Sekisui House, Ltd.

Transcript for Earnings Results Briefing for FY2019 (Telephone Conference)

Date: March 5th, 2020, 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

Both net sales and profit exceeded initial plans and hit record highs. However, we recorded total losses of ¥23.7 billion, comprising a valuation loss of ¥10.2 billion and an impairment loss of ¥13.5 billion, in relation to real estate on which we might incur losses in the future, in readiness for the Fifth Mid-term Management Plan.

Orders received in the Custom Detached Houses Business fell 10.5% year on year, reflecting the impact of a reactionary fall due to the consumption tax hike and weaker confidence amid a sense of slowdown in corporate earnings caused by the trade friction between the United States and China. Following negative GDP growth in the October-December quarter, GDP growth for the January-March quarter is also expected to be negative, largely due to the Covid-19 outbreak. However, we expect orders received are likely to pick up again when the outbreak comes to an end, creating a sense of recovery in corporate earnings. In the Rental Housing Business, orders received rose 2.5% year on year, despite sharp decline in the market as a whole, due to our concentration of efforts on area marketing focused on the three major metropolitan areas, which began 10 years ago, the effect of increased specialization through organizational restructuring last year, the differentiated quality of ShaMaison rental housing, and the maintenance of high occupancy rates through stronger cooperation with Sekisui House real estate companies, which changed their names as of February 1.

Looking at the overview of earnings results, net sales increased ¥254.8 billion year on year, to ¥2,415.1 billion. In the Overseas Business, the multifamily business (development of rental housing) in the United States performed strongly, making up for the sales result of the Built-to-Order Business, which fell short of the full-year plan. Sales in the Built-to-Order Business rose 3.6%, or ¥27.6 billion. Sales of Custom Detached Houses were in line with the plan and sales of Rental Housing were ¥27.3 billion less than the full-year plan, partly due to an increase in larger-scale properties. Sales in the Supplied Housing Business climbed 4.9%. Both the Remodeling Business and the Real Estate

Management Fees Business performed solidly, but sales were ¥3.3 billion less than the full-year plan. Sales in the Development Business fell 6.0%. Sales in the Houses for Sale Business fell short of the full-year plan, while sales in both Condominiums and Urban Redevelopment Businesses surpassed targets, and sales were ¥9.1 billion higher than the full-year plan. In the Overseas Business, sales grew 58.5% or ¥143.9 billion. Business in the United States, including the multifamily business, performed strongly, China business also held firm, and sales were ¥58.2 billion up on the full-year plan. Sales also include net sales for the October-December quarter of Otori Holdings, Co., Ltd. (holding company of Konoike Construction Co., Ltd.), which was made into a consolidated subsidiary on October 1, amounting to ¥72.4 billion.

Gross profit increased ¥33.4 billion, to ¥478.0 billion, ¥3.0 billion higher than the full-year plan. The gross margin dropped 0.8p. Factors such as a change in the discount rate (1.4%→0.8%) for retirement benefit obligations affected the cost of sales and SG&A expenses, and retirement benefit expenses increased ¥12.0 billion in total. This caused a drop of around 0.2p at the gross margin stage. We addressed the risk of the occurrence of future losses on our property portfolio and recorded a valuation loss of ¥10.2 billion. This consisted of a loss of ¥0.9 billion in the Houses for Sale Business, a loss of ¥0.9 billion in the Condominiums Business and a loss of ¥8.3 billion in the Overseas Business. In the Built-to-Order Business, sales fell short of the full-year plan and the gross margin was 0.1p lower than planned. The Supplied Housing Business registered a 0.2p improvement. The Development Business saw a 3.3p drop. The Urban Redevelopment Business experienced a 10.3p fall due to decreased sales and lower profit margins on properties sold. The Overseas Business recorded improvement of 0.5p.

The rise of ¥17.4 billion in SG&A expenses included an increase of ¥12.9 billion in personnel expenses, which includes retirement benefit expenses.

