Sumitomo Forestry Group

Financial Results for the Second Quarter of the Fiscal Year Ending December 31, 2023

Conference Call with Analysts and Institutional Investors - Q&A

Time and date:

1:00 p.m. – 2:30 p.m., Wednesday, August 9, 2023

Answers:

Toshiro Mitsuyoshi, President and Representative Director, Sumitomo Forestry Co., Ltd.

Tatsumi Kawata, Director and Senior Managing Executive Officer, Sumitomo Forestry Co., Ltd.

Q

Could you tell us about the return for the forestry fund? Also, will you be able to arrange 60 billion yen for the fund?

A

As for the forestry fund, 60 billion yen has been committed by 10 companies, including by Sumitomo Forestry, and we have already begun due diligence and purchase negotiations for candidate forests from the pipeline. We plan to purchase appropriate forest assets while diversifying the risks by diversifying the areas, tree species, and sales markets, etc., and plan to make purchases over the next two to three years.

Forests are long-term investment targets as real assets that grow every year, and forestry funds have a more than 30-year history as alternative investments for pension funds in the United States. The return mechanism is designed to offer two values: 1) profit from logging and selling timber, and 2) carbon credits that are created by increasing the amount of CO_2 absorption and carbon fixation through improvements to operating methods.

As a return, the investing companies can choose the carbon credits themselves or the cash that is obtained by selling the carbon credits. We are planning for the fund to have a 15-year term. The first fund is targeted at forests in the United States, but, from the second fund onwards, we would also like to target Japan, Asia, and Oceania as well.

Q

Regarding shareholder returns, do you have any plans to come up with a more in-depth shareholder return policy, such as a policy for the dividend payout ratio or for share buybacks?

A

As for shareholder returns, while we are not completely ruling out the possibility of share buybacks, etc., we have not changed our stance so far, which is basically to pay continuous and stable dividends.

In a situation where ROE greatly exceeds the cost of equity capital, we intend to prioritize business growth by using cash on hand for investment at this point.

Going forward, we will continue to provide stable shareholder returns while keeping an eye on both financials and business growth by maintaining a balance.

Q

With regard to the US single family homes business, both unit sales prices and profit margins in the second quarter were at levels that exceeded initial expectations. Based on the current market conditions, what are your thoughts on future profit margins and on achieving the sales target of 16,000 units for the fiscal year ending December 31, 2024?

A

At the beginning of the fiscal year, we assumed that an approximately 5% discount on unit sale prices would be necessary. However, with 30-year fixed mortgage rates remaining in the high 6% range and a sharp decline in the volume of existing homes in circulation, demand has been flowing into the market for newly built single family homes. In addition, with the collapse of some financial institutions in the United States, small unlisted builders are having difficulty in procuring funds for land purchases and in procuring constructions loans, and builders with financial strength, such as listed companies, are increasing their share of the new single family home market. Against this backdrop, we have been able to sell homes at higher unit prices that we expected at the beginning of the period. The price of lumber, a major building material, has also returned to pre-COVID-19 levels, and we were able to reduce costs by shortening construction periods, which enabled us to maintain a recurring income margin in the high 14% range in the second quarter. Given current market conditions, we expect that we will be able to maintain the same level of profit margins in the second half of the current fiscal year. As for the number of units sold, our number of orders received has significantly improved, so the initial sales target of 9,000 units was revised upward to 10,500 units. At present, it will not be easy to achieve the sales target of 16,000 units for the fiscal year ending December 31, 2024, but, because we have been able to maintain high unit sales prices and profit margins, we believe that we can approach the target figure in terms of profit and will continue to implement measures to achieve it.

Q

Regarding the US real estate development business, your target of selling eight properties this fiscal year was changed to selling seven properties. Please tell us about the current status of property contracts for sale and about the market environment.

A

With regards to the status of sales contracts, we have already received deposits for three of the seven properties, and we expect to sell them in the second half of the fiscal year. All seven of the properties are multi-family housing. Occupancy of rental properties is very stable due to the housing shortage, and we plan to sell them at an appropriate time. Additionally, given the extremely tight financial market, we intend to promote a differentiation strategy that contributes to decarbonization through wooden construction in order to achieve our goals.

