Sekisui House, Ltd.

Transcript for Earnings Results Briefing for the First Quarter of FY2019 (Telephone Conference)

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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

Record-high quarterly sales were achieved and orders received also fared well. In the Built-to-Order Business, sales overall increased ¥10.0 billion, attributable to the buoyant Custom Detached Houses segment, although sales declined in the Rental Housing segment due to a fall in orders received. In the Supplied Housing Business, sales grew steadily by 5.6%. The Remodeling segment was supported by successful proposal-based remodeling and environment-based remodeling. The Real Estate Management Fees segment achieved growth in sales, reflecting an increase in the number of units under management and stable, high levels of occupancy. In the Development Business, sales amounted to ¥71.0 billion, down by 10.1%. Sales increased in the Houses for Sale segment, while sales declined in the Condominiums segment and the Urban Redevelopment segment, reflecting a small number of properties for delivery. In the Overseas Business, sales grew by 16.5%, thanks to good progress made in the community development business and the homebuilding business by Woodside Homes in the United States as well as the delivery of condominiums in the city of Suzhou in China.

Gross profit increased ¥5.7 billion to ¥98.6 billion, and the gross margin improved 0.5p year-on-year to 20.7%. The gross margin for the Built-to-Order Business was almost on par with the level a year ago. The gross margin for the Supplied Housing Business improved 0.4p. The gross margin for the Development Business declined 1.0p. The gross margin for the Overseas Business improved 6.1p, to 25.1%.

General administrative expenses rose 4.4% to ¥64.5 billion, and The SG&A ratio rose 0.1p to 13.5%. Labor expenses increased ¥3.0 billion. Of the increase, ¥1.7 billion were due to the expenses related to retirement benefits.

Operating income grew 9.8% to ¥34.1 billion, and the OP margin improved 0.4p, to 7.2%. The OP margin for the Built-to-Order Business improved, attributable to the growth in overall sales, despite a rise in costs related to retirement benefit expenses. Operating income for the Supplied Housing Business increased ¥1.6 billion, to ¥16.0 billion, and the OP margin improved by 0.5p. The OP margin for both the Remodeling segment and the Real Estate Management Fees segment improved. Operating income for the Overseas Business diminished ¥2.2 billion, to ¥7.8 billion, and the OP margin fell 1.8p, to 11.0%. Operating income for both the Condominiums segment and the Urban Redevelopment segment decreased. Operating income for the Overseas Business returned to black, at ¥2.9 billion, representing an increase of ¥3.1 billion. Business in Australia posted an operating loss, while operations in China returned to the black, and profit increased in the business in the United States.

Non-operating income totaled ¥0.7 billion, decreasing ¥0.2 billion year-on-year. Of the equity in earnings of affiliates, profit from Otori Holdings (a holding company of Konoike Construction Co., Ltd.) was approximately ¥1.0 billion, increasing ¥0.1 billion year-on-year, and that earned in Singapore was approximately ¥0.4 billion, decreasing by ¥0.6 billion year-on-year.

With respect to the impact of currency fluctuations, foreign exchange gains increased ¥0.7 billion year-on-year, attributable to foreign exchange gains of ¥0.5 billion for the current first quarter. Interest expenses increased ¥0.5 billion, to ¥1.5 billion, reflecting the treatment of interest rates in our multifamily business in the United States. Interest rates were added to the cost of properties before the completion of property development and were recorded in the profit and loss statement after the completion. There was an increase in the number of rental housing properties after the completion so that interest expenses increased.

Both orders received and accumulated orders were at high levels, excluding those for the Development Business. The accumulated orders increased 11.9% from the end of the previous fiscal year, to ¥1,114.8 billion, mainly reflecting orders received in the Overseas Business and for the development of rental housing in Denver, USA.

[Sheet 2] Financial position

Of current assets, cash and deposits decreased ¥78.8 billion in accordance with payments of notes and accounts payable, income taxes and dividends in the current first quarter。 Real estate for sale amounted to ¥1,138.6 billion, increasing ¥39.5 billion in Japan and ¥19.6 billion overseas. Noncurrent assets declined ¥10.0 billion, of which property, plant and equipment decreased ¥14.6 billion. Capital expenditures increased ¥11.7 billion to ¥26.4 billion, of which investment in rental real estate were ¥24.0 billion.

Total liabilities declined ¥22.1 billion from the end of the previous fiscal year, mainly reflecting decreases in accounts payable and accrued income taxes. Interest-bearing debts increased ¥23.0 billion to ¥662.6 billion. The D/E ratio rose 1.8p, to 55.9%.

