Sekisui House, Ltd.

Transcript for Earnings Results Briefing for the Third 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

Sales and profit surpassed previous record highs in the third quarter, aided by an increase in sales and profit in the Custom Detached Houses segment and sales in the multifamily business in the United States. In the Built-to-Order Business, sales rose ¥41.4 billion, to ¥588.1 billion. The steady progress of construction in the Custom Detached Houses segment, coupled with the recovery of the Rental Housing segment to the previous' year's level, resulted in an increase in overall sales in the Built-to-Order Business. In the Supplied Housing Business, sales grew by 6.9%. 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 grew 5.0%. Revenues rose in the Houses for Sale segment and Urban Redevelopment segment. Revenues in the Condominium segment fell due to the concentration of deliveries in the coming fourth quarter. In the Overseas Business, sales increased 107.2%, to ¥298.3 billion. In the multifamily business in the United States, the sale of properties in seven projects was completed in this fiscal year as projected. Deliveries of condominiums were made steadily in Suzhou, China.

Gross profit increased ¥50.9 billion to ¥353.1 billion, and the gross margin improved 0.1p year-on-year. The gross margin for the Built-to-Order Business improved 0.3p. The gross margin for the Supplied Housing Business improved 0.6p. The gross margin for the Development Business declined 3.1p. The gross margin for the Overseas Business improved 1.1p.

General administrative expenses rose 5.3% to ¥198.1 billion. The SG&A ratio declined 1.2p to 11.4%. Labor expenses increased ¥7.2 billion. Of the increase, ¥4.9 billion were due to the expenses related to retirement benefits.

Operating income grew 35.9% to ¥154.9 billion, and the OP margin improved 1.2p, to 8.9%. 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 ¥6.2 billion, to ¥49.4 billion, and the OP margin improved by 0.6p. The OP margin for the Remodeling segment and the Real Estate Management Fees segment improved. Operating income for the Development Business diminished ¥5.2 billion, to ¥29.4 billion, and the OP margin fell 2.5p, to 10.6%. Profit declined in the Condominium and Urban Redevelopment segments, although the result was in line with the plan. In the Overseas Business, sales increased ¥33.5 billion, to ¥41.2 billion. The OP margin improved 8.5p, to 13.8%. Business in Australia suffered operating loss, although it is expected to return to profitability on a full-year basis. Business in China recorded an increase of ¥2.8 billion in operating income. Business in the United States achieved a significant rise in operating income.

The overall progress of operating income against the full-year projections was 75.6%. It was 66.0%, 73.3%, and 79.5% for the Built-to-Order, Supplied Housing, and Development Businesses, respectively, and stood at 117.8% for the Overseas Business, which had already surpassed the plan.

Non-operating income totaled ¥6.0 billion, increased ¥1.6 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 ¥5.8 billion, increasing ¥2.2 billion year-on-year, and that earned in Singapore was approximately ¥2.1 billion. With respect to the impact of currency fluctuations, foreign exchange gains and losses diminished ¥0.3 billion year-on-year, attributable to foreign exchange losses of ¥0.5 billion for the current third quarter. Interest expenses increased ¥0.5 billion, to ¥3.9 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.

Extraordinary income increased ¥11.8 billion, to ¥12.2 billion. The increase was mainly attributable to ¥8.5 billion yen in association with Otori Holdings, which was converted into the Company’s consolidated subsidiary, and ¥3.6 billion resulting from the sale of some equities in the SPC in Singapore. With respect to extraordinary income and loss, the Company intends to take measures as needed after carefully examining the risk of impact of such income or loss on profitability projections for its medium-term plan for the next term. For example, the Company is examining how to ensure the possibility of recovering the amount of investments for business in China during the period of the medium-term business plan for the next term.

Orders received increased ¥290.8 billion, to ¥1,873.2 billion. An increase of ¥230.2 billion in the Overseas Business is notable. Accumulated orders rose 48.8%, to ¥1,481.5 billion, including the accumlated orders of ¥347.7 billion attributable to Otori Holdings.

[Sheet 2] Financial position

In the current assets, cash and deposits rose ¥210.4 billion, of which ¥95.0 billion was attributable to Otori Holdings, which became the Company’s consolidated subsidiary, and approximately ¥66.0 billion was due to advances received pertaining to the sale of condominiums in China. Real estate for sale amounted to ¥973.7 billion, diminishing ¥23.2 billion in Japan and ¥82.4 billion overseas. Noncurrent assets increased ¥8.5 billion, of which property, plant and equipment increased ¥12.6 billion. Capital expenditures increased ¥14.8 billion to ¥57.8 billion, of which investment in rental real estate were ¥47.9 billion. The increase reflected an increase in land for rental houses for REIT, among other factors.