Q

For the US single family home market, we understand that it is currently on a recovery track, but, on the other hand, how do you perceive risks in a situation where interest rates are hovering in the high 6% range?

A

We believe that the reason why the housing and real estate industries fell into a catastrophic situation during the Lehman Shock in 2008 was that people who purchased properties via subprime loans with unreasonable repayment plans were unable to repay their loans and went bankrupt, which resulted in a large amount of inventory being released into the market as auction properties. We are monitoring the delinquency rate for housing loans and the status of payment deferment measures, but these figures have remained at low levels, even in 2020 when the employment situation worsened due to the spread of COVID-19, and no outliers have emerged so far. Given the low unemployment rate, rising wages, and the fact that many homebuyers are taking out 30-year fixed mortgages, we believe that the risk of a large number of homes being auctioned off due to inability to pay loan interest is extremely low. Additionally, due to the rise in housing prices over the past 2 to 3 years, net assets, which are the values of houses minus liabilities, are thought to have grown considerably, and this also is a major difference from when the Lehman Shock happened.

Q

Earlier, in the explanation of the shareholder return policy, it was said that "continuous and stable dividends" will be paid. In other words, is it correct to assume that the dividend will not be reduced? Other companies have declared progressive dividends, so is it possible for Sumitomo Forestry to also do so?

A

Until now, we have been increasing our dividend in stages, using recurring income as one indicator. Recurring income exceeded 100 billion yen in the fiscal year ended December 31, 2022, and the dividend was raised to 125 yen.

This was the result of our judgement that we had established a structure that would allow us to stably earn 100 billion yen in recurring income. Going forward, it is our policy not to reduce our dividend in the future unless there are serious circumstances.

On the other hand, many investors have pointed out that the shareholder return policy will not be widely known to the public unless a policy is clearly stated, such as by setting a minimum limit. We will continue to consider this issue internally.

Q

Orders for single family homes in the US were quite strong from April to June, but will they be similarly strong in July and beyond, or will there be a slowdown? I know there is some seasonality, but what is your outlook?

A

The number of orders we received in July was approximately 850 to 900 units, so, if the average number of monthly orders received in the third quarter is 800 to 900 units, then for the third quarter that would be 2,400 to 2,700 units. Excluding the third quarter of the previous fiscal year, which was in the middle of a phase of rising interest rates, in the third quarter of 2021 we received orders for approximately 2,200 units, and in the third quarter of 2020 we received orders for approximately 3,900 units. We think that a monthly average of 800 to 900 units for the third quarter of the current fiscal year is a reasonable level, above that of 2021 but not reaching the level of 2020. Recently the churn rate has been about 15%, which is below the standard level of less than 20%, so we think that the situation is good.

Affordability is difficult due to rising housing prices, but customers who want to purchase homes are flowing into the newly built market, and we want to steadily seize opportunities as market share shifts from small- and medium-sized builders to leading companies. Additionally, the area in which we are developing our business is a growing market known as the Sunbelt, and we would like to firmly increase our orders.

Q

As for orders received for custom-built housing in Japan, it appears that the effects of price pass-through are progressing, but what is the outlook for further improvements to profit margins in the next fiscal year and beyond?

A

The market environment continues to be severe nationwide, with owner-occupied homes declining year-on-year for the 19 consecutive months until June 2023. Although some companies may see orders increase due to last-minute demand just before price pass-throughs, the reality is that the environment for orders is extremely severe. In our case, unit price exceeded 41 million yen in the second quarter results, but orders from customers who purchase within the 30 million yen or less bracket, especially among first-time home buyers purchasing from land, are decreasing. To address this situation, we are proposing one-story houses and land measures, and are also proposing Forest Selection BF, a planned-home style product that offers 1,200 design patterns. By combining these proposals, we are aiming to increase orders in the second half of the year.

Overall, profit margins have risen due to higher home sales prices and lower prices for lumber, a key material. On the other hand, materials such as insulation, concrete, and cement are still expensive due to rising energy costs. Going forward, our profit margins will be affected by the extent to which we can reduce overall material costs.

As for profit margin improvements, some price revisions were made in April of the current fiscal year, and their effects will be seen in the next fiscal year.

