SEKISUI HOUSE GROUP

Sekisui House, Ltd.

Transcript for Earnings Results Briefing for FY2018 (Telephone Conference)

Date: March 7th, 2019, Thursday 17:00 – 18:00 JPT

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< Presentation >

Note: The following generally omits the details of financial results presented in the "Summary of Consolidated Financial Results."

[Sheet 1] Overview

Net sales increased ¥0.9 billion to ¥2,160.3 billion. Net sales hit a record high but were slightly below the initial plan. The gross margin was 20.6%, remaining flat year-on-year. Of the increase of ¥5.8 billion in SG&A expenses, ¥2.5 billion were incurred in the Overseas Business, and ¥3.3 billion were incurred in the domestic businesses. The SG&A ratio rose 0.3p.

In the Built-to-Order Business, sales fell short of the plan. Due to rises in rates of general administrative expenses and expenses at construction sites following a decrease in sales volume, OP margin declined 1.4p. While orders received in the Custom Detached Houses segment grew 6.7%, those for the Rental Housing segment declined 8.3% as orders received for reinforced concrete buildings (RC) dropped approximately 30%. The accumulated orders in the Built-to-Order Business increased ¥37.4 billion.

In the Supplied Housing Business, both sales and profit grew in the Real Estate Management Fees segment thanks to advancement in involvement and occupancy rates. The OP margin developed 0.8p. Orders in the Remodeling segment were also strong, rising 7.7%.

In the Development Business, sales and profit grew significantly in the Urban Redevelopment Business. The significant growth was largely attributable to the sale of a 40% interest in the Ritz Carlton Kyoto sold to a Reit in January and the successful sales of other large properties.

The Overseas Business suffered a decline in both sales and profit, primarily reflecting the fact that the sale of multifamily properties planned in the fourth quarter did not go through due to the sudden withdrawal of the Chinese investor lined up for the sale. The risks associated with the overconcentration of sales on the third and fourth quarters will be corrected in the future. A sales contract for one multifamily property has already been completed and, in FY2019, we plan for a significant growth in sales and profit through the steady realization of properties sales.

Operating income decreased 3.2% year-on-year to ¥189.2 billion, and the OP margin fell 0.3p. Non-operating income was ¥5.9 billion. Of the ¥7.7 billion in equity in earnings of affiliates, profit earned in Singapore was approximately ¥3.8 billion and that from Konoike Construction Company Ltd. was approximately ¥4.6 billion. Foreign exchange losses totaled ¥0.5 billion, decreasing ¥1.6 billion.

Of extraordinary income, ¥3.0 billion of gain on sales of investments in securities was generated following the selling of cross-holding shares. ¥9.3 billion of loss on impairment of fixed assets and ¥1.6 billion of loss on sales or disposal of fixed assets were recorded in the extraordinary loss.

Profit attributable to owners of parent amounted to ¥128.5 billion, falling 3.5% year-on-year. Dividends rose ¥2.0 to ¥79, and payout ratio was 42.4%. Orders received fell ¥66.5 billion, mainly attributable to significant decline in the Overseas Business.

[Sheet 2] Financial position

Of current assets, real estate for sale increased ¥1.3 billion, of which ¥29.6 billion decreased in Japan and ¥31.0 billion increased overseas. The increase in real estate for sale has started to falter slightly. Of capital expenditure of ¥58.6 billion, investment in rental real estate amounted to ¥45.6 billion. Investment in hotels was carried over to the next fiscal year and, in FY2019, capital expenditures of ¥70.0 billion consisting mainly of investment in hotels and depreciation and amortization of ¥22.0 billion are planned.

Total liabilities increased ¥5.2 billion. Interest bearing debts increased ¥17.4 billion. The D/E ratio rose 2.0p but there was no increase in net interest-bearing debt due to an increase in cash and deposits. Net assets declined ¥11.1 billion. Profit attributable to owners of parent totaled ¥128.5 billion; whereas payments of dividends amounted to ¥54.5 billion, translation adjustments declined ¥29.4 billion associated with the appreciation of the yen, and retirement benefits liability adjustments diminished ¥38.6 billion yen.

Looking at cash flow, that from operating activities declined ¥40.2 billion, due to decreases in profit before income tax and in notes and accounts payable. Cash flow used in investing activities amounted ¥70.1 billion, attributable to a decrease in capital expenditure. Free cash flow declined 34.3 billion to ¥54.9 billion. We expect the free cash flow for the FY2019 to improve significantly.