Total liabilities increased ¥140.7 billion from the end of the previous year, mainly reflecting rises in notes payable, accounts payable for construction contracts and interest-bearing debt due to Otori Holdings which was made into our subsidiary. Interest-bearing debts diminished ¥11.6 billion to ¥627.8 billion. The D/E ratio fell 2.5p, to 51.6%.

Net assets increased ¥76.3 billion from the end of the previous year. Profit stood at ¥117.4 billion, while the payments of dividend amounted to ¥55.0 billion. A loss was posted in comprehensive income due to translation adjustments of ¥24.3 billion. Non-controlling interest was up ¥42.0 billion. Equity ratio fell 2.7p, to 46.3%.

With respect to cash flows, cash from operating activities improved significantly, reflecting a decrease of ¥200.0 billion in inventories, an increase in advances received for the sale of condominiums in China, and rise in profit. Cash used in investing activities increased due to investments in real estate for rent. As a result, free cash flows improved by ¥346.3 billion, the balance of which stood at ¥552.3 billion at the end of the quarter, including the cash and its equivalents of ¥93.9 billion attributable to Otori Holdings.

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

In the Custom Detached Houses Business, sales increased significantly because the amount of orders had been recovering since the second half of the previous year. Gross profit margin improved 0.5p. Operating income and the OP margin improved as a result of the efforts for offsetting the increased costs related to retirement benefit expenses with increasing order quantities. Orders received fell 5.7% due to a decline in orders in the third quarter (August – October). In terms of the development of the Platform House, a research collaboration has commenced with the Institute of MIT’s Medical Engineering and Science with an eye on sales next year. ASP per building improved ¥1.03 million to ¥39.78 million, and ratio of Green First Zero was 85%.

Sales decreased but profit increased in the Rental Housing Business because negative impacts started to fade away with respect to the extension of revenue recording timings resulting from a growing number of large-scale properties. Consequently, despite a decline of 0.1% to ¥295.0 billion in the nine months ended October, sales showed a recovery with an increase of 7.7% from the previous year, in terms of the third quarter. Full-year sales are expected to reach the previous year’s level. The gross profit ratio remained unchanged from the previous year despite the increased costs related to retirement benefit expenses. Both operating income and the OP margin improved. Business environments pertaining to orders remained as tough as ever due to the tightened lending attitude of financial institution and a range of issues in the rental market. Despite that, orders received increased 6.8% aided by area marketing focusing on urban areas. Sales in non-housing segments were strong on the back of effective proposals on nursery facilities and stores. With respect to the Michi-no-Eki Stations Project, orders received by Sekisui House and Konoike Construction Co., Ltd. totaled approximately ¥10.0 billion and ¥4.0 billion, respectively. ASP per building rose ¥0.59 million to ¥100.78 million. Ratio of three- and four-story housing in value climbed to 73.4%.

[Sheet 3] Segment information (Supplied Housing Business)

In the Remodeling Business, both sales and profit increased, reflecting a significant increase in the number of deliveries to be made by the end of September, before the implementation of the consumption tax hike. Orders for proposal-based and environment-based remodeling remained positive. In the rental housing sectors, efforts were made to facilitate proposals for renovations aimed at maintaining and improving rents and occupancy rates.

Sales and profit also rose in the Real Estate Management Fees Business. The number of housing units under management increased by 15,000 units from the end of the previous year. The occupancy rate declined 0.1p but still remained high. The Company will continue to work to maintain high levels of occupancy rates by providing quality services.

[Sheet 4] Segment information (Development Business)

Both sales and profit increased in the Houses for Sale segment. On the other hand, orders received decreased ¥10.5 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. Orders received declined ¥10.2 billion. Profit fell partly due to the small number of properties delivered. Nevertheless, with the delivery of large-scale properties expected to take place in the fourth quarter, progress was made according to the full-year plan. The completed inventory decreased 57 units from the end of the second quarter, to 115 units.

The Urban Redevelopment segment posted an increase in sales and a decline in profit, progress is being made in line with the full year plan.

Although the Development Business, as a whole, posted an increase in sales and a decline in profit, progress is being made in line with the full year plan.

