Sekisui House, Ltd.

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

Date: September 5th, 2019, Thursday 17:00 – 18:00 JPT

Participants: Shiro Inagaki, Representative Director and Vice Chairman

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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 sales and profit were achieved in the first half of fiscal 2019. The major contributing factor was the completion of the sale of six properties in the multifamily business in the United States. Orders received in the Built-to-Order Business were slightly affected by a small reactionary fall due to the upcoming consumption tax hike, although the impact was insignificant compared to when the tax was raised from 5% to 8%. Demand for rental housing continued to be strong in the three major metropolitan areas.

Today, we announced the repurchase of its own stock up to five million shares. The repurchase, which is not significant from a monetary perspective, will be conducted to eliminate cross-shareholdings. We will move forward with the elimination of strategic shareholdings, which will apply to approximately 10 brands this year. In addition, we made a policy decision to submit proposals aimed at shortening the term of office of Directors from two years to one year and abolishing the Executive Advisor system at a General Meeting of Shareholders next year.

With the financial conditions showing better-than-planned improvements, the time is approaching when we will be able to implement investment and financing strategies in a flexible manner.

Looking at the overview of earnings results, net sales increased 20.5%, showing progress of 51% against the full-year plan. In the Built-to-Order Business, the progress was 48.1%, reflecting slightly slower progress in the Rental Housing segment than in the Custom Detached Houses segment. In the Supplied Housing Business, the progress was 49.7% on the back of the steady performances of both the Remodeling segment and the Real Estate Management Fees segment. In the Development Business, the progress was 57.7%, on par with the full-year plan, more than offsetting a decline in sales registered solely by the Condominiums segment. The Overseas Business showed progress of 63.0%, helped by strong sales in China and the United States.

The gross margin declined 0.1p year on year, which was attributable to a 3.1p drop in the profitability of the Development Business. On top of this, an increase in retirement benefit expenses partly due to a change in the discount rate, combined with rises in on-site expenses and general administrative expenses, to come approximately ¥12.0 billion in FY2019, putting pressure on profitability.

Of the increase of ¥6.6 billion in general administration expenses, ¥5.2 billion was due to an increase in labor expenses, including the impact from a rise in costs related to retirement benefit expenses.

Progress in operating income was 46.4% in Built-to-Order, 49.3% in Supplied Housing, 63.5% in Development, and 86.1% in Overseas.

With respect to non-operating income, equity in earnings of affiliates rose ¥1.4 billion, reflecting the contribution made by Konoike Construction Co., Ltd. The increase in interest expenses was due to an increase in the number of completed projects in the multifamily business in the United States. This is because interest, which is included in the cost before completion, is posted as interest expenses after completion.

Progress in ordinary income and profit attributable to owners of parents were 56.0% and 55.7%, respectively.

[Sheet 2] Financial position

Real estate for sale decreased ¥105.5 billion from the end of the previous fiscal year, decreasing ¥74.2 billion overseas and ¥31.2 billion in Japan. Cash and deposits increased ¥127.6 billion in accordance with the progress of property sales.

Interest-bearing debts decreased ¥31.1 billion. Net debt, excluding cash and deposits, improved ¥158.7 billion. The D/E ratio declined 4.2p, to 49.9%, and equity ratio rose 1.2p, to 50.2%.

Looking at cash flows, cash provided by operating activities improved, reflecting the progress in the sale of properties in the Overseas and Urban Redevelopment segments. With respect to cash used for investing activities, capital expenditures increased. As a result, the free cash flow status improved by ¥281.6 billion. The reduction of interest-bearing debt had an impact on cash flows related to financing activities.

With the financial conditions continuously improving, we aim to keep the D/E ratio below 45% while simultaneously maintaining growth and financial efficiency. Improvements in the financial conditions are highly significant for making investments for growth while at the same time maintaining efficiency such as high ROIC, although it takes a long time. We also aim to enhance shareholder returns and improve ROE. On top of this, it is important to maintain solid credit ratings and have sufficient financial strength that enables us to make additional investments even if the real estate market is declining.

