SEKISUI HOUSE GROUP

Sekisui House, Ltd.

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

Date: September 6th, 2018, 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 decreased 0.7% year-on-year. In the Built-to-Order Business, both Detached House and Rental House segments saw declines in sales. In the Supplied Housing Business, sales increased in both the Remodeling and Real Estate Management Fees segments. The Development Business recorded increased sales, attributable to a rise in sales in the Condominiums segment which more than offset falls in sales in both the Houses for Sale and Urban Redevelopment segments. In the Overseas Business, although sales decreased, the business is progressing in line with the initial plan. In Australia, sales declined due to the absence of sales of large-scale condominiums. In China, sales were down amid the ongoing restrictions on real estate purchases, despite progress in the handovers of condominiums in Taicang. In the United States, sales climbed thanks to Woodside Homes and master-planned community business.

The gross margin has been recovering, thanks to an increase in sales compared to the first three months of the current fiscal year, despite a decline of 0.3p year-on-year. The profitability of the Built-to-Order Business fell 1.2p, of which approximately 1.0p was due to a rise in expenses at construction sites, including design and construction costs. The Supplied Housing and Development Businesses saw improvements in profitability of 0.8p and 0.5p, respectively. The profitability of the Overseas Business fell 0.6p due to a decline in sales.

Of the increase of ¥5.2 billion in general and administrative expenses, ¥2.6 billion was caused by a rise in labor expenses. The increase incurred in the Overseas Business was ¥2.1 billion, and that in the domestic businesses was ¥3.0 billion.

In operating income, the OP margin of the Built-to-Order Business declined 1.9p, caused by the lower gross margin and a rise of 0.7p in the general and administrative expense ratio. The OP margin of the Supplied

Housing Business improved by 0.7p, to 9.4%, and the OP margin of both the Remodeling and Real Estate Management Fees segments also advanced. The OP margin of the Development Business improved by 0.7p to 12.6%. Both sales and profit decreased in the Houses for Sale segment, while both sales and profit increased in the Condominiums segment. Sales declined but profit climbed in the Urban Redevelopment segment. In the Overseas Business, the operation in Australian and Chinese suffered deficits due to lower sales, while both sales and profit rose in the Unites States.

Non-operating income was ¥3.9 billion. Of the ¥4.3 billion in equity in earnings of affiliates, profit earned in Singapore was approximately ¥1.9 billion and that from Konoike Construction Company Ltd. was approximately ¥2.5 billion. Foreign exchange gains decreased ¥0.8 billion and interest on loans increased ¥0.9 billion. Extraordinary income or loss improved by ¥7.8 billion in the absence of an allowance for doubtful accounts and a loss on valuation of investment securities.

[Sheet 2] Financial position

Of current assets, real estate for sale in Japan grew ¥1.2 billion from the end of the previous fiscal year, to ¥363.9 billion. Real estate for sale in the Overseas Business increased ¥28.7 billion, to ¥741.7 billion. Cash and deposits decreased ¥92.7 billion. Of capital expenditure of ¥26.3 billion, investment in rental real estate amounted to ¥18.9 billion. The annual capital investment plan is expected to amount to approximately ¥70.0 billion compared to the initial estimate of ¥60.0 billion, due to additional investments, including Grand Front Osaka.

Interest-bearing debt increased ¥21.4 billion from the end of the previous fiscal year. The D/E ratio rose 1.7p, to 53.8%, and is estimated to fall to approximately 52% at the end of the current fiscal year, thanks to a significant increase in sales in the Overseas Business planned in the latter half of the current fiscal year. Net assets increased ¥1.3 billion from the end of the previous fiscal year. Translation adjustment fell ¥20.0 billion, associated with the appreciation of the yen. The equity capital ratio rose 1.3p, to 50.7%.

Looking at cash flow, that from operating activities declined ¥59.2 billion, due to an increase in real estate for sale and a decrease in notes and accounts payable. Cash flow from investing activities improved by ¥31.9 billion in the first six months of the fiscal year under review, due to the absence of the expense for the acquisition of Woodside Homes recorded in the previous fiscal year. As a result, free cash flow for the fiscal year under review is expected to be positive again, supported by the increase in sales in the Overseas Business in the latter half compared to the first half, despite a decrease of ¥27.3 billion year-on-year in the first six months.

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

The gross margin of the Custom Detached Houses segment declined 1.2p, of which approximately 1.1p was due to an increase in the portion of expenses at construction sites, including costs of Sekiwa Construction companies as well as design and construction costs. The OP margin declined 2.1p, reflecting a rise of 0.9p in

the general and administrative expense ratio. Sales are progressing in line with the initial plan. Orders received in the first six months of the fiscal year under review have been progressing better than the initial plan and are expected to exceed the level of the previous fiscal year in the latter half. Orders received in August 2018 increased 12% year-on-year, representing the positive effects of the corporate reorganization implemented on April 1, 2018. We maintain our initial forecast for operating income in this segment at ¥45.0 billion, considering overall cost reduction and cost savings at factories.