[Sheet 4] Segment information (Overseas Business)

Business in Australia posted an decrease in sales and profit. The operating loss stood at ¥0.8 billion. The real estate market continues to face tough conditions despite policy interest rates cuts and loan deregulations. However, market sentiment shows signs of improvement partly due to solid housing demand on the back of stable population increases and subsidy policies for first home buyers expected to be taken next year. Both order and investment balances were higher than in the previous year. The commercial portion of the Central Park will be sold in the fourth quarter. Full-year financial results are expected to return to profitability.

Both sales and profit increased in China, and operating income rose ¥2.8 billion to return to profitability, at ¥2.0 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 ¥77.8 billion from the end of the previous fiscal year. Investment balance decreasing ¥31.3 billion from the end of the previous fiscal year.

Business in the United States posted a significant increase in sales and profit due to the sales of seven properties as projected. Sales for the multifamily business, community development business and homebuilding business were ¥147.2 billion, ¥36.8 billion and ¥64.7 billion, respectively. Operating income for the multifamily business, community development business and homebuilding business were ¥29.2 billion, ¥6.2 billion and ¥3.5 billion, respectively. Orders received increased ¥23.3 billion from the end of the previous year, to ¥91.7 billion, of which ¥50.6 billion and ¥40.1 billion was attributable to the community development and homebuilding businesses, respectively. Investment balance decreased ¥55.0 billion thanks to the progress of sales in the multifamily business.

Equity in earnings of affiliated posted in Singapore decreased ¥0.2 billion. In the meantime, an extraordinary income of ¥3.6 billion was posted through the sale of some equities in the SPC-owned commercial facilities.

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, although results may differ more or less by segment. We are making progress in line with the plan.

< Summary of Question and Answer Session >

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

Question

- **Specifically, what risks is the Company examining for business in China for the next year?**
- **The overall housing market has been experiencing sluggish orders since April. Is there any possibility of the Japan Federation of Housing Organizations, an industrial association that your company represents as president, requesting the government to take measures?**

Answer

- Specific risks include guest room rates that do not rise despite improving occupancy rates and revenues from restaurants that do not reach the expected levels with respect to a hotel that the Company owns as noncurrent assets in Shenyang. We are scrutinizing risks related to noncurrent assets.
- With respect to custom detached houses that we had been receiving until the first half, we were able to control reactionary decreases. However, looking at recent orders we have been receiving, we see possible impact from such reactionary decreases to some degree. As a company that represents the Japan Federation of Housing Organizations as president, we feel the need to implement lobbying activities after discussing the issue with other housing manufacturers.

Question

- **Which business or businesses are making sluggish progress against the full-year plan?**
- **What is the ratio of holding shares in Otori Holdings? What are impacts on financial results for the current and fiscal years as a result of consolidation?**

Answer

- The segment that is showing poor progress is the Rental Housing Business. The main factor was the poor business results it had recorded before the second quarter, although improvements were made in the third quarter. In addition, the Real Estate Management Fees Business may not achieve the forecast.
- We held 51.8% when the company became a consolidated subsidiary. Currently, the ratio has increased to 67.1% partly due to additional acquisitions carried out thereafter, which we think will cease for the time being. In terms of the impact on financial results, we expect contributions to sales and operating income in the amount of ¥68.0 billion and ¥2.7 billion, respectively, for the current year. For next year and beyond, assume contributions to sales and operating income in the amount of ¥270.0 billion and ¥15.0 to 16.0 billion on a full-year basis.

Question

- **Concerning orders in November for the Custom Detached House segment (down 22% from the same period of the previous year), what are your expectations for orders, going forward?**
- **Describe the areas and use types of real estate that you have been acquiring for the REITs.**

Answer

- In terms of the business of custom detached houses, due to the robust order level of the previous year, we are at the stage where reaching that level becomes difficult. In addition, we may be affected to some extent by the reactionary decreases. We take a cautious view of orders to be received going forward. Meanwhile, with respect to the business of rental housing, the area marketing strategy was implemented successfully. With the contributions of the Michi-no-Eki Stations Project and non-housing segment, we expect that orders received will continue to be solid.
- We focus on the Tokyo area and are striving to acquire medium-scale properties for rental houses.

Question

- **The outlook for the D/E ratio at the end of the fiscal year**
- **Share any available information with respect to reconstruction demand attributable to Typhoon No. 19.**

Answer

- There is no change in the forecast of approximately 48% in terms of the D/E ratio at the end of the fiscal year.
- At this point, it is difficult to explain the impact of reconstruction demand on earnings.