareholding of around 30%, we must now consider ourselves a global issue, more than ever subject to global standards of excellence, especially as regards corporate governance and disclosure. Of course, all of these achievements will support the establishment of the Daiwa Securities Brand. This year is the one hundredth anniversary of the founding of Daiwa Securities. As a group we are resolved to take steps to achieve continuous growth during our second hundred years.