Operating income climbed 8.5%, to ¥205.2 billion. The OP margin fell 0.3p, to 8.5%. Operating income was ¥0.2 billion higher than the full-year plan, while the OP margin was 0.2p lower. An increase in retirement benefit expenses caused a drop of around 0.5p. In the Built-to-Order Business, operating income grew 2.4%, to ¥94.8 billion. The OP margin fell 0.2p, with higher retirement benefit expenses accounting for a drop of 1.0p. Compared to the full-year plan, operating income was down ¥6.1 billion due to delays in the construction of rental housing while the OP margin was 0.4p lower mainly owing to higher SG&A expenses. In the Supplied Housing Business, operating income increased 6.7%, to ¥64.5 billion. The OP margin improved 0.2p. Compared to the full-year plan, operating income was down ¥2.9 billion, while the OP margin was 0.4p lower. This is because growth in the number of rental properties was less than expected due to delays in the progress of construction of ShaMaison rental housing, and in FY2020, progress with construction will likely lead to growth. In the Development Business, operating income sank 32%, to ¥39.4 billion. The OP margin dropped 3.9p. Operating income was ¥2.4 billion up from the full-year plan, and the OP margin was up 0.4p. In the Overseas Business, operating income rose 172.6%, to ¥44.5 billion, and the OP margin improved 4.8p. The operating income of the Overseas Business was ¥9.5 billion higher than the full-year plan, making up for the shortfall in the Build-to-Order Business. Operating income also includes operating income for the October-December quarter of Otori Holdings, Co., Ltd. amounting to ¥4.9 billion.

Non-operating income (expenses) grew ¥2.6 billion, to ¥8.6 billion. This included equity in earnings of affiliates of ¥10.4 billion and foreign exchange gain of ¥0.7 billion.

Ordinary income increased 9.6%, to ¥213.9 billion. This was ¥5.9 billion higher than the full-year plan due to improvement in non-operating income (expenses).

Extraordinary income amounted to ¥12.9 billion. Major items were a gain on step acquisition of Otori Holdings Co., Ltd., which became a consolidated subsidiary on October 1, amounting to ¥8.5 billion, and a gain on sales of shares of subsidiaries and affiliates of ¥3.6 billion due to the partial sale of SPC stake in a project at Punggol in Singapore. In FY2019, we unwound stakes in 13 companies and recorded a gain on sales of investments in securities of ¥0.7 billion. Extraordinary loss came to ¥15.4 billion. This consisted of impairment losses of ¥13.5 billion, including an impairment loss of ¥11.1 billion because the ADR (average daily rate) of a hotel in Heping District, Shenyang, China was lower than anticipated, a loss on sales or disposal of fixed assets of ¥1.4 billion, and a loss on sales of investments in securities of ¥0.4 billion as a result of the unwinding of cross-shareholdings.

Profit attributable to owners of parent rose 9.9%, to ¥141.2 billion, and was ¥2.2 billion up on the full-year plan. EPS was ¥205.79. We paid a dividend of ¥81 and the dividend payout ratio was ¥39.4%, increasing for an eighth consecutive year. ROE was 11.6%.

Orders received amounted to ¥2,480.0 billion, a rise of ¥302.5 billion. The Built-to-Order and Development Businesses saw declines, while the Supplied Housing and Overseas Businesses registered growth. Orders received include orders received for the October-December quarter of Otori Holdings Co., Ltd. amounting to ¥61.3 billion. The order backlog expanded by ¥412.6 billion, to ¥1,408.4 billion. The order backlog in the Overseas Business doubled, reaching ¥222.3 billion, and the order backlog of Otori Holdings Co., Ltd. was ¥330.8 billion.

[Sheet 2] Financial position

Total assets grew ¥221.7 billion, to ¥2,634.7 billion. This was mainly due to an increase of ¥229.4 billion in the assets of Otori Holdings Co., Ltd. Real estate for sale decreased ¥100.5 billion due to a rise in property sales. Cash and deposits rose ¥241.2 billion due to improvement in cash flow.

