

Sumitomo Forestry Group
Financial Results for the Second Quarter of the Fiscal Year Ending December 31, 2024
Conference Call with Analysts and Institutional Investors – Q&A

Time and date: 1:00 p.m. – 2:30 p.m., Wednesday, August 9, 2024

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

Nobuyuki Otani, Director and Managing Executive Officer, Sumitomo Forestry Co., Ltd.

Q

Recurring income to net sales ratio for the US single-family homes business was 18.3% for the cumulative second quarter of FY12/2024, but it has been forecast at the lower rate of 16.4% for the full year. Is this simply a conservative forecast, or are there certain concerns behind that? Could you tell us the outlook for the future?

A

Firstly, with regard to the first half of the fiscal year, the sale of land alone added to profits and contributed to the upswing of recurring income to net sales ratio. Going forward, we aim to achieve our target sales volume while securing unit selling price and profit margin in the second half of the fiscal year. Each subsidiary is proceeding with the construction of spec (ready-built) properties while keeping a close watch on the local demand trends, and we expect to be able to achieve the full-year target of 11,675 units. As for unit selling price, excluding the impact of product mix such as townhouses and condominiums, we expect unit prices in the second half of the fiscal year to remain at about the same level as in the first half. With regard to profit margins, we are presently maintaining high profit margins for as much as 80% to 90% of our properties, even while granting incentives such as late buy-downs. Therefore, going forward, we believe that we will be able to secure the full-year forecast of 16.4% while continuing to grant a certain level of incentives.

Although the number of existing homes available on the resale market has increased slightly recently, at around 1.3 million units, it remains considerably lower than the previous level of 4 million units. At the same time, with 30-year fixed interest rates falling temporarily to below 6.5%, pent-up demand may become even more apparent in the future. Due to robust demand caused by a housing shortage, it is difficult to imagine that unit selling prices will fall. If the number of existing homes available on the resale market were to increase dramatically, this could have an impact on unit selling prices and profit margins. However, since this is difficult to envisage at this point, we believe that we will be able to maintain our unit selling prices and profit margin levels.

Q

Orders for US single-family homes were somewhat weak from April to June. How should we view

the market for July and August?

A

Mortgage interest rates rose to around 7% between April and June, and an increasing number of customers adopted a wait-and-see attitude. This is believed to be the reason behind the decline in orders received compared to the period from January to March. This does not signify a worsening of market conditions; rather, it lies within the expected range. We received orders for 795 units in July. July marks the start of the summer vacation season, and it is a period when demand typically slows down each year. However, we will continue to ascertain order trends while keeping a close eye on factors such as whether interest rates will fall in September.

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The full-year forecast is based on the premise that exchange rate will be 152 yen. Is it correct to understand this to mean that even if the yen appreciates going forward, Sumitomo Forestry will be able to achieve its overall plan with ease thanks to the growth of the US single-family homes business and other factors?

A

The Group's full-year financial statements are calculated using the exchange rate averaged across the year, but the current exchange rate sensitivity means that a movement of 1 yen against the US dollar will have an impact of approximately 1 billion yen on recurring income. We believe that it is fully possible to maintain unit selling price and profit margin, and we consider it important to start construction and proceed with the sale of spec (ready-built) properties.

Q

Regarding US single-family homes, due to the difference between the results for the first half of the fiscal year and the full-year forecast, the Company will have to sell 6,225 units in the second half of the fiscal year. Is that attainable? Could you also tell us the outlook for interest rates and backlog at the end of the fiscal year?

A

Among our five US single-family homes companies, while some continue to focus on presales, others are taking a strategy that emphasizes spec homes. At present, the total for backlog and spec homes (completed and under construction) exceeds 7,000 units, and we think that it is possible to achieve sales of 6,225 units in the second half of the fiscal year.

Taking reference from sources including forecasts by various think tanks, we expect interest rates to fall to around 5.8% to 6.2% at the end of the fiscal year. By increasing orders accordingly and building up our end-of-year backlog to about 3,500 to 4,000 units, we should be able to get off to a good start in the next fiscal year.

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Although the dividend has been increased this time, the dividend payout ratio is about 25% on a full-year basis, and approximately 27% if we were to look at the second half of the fiscal year alone. Can we consider this a transitional period toward increasing the dividend payout ratio to 30% from next fiscal year?