Sales in the Rental Housing segment decreased ¥6.5 billion, because of the longer preparation time before construction. This reflects factors such as an increase in the size of buildings as shown in the rise in the rate of three- and four-story housing units, development permit applications and measures for preventing disturbances to the neighborhood. The gross margin declined 1.2p on factors similar to those affecting the Detached Houses segment. Orders received decreased 11.4%, reflecting a fall in orders received in regional areas, despite strong orders in the three major metropolitan areas and the non-residential properties. We revised the annual forecasts for both sales and orders received in this segment due to a delay in progress compared to the initial plan. Orders received in August 2018 increased 6% year-on-year, backed by orders received in the three major metropolitan areas and non-residential properties.

[Sheet 3] Segment information (Supplied Housing Business)

The Remodeling segment achieved growth both in sales and profit, thanks to increases in proposal-based remodeling, which offers lifestyle ideas, and environment-based remodeling, such as energy-saving renovation for detached house owners. Both the gross margin and OP margin improved. No change to the initial plan.

The Real Estate Management Fees segment achieved growth in both sales and profit. Both gross margin and op margin improved. The occupancy rate remained a high level, at 97.6%, attributable to an increase in the number of units under management and differentiation through offerings of three- and four-story rental housing units. Both sales and profit remained solid and we made upward revisions to the initial plan.

[Sheet 4] Segment information (Development Business)

Sales in the Houses for Sale segment decreased ¥5.9 billion as reconstruction demand in Tohoku has run its course. The OP margin declined 2.5p, reflecting a rise in the general and administrative expense ratio. We have made downward revisions in the initial plan, in terms of sales, profit and orders received.

Sales increased significantly in the Condominiums segment. Although the gross margin declined 1.7p, reflecting properties with comparatively low profitability, OP margin improved by 0.9p, thanks to a fall of 2.6p in the general and administrative expense ratio. The completed property inventory at the end of the second quarter was 79 units, the first phase of Grande Maison Ekoda No Mori. The number of new visitors to the site is increasing with the town opening planned in the fall of 2018, and the Company strives to sell out the properties at an early stage. In response to the strong performance of the first six months, we have made upward revisions in the initial plan, in terms of sales, profit and orders received.

In the Urban Redevelopment segment, although sales decreased, gross margin and OP margin both

improved. Net sales of ¥35.4 billion and operating income of ¥6.7 billion resulted from property sales. As property sales and profit are progressing better than the initial plan, and taking the property sales plan in the latter half into account, we have made upward revisions in the initial plan, in terms of sales, profit and orders received.

[Sheet 4] Segment information (Overseas Business)

Sales for the Overseas Business segment declined, but progressed in line with plans, with property sales expected for the multifamily business in the fourth quarter of the current fiscal year. The OP margin fell 4.3p due to a rise in general and administrative expenses. The investment balance rose ¥39.1 billion from the end of the previous fiscal year, to ¥822.0 billion.

In Australia, condominiums sold in Central Park contributed to sales in the first half of the previous fiscal year. Sales and profits for Australia decreased substantially in the first half under review because sales during the period focused on detached houses for sale. The Company received no large condominium orders in Australia during the first half under review. In the second half, handovers are scheduled in West Village in Brisbane and Central Park in Sydney. The Company had forecast net sales of ¥45 billion and operating income of ¥5.4 billion on a full-year basis. However, the Company has revised its operating income forecast downward, incorporating the risk of a valuation loss that may arise in one project.

In China, projects in Taicang, Suzhou and Wuxi accounted for about three quarters of net sales. The investment balance decreased ¥11.8 billion from the end of the previous fiscal year, to ¥181.1 billion. An operating loss resulted from a sales decline and depreciation expenses for a hotel in the Heping District of Shenyang. Properties were almost sold out in the Taicang project. In the meantime, condominium contracts showed an uptrend in Suzhou and Wuxi. These developments kept orders received unchanged. The order level was slightly lower than the Company’s forecast on a full-year basis.

In the United States, both sales and profits climbed with contributions made by Woodside Homes. Orders received fell ¥0.5 billion, however. Their decline resulted from the inclusion of approximately ¥20 billion in Woodside Homes’ accumulated orders at the point of its acquisition in orders in the previous fiscal year. Woodside Homes accounted for about 70% of sales in the United States where no multifamily business property was sold during the first half under review. Non-consolidated operating income for Woodside Homes doubled. Woodside Homes and the community business contributed to orders received. Operating income is set to rise with contributions made by the multifamily business and Woodside Homes. However, there is a possibility that net sales will fall slightly below the Company’s forecast on a full-year basis.