Interest-bearing debts fell ¥52.6 billion, and the D/E ratio dropped 7.7p, to 46.4%. Net debt, excluding cash and deposits, improved ¥293.8 billion, and improvement in the financial position progressed steadily. The equity ratio was 48.1%, down 0.9p.

Looking at cash flows, cash provided by operating activities improved ¥238.6 billion, reflecting progress in the sale of properties in the Urban Redevelopment and Overseas segments. Cash used for investing activities improved ¥4.9 billion. The free cash flow status improved by ¥243.6 billion. Cash flow used in financing activities was ¥148.1 billion, mainly reflecting reduction of interest-bearing debt, dividends paid, the acquisition of treasury stock, and the acquisition of treasury stock of Otori Holdings, Co., Ltd. Cash and deposits rose sharply, including that of Otori Holdings, Co., Ltd.

In capital expenditures, investment in real estate for lease amounted to ¥60.1 billion, and depreciation and amortization came to ¥21.5 billion. In FY2020, we plan to make investment in real estate for lease of ¥75.0 billion as part of capital expenditure of ¥90.0 billion, and project depreciation and amortization of ¥22.0 billion.

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

The Custom Detached Houses Business posted gains in sales and profit. Both the gross margin and the OP margin were unchanged. Although retirement benefit expenses had the effect of pushing the gross margin and the OP margin down by 0.6p and 0.9p respectively, this impact was offset by the effect of higher volume, firmer establishment of the brand, and cost reductions. The OP margin absorbed the increased allocation of SG&A expenses associated with decreased sales of rental housing. Orders received fell by 10.5%. Averare selling price per building, the ratio of Green First Zero houses, and the ratio of 3- and 4-story houses climbed steadily.

The Rental Housing Business recorded declines in sales and profit. The gross margin fell 0.4p, and the OP margin was down 0.2p. Retirement benefit expenses had an effect of 0.6p on the gross margin and 0.9p on the OP margin, which could not be offset because sales fell short of the full-year plan. Orders received climbed 2.5%. Averare selling per building and the ratio of 3- and 4-story houses rose. Orders receiving for non-housing projects amounted to around ¥90.0 billion.

[Sheet 3] Segment information (Supplied Housing Business)

The Remodeling Business recorded gains in sales and profit. Both the gross margin and the OP margin improved. Orders received grew 0.9%. Major remodeling projects worth more than ¥5 million such as proposal-based remodeling and environmental remodeling accounted for a share of more than 30%.

The Real Estate Management Fees Business achieved gains in sales and profit. Both the gross margin and the OP margin remained flat. The number of units under management increased by 20 thousand units from the end of the previous fiscal year, to 639 thousand units, and the occupancy rate remained high at 97.7%.

[Sheet 4] Segment information (Development Business)

The Houses for Sale Business recorded declines in sales and profit. Both the gross margin and the OP margin improved.

The Condominiums segment posted increases in sales and profit, Net sales topped the ¥100 million mark for the first time. Both the gross margin and the OP margin improved. Orders received declined 14.2% due to a decrease in the number of construction projects for completion next fiscal year. Completed inventory fell 108 units from the end of the previous fiscal year, to 78 units.

The Urban Redevelopment Business registered declines in sales and profit. Due to lower profit margins on sold properties, the gross margin and the OP margin each fell around 10p. Net sales from property sales amounted to ¥88.8 billion, while profit came to ¥11.3 billion. This included sales of properties such as Akasaka Garden City, Hommachi Minami Garden City and Garden City Shinagawa Gotenyama amounting to just over ¥70.0 billion to Sekisui House Reit, Inc.

[Sheet 4] Segment information (Overseas Business)

The Overseas Business recorded sharp increases in sales and profit. Both the gross margin and the OP margin improved. We recorded a valuation loss of ¥8.3 billion to address the risk of future losses. Orders received expanded 110.9%, to ¥500.8 billion. The order backlog increased ¥111.0 billion, to ¥222.3 billion. The investment balance declined ¥80.7 billion, to ¥749.0 billion. Thanks to the significant improvement in our financial position, we plan to make investment for the future growth under the Fifth Mid-term Management Plan.