Q

With regards to carbon credit trading, given Sumitomo Forestry's CO_2 absorption and fixation amounts, it can be calculated that you have the potential to generate profits of approximately 10 billion yen per year, so please tell us how you will realize future transactions for carbon credits.

A

As for profits from the forestry fund, the subsidiary acts as the asset manager for the managed forests, so we can take profits from that, and, because we have made a same-boat investment in the fund, we can also expect a return. By launching the second and third funds, we intend to grow this as a core business for decarbonization while firmly securing profits for the entire Group.

Q

With regards to single family homes in the US, what is your forecast for the order backlog at the end of the fiscal year ending December 31, 2023? You previously mentioned that it would be difficult to achieve the 16,000 unit sales planned for the next fiscal year, but, at the end of the current fiscal year, about how much of an order backlog do you expect to have for the next fiscal year?

A

First, we have raised our full-year sales forecast for the current fiscal year from 9,000 units to 10,500 units. In terms of orders, we expect to receive 800 to 900 units each month from the third quarter onwards, and for the full year, orders are expected to exceed the level of the number of units sold. As a result, we believe that the best scenario would be to start the next fiscal year with a backlog of around 4,000 to 5,000 units at the end of the fiscal year ending December 31, 2023.

Q

When Sumitomo Forestry reported first quarter results, it was stated that the company is not actively moving forward with land acquisition in the single family homes business in the US. What is your current stance on this?

A

As of the end of the second quarter for the fiscal year ending December 31, 2023, we had 45,038 purchased lots, and inventory volume including option contracts was 71,036 lots. At the current pace of 10,000 units sold per year, we have purchased or secured option contracts for land for approximately seven years. Since the middle of the previous year, when interest rates rose and people became more cautious about owning land, we have been working to secure land via risk-reducing methods such as revising contract terms and conditions.

Now that conditions have recovered, we are once again carefully selecting and option contracting or purchasing prime land, particularly in the Dallas and Seattle areas, which are on a recovery trend. We will continue to actively purchase land while maintaining an inventory level of approximately 70,000 lots.

Additionally, we would like to move forward with securing prime land while applying wisdom for each area given that there are a variety of opportunities to purchase land despite the difficult situation, such as by sharing land for residential subdivisions with unlisted small- and medium-sized builders who are struggling financially.

Q

The market for newly built single family homes in the US has remained strong against the backdrop of a decrease in the volume of existing single family homes in circulation due to rising interest rates. We would like to know what measures you will take in the future if interest rates decline and the volume of existing homes in circulation increases. Are you considering strategies in the existing homes market, such as the purchase and resale, brokerage of sales and purchases, and renovation businesses, etc. for buyers of single family homes that were newly built by Sumitomo Forestry Group?

A

If interest rates fall in the future, then it is expected that the need to replace existing homes will increase and that the circulation of existing homes will also become more active. The US housing market is said to be short of supply by 4 to 6 million units relative to demand, and, because this housing shortage is expected to continue for the foreseeable future, we do not anticipate an oversupply that will disrupt the market. As for how we will compete in the existing homes market, we will first focus on newly built single family homes and multi-family housing, and will thoroughly consider business strategies in the future.

Additionally, we would also like to prepare for the coming severe situation by securing profits and strengthening competitiveness as a whole, such as by reducing costs in vertically integrated businesses such as the FITP business.

Q

If the 300 billion yen planned for investments and loans in the Medium-Term Management Plan is not fully implemented over the three-year period, where do you plan on allocating those funds?

A

Of the 300 billion yen planned for investments and loans, we expect to exhaust about 190 billion yen in the two years through the current fiscal year. The remaining approximately 100 billion yen will be invested for business expansion by actively considering new M&A and other opportunities.

Q

In your Medium-Term Management Plan, you have set a target of ROE of 15% or more as part of your management policy of being conscious of the cost of capital, and we would like you to tell us about the direction and numerical targets for the next Medium-Term Management Plan.

A

We are in the process of preparing our next Medium-Term Management Plan and do not have a target figure at this time. We recognize that the cost of shareholders' equity is approximately 7%, however, recent stock price movements suggest that the cost of equity may rise a little more, so we will take this into consideration in setting a ROE that exceeds the cost of equity and ensures that it is achieved.