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

Both sales and profit jumped in the Custom Detached Houses segment. Gross margin improved 0.4p, and

OP margin improved 1.2p. The rise in costs related to retirement benefit expenses, or the factor that caused the gross margin and OP margin to decline by 0.6p and 0.9p, respectively, was more than offset by increased sales and cost reductions. ASP per building steadily grew, increasing ¥0.57 million to ¥39.32 million, as a result of promoting value-added houses.

In the Rental Housing segment, both sales and profit declined. Gross margin declined 0.3p, and OP margin declined 0.2p. The rise in costs related to retirement benefit expenses, or the factor that caused the gross margin and OP margin to decline by 0.6p and 0.9p, respectively, was not offset due to a decrease in sales and a decline in the profitability of reinforced concrete buildings (RC). There was a slight delay in construction due to larger Sha Maison apartments. ASP per building rose ¥1.99 million to ¥102.18 million, partly thanks to an increase in three- and four-story properties.

[Sheet 3] Segment information (Supplied Housing Business)

The Remodeling segment achieved growth both in sales and profit. Large-scale remodeling worth more than ¥10 million increased 19% year on year, accounting for 15% of the overall Remodeling segment sales. Profitability continued to improve, partly due to the promotion of high value-added remodeling.

The Real Estate Management Fees segment also achieved growth in both sales and profit. The number of units under management increased 11,000 units compared to the end of the previous fiscal year, to 630 thousand units. The occupancy rate remained high at 97.8%.

[Sheet 4] Segment information (Development Business)

Both sales and profit increased in the Houses for Sale segment. Efforts will be made to secure new land from the second half.

Both sales and profit decreased in the Condominiums segment. On the other hand, the status of orders received remained steady. With respect to the sales plan of approximately ¥55.0 billion for the second half, 95% of the plan has been already secured by orders received, representing progress in line with the full year plan. The completed property inventory was 172 units, slightly decreasing from the end of the previous fiscal year.

In the Urban Redevelopment segment, both sales and profit increased. We sold Akasaka Garden City, Hommachi Minami Garden City, and Garden City Shinagawa Gotenyama, and other properties to Sekisui House Reit, Inc. As a result, the REIT’s asset size surpassed ¥520.0 billion.

[Sheet 4] Segment information (Overseas Business)

Both sales and profit grew significantly. No properties were sold in the multifamily business in the United States during the fourth quarter of the previous fiscal year. In light of this, successful efforts were made to complete the sale of six properties in the second quarter of the current fiscal year. Meanwhile, business remained favorable in China. Investment balance amounted to ¥757.8 billion, decreasing ¥72.0 billion from the end of the previous fiscal year.

Business in Australia posted increases both in sales and profit. Thanks to policy interest rate cuts and loan deregulations, there was a temporary improvement in the real estate market. A full-scale recovery, however, is expected to be achieved next year when subsidy policies will be implemented. Sales were attributable to the delivery of condominium units and residential land lots in Sydney and Brisbane. We plan to sell the commercial section in Central Park in the second half. Orders received declined ¥4.5 billion to 8.6 billion. Investment balance increased ¥3.3 billion to ¥139.6 billion.

Both sales and profit increased in China. The Chinese government has implemented measures to stimulate domestic demand to ensure that its economy does not slow due to the U.S. - China trade issue. Given the situation in which the government sought to change its policy to facilitate consumer spending, housing investment and infrastructure investment, orders received increased rapidly, partly aided by enhanced recognition of the Company's brand. Contracts that had been concluded for 948 units in one year in the previous fiscal year increased sharply to 1,840 units in the first half of the current fiscal year. The number of contracts rose steadily in Suzhou and Taicang. The investment balance declined ¥16.9 billion to ¥148.7 billion.