In Australia, both sales and profit fell. The 0.25% cut in the official interest rate, the easing of lending rules, subsidies and other policy measures, as well as an end to the bush fires may bring about a recovery trend in the housing market. We recorded a valuation loss of ¥3.3 billion to guard against the risk of future losses in complex development in Queensland. Orders received rose ¥5.2 billion, to ¥29.1 billion, and the investment balance increased ¥3.9 billion year on year. In FY2020, net sales are projected to grow ¥19.9 billion, to ¥43.4 billion, and operating income is projected to climb ¥5.7 billion, to ¥3.5 billion.

In China, both sales and profit increased. Progress was good, with contracts concluded for 3,141 units in FY2019 compared to 948 units in FY2018. Sales center activities and construction were suspended due to the Covid-19 outbreak but the number of new cases in the Suzhou, Taicang, Wuxi and Shenyang areas has remained at zero recently and infections in these areas appear to have peaked. Of net sales of ¥57.1 billion, around 70% were properties in the Suzhou (East / West).　Orders received amounted to ¥135.8 billion, an increase of ¥86.2 billion. Properties in the east and west of Suzhou account for around just over 50% of this and TaicangⅡ for around just over 30%. The investment balance declined ¥48.8 billion from the end of the previous fiscal year, to ¥116.8 billion. We recorded a valuation loss of ¥2.1 billion for commercial facilities in a project in Wuxi and an impairment loss of ¥11.1 billion for a hotel in Heping District, Shenyang. In FY2020, we plan net sales of ¥81.0 billion, up ¥23.9 billion, and operating income of ¥12.0 billion, up ¥8.4 billion.

In the United States, both sales and profit increased. The impact of the trade tension between the United States and China was limited, and against the backdrop of a robust economy, falling interest rates and strong demand for rental housing, the multifamily, community development and homebuilding businesses all performed well. We recorded a valuation loss of ¥2.1 billion mainly for a condominium in the suburbs of Washington DC. Orders received increased ¥171.7 billion, to ¥335.7 billion. The investment balance was down ¥34.4 billion from the end of the previous fiscal year. In the multifamily business, net sales were ¥148.1 billion, operating income was ¥29.4 billion, orders received were ¥164.0 billion and the investment balance was ¥199.0 billion. We sold a total of seven properties: three properties in Los Angeles, two properties in Seattle, one property in Denver and one property in San Pedro. In the community development segment, net sales were ¥59.2 billion, operating income was ¥8.4 billion, orders received were ¥64.7 billion and the investment balance was ¥135.2 billion. In the homebuilding business, net sales were ¥99.6 billion, operating income was ¥5.9 billion, orders received were ¥105.7 billion, and the investment balance was ¥103.0 billion. The plan for FY2020 is net sales of ¥285.6 billion, down ¥23.5 billion, and operating income of ¥38.1 billion, down ¥12.6 billion. In the multifamily business, we expect property sales for five projects.

In Singapore, equity in earnings of affiliates was ¥3.0 billion, while the investment balance shrank ¥4.9 billion, to ¥43.8 billion. The housing business is firm, but we are cautious about investment given the slowdown in GDP growth. In FY2020, we project equity in earnings of affiliates of ¥2.5 billion. The investment balance in the United Kingdom is ¥3.4 billion but there is huge growth potential.

[Sheet 5] Full−Year Forecasts

Net sales will amount to ¥2,585.0 billion, up 7%. Operating income will show a slight increase, affected by increased retirement benefit expenses (up around ¥8.0 billion year on year). The OP margin is expected to drop 0.5p, to 8.0%.