In Singapore, the Company made a successful bid for a new development project. The investment balance increased ¥9.6 billion from the end of the previous fiscal year, to ¥41.6 billion.

[Sheet 5] Full-Year Forecasts

Operating income for the first half was within expectations. However, the Company revised its full-year forecasts, taking orders received, the progress of construction work and a possible valuation loss in Australia into consideration. The Company revised its net sales forecasts ¥31.0 billion downward for the Rental Housing segment, expecting the adverse effects of protracted preparation time before construction associated

with an increase in the size of Sha-Maison rental apartment units, ¥3.0 billion upward for the Real Estate Management Fees segment in view of favorable occupancy rates, ¥9.0 billion downward for the Houses for Sale segment, ¥3.0 billion upward for the Condominiums segment, ¥29.0 billion upward for the Urban Redevelopment segment to reflect an anticipated growth in property sales, ¥8.0 billion downward for the Overseas Business segment to incorporate a decrease in master-planned community development in the United States and the continuation of real estate sales restrictions in China, and ¥6.0 billion downward for the Other Businesses segment. As a result, net sales forecast for the current fiscal year decreased ¥19.0 billion from the Company's initial projection.

The Company also reduced its gross profit forecast by ¥15.0 billion with no change made to general and administrative expenses.

Looking at operating income, the Company revised forecasts ¥9.0 billion downward for the Rental Housing segment to reflect an anticipated sales decline, ¥1.0 billion upward for the Real Estate Management Fees segment, ¥2.5 billion downward for the Houses for Sale segment, ¥1.0 billion upward for the Condominiums segment, and ¥4.0 billion upward for the Urban Redevelopment segment. For the Overseas Business segment, the Company revised its operating income forecast ¥7.0 billion downward considering the valuation loss that may result from changes in a complex development plan for its project in Queensland, Australia, due to parliamentary disapproval. By country, the Company revised its operating income forecast for Australia downward by ¥7.0 billion, to a loss of ¥1.6 billion, while keeping its net sales forecast unchanged from the initial plan. For China, the Company revised forecast net sales ¥3.0 billion downward and projected operating income ¥0.8 billion downward. For the United States, the Company revised its net sales forecast ¥5.0 billion downward and operating income forecast ¥0.8 billion upward. There is no other property for which a heavy valuation loss may arise at this point. The operating income forecast reached about ¥43.0 billion against the ¥55.0 billion set as a target for the next fiscal year, which ends the Mid-Term Management Plan.

The Company revised its non-operating income forecast ¥1.0 billion downward, to ¥5.0 billion. Forecast annual dividends remained unchanged at ¥79 per share. At a meeting held today, the Board of Directors of the Company resolved to buy back 2 million shares. The Company plans to carry out the share buyback using funds raised from the sale of cross-held shares.

< Summary of Question and Answer Session >

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

Question

- **Orders received by the Built-to-Order Business. Orders received in August increased on a yearly basis in both the Custom Detached Houses and the Rental Housing segments. Will this trend continue in the future? Have last-minute demand before the tax hike been seen? In the Rental Housing segment, did the issues relating apartment loans have any impact on orders activities?**
- **An outlook for the profitability of the Built-to-Order Business after the next fiscal year.**

Answer

- We think that the trend for an improvement in orders received will continue given that our corporate reorganization on April 1 to enhance the expertise of sales capabilities has taken effect. Signs of last-minute demand before the consumption tax hike have not been observed as expected, mainly thanks to the fact that the rate of increase in consumption tax from 8% to 10% this time is smaller than the 5% to 8% seen last time, when there was significant last-minute demand followed by a reactionary decline, as well as government measures. Orders received for rental housing remains firm in the three major metropolitan areas and non-residential fields. In regional areas, orders received for rental housing are falling because Sekisui House is affected by the declining confidence of the wealthy associated with the guidance the Financial Services Agency has given regional banks to tighten loan standards for apartments, as well as the problem of falling occupancy rates due to the oversupply of apartments, even though these underlying factors are irrelevant to the Company. However, we are determined to bring back orders in the second half because we think that orders received for our differentiated products will remain firm in the three major metropolitan areas and we have been redeploying our staff to the three major metropolitan areas.
- The gross margin declined by 1.2p in both the Customer Detached Houses and the Rental Housing segments. The biggest factor was a rise in the ratio of expenses at construction sites, and there was no other major factor. We think that profit margins will improve if orders remain firm in the second half, and if the sales volume in the next fiscal year will return to the level of FY2017. In addition, we are also reducing expenses and costs in the production and construction departments, and we will work on the theme of improving profit margins in the Built-to-Order Business, our core business, in the next fiscal year, the final year of our Medium-Term Management Plan.