A

As profit levels have risen, the dividend has been adjusted accordingly to ensure that payout ratio for the beginning of the fiscal year will not fall below 25%. We forecast interim dividend of 65 yen, the year-end dividend of 80 yen, and full-year dividend of 145 yen, with a dividend payout ratio of 25.8%, for the fiscal year ending December 2024. This was determined with consideration for the balance with cash flow levels.

We hope to provide a clearer explanation of our dividend policy for the next fiscal year and beyond in our next Medium-term Management Plan to be announced in February 2025.

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Regarding the US real estate development business, could you tell us the reasons for lowering the forecast at this point? Can we expect good results in the next fiscal year?

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The forecast reduction can be broken down as a downward revision of 5 billion yen for JPI and 3 billion yen for Crescent. For JPI, the downward revision was due to a reduction in the number of rental property projects planned by the general construction business, from 17 projects at the beginning of the fiscal year down to 14. With regard to Crescent, it had reduced the number of property sales from 12 planned at the beginning of the fiscal year to 9. Combined with two property sales under SFAMF, there are plans for 11 property sales projects this fiscal year, with two already sold, three scheduled for the third quarter, and six scheduled for the fourth quarter. If the company assesses, in consultation with its joint investment partners, that it would be better to postpone the sales rather than sell them at a low price, the sales may be postponed to next fiscal year.

The multi-family housing market has been growing steadily against the backdrop of a housing shortage, but supply has increased over the past two years. Compared to the previous demand-supply balance, we expect the supply surplus to continue through 2025. However, our view of the current situation is that the rate of increase in rents has cooled off.

The housing shortage situation is ongoing, and it is difficult to structure new properties under the current capital market environment. Nevertheless, we plan to continue structuring properties for sale from the second half of 2025 to 2026 when supply is expected to stabilize.

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The full-year forecast for the FITP business has also been revised downward. What are the reasons for this?

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With regard to the FITP business, we have revised downward our full-year forecasts set at the beginning of the fiscal year by 4 billion yen for sales and 3 billion yen for recurring income. The main reason for this is that one of our Group companies has a large percentage of multi-family housing construction, and the current slump in the real estate development market has led to the postponement of property structuring and a drop in the number of projects. In addition, there are cases in which the prices themselves are being revised. Currently, two Group companies are operating eight factories; one of the companies has two factories that mainly produce single-family homes, and the other has six factories that mainly produce multi-family homes. The high proportion of factories producing multi-family homes and non-residential properties is also a factor contributing to the significant decline in sales and profits.

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I believe there are cases in which Sumitomo Forestry collaborates with Japanese developers on medium- to large-scale wooden construction projects. Could you explain what benefits, if any, that the Company can gain through such collaboration?

A

One of the greatest benefits is risk sharing. Moreover, since our Company did not have a track record in real estate development, we believe that we can learn much about architectural technology and design through collaboration with developers that have a proven track record. In addition to developing overseas housing markets with our partners, we also think that it is possible to collaborate on land development other than detached houses in Japan. JPI and Crescent, which develop multi-family buildings in the U.S., achieved construction starts on more than 8,000 units of multi-family housing in the U.S. in 2023, and they aim to increase this to 10,000 units. We hope to demonstrate how we will achieve this goal in our next Medium-term Management Plan, which will be announced in February next year.

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With regard to the domestic housing business, although profitability has improved through price increases and appealing to customers on the added value of our properties, I believe the housing market remains in a tough situation. Could you tell us your outlook for the domestic housing market from next fiscal year and beyond, including Sumitomo Forestry's strategy for the domestic housing business?

A

The domestic housing business continues to face a tough situation, with the number of construction starts for owner-occupied houses declining year-on-year for 32 consecutive months. As a sign of how difficult the situation is, last fiscal year, the number of orders received after the contract cancellations fell below 8,000 units for the first time since 2017. We analyzed the data by area and price range and found the greatest decrease in the number of orders from customers with a unit order price of less than 35 million yen. Based on that, we have strengthened sales efforts for the cost-competitive "Forest Selection," a planned product series. In the second quarter of FY12/2024, we have seen a recovery in orders with a value of less than 35 million yen. Among them, "Forest Selection" accounted for more than 60% in terms of the number of houses. In addition, the land price per tsubo in rural areas is cheaper than in urban areas, making single-story houses more suitable for rural areas. Our efforts to boost the appeal of the benefits of single-story houses have been successful, and the ratio of single-story houses has now increased to about 45% of all orders. Additionally, we are strengthening our "Grand Estate Design Project" launched in 2014, developing a system that can respond to the requests and preferences of customers with contract amounts exceeding 60 million yen per house. We are also strengthening our proactive approach to the high-priced segment, with the aim of starting construction on 8,000 buildings overall at any one time.