In the Custom Detached Houses Business, assuming the level of orders received in FY2019, we project net sales of

¥346.0 billion, down 11.5%, and operating income of ¥27.5 billion, down ¥18.4 billion. The OP margin will fall 3.9p but the base gross margin will continue to improve. We will ensure the benefits of volume and translate this into improvement in profit margins. The Rental Housing Business will consist solely of ShaMaison and non-residential properties using materials shipped from our factories, with revenue from reinforced concrete (RC) constructions reclassified into the new Architectural and Civil Engineering segment, and net sales will amount to ¥380.0 billion (around ¥430.0 billion based on the existing segments). Operating income is expected to be ¥50.0 billion. The new Architectural and Civil Engineering segment is projected to post net sales of ¥325.0 billion and operating income of ¥16.5 billion. In the Built-to-Order Business overall, we forecast an increase of 20.5% in net sales, a decrease of ¥5.3 billion in operating income, and an OP margin of 8.9%. In the Supplied Housing Business, we forecast net sale of ¥719.0 billion, up 4.6%, and operating income of ¥71.0 billion, rising ¥6.4 billion. In the Development Business, we forecast net sales of ¥330.0 billion, down 14.8%, and operating income of ¥39.0 billion. Our Overseas Business forecasts are net sales of ¥410.0 billion, climbing 5.2%, and operating income of ¥46.0 billion, an increase of ¥1.4 billion.

Ordinary income will be ¥205.0 billion, with equity in the earnings of affiliates such as Otori Holdings Co., Ltd. falling around ¥8.0 billion. Extraordinary income will feature a gain on sales of investments in securities of ¥5.0 billion due to the continued unwinding of cross-shareholdings. Extraordinary loss will include a loss on the disposal of fixed assets of ¥2.0 billion. Profit attributable to owners of parent is expected to fall ¥4.2 billion, to ¥137.0 billion. Our EPS forecast is ¥202.52. ROE will be 10.6%. Dividend per share will be ¥86, consisting of a commemorative dividend of ¥5 to mark our 60th anniversary on August 1 this year and a dividend of ¥81. This represents an increase of ¥5. Our dividend payout ratio will be 42.5%. We announced today that we plan to acquire 7 million shares (¥15.0 billion) of treasury stock as well as cancelling 6 million shares of treasury stock acquired under the previous mid-term management plan.

Under the Fifth Mid-term Management Plan, we aim to maintain operating income of at least 200.0 billion and an ROE of 10%, and will strive to improve our financial position to allow us to make growth investments and respond flexibly even during phases of real estate market decline, making appropriate investments and laying the foundations for sustainable growth. We will also aim to be a leading company in ESG management, stepping up initiatives and making further improvements and also strengthening shareholder returns through continuous dividend increases and flexible treasury stock acquisitions.

< Summary of Question and Answer Session >

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

Question

- **Regarding your plan for improvement in orders received in the Custom Detached Houses Business, when will the upturn occur and what will trigger it?**
- **What is your stance on future investment in the Overseas Business?**
- **Give a breakdown of your current fiscal year plan for business in the United States?**

Answer

- Orders received for the month of February announced today dropped 3% year on year. The previous year, orders grew continuously through April, with February up 18%. The announced drop of 3% indicates an upward trend compared to the year before last. We do not expect a full-fledged recovery until the Covid-19 outbreak comes to an end, but we believe that monthly orders received will soon start to show year-on-year growth.
- In terms of investing in growth, we will concentrate on the rental housing development (multifamily) business in the United States and the global rollout of Sekisui House homes. In China, we have yet to conclude contracts for some 1,000 homes and the investment balance will continue to decline. In Australia, the investment balance may increase due to current large-scale projects such as Melrose Park, but investment will not be on the same scale as our investment in the United States.
- In the multifamily business, we project net sales of ¥120.5 billion and operating income of ¥18.5 billion. Community development will account of net sales of ¥55.0 billion and operating income of ¥6.9 billion. Homebuilding business will generate net sales of ¥110.1 billion and operating income of ¥5.9 billion.

Question

- **How will Covid-19 impact on the Custom Detached Houses Business in Japan?**
- **What is the projected decline in operating income in the Custom Detached Houses Business? What is your future strategy?**

Answer

- Construction has been affected by supply interruptions for certain kitchen and bathroom parts but we do not expect the outbreak to have a significant impact on the full-year plan. Regarding orders received, footfall may decline in the future, but the number of visitors to the exhibition in February increased by 4%. Assuming that the outbreak comes to an end soon, we do not expect orders received to be affected so seriously.
- In the Custom Detached Houses Business, we project a 40% decline in operating income, reflecting the negative impact of a ¥45.0 billion drop in net sales. Under the Fifth Mid-term Management Plan, we will seek recovery

through the promotion of high-end houses and increased sales of affordable homes for first-time buyers upward of ¥20 million by new company SEKISUI HOUSE noie.