Net assets increased ¥3.1 billion from the end of the previous fiscal year. Profit attributable to owners of parent came to ¥23.6 billion, whereas the dividend payment amounted to ¥27.5 billion. Translation adjustments and net unrealized holding gain on securities increased ¥4.2 billion and ¥3.7 billion, respectively. Equity ratio rose 0.5p, to 49.5%.

Looking at cash flow, that from operating activities improved significantly, primarily attributable to a smaller increase in inventories and a large decrease in accounts payable. With respect to cash flow used in investing activities, investment in rental real estate increased. As a result, free cash flow improved by ¥62.0

billion. In the second quarter, it is expected to make a significant improvement, backed by sales of properties to Sekisui House Reit, Inc. and sales of rental housing properties developed in the multifamily business in the United States.

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

The Custom Detached Houses segment saw a significant a sales improvement thanks to the orders recovery since last year. The gross margin improved 0.3p. Operating income and the OP margin improved, reflecting an increase in sales volume which more than offset the rise in costs related to retirement benefit expenses. Orders received jumped by 16.3%. Although the last-minute demand ahead of the consumption tax hike and reactionary fall were insignificant, in the broader market as well, the decrease in orders received in May prevents optimism about the future outlook. The three-year extension of the tax deduction period for housing loan users and the expansion of the tax exemption on inter vivo gifts related to property acquisition, among other things, will likely to serve as a tail wind for the business. ASP per building improved ¥1.16 million to ¥39.91 million, and ratio of Green First Zero was 83%.

In the Rental Housing segment, both sales and profit declined due to the impact of falling orders in the first half of the previous year. The negative percentage point figures for the first quarter were getting smaller and we expect revenues to begin to rise in the second quarter, considering the ample accumulated orders. The gross margin deteriorated by 0.6p. The factors behind this included the rises in costs related to retirement benefit expenses and in the component ratio of lower-margin reinforced concrete buildings (RC), representing negative impacts of 0.5% and 0.5%, respectively. Amidst the trend of tightening of loans by financial institutions for rental property purchases, the environment for orders received remains mixed, with a slump in demand in rural areas and high-levels of needs and demand from the population concentrated in urban areas. With regard to non-residential properties, proposals for nursing care facilities, shops, etc. fared well. Last-minute demand ahead of the consumption tax hike was seen in March to a certain degree, while it is unlikely that reactionary decreases in orders received will persist over a long period. ASP per building rose ¥5.47 million to ¥105.66 million. Ratio of three- and four-story housing in value climbed to 72.9%.

In the Built-to-Order Business, there are accumulated inventories of orders both for the Custom Detached Houses segment and the Rental Housing segment, although orders received in June and thereafter will need to be closely monitored.

[Sheet 3] Segment information (Supplied Housing Business)

The Remodeling segment achieved growth both in sales and profit. Looking at the remodeling of detached houses, proposal-based remodeling and environment-based remodeling showed positive development, including the proposal of Idokoro Dan-netsu products based on the idea of partial insulation for targeted area and other thermal insulation remodeling proposals. The profitability of the business improved with no price competition.

The Real Estate Management Fees segment also achieved growth in both sales and profit. The number of units under management increased approximately 6,000 units compared to the end of the previous fiscal year, and the occupancy rate improved 0.4p, to 98.2%. The occupancy rate in excess of 98% shows the heightened popularity of Sha Maison and the effectiveness of the Company's area marketing. The Company will continue to work to maintain high levels of occupancy rates by providing quality services.

Stable income growth has been continued in the Supplied Housing Business.

[Sheet 4] Segment information (Development Business)

Both sales and profit increased in the Houses for Sale segment. On the other hand, orders received decreased ¥5.2 billion year-on-year. Although severe conditions persist, the Company will work to promote land acquisition continuously in the future.

Both sales and profit decreased in the Condominiums segment. OP margin improved 0.2p, to 14.4%. Orders received declined ¥7.7 billion, representing a reactionary decrease in the absence of the large properties delivered in the previous fiscal year. The progress of the business is in line with the full year plan, as the properties arranged for delivery in the second quarter and in the near future have been confirmed. The completed property inventory was 143 units, decreasing 43 units from the end of the previous fiscal year.

The Urban Redevelopment segment saw decreases in both sales and profit. ¥3.6 billion of sales were earned from property sales. Progress is being made as planned, as sales of properties to Sekisui House Reit, Inc. will take place in the second quarter.

Although the Development Business, as a whole, sustained declines in both sales and profit, progress is being made in line with the full year plan.