The Company's share in the sales of custom-built detached houses against the total number of housing starts for owner-occupied homes grew to 3.69% in FY12/2023. Going forward, by promoting sales measures by price range, we will maintain the number of orders at 8,000 units and increase our share of the sales of custom-built detached houses.

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Concerning the US single-family homes business, how do you view the impact of recent fluctuations in interest rates and stock prices on home sales? Also, please tell us the percentage of people taking out mortgage loans.

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With regard to interest rate trends, there is a growing view that interest rates will fall in September and November, and current mortgage interest rates have fallen to the low 6% range. As a base scenario for the four to five months until the end of the fiscal year, we anticipate orders to increase, as long as there is no increase in the number of people taking a wait-and-see attitude in hopes that interest rates will fall further. Moreover, a simulation shows that, in the case of purchasing a US\$400,000 home with a 20% down payment and a 30-year fixed loan, there will be a difference of about US\$250 in monthly payments between the interest rates around April this year and the current interest rate at the low 6% range. Since this will reduce payments by about US\$3,000 per year, those who would not have been able to pass the mortgage loan screening in the past will now be able to purchase a home. Therefore, we believe that lower interest rates will expand the range of buyers.

We are constantly monitoring trends in delinquency (delinquency rate for mortgage loans) and forbearance (payment moratorium rate). As they are currently in a healthy state, we believe that unless a financial crisis occurs, such as rising unemployment rates or bank failure, we will not see a situation of surplus existing homes to a similar degree as during the Lehman Shock. In addition, as the net assets of homeowners after loan repayment have increased with rising housing prices, we believe that slight fluctuations in stock prices will not have a significant negative impact overall.

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The utilization rate for mortgage loans is around 80% to 90%, meaning that most people are using them.

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It was mentioned that it will be difficult for the recurring income to net sales ratio of the US single-family homes business to exceed the FY12/2022 level of 20.1%, when it was affected by the COVID-19 pandemic. However, is it possible to continue increasing the recurring income to net sales margin of the entire company? Can you increase profit margins through the growth of other businesses such as the domestic custom-built detached housing business?

A

Firstly, the recurring income to net sales ratio of the US single-family homes business had hovered around 12% before the COVID-19 pandemic, but due to increased housing demand with more people staying at home, it reached a record high of 20.1% for the full fiscal year ended December 2022. The recurring income to net sales ratio for the full year of FY12/2024 is expected to be 16.4%, but we consider a profit margin of 15% to 16% to be a very good level.

On the other hand, the single-family homes business in Australia, which are seeing a recovery in performance, and the domestic housing business are centered on custom-built housing, so the recurring income to net sales ratio for the full year of FY12/2024 is approximately 6%.

Since the US single-family homes business is centered on spec homes, we incur capital costs for owning the land. However, since the profit level is high compared to the rest of the world with the recurring income to net sales ratio being about 10 points higher than in Australia and Japan, we aim to work toward selling 23,000 units by 2030 through organic growth and, if necessary, M&A. To guarantee that we achieve this, we will secure land through by purchasing land lots and acquiring land through purchase contracts.

In these ways, we will ensure profits by steadily expanding our high-profit margin US single-family homes business, while also increasing the profitability of other businesses in Australia, Japan, and other areas to increase the Company's overall profit margins.

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Is it possible to further increase the profit margin of the Australian housing business from the full-year forecast of 6.2% for FY12/2024?

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The recurring income to net sales ratio forecast for the full year of FY12/2024 is 6.2%. Looking back at the past, it was 5.4% for the full year of 12/2021, 1.2% for the full year of FY12/2022, and 3.9% for the full year of FY12/2023, indicating extremely severe conditions. As order homes account for 60% to 70% of the Australian housing business, what is known as "gross margin erosion" occurred, meaning that material costs and labor costs increases between the point when the contract was concluded and the start of construction. Although the supply chain is currently showing signs of settling down and recovery, rising labor costs and labor shortages pose challenges, so we believe that it is necessary to shorten construction periods, reduce costs, and streamline production, while at the same time consider taking up the FITP business as in the U.S.

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