Sekisui House, Ltd.

Transcript for Earnings Results Briefing for the First Quarter of FY2018 (Telephone Conference)

Date: June 8th, 2018, Friday 17:00 – 18:00 JPT

Participants: Shiro Inagaki, Representative Director and Vice Chairman

Atsushi Yoshida, Chief Manager of Investor Relations Department

< Presentation >

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

[Sheet 1] Overview

Net sales rose to a new record high in the first quarter. Operating income declined ¥2.4 billion, mainly due to a fall in the Built - to - Order and Overseas Businesses. The amount of goodwill of Woodside Homes was determined in the third quarter of the previous fiscal year, and the figures for the first quarter of the previous fiscal year have been revised. (Operating income, ordinary income, and profit were deducted by ¥0.3 billion, ¥0.2 billion, and ¥0.1 billion, respectively.)

Sales in the Built-to-Order Business decreased in both the Custom Detached Houses and Rental Housing segments due to weak orders since last year. In the Supplied Housing Business, the Real Estate Management Fees segment achieved steady growth. In the Remodeling segment, while growth was small, orders received gradually increased. In the Development Business, while sales in the Houses for Sale segment decreased, both the Condominiums and Urban Redevelopment segments achieved substantial sales growth. In the Overseas Business, sales declined due to the absence of sales from large condominiums in Australia. In China, sales decreased slightly amid the ongoing restrictions on real estate purchases, despite progress in the handovers of condominiums in Taicang. In the United States, sales increased significantly thanks to Woodside Homes and master-planned community business.

As part of gross profit, the profitability of the Built-to-Order Business fell 1.1p year-on-year. The ratio of expenses at construction sites rose as a result of a decline in sales. The production profit margin decreased, partly due to the higher cost of raw materials despite progress with cost reductions. The profitability of the Supplied Housing Business increased 0.6p. The profitability of the Remodeling segment improved through cost reductions, and that of the Real Estate Management Fees segment rose thanks to a high occupancy rate. While the profitability of the Development Business dropped 0.7p, profit increased by ¥3.5 billion as a result of sales growth. Both sales and profit decreased in the Houses for Sale segment, and both sales and profit increased in the Condominiums and Urban Redevelopment segments. The profitability of the Overseas Business fell 2.3p to become 19%.

Of the ¥3.4 billion in general and administrative expenses, the increase incurred in the Overseas Business was ¥1.6 billion, and that in the domestic businesses was ¥1.8 billion. This increase was caused primarily by labor expenses.

In operating income, a fall in the profitability of the Built-to-Order Business was caused by the same factors as the decline in gross margin. The growth of the Supplied Housing Business was attributable to the increased profitability of the Remodeling segment, a larger number of units under management, and a high occupancy rate. The profitability of the Development Business rose 0.1p. In May, during the second quarter, rental condominium units and other properties were sold to Sekisui House Reit for ¥25.3 billion. The Overseas Business suffered a deficit in its Australian and Chinese segments due to a fall in sales and reduced profit in the US segment despite growth in sales, which resulted in an overall deficit of ¥0.2 billion.

Non-operating income was ¥1.0 billion. Of the ¥1.7 billion in equity in earnings of affiliates, profit earned in Singapore was approximately ¥1.0 billion. Interest on loans increased by ¥0.4 billion.

[Sheet 2] Financial position

Of current assets, real estate for sale in Japan grew ¥12.9 billion from the end of the previous fiscal year, to ¥378.0 billion. Real estate for sale in the Overseas Business decreased to ¥701.7 billion after a decline of ¥39.0 billion owing to foreign exchange and an overall fall of ¥11.2 billion. Cash and deposits decreased, which is characteristic of first quarters, by ¥147.8 billion. Of capital expenditure, investment in rental real estate amounted to ¥11.3 billion.

Liabilities decreased ¥110.5 billion from the end of the previous fiscal year. The increase in interest-bearing debt and the D/E ratio was caused by seasonal factors in the first quarter. D/E ration decreased 8.1p from 61.8% as of the end of the same period of the previous year, and the reduction has generally been in line with the plan.

Net assets declined ¥34.7 billion from the end of the previous fiscal year. Translation adjustment fell ¥23.9 billion due to the appreciation of the yen. The equity ratio rose 1.7% as a result of a decrease in total assets.

