

Sekisui House, Ltd.

Transcript for Question and Answer Session of the Management Plan Briefing for the Second Quarter of FY2018

Date: September 7th, 2018, Friday 13:30 – 15:00 JPT

Participants: Yoshihiro Nakai, President and Representative Director
Fumiyasu Suguro, Senior Managing Officers and Director
Hideyuki Kamijo, Managing Officer
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< Summary of Question and Answer Session >

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

Question

- What led you to forecast an appraisal loss for Australia? Were you unable to ascertain the overall picture before launching the business?
- Your competitors are also targeting major cities in the Rental Housing segment. What is the recipe for winning the competition? What are the results and future prospects of orders for non-residential fields?

Answer

- We acquired the land in the state of Queensland in 2010 and had proposed a highly concentrated complex development aiming for economic vitalization that would lead to Sunshine Coast tourism or job creation. However, we were met with opposition from the residents from 2014 to 2015, and the city council rejected our proposal. In June this year, the business plan was approved with changes made. That is what happened. Including country risks in terms of resort development, we take this as a lesson going forward. For Australia, we would like to shift to development centered on Sydney.
- Based on the area marketing strategy, we are promoting the Rental Housing segment. There are two differentiation points. The first point is the β system construction method of our company, maintaining overwhelming superiority in terms of performance including the high-function, soundproof, earthquake-proof and insulation properties mainly found in 3-story and 4-story buildings. The second point is the Sha-Maison Brand including rental placement, long-term maintenance, property management ability and PR of Sekiwa Real Estate, Ltd. We believe that we can beat our competitors with these two points. The results for the first six months of the current fiscal year in the non-residential

construction sector increased 17% year-on-year. Compared to ¥77.0 billion for the previous fiscal year, we would like to see results at the ¥80.0 billion level in the current fiscal year. The β system construction method is well received, and we receive offers from nurseries, care facilities, commercial facilities that require a large space on the first floor and hotels as well.

Question

- In terms of order forecasts for the Rental Housing segment in the next fiscal year, do you presume that the orders will not grow in local areas? Could you tell me your estimate of the timing for order recovery and profit margins?
- What are the factors for downward revisions in the Overseas Business, and what is your view of risk management regarding the market environment in Australia and the U.S.?

Answer

- The orders for Rental Housing were 6% in the most recent August on a single-month basis, and we are on a recovery track mainly in the non-residential fields. Accumulated orders are piling up due to prolonged approvals and permits of larger houses and non-residential properties, so we expect that profit margins will recover. In local areas, we expect that a stricter stance for extending loans will have an impact for the time being. If we focus on an area where we can win a competition with good-quality, mid- to high-end products and increase orders, we do not believe that profit margins will decline.
- The Overseas Business remains steady in line with our plan in the current fiscal year. However, there are restrictions on real estate investment in Australia, and there is a risk factor for China that the government may intervene not only in architecture confirmation permits but also in sales permits, which will affect the next fiscal year. Mainly on the West Coast of the U.S., the multifamily business remains favorable. We are exploring with our partners to ensure that we increase IRR and sell at the best time. We do not foresee any risk. Homebuilding of Woodside Homes also remains strong. Although there was a press report stating that sales appeared to have peaked out in NY, SF, Silicon Valley, etc., we think that the situations are a little different because the prices in these cities are too high for the general public to afford. There is a labors' shortage risk in the Woodside Homes sector. Our challenge is how efficiently we can build ready-built housing, and our technical team and local technical teams are discussing this aspect.