[Sheet 3] Segment information (Built-to-Order Business)

Sales of the Custom Detached Houses segment declined due to a fall in orders received from the previous fiscal year, and the gross margin declined 0.8p. The primary cause was an increase in the portion of expenses at construction sites due to a decrease in sales volume. The OP margin declined 1.1p. Meanwhile, orders received grew 6.7% year-on-year. Monthly orders have been up month on month since August. Accumulated orders are building up by ¥28.8 billion, which will contribute to sales and profit growth in FY2019.

Sales in the Rental Housing segment decreased due to the longer preparation period required before construction as a result of growing sizes of buildings such as three- and four-story housing units and non-residential properties. The gross margin declined 1.1p on factors similar to those affecting the Custom Detached Houses segment, as well as an increase in RC buildings. Order fell 8.3%, of which for RC buildings dropped ¥22.2 billion. It is still the case that Sha Maison rental apartments show growth in the three major

metropolitan areas but decline in regional areas and orders have maintained growth since October last year. Given that the trend towards prolongation of the period until the start of construction is also coming to an end, gains in sales and profit are expected in FY2019.

[Sheet 3] Segment information (Supplied Housing Business)

The Remodeling segment achieved growth both in sales and profit, reflecting successful proposal-based remodeling and environment-based remodeling. Large-scale remodeling projects of ¥10.0 million or more showed double-digit growth and orders received increased 7.7% while accumulated orders also increased ¥7.0 billion.

The Real Estate Management Fees segment achieved growth in both sales and profit. The OP margin continued to grow, thanks largely to an increase in the number of units under management and improved occupancy rate.

[Sheet 4] Segment information (Development Business)

Both sales and profit in the Houses for Sale segment declined, while orders received and accumulated orders rose ¥2.5 billion and ¥7.3 billion respectively.

The Condominiums segment posted increased sales but a sharp decrease in profit, reflecting the recording a valuation loss of ¥3.8 billion due to sales promotions mainly for one struggling property. The completed property inventory was 186 units. Other properties generated profit through steady sales.

In the Urban Redevelopment segment achieved growth in sales and profit thanks to property sales to Sekisui House Reit, Inc. and funds. We sold our 25% ownership interest in Kokusai Akasaka Building in order to change to 50:50 joint development. Sales of large properties, such the sale of a 40% interest in the Ritz Carlton Kyoto, increased.

[Sheet 4] Segment information (Overseas Business)

Business in Australia posted declines in sales and profit due to an in-between season despite the delivery of Central Park office and hotel accommodation in Sydney. The investment balance decreased ¥21.2 billion from the end of the previous fiscal year. We posted a valuation loss totaling ¥5.6 billion on the complex development project in Queensland. The real estate market remains in a downward trend due to real estate regulation introduced in 2017 and Chinese capital controls.

Progress in China was mostly in line with the plan, with handovers going ahead mainly in Suzhou (East/West). Orders received also increased ¥13.3 billion year on year, to ¥49.6 billion, centering on Suzhou (East/West), Wuxi and Taicang. Real estate regulation remained in place, but sales made steady progress as the Sekisui House brand became more firmly established. The investment balance decreased ¥27.3 billion from the end of the previous fiscal year to ¥165.6 billion.

In the United States, both sales and profit fell, as the sales of two properties in the multifamily business fell through. Of ¥166.6 billion of the sales, ¥60.1 billion was generated from the community development, ¥99.0 billion from Woodside Homes, and ¥4.7 billion from multifamily rental fees. Of the ¥16.5 billion of the operating income, ¥8.2 billion was generated from the community development, ¥5.6 billion from Woodside

Homes, and ¥1.0 billion from multifamily business. The occupancy rates of the two properties whose sales fell through was 95%, rents were also as planned, and there was no major change in the market environment. Of the orders received, ¥64.8 billion was generated from the community development, ¥93.2 billion from Woodside Homes, and ¥4.7 billion from multifamily business. Of the investment balance, ¥144.2 billion was generated from the community development, ¥86.8 billion from Woodside Homes, and ¥220.3 billion from multifamily business.

[Sheet 5] Full-Year Forecasts

For FY2019, net sales is planned to amount to ¥2,367.0 billion, up 9.6% year-on-year and gross profit to ¥475.0 billion, up 6.8%, with targeted gross margin of 20.1%, down 0.5p year-on-year. The SG&A expenses will total 270.0 billion, up 5.7% year-on-year. Operating income is expected to amount to ¥205.0 billion, up 8.3%, and OP margin will diminish 0.1p year-on-year, to 8.7%. Expenses related to retirement benefits will increase around ¥12.0 billion mainly due to a change in the discount rate for retirement benefit obligations (1.4% to 0.8%) and the impact of actuarial differences. This is why the increase in operating income is small. The increase in expenses related to retirement benefits will be reflected fifty-fifty in cost of goods sold and SG&A expense.