[Sheet 4] Segment information (Overseas Business)

Business in Australia posted an increase in sales and a decline in profit. It recorded an operating loss of ¥0.4 billion, due to fixed costs that could not be offset. This reflected severe housing market conditions against the backdrop of the government policy of restricting purchases by foreign investors which has been imposed since 2017 and the tightening of housing loans by financial institutions. Both orders received and the outstanding balance of investment increased year-on-year. The Company hopes to see some improvement in the real estate market in Australia.

Sales increased in China, and operating income rose ¥1.3 billion to return to profitability, at ¥0.9 billion. The condominiums in Suzhou which accounted for approximately 70% of the sales in China made a great contribution based on good performance. Sales of condominiums were also buoyant in Taicang, partly attributable to the reduced impact from the regulatory restrictions against real estate sale. The accumulated order increased ¥13.3 billion from the end of the previous fiscal year. Investment balance amounted to ¥162.3 billion, decreasing ¥3.3 billion from the end of the previous fiscal year.

Business in the United States posted increases both in sales and profit. Sales comprised ¥8.2 billion in the community development business and ¥18.9 billion in the homebuilding business. Operating income posted included ¥1.0 billion in the community development business and ¥0.7 billion in the homebuilding business. With regards to orders received, contracts for the transfer of a property in Denver were concluded in the multifamily business in the first quarter. The portion of the year-on-year increase in orders received mostly reflected property sales contracts in the multifamily business. At present, contracts for 6 projects have been executed, and some of the properties will be delivered in the second quarter. The investment balance increased

¥17.5 billion, mainly due to progress in rental housing construction in the multifamily business.

Equity in earnings of affiliates posted in Singapore decreased ¥0.6 billion, and investment balance of Singapore business totaled ¥49.5 billion.

The Overseas Business has made solid progress, excluding the business in Australia.

[Sheet 5] Full−Year Forecasts

There has been no change in the full-year forecasts. The Company got off to a good start toward achieving record sales and profit on a full fiscal year basis.

< 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 the future environment for orders, what is your understanding of reactions to last-minute demand ahead of the consumption tax hike, as monthly orders received had fared well until April but those in May declined by 11% for the Custom Detached Houses segment and 5% for the Rental Housing segment?**
- **Regarding the schedules for the sales of rental housing in the multifamily business in the United States, please tell us about the progress of contracts and time of delivery.**

Answer

- The reactionary declines in orders received in the Custom Detached Houses segment were insignificant. Monthly orders received fell in May, but there were many holidays in that month and we should closely monitor the movements in June and thereafter. The extension of the tax deduction period for housing loan users and the expansion of the tax exemption on inter vivo gifts related to property acquisition contributed to the orders acquired in April and May. In addition, our focus has shifted to mainly selling houses for sale since April. Combining the Custom Detached Houses segment and the Houses for Sale segment, we have maintained the same levels as those last year. The reactionary decline in orders received in the Rental Housing segment is not likely to persist for very long. Rental housing management are over a long period, and if consumption tax is raised by 2 percentage points, a yield of 10% for properties, for example, would only decline to around 9.8%. Although demand for rental housing units, occupancy rate, interest rates, etc. will have an impact, orders received will likely recover because needs in the urban areas will remain at high levels.
- Through the second quarter, contracts for six projects have already been executed, showing steady progress. Some of the subject properties will be delivered in the second quarter and others will be delivered in the latter half of the current fiscal year.

Question

- **Breakdown of ¥74.3 billion of the orders received in the United States**
- **Land in noncurrent assets decreased ¥10.0 billion from the end of the previous fiscal year. Is this understood to be a transfer from noncurrent assets to real estate for sale? Is the Urban Redevelopment business behind schedule so much that necessitates the transfer from noncurrent assets to real estate for sale?**

Answer

- Orders comprised a little over ¥30.0 billion in the multifamily business, approximately ¥13.5

billion in the community development, and approximately ¥25.0 billion in homebuilding business.

- In the second quarter, the Company will sell properties at the value of ¥70.1 billion to Sekisui House Reit, Inc., who has announced to issue new investment units through public offering. Of that amount, a little over ¥30.0 billion will be appropriated for the transfer from noncurrent assets to real estate for sale in the first quarter, to prepare for sale in the second quarter. With regard to rental properties, the Company has adopted the method of transferring it from noncurrent assets to real estate for sale, prior to implementing the sale. The properties subject for sale this time included the properties for sale which the Company had held for a certain period and the properties for sale that were transferred from noncurrent assets.