Question

- **Of orders for rental housing, what percentage consists of sales of rental housing for sale in which land and a building are sold in one set?**

- **What is your policy for selling cross-shareholdings? Is it correct to think that you will basically implement share buyback with the proceeds from selling cross-shareholdings?**

Answer

- Our customers in the Rental Housing segment are centered on wealthy landowners. On the top of that, orders received for company dormitories and company housing have also been increasing recently. We do not have specific numbers, but orders for rental housing for sale in which land and a building are sold in one set are also showing an upward trend on a year-on-year basis.
- With respect to cross-shareholdings, our policy is to reduce cross-shareholdings while determining the purpose and legitimacy of a cross-shareholding in accordance with the policy of reducing cross-shareholdings in Japan's Corporate Governance Code. As a basic policy, we would like to use the proceeds from selling cross-shareholdings for share buybacks, but we will do so after taking into account our financial situation and the D/E ratio at the time, among others.

Question

- **The background of the share buyback this time..**
- **The housing market is decelerating in the United States and Australia. What is your future outlook?**

Answer

- If a company that holds our shares as a cross-shareholding sells our shares, we will have the company sell them in the market, or we will respond with the repurchase of such shares. The share buyback this time is based on such a request. The reason why the scale is small is that the size of the cross-shareholdings to be sold is small, and we will basically repurchase our shares in the market.
- While it is reported that construction starts of custom detached houses are decelerating in the United States, it is a result of the labor shortage, and we do not see demand slowing significantly. Meanwhile, in Australia, regulations on real estate purchases are having an impact, and real estate prices have been falling in Queensland. In Sydney, the rise in real estate prices is also easing. However, the visibility of condominiums we supply is high, particularly in Sydney, and we think that we will be able to sell them with sufficient profit even if the market decelerates. Consequently, we are not too worried.

Question

- **For orders in the Built-to-Order Business, the possibility of achieving the plan for the second half.**
- **With respect to the policy of a 40% payout ratio, will you maintain current dividends or set the payout ratio at 40% automatically in the phase where your business performance declines temporarily?**

Answer

- In our plan for the second half, orders will increase 6.9% year-on-year to ¥180.5 billion in the Custom Detached Houses segment and decrease 1.0% year on year to ¥223.7 billion in the Rental Housing segment. In the Rental Housing segment, the decrease is expected to be smaller than the decline of 11.4% from the first half of the previous fiscal year in our plan. Orders in August increased on a yearly basis in both the Custom Detached Houses and the Rental Housing segments, and orders for rental housing have been revised to a level at which we were able to achieve the plan. We would like to build up accumulated orders in both the Custom Detached Houses and Rental Housing segments to take a clear view of earnings for the next fiscal year.
- Our policy on the payout ratio is not to reduce dividends quickly. We consider the payout ratio in a medium- to long-term range of three to five years, rather than a single fiscal year. Speaking of the relationship with share buybacks, which is another form of shareholder return, we do not have a policy of reducing dividends when we have increased share buybacks.

Question

- **Was the prolongation of preparation time before construction due to measures for preventing disturbances to the neighborhood in the Rental Housing segment, which was mentioned in your explanation, prompted by administrative guidance? Or are you taking the measures voluntarily for your relationship with customers?**
- **Are you going to move forward with the policy of terminating cross-shareholdings, placing no areas off-limits? What is the possibility that the total shareholder return ratio will return to the previous level of 60%?**

Answer

- Although it differs depending on local administrations, it takes time for large properties with a total floor area of more than 3,000 m² to go through the examination period for the building certification. We are advancing the construction of three- and four-story houses more carefully in consideration of the neighborhood
- We need to reduce cross-shareholdings that have deviated from our standards in terms of the purpose of holding, the yield for five years, capital cost and others, but we want to do this with some time to spare. While we have a desire to return the total shareholder return ratio to the previous level at some future time, current policy will be maintained over the next fiscal year, considering having credit ratings unchanged.

Question

- **Factors other than the completion of reconstruction demand in the Tohoku region for the downward revision in the Houses for Sale segment.**
- **It seems that the upward revision in the Urban Redevelopment segment is due to the sales of properties, but what were the specifics?**

Answer

- The major factors were the lack of progress in securing high-quality housing land, in addition to the completion of reconstruction demand. We would be delighted if we could record sales of about ¥150.0 billion in the Houses for Sale and the Condominiums segment combined. We will continue to focus on the purchase of high-quality housing land.
- In the first half, we sold rental condominium properties including Prime Maison condominiums to REIT. In the second half, there is no major property sales to REIT, and we plan to sell office buildings and land for office building to funds. For this reason, we have made the upward revision.