Question

- **Why did operating income in the Real Estate Management Fees Business fall ¥3.5 billion short of the full-year plan?**
- **Your current fiscal year plan for the Rental Housing Business seems conservative given the level of order backlog. What is the profit margin for RC?**
- **What is the forecast for the D/E ratio at the end of the current fiscal year?**

Answer

- Operating income fell short of the plan because decreased sales of ShaMaison rental housing meant that growth in leased units was less than expected and because we failed to absorb the rise in SG&A expenses associated with increased personnel for future growth. In 2020, the Real Estate Management Fees Business will return to the growth path, bolstered by sales volume.
- Starting from the current fiscal year, general RC construction, which was previously included in the Rental Housing segment, was reclassified into the new Architectural and Civil Engineering segment. Consequently, although the FY2020 plan makes it look as though sales of rental housing are not growing much, this plan plus ¥50 billion in RC sales would be the result under the previous segment classification. Rental housing (ShaMaison rental housing and other construction using materials shipped from our factories) included in the new segment will post sales growth of around ¥20 billion. However, we will not be able to absorb the increase in retirement benefit expenses (up by a total of ¥8.0 billion year on year) and operating income will remain flat. From FY2021, the previous year's rise in retirement benefit expenses will also be eliminated and we, therefore, believe that operating income is likely to recover over the coming years.

  The Architectural and Civil Engineering segment, including RC, is pushing down the overall OP margin, and under the Fifth Mid-term Management Plan, improvement of this segment's profit margins through synergy with Konoike Construction will be crucial.
- The D/E ratio is expected to remain mostly unchanged from 0.46 at the end of the previous fiscal year. Our financial position is improving, and we plan to actively make investments.

Question

- **Regarding your projection of 4.6% growth in orders received in the Rental Housing Business, which segment will grow -ShaMaison or non-residential properties?**

  Will accommodation facilities associated with Michi-no-Eki projects and other projects be classified into the Rental Housing segment or the Architectural and Civil Engineering segment?
- **Give details of the ¥60.1 billion investment in real estate for lease.**

Answer

- The growth in orders received is due to an increase in ShaMaison rental housing using materials shipped from our factories. Properties such as accommodation facilities using materials shipped from our factories will be classified into the Rental Housing segment. Properties with specifications for colder regions such as Hokkaido and high-rise properties with five or more stories will be classified into the Architectural and Civil Engineering segment because they will be RC.
- Real estate for lease used to be mainly offices but this has changed recently and, in FY2019, around half was hotels, residential property accounted for the second largest share, followed by offices in third.

Question

- **Give details of governance of Otori Holdings. Describe systems for the careful examination of the details of orders received, management of profitability and checks to prevent increased provision for loss on construction contracts.**

Answer

- Since we acquired a one-third stake around three years ago, we have been promoting collaboration with Otori Holdings through the establishment of a subcommittee to create synergy among administrative and sales divisions. We have also dispatched our own personnel to Otori Holdings and put effort into J-SOX compliance, and we have made considerable checks in relation to governance. We will work to further promote governance to ensure that governance at Otori Holdings is on a par with our own.

Question

- **Regarding the recording of valuation losses associated with business in the United States, you should have perhaps dealt with this sooner. What system of checks do you have in place?**

Answer

- Personnel who is an expert in real estate development is currently in charge of business in the United States. We re-evaluated the condominium business in the suburbs of Washington DC previously but, judging these latest additional steps necessary, we decided to record a valuation loss. We have made considerable progress in regard to governance-related checks compared with before and are also implementing a fairly effective PDCA cycle in relation to the profit structure and at the present time, we do not anticipate any further valuation losses under the Fifth Mid-term Management Plan.