Business in the United States posted increases both in sales and profit. In the multifamily business, net sales, operating income, orders received, and investment balance were ¥116.8 billion, ¥23.5 billion, ¥116.8 billion, and ¥174.5 billion, respectively, where the sales of six projects led the significant improvement. In the community development business, net sales, operating income, orders received, and investment balance were ¥21.2 billion, ¥2.6 billion, ¥28.9 billion, and ¥138.3 billion, respectively. In the homebuilding business, net sales, operating income, orders received, and investment balance were ¥40.4 billion, ¥1.9 billion, ¥52.3 billion, and ¥99.7 billion, respectively.

Equity in earnings of affiliates posted in Singapore was ¥1.6 billion, and investment balance of Singapore business decreased ¥0.6 billion to ¥48.2 billion. House prices have been rising and demand has been solid. Even so, with the slowdown of GDP growth becoming apparent, we will take a cautious stance.

Other investment balances totaling ¥3.4 billion in the Overseas Business are investments in the United Kingdom, where we launched its business this year.

[Sheet 5] Full−Year Forecasts

There has been no change in the full-year forecasts.

< Summary of Question and Answer Session >

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

Question

- **What is the future outlook on the sale of rental housing in the multifamily business in the United States?**
- **When will the Michi-no-Eki project make a contribution in terms of increases in sales and orders received?**

Answer

- The number of properties sold will not keep rising every year. Instead, we assume that it will fluctuate. We plan to sell one more property this fiscal year. There are three projects in 2020, four projects in 2021 and six projects in 2022, in which properties are ready to be sold through leasing after their construction is completed. To continue growing going forward, we are considering the inclusion of not only large properties but also slightly smaller and faster-moving properties.
- Orders received totaling approximately ¥7.0 billion were posted in the second quarter. Profits will be divided and posted in the second half of the current fiscal year and the first half of the next fiscal year. We project around ¥20.0 billion in the first stage.

Question

- **It was expected that Woodside Homes' OP margin would be 10%. What is the current status?**
- **What is the reason behind the Rental Housing segment's performing better than other companies with orders received up from the year-ago level in August?**

Answer

- When we acquired the company in 2017, we said that we aimed to achieve net sales of ¥150.0 billion and operating income of ¥15.0 billion within five years. Currently, net sales per year are in the vicinity of ¥100.0 billion, and the OP margin after amortization of goodwill is around 5%. We will not only expand sales but will also work to incorporate our environment technologies, streamline on-site construction work and reduce costs. By doing so, we will aim to raise the profit margin to around 10%.
- Orders received made an upturn from the year-ago level for both apartments and non-residential properties such as Michi-no-Eki, or properties that are included in the Rental Housing segment. This is because over the past 10 years, we have been shifting sales to the three major metropolitan areas and changing our strategies to focus on area marketing. In addition, we implemented organizational changes in April last year and made the sales organizations for the Custom Detached Houses segment and the Rental Housing segment totally separate. This effort of increasing sales by enhancing specialization is producing results.

Question

- **What are the factors behind the further increase in the balance of orders received from ¥170.5 billion at the end of the first quarter to ¥188.4 billion in the Overseas Business, as well as the business conditions associated with the orders?**
- **The OP margin of 7.9% recorded by the Real Estate Management Fees segment appears to fall short of the full year plan. Do you expect any improvement in the second half?**

Answer

- With respect to orders received in the Overseas Business, orders are increasing sharply in China. The main factor behind this is we already achieved the orders received of ¥80.0 billion in the first half that were projected on a full-year basis. We succeeded in selling properties in six projects in the multifamily business in the United States by the end of the second quarter. As for Australia, where business conditions have been worsening since 2017, orders received, which we had expected to remain at low levels this year as well, surpassed the plan in the first half. Orders are steady in all countries.
- Sekisui House Reit, Inc., whose main sponsor is the Company, merged in May last year, and the relevant merger fees were paid to the asset management company and posted in the Real Estate Management Fees segment. A decline in profits recorded by the asset management company curbed an increase in the profits of the Real Estate Management Fees segment. Meanwhile, the number of Sha Maison apartments delivered is expected to increase in the second half, leading to a rise in the number of units under management. We therefore expect that the full year plan will be achieved.