As for cash flow, that from operating activities declined due to a decrease in notes and accounts payable despite a year-on-year reduction of growth in inventories. Cash flow from investing activities increased ¥35.3 billion in the first quarter of the fiscal year under review, for the payment for the acquisition of Woodside Homes recorded in the previous fiscal year. As a result, free cash flow rose ¥8.9 billion year-on-year.

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

The gross margin of the Custom Detached Houses segment declined 1.0p, to 24.2%, due to a fall in sales despite progress in cost reductions and high value-added development. Visitors to display home sites have been increasing and the ZEH subsidy commenced in May 2018. The Company will focus on acquiring orders for detached houses by taking advantage of the corporate reorganization implemented on April 1. From the beginning of the fiscal year under review, the Company expected that the difficulties suffered at the end of last year would remain in the first half of the fiscal year under review. It aims to achieve the full-year targets by acquiring more orders from now on. Both the Green First ZERO ratio and the three- and four-story housing ratio rose year-on-year. The ASP per building also increased substantially as a result of the high weight of high-priced products such as ZEH products.

The gross margin of the Rental Housing segment declined 1.2p for the same reason as the fall in the gross margin of the Custom Detached Houses segment. The decrease in orders received was caused by discouragement received by the Company's customers, primarily through news and reports for anxiety in occupancy of properties in regional areas not targeted by the Company and changes in the lending attitudes of local banks. Meanwhile, the Company is focusing on acquiring orders for nurseries, hotels and other non-residential properties. The three- and four-story housing ratio rose 5.8p from the first quarter of the previous fiscal year, to 68.9%. Consequently, the ASP per building grew significantly, just as in the Custom Detached Houses segment.

[Sheet 3] Segment information (Supplied Housing Business)

The Remodeling segment achieved growth both in sales and profit. Its profitability also increased. Orders received increased in the proposal-based remodeling provided by the Sekisui House Remodeling companies, remodeling for Sha-Maison rental apartment units provided by the Sekiwa Real Estate companies, and general remodeling provided by the Sekiwa Construction companies.

Both sales and profit grew in the Real Estate Management Fees segment. The Company changed the method of calculating the occupancy rate from one that considered whether rooms were occupied at the end of a month to one that included the occupancy if rent was received during the month. Occupancy was 97.4%, or an increase of 0.5p, even based on the conventional method, and high occupancy rates have been maintained. The segment has been growing steadily based on an increase in the number of units under management, growth in rent revenue attributable to a rise in three- and four-story housing units, area marketing, and product differentiation, and by maintaining a high occupancy rate backed by Sha-Maison remodeling.

[Sheet 4] Segment information (Development Business)

In the Houses for Sale segment, highly profitable properties decreased from the first quarter of the previous fiscal year. The Company is currently focusing on purchasing high-quality housing land. The balance of land for sale at the end of the first quarter increased slightly less than ¥10.0 billion from the end of the previous fiscal year.

In the Condominiums segment, the handover of Grande Maison Misonoza Tower contributed to sales and profit. The completed property inventory at the end of the first quarter was 98 units, the first phase of Grande Maison Ekoda No Mori. The Company expects that the sales situation will improve as the entire block of Ekoda No Mori will begin to be built in the fall of this year. The accumulated orders at the end of January was ¥121.7 billion, which is equivalent to approximately 1.5 times the full-year sales plan, suggesting considerable progress in sales.

The Urban Redevelopment segment attained growth in both sales and profit. Net sales of ¥4.6 billion and operating income of ¥1.4 billion resulted from property sales. Rental condominium buildings were sold to Sekisui House Reit for ¥25.3 billion in May 2018.

[Sheet 4] Segment information (Overseas Business)

Sales in the Australian segment declined substantially due to a lack of large condominium units during the first quarter of the fiscal year under review despite the contribution of sales from Central Park in the first quarter of the previous fiscal year. Orders received were also limited to the sale of The Hermitage, etc. (detached houses and housing land) due to a lack of large properties to sell in the first quarter of the fiscal year under review. Orders received fell approximately ¥3.0 billion due to the appreciation of the yen, and the value of orders received was, in essence, approximately ¥4.5 billion.