Non-operating income will increase ¥3.0 billion, and ordinary income will total ¥208.0 billion. Today, we also announced that we are making Konoike Construction into a subsidiary and, on October 1, we plan to convert preference shares into common shares and to acquire more than 50% of the voting rights in Konoike Construction through the acquisition of shares from certain shareholders. The FY2019 plan already factors in net sales of ¥64.2 billion and operating income of ¥2.8 billion for the three months from October into the "Other Businesses" segment as well as equity in earnings of affiliates to the end of September of ¥3.4 billion.

EPS will be ¥201.99 and ROE is expected to be 11.3%. Dividends will be increased by ¥2 to ¥81, and payout ratio will be 40.1%.

By segment, net sales in the Custom Detached Houses business will increase ¥32.0 billion, to ¥390.0 billion due to recovery in orders received. Operating income is expected to climb ¥5.2 billion due to a recovery in volume, and a 0.4p improvement in the OP margin is forecast. Higher costs related to retirement benefit expenses will have a negative impact of around 1.2p on the OP margin. In the Rental Housing business, given that the delay in construction starts will also come to an end, net sales will rise ¥21.9 billion, to ¥438.0 billion, and operating income will increase ¥3.1 billion, to ¥53.5 billion. The OP margin will improve 0.1p, to 12.2%. As in the Custom Detached Houses business, higher costs related to retirement benefit expenses will have a negative impact of 1.1p on the OP margin. The Remodeling business is expected to show steady expansion, with net sales up ¥10.5 billion and operating income up ¥1.8 billion.

In the Real Estate Management Fees Business, net sales will increase ¥24.9 billion and operating income will grow ¥5.0 billion. The business will be growing, owing to an increase in the number of units under management and high occupancy rate. In the Houses for Sale segment, net sales will rise ¥13.1 billion and operating income will increase ¥2.9 billion. In the Condominiums business, net sales will climb ¥0.4 billion, while operating income will rise ¥2.5 billion as no valuation loss will be recorded. In the Urban Redevelopment Business, declines of ¥47.3 billion in net sales and ¥26.4 billion in operating income are

forecast as a result of decline in property sales. ¥331.6 billion of net sales and ¥35.0 billion of operating income will be expected in the Overseas Business. In Australia, taking the shortage of completed properties and market deterioration into consideration, we project net sales of ¥24.8 billion and operating income of ¥0.9 billion. In China, sales are progressing steadily, and we expect net sales of ¥50.0 billion and operating income of ¥4.1 billion. In the United States, we predict net sales of ¥256.8 billion and operating income of ¥31.1 billion. In the multifamily business, we will steadily sell two properties, the sale of which had been postponed, in addition to a property for which a contract has already been signed.

< Summary of Question and Answer Session >

Note: Matters previously described in the financial statements and documents subject to timely disclosure are omitted here.

Question

- **In the Built-to-Order business, orders for February were also strong. Is this understood to be last-minute demand ahead of the consumption tax hike? If so, will weaker demand after the tax hike affect the financial results for FY2019?**
- **Planned property sales in the multifamily business in the United States is one property for which a contract has already been signed and two properties whose sales were postponed, making a total of three properties. Is that correct?**

Answer

- It is our understanding, based on the results of interviews, that last-minute demand ahead of the tax hike is not that apparent. Although the government is implementing stimulus measures for custom detached houses but not for rental housing, this is not producing any last-minute rush at present. In case of 20-year rental housing management plan, a 2% increase in the consumption tax rate will have an impact of around 0.1% per year. Compared to our full-year sales plan, orders received for Custom Detached Houses are equivalent to seven months of the full-year plan and orders received for Rental Housing are equivalent to 11.5 months of the full-year plan. Even if orders for rental housing slow down, this will not have any major impact on our financial results for FY2019. The Custom Detached Houses business may be impacted slightly, but with no last-minute rush evident, there is unlikely to be any major decline from April. Orders are planned to increase 7.3% in FY2019. In the Rental Housing business, ¥20.0 billion for the Michi-no-Eki Project will be added to orders but if we exclude this, orders received in FY2019 are projected to be mostly unchanged from FY2018.
- We have already signed a contract for one property. We also intend to sell the two properties with 95% occupancy as soon as possible. We plan to sell other properties as plus alpha. If possible, we would like to secure orders during the first half of the current fiscal year.

Question

- **Please give a breakdown of the ¥43.0 billion in noncurrent assets reclassified as inventory. Are there any properties that could offset the shortage even if the situation changes for the plan to be underachieved?**
- **Breakdown of the ¥3.8 billion of valuation loss in the Condominiums segment**

Answer

- The two main properties that were reclassified were 25% interest in Kokusai Akasaka Building and 50% interest in the Ritz Carlton Kyoto. There are also other properties in the pipeline.