Question

- Since a difficult Rental Housing order environment is occurring and the risks of the Overseas Business are rising, are there any measures for increasing the turnover of real estate for sale in Japan and abroad?
- The development of the Built-to-Order Business in the Overseas Business

Answer

- With regard to the improvement of the asset turnover or promotion of property sales mainly in the U.S., since the rent of rental housing on the West Coast is rising at an annual rate of 3-4%, it is very difficult to determine the ideal timing of the sale. We would like to carefully discuss the sales method for the best timing with our local partners. As for the overall Overseas Business, despite country risks, etc., we would like to advance business management with a broad vision to accelerate the return on the business in China and reinvest the collected funds in Japan and the U.S.
- There are almost no countries with a Built-to-Order Business overseas. We have heard that there is a world of Built-to-Order Business for the most luxurious residential houses worth ¥300 million in Beverly Hills in the U.S., but 90% and over is ready-built housing. The same is true for Australia. The Built-to-Order Business is established in Japan, which we think is a business model that is unique to Japan. Under these circumstances, by not adhering to the Built-to-Order Business, we would like to explore the Built-to-Order Business, including how we build buildings with our technology in ready-built housing as well. We have already constructed a factory for SHAWOOD Homes in Australia. Sales are currently around 100 homes per year, against a capacity of 300 homes per year. We would therefore like to establish a production/construction system in full operation at an early stage. By combining it with the ready-built housing business, we would like to develop the Built-to-Order Business including housing construction utilizing the company's house construction technology.

Question

- Explain the specific sales activities or strategies regarding the effects of the organizational change in April. What is the rationale for your judgment that the order recovery will continue?
- What is the increase/decrease in sales personnel for Custom Detached Houses and Rental Housing? If the number of sales personnel for Rental Housing is on the decrease in substance, is it really possible for rental housing to recover in the future? What is the status of allocating personnel to urban areas?

Answer

- We have had separate branches dealing with only Sha-Maison rental apartments or detached houses. Since there was an issue of allocating personnel in local areas in particular, we had allowed to sell both rental housing and detached houses in such areas. In April, we restructured the sales system and drew a strict organization line. This constituted the organizational restructure on this occasion. The strategy is that we establish the Digital Marketing Office and examine a logical method of attracting customers using digital techniques. Moreover, we hold various events, such as a design event where potential customers can receive presentation planned by chief architects, an in-house qualification system that represents a top group. Accordingly, a range of ideas are coming up from on-site, and innovation is occurring there as well. We envision starting off with the corporate reorganization in April through to holding all sorts of events through July, leading up to a 12% increase in receipt orders in August.
- In areas where we sold both rental housing and custom detached houses, when there was a rental

housing boom due to measures for inheritance tax, etc., we were more inclined to carry out rental housing sales. This is our assumption, but the number of sales personnel for custom detached houses was reduced by 100-200 persons in substance, and the number of sales personnel for rental housing had increased in the past few years. Since there is no change in the total number of sales personnel, it is assumed that the number of sales personnel for rental housing might have reduced in substance due to the organizational change on this occasion. Sales of rental housing require corporate sales skills in addition to sales skills directed toward individual owners. We think that we can compete sufficiently using the remaining sales personnel for rental housing by reinforcing the corporate sales skills.

Rental Housing is divided into two Headquarters: the East Japan Building Sales Administration Headquarters and the West Japan Building Sales Administration Headquarters. We are undertaking fluid personnel exchanges freely between the two Headquarters. For instance, sales personnel from regional cities such as Utsunomiya or Mito, are coming into the Tokyo Metropolitan area. The personnel are concentrated in the urban areas.

Question

- What do you think of the future relationship or synergy with Konoike Construction Co., Ltd.?

Answer

- Regarding the collaboration with Konoike Construction Co., Ltd., there are three sub-committees: the sales sub-committee, the technical sub-committee and the general affairs/management sub-committee. They have discussions almost every month, and it is going smoothly. At the sales sub-committee, information on civil engineering and administration, the strength of Konoike Construction Co., Ltd., is used for the company's CRE sector, the Development sector. Our company places construction orders to Konoike with a focus on the Condominiums Business. There are synergies in terms of sales like this. At the technical sub-committee, we are proceeding with discussions on joint purchases or joint logistics to see whether the conventional construction method of RC-built of Konoike can be used for our factory shipped materials, particularly the interior materials of the company. At meetings of the general affairs/management sub-committee, they are discussing operational efficiency in the individual indirect departments. Since there is a difference in corporate culture and the way of doing business between general contractors and housing makers, even in the same construction industry, good synergies are being created through mutual motivation.