In China, approximately 70% of sales were derived from the Taicang project and the rest included Suzhou, Wuxi, and Shenyang. Because the Taicang project is almost sold out, approximately 60% of orders received were for Suzhou. Operating income decreased. This was caused by the fact that income was unable to absorb selling expenses and that the occupancy rate of a hotel that had opened in the Heping District of Shenyang at the end of last year was low at 10% to 20% due to the winter season, which coincided with the first quarter of the fiscal year under review. The hotel suffered a deficit of ¥0.4 billion (of which ¥0.3 billion was depreciation expenses). The occupancy rate has now risen to approximately 40%. While regulations on real estate purchases in China continue, orders received began to increase in April.

In the United States, operating income for the first quarter of the previous fiscal year was revised to ¥1.2 billion after the amount of goodwill of Woodside Homes was determined. Net sales can be broken down into ¥19.8 billion in Woodside Homes and approximately ¥7.3 billion in master-planned community development. Non-consolidated operating income from Woodside Homes has been growing steadily. Meanwhile, sales in master-planned community business decreased by 0.2 billion due to low sales of highly profitable properties. Orders received can be broken down to approximately ¥29.0 billion in Woodside Homes and approximately ¥11.0 billion in master-planned community development. A significant decline in orders received was caused by the addition of ¥29.9 billion in backlog to the orders received in the first quarter of the previous fiscal year since Woodside Homes was acquired in the first quarter of the previous fiscal year.

[Sheet 5] Full−Year Forecasts

While the Built-to-Order Business incurred a decrease in both sales and profit in the first quarter, difficulty receiving orders for both detached and rental houses in the first half of the fiscal year under review is within the range of the Company's expectation. The Company aims for recovery based on the current backlog and orders to be received in the rest of the fiscal year. The Company expects that the Overseas Business will be fully capable of achieving the full-year plan with the concentration of business in the fourth quarter. The Supplied Housing Business and the Development Business are maintaining performance above expectations. There is no change in the full-year plan at present.

< Summary of Question and Answer Session >

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

Question

- **Was the deterioration in the profitability of the Built-to-Order Business affected by rises in costs of materials, costs of labor and sales expenses or other factors, in addition to the increased burden of expenses at construction sites caused by the lower volume effect?**
- **Regarding the U.S. operations, what is the outlook for progress toward the full-year plan, including the multifamily business and the interest rate environment?**

Answer

- The gross margin of the Custom Detached Houses segment decreased by 1.0p, of which 0.6p was expenses at construction sites and 0.3p was production costs in factories. Expenses at construction sites increased by approximately ¥0.1 billion. Production costs rose slightly less than ¥0.3billion, due in part to rises in materials costs. The decrease of 1.2p in the gross margin of the Rental Housing segment was due to rises of 0.6p in expenses at construction sites, 0.3p in production costs in factories and 0.3p in other factors.
- In the multifamily business in the U.S. operations, there are no specific negative factors, as rents are on a rising trend and there are no changes in occupancy rates or capitalization rates. Occupancy rates in the properties in Los Angeles and other locations are rising positively, and there is no concern that the multifamily business will have an adverse impact on profits on a full-year basis. Although we will need to keep a close eye on interest rate behavior and other factors in the future, there are no market prospects for a rapid rise in interest rates and the associated surge in capitalization rates.

Question

- **Under the new management structure that was approved on April 26, 2018, how should we see the future roadmap in terms of the situations in the U.S. and China, selection and concentration and other aspects of real estate development, or the bolstering of the domestic businesses and so forth?**

Answer

- On April 1, 2018, we restructured the sales system. All the branch offices that were also selling custom detached houses and branch offices and so forth under local sales headquarters were consolidated and integrated, and the East Japan Building Sales Administration Headquarters and the West Japan Building Sales Administration Headquarters were created for the purpose of strengthening our expertise in handling Sha-Maison rental houses nationwide. In the detached housing business, we will promote sales of custom detached houses, the original forte of Sekisui House, Ltd. Orders in May for Custom Detached Housing Segment remained unchanged on a monthly basis, which seems to represent the fact that our efforts are gradually producing favorable results.