- We recorded valuation losses on a property with high levels of completed property inventory and a property that required plan changes mainly due to adjustments with neighbors and are still awaiting the start of construction. There are no major problems with any other properties.

Question

- **Are there plans to make Konoike Construction into a wholly owned subsidiary in the future? What impact will its acquisition have on the balance sheet?**
- **Breakdown of FY2019 plan for the business in the United States**

Answer

- We may make Konoike Construction into a wholly owned subsidiary in the future. However, we see the company's composition of shareholders, which include founding family members and employee stock ownership, as an issue that would have to be resolved through greater mutual understanding. As for the impact on the balance sheet, Konoike Construction's equity ratio is now over 30%. It essentially has no interest-bearing debt and we do not think that its inclusion in the scope of consolidation will have any major impact on the balance sheet. We will have Konoike Construction settle its accounts in December and we will include its results for three months into our FY2019 financial results before full inclusion from FY2020.
- For FY2019 results plan of the business in the United States, we will expect ¥120.9 billion of sales and ¥23.1 billion of profit generated from multifamily business, ¥46.7 billion of sales and ¥5.8 billion of profit from community development, and ¥84.3 billion of sales and ¥2.5 billion of profit from Woodside Homes. The residential market in the United States is on a downward trend and our community development and Woodside Homes plan is conservative.

Question

- **Regarding the sales of properties in the multifamily business in the United States, which was expected to achieve considerable growth at the time of formulation of the current Mid-term Management Plan, are there any risks with regard to securing sales in the future?**
- **Breakdown of the ¥14.0 billion of operating income plan in the Urban Redevelopment segment**

Answer

- Under the Fourth Mid-term Management Plan announced two years ago, we assumed the sale of multifamily properties soon after their completion and had factored this into the plan. Usually developers sell properties when they have secured a high occupancy rate and there is a prospect of raising rents in the next round of rent negotiations. However, conditions through to the middle of last year were such that sale was possible ahead of schedule even though rents were still low due to rising rents and high certainty surrounding occupancy rates. Currently, we believe that it is better to maximize property value before seeking a sale. Our revision of the plan for FY2019 operating income in the United States under the

Mid-term Management Plan from ¥39.1 billion to ¥31.1 billion plan reflects a conservative review of the situation. We intend to increase the certainty of securing buyers by not relying on Chinese investors and pursuing sales to other investors especially investors in the United States.

- Of the ¥14.0 billion, ¥11.4 billion will be generated from property sales. Rent income will decrease in line with the sale of properties.

Question

- **You explained that you expect orders of around 20.0 billion for the Michi-no-Eki Project. What is the expected contribution to FY2019 financial results?**
- **Moves such as the Michi-no-Eki Project and the acquisition of Konoike Construction create the impression that you have branched out from your previous business strategy of focusing on residential-related business into non-residential one. Has there been a change in your management policy?**

Answer

- The project is scheduled for completion in autumn 2020. Sales will also arise in FY2019 on a percentage of completion basis but the project will not make a full contribution to the financial results until FY2020. Orders will not be received altogether but will be received gradually starting from orders for which the details have been finalized. Orders could also start emerging to some extent during the first half of this fiscal year.
- There is no change in our policy of focusing on the residential domain. Our policy in the Built-to-Order Business is to seek growth through non-residential field as a "plus alpha" in addition to our high added value strategy in the Customer Detached Houses and Rental Housing business, utilizing materials shipped from factories. Under the Michi-no-Eki Project, we are also implementing plans in cold regions such as Hokkaido and, if RC structures are required, we will no doubt borrow Konoike Construction's expertise.

Question

- **Don't you consider that Konoike Construction's contribution to operating income of ¥2.8 billion for three months is low? The company has reported operating income of more than ¥20.0 billion per year for the past three years.**
- **What are the margin forecasts for the Custom Detached Houses and Rental Housing segments?**

Answer

- Konoike Construction's financial results for the past three years were strong and its profit margins also improved, but its operating income for the fiscal year ending September 2019 is expected to be around ¥16.0 billion. In addition, the three months that will be included in our FY2019 financial results belong to the next fiscal year and we have conservatively estimated the contribution at ¥2.8 billion, taking into consideration various factors including the period included, i.e. October to December, and the elimination of transactions between Konoike Construction and Sekisui House.

- Excluding the impact of retirement benefit expenses, results for both the Custom Detached Houses business and the Rental Housing business are expected to recover to FY2017 levels. Improvement in the Rental Housing business will be slower than in the Custom Detached Houses business mainly due to a difference in the recovery of the volume of materials shipped from factories and the rise in the RC proposition ratio. We believe that there is room for improvement in the Rental Housing business through cost reductions.