Question

- **In conjunction with Woodside Home, are we correct in assuming that sales are steady? Are there any signs of deterioration in profit margins due to increases in logistics and construction costs?**
- **What will be the expected amount of interest-bearing debts and the D/E ratio at the end of this fiscal year?**

Answer

- Orders received had been on a downward trend due to rising interest rates in the second half of last year in the United States. Due to the impact of these conditions, sales in the first half remained relatively low. Now, however, with interest rates falling due to monetary easing in the United States and the U.S. - China trade issue, orders received have surpassed expectations. Profit margins showed better-than-expected improvements even in the first half. There are factors that contribute to increases in a range of expenses, including labor costs. However, we expect that they will be more than offset through sales volume effect and labor-saving measures that are being implemented with respect to on-site construction work.
- We think that the year-end interest-bearing debts will drop by a little more than ¥10.0 billion from the level at the end of the second quarter. Consequently, the D/E ratio will be around 48%. This ratio is lower

than initially expected. With cash and deposits increasing, we are in the process of generating sufficient cash reserves to reduce interest-bearing debts.

Question

- **Orders received in August decreased approximately 20% from the same month of the previous year in the Custom Detached Houses segment. Please tell us about trends in orders received.**
- **What is the impact of the consolidation of Konoike Construction Co., Ltd. planned in October on sales and profits?**

Answer

- There was the impact of workstyle reforms, in addition to that of fewer effective working days in August. Another factor was the effort of attracting customers to sales promotion events such as *Sumaino Sankanbi* to assess the impact of the consumption tax hike after September. That said, with the absolute sales volume being small in August, the numbers are in line with expectations. We expect orders received in September and thereafter.
- With the fiscal year of Konoike Construction Co., Ltd. closing in September, results for the October - December period, namely the first quarter results of Konoike Construction Co., Ltd., will be reflected in our consolidated results. Net sales and operating income are expected to be ¥64.0 billion and ¥2.0 billion, respectively. For the next fiscal year, net sales will reach ¥250.0 to ¥260.0 billion and operating income will come to around ¥15.0 billion. Currently, orders received are solid at Konoike Construction Co., Ltd., but profitability is declining slightly, taking into consideration the overall trend of major construction companies. Results will be reflected in the Other segment this fiscal year. For the next fiscal year and thereafter, we are considering a system of indicating the sales and profits of Konoike Construction Co., Ltd., and those related to RC by adding a segment in the Build-to-Order Business.

Question

- **With respect to the sales environment of the multifamily business in the United States, has the environment been established in such a way that sales mainly to local investors, whenever they are available, can be smoothly facilitated this year?**
- **You have referred to flexible financial strategies. Please elaborate on flexibility.**

Answer

- The sales environment of the multifamily business in the United States is very good because of developments since the beginning of this year; namely, a sense of security that the U.S. - China trade issue will not become serious and a decline in interest rates. If the slowdown of the U.S. economy is not significant, we believe that this environment will continue.
- The most important point is to achieve both growth and improvements in financial efficiency simultaneously. We will implement strategies for proactive investments, given the current situation where available real estate has been diminishing in the United States and Japan. In the meantime, we are actually

already in an environment in which we can repurchase our own shares more flexibly. We have eliminated cross-shareholdings by repurchasing two million shares last year and five million shares this year, and we are in a position to implement financial strategies that respond to shareholders' expectations next year and thereafter. We should utilize the period of the next medium-term management plan to achieve full-scale improvements in financial conditions. Even so, we would like you to understand that we can implement a range of measures with confidence if the major direction is clear in terms of improvements.