- Common to the Development Business and the Overseas Business is how to improve cash flows and raise investment returns. Multifaceted examinations of investment projects have been progressing as a result of the newly established management meetings, and we will promote the Development Business and the Overseas Business with a focus on improving returns. In the meantime, our keyword "Growth" is basically unchanged, and the four mainstays will be "growth," "efficiency," "solid financial foundation" and "ESG (environment, society and governance)."

Question

- **Future prospects for orders for custom detached houses.**
- **In Australia, there is a movement toward more stringent regulations on real estate acquisition. Are there any impacts on the business?**
- **More detailed descriptions of the progress of the business in the China market, in which you mentioned that there was a signs of recovery.**

Answer

- We expect that orders for Custom Detached Houses will begin to increase in June and thereafter, having leveled off in May. Although orders for Rental Housing still remain weak, non-residential areas that use factory shipped materials represent strong potential growth. We are not pessimistic about achieving the full-year plan.
- In Australia, real estate prices are rising, particularly in Sydney and Melbourne. The factors behind this situation include purchases by Chinese, and regulations on real estate acquisition have become more stringent. Stamp duty on the acquisition of real estate by non-residents has risen, and regulations on housing loans have been strengthened. As a result, the overall market has decelerated somewhat. Under these circumstances, sales of properties in the suburbs of Sydney have been strong. As the Sekisui House brand is already well established and has differentiated itself from other brands, we will endeavor to minimize the effects of market conditions.
- In China, the Chinese government has attempted to lower real estate prices by granting approval for contracts to local contractors whose contract prices are lower. Recently, however, the number of approvals for contracts for high-end properties offered by Sekisui House has been increasing with its growing reputation.

Question

- **Will gross margins for custom detached houses and rental housing start to recover in the latter half of the fiscal year?**

- **Regarding the state of interest-bearing debts or capital investment, is there any change? Is there any change in the D/E ratio forecast?**

Answer

- We have anticipated slower orders in the first half of the current fiscal year, and the recovery of profit margins will likely occur in the 3rd quarter and thereafter due to the significant volume effect.
- We have planned annual capital expenditures of ¥60.0 billion, and the capital investment in real estate for rent of slightly above ¥11.0 billion in the first quarter is within the assumed range. We will bring interest-bearing debts close to our D/E ratio goal of 45%. However, interest-bearing debts will be reduced by achieving a balance between investment and returns, not by significantly decreasing investments. We have set a capital investment target of ¥1,700 billion in our Medium-Term Management Plan, and we will aim to keep it in that range.
- In relation to interest-bearing debts, although a shareholder return policy of share buyback will be resumed after interest-bearing debts and the D/E ratio are lowered, we will implement share buyback as opportunities permit. The reason behind this is that Japan's Corporate Governance Code has added impetus to the trend of ending cross-shareholding. When the company's stock will be released on the market in relation to terminating cross-shareholding, we will respond to it with the repurchase of such shares.

Question

- **The impact of foreign exchange rates on the Overseas Business.**

Answer

- The effects of the strong yen on orders were ¥3.0 billion in Australia, ¥0.2 billion in China and ¥4.6 billion in the U.S., totaling approximately ¥8.0 billion (the decrease in the accumulated order that was affected by foreign exchange rates was a negative factor for orders). In the first quarter of the previous year, orders received by Woodside Homes amounted to ¥40.9 billion, which consisted of an accumulated order before the acquisition of the company of ¥29.9 billion and orders after the acquisition of ¥11.0 billion. Compared to ¥11.0 billion for orders in the first quarter of the previous fiscal year, which was received in the month of March when the company was acquired, orders for the 3 months of the first quarter of the current fiscal year came to ¥28.7 billion, which reflected an impact of more than ¥3.0 billion from foreign exchange rates. Accordingly, we believe that the orders received by Woodside Homes were almost on par with the level a year ago.

Question

- **The effects of ZEH subsidies in boosting orders.**

Answer

- The commencement of applications for ZEH subsidies in May has had a certain impact on us in terms of winning orders. Our ZEH ratio is very high, and we would like to continuously win orders by utilizing ZEH subsidies. Rises in ZEH ratios, not only for custom detached houses but also for Sha-Maison rental houses, would make a significant contribution to CO_2 reduction in Japan as a whole. We also think that it is important to use the subsidies for remodeling in the Supplied Housing Business.