Question

- With regard to the sales methods of rental housing, what is the actual situation of referrals or the number of visitors to display home sites? Amid a series of negative campaigns, what are the declining confidence of the customer base and referrals from financial institutions like?
- It seems that the deterioration of profit margins in the non-residential construction fields has commenced. I would like to know about changes in or forecasts of profit margins in the non-residential fields.

Answer

- The company's sales methods include two aspects: referral and event strategy. Referrals from financial institutions, TKC tax accountants and companies with which we have a business tie-up account for about 80% of all orders. In addition, we do not undertake walk-in sales, but we hold an event every month to enable visitors to come to our sites; for instance, measures for circumventing inheritance tax, seminars on wills, business continuity, etc. By pairing with financial institutions, we hold an event that interests the wealthy and major landowners, and suggest the construction of rental housing where rental housing management becomes a solution. Even given the negative campaign, we receive referrals from financial institutions, and our customers discuss the loan conditions with ease. Since we suggest rental housing management to customers that has a very low default rate, we are rated highly. Due to stricter conditions for extending loans, the impact on the minds of the customer base and the time and effort to provide explanations have increased somewhat, but we welcome this.
- As for the profit margins of non-residential fields, where the β system construction method is used, there is no change in the setting of the gross margin ratio or profit margins. In competitive bidding for facilities for the care facilities or nurseries, there are cases where we go and get the projects by purposely lowering the profit margins, but basically where the β system construction method is used, the profit margins are fixed.

Question

- Order composition of rental housing in the three major metropolitan areas and local areas?
- Future development of the Overseas Business in your Medium-Term Management Plan? Will the current Medium-Term Management Plan be reviewed?

Answer

- The order ratio in urban areas accounts for 75% of all orders.
- Domestically, it took 10 years to strike a balance among the three business models: the Built-to-Order Business, the Supplied Housing and the Development Businesses. We believe that it will take more time to grow the Built-to-Order and Supplied Housing in the Overseas Business. Discussions have already commenced. Discussions and experiments are underway, such as what we are going to do with the fees businesses, particularly in the U.S. and Australia. But the way these aspects will be incorporated as figures into the next Medium-Term Management Plan is undecided at the present time.

Question

- View on improving the gross margins. Are profit margin improvements in the first six months of the current fiscal year anticipated due to the volume effect? Are there any drivers?
- How are you involved in the second stage development of Umeda Kita Yard?

Answer

- There will be room for profit margin growth depending on how we rationalize the production division and production line for β system construction method at our plants. Our most urgent issue is to recover volume to cover the overheads. The impact on profit margins is significant, and it is our view that there is room for improvement in two respects: efforts made on-site and improvements of plants.
- We were able to make a successful bid in a joint venture of companies who were eager to vitalize Osaka. We will announce the composition of the companies and concrete details of the business as soon as they are confirmed.

Question

- Regarding the order backlog of rental housing, you assume that there is a possibility that the start of construction work may be delayed due to larger properties in the next fiscal year and beyond, as in the current fiscal year?
- Analysis of the negative factor for CF from operating activities, is it temporary or continuous? Future outlook for free cash flow?

Answer

- Even though the β system construction method has the advantage of rapid construction confirmation by type approval, nurseries or care facilities for the elderly require approvals and permits other than construction administration. This gives rise to a risk that is unique to non-residential construction in that a delay is generated. The construction method is used for higher construction such as 3-story and 4-story buildings, and depending on the municipality, the range of the neighborhood briefing is stipulated, which may extend the period up to the start of construction. We are not too concerned about rental housing. Rather, we consider the risks to be approvals and permits other than the construction administration of non-residential fields.
- Since payments for the construction of order projects in 2H of the previous fiscal year occur in the following year, cash flow will be very tight in 1H. Meanwhile, construction costs will flow in during 2H, when cash flow will improve. Free cash flow is also expected to improve, turning positive for the full year.