Question

- **Regarding the properties in the development pipeline in the Urban Redevelopment segment, is the number of properties smaller after the sale of properties to the REIT?**
- **Please give us your comments about the fall in May in orders received for the Custom Detached Houses segment. With regard to properties with higher unit prices, it may be viewed that the last-minute demand ahead of the consumption tax hike arose in March and April and that actually became less in May.**

Answer

- The number of large properties for REITs, including office buildings and commercial buildings, has been decreasing. The Company continues to develop residential properties and hotels and has not actually sold all such properties. The total value of properties in the pipeline, including those under development, is approximately ¥210.0 billion, comprising approximately ¥150.0 billion for office and commercial buildings and hotels and ¥60.0 billion for residential properties. How they will be taken to the market in the future will be discussed in the next mid-term management plan.
- Since April, the Company has focused on selling houses that can be delivered by the end of September. We expanded marketing of high value-added products in the Custom Detached Houses segment, while at the same time increased the allocation of resources to the Houses for Sale segment. As a result, the level of total orders received with the Custom Detached Houses segment and the Houses for Sale segment combined was the same as that in the previous fiscal year and it is not deemed, up to present, that we are greatly affected by the reactionary falls in orders received. As we cannot be optimistic, we will continue to closely monitor the situation of orders received in June and July.

Question

- **The actual result of the first quarter in terms of gross margin for the Rental Housing segment fell 0.6p year-on-year while the full year plan is 23.3%. Do you see any problem in your forecasts?**
- **Please tell us about the recent situation of Woodside Homes in the United States and the future outlook.**

Answer

- The impact of the RC on the profitability of the Rental Housing segment was 0.5% in the first quarter. The profitability was also affected by a rise in costs related to retirement benefit expenses. Without these factors, it would have improved 0.4p. Considering that the volume of rental housing declined in the first quarter, we achieved profitability almost on par with the level a year ago, if the impacts of the RC are excluded. Going forward, total volume effect will be expected with sales to be recorded and profitability will rise accordingly.
- Orders received by Woodside Homes recorded a low level at the end of the previous year so that the subsequent marketing plan was not made based on great expectations. The recent situation of orders received is better than the original plan and steady progress is being made.

Question

- **Please show us the breakdown of the gross margin for the Custom Detached Houses segment in the same manner as that for the Rental Housing segment.**
- **Please give us your comments on the full-fledged entry into the market in the United Kingdom, including your outlook and its suitability for business.**

Answer

- The impact on the gross margin from the rise in costs related to retirement benefit expenses concerning the Custom Detached Houses segment was 0.6p. Excluding that impact, the gross margin rose about 0.3 to 0.9 percentage point.
- In the UK, we invested ¥3.3 billion to obtain an approximately 35% stake in an entity in May. We basically entered industrialized housing market. We will develop our business in Manchester and other regional centers to offer our technologies and knowhow on industrialized housing. Homes England, our partner in the UK, is a government body similar to the Urban Renaissance Agency Japan. It provides great support to land acquisitions and initiatives for the development of our industrialized housing technologies. Prior acquisition of land and other upfront investment will not be large. By examining the possibility for ensuring the quality, engineering capabilities, production efficiency, etc. required by the Company at the minimum and the applicability of industrialization technologies and by implementing research and development of the local customs and culture, we hope to advance our business with an eye to establishing a presence on the European continent. About 1,000 units will be offered over the next four years and the effect on revenue will become visible after four or five years.

Question

- **Contracts for six projects have been executed in the multifanily business in the United States. Has the number exceeded the plan?**
- **Please tell us about the current situation of the Michi-no-Eki Project.**

Answer

- A contract was executed for one building at the end of February 2019. In addition, two properties for which a contract was cancelled last year was put up for sale again during this fiscal year. We explained earlier that contracts for the three projects were confirmed but did not suggest that it was the end of the plan.
- We will expect orders for some hotels and start construction as early as in June. The project is steadily progressing on the premise that we will have accumulated contracts at the beginning of fall this year.

Question

- **Regarding the situation of Konoike Construction, the revenue from Otori Holdings, Co., Ltd. increased by ¥0.1 billion, which was included in the equity in earnings of affiliates of ¥1.3 billion. Is this understood to be progress being made beyond initial expectations?**

Answer

- The situation of Konoike Construction is gradually improving beyond initial expectations. It is an affiliate accounted for by the equity method and will become a subsidiary of the Company in October 2019. Its contribution to the Group's earnings for this fiscal year will be equity in earnings of affiliates and operating income after it becomes a subsidiary for the period between October 1st and December 31st.