SPECIAL FEATURE

LONG-TERM OUTLOOK PROMISES SUCCESS FOR THE SUMITOMO FORESTRY GROUP

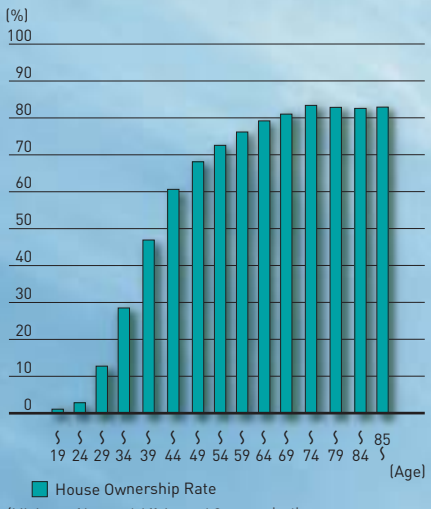
Japan is now in the midst of a demographic wave characterized by low birth rates and an aging population, and its population has been declining since 2005. Owing to this trend, it is expected that growth in new housing starts will slow moderately over the long term. Nevertheless, the children of the baby boomers will now step forward to drive the market and stable demand for detached housing is forecasted for the time being. As society passes into a new era, peoples' values toward housing are changing, and demand is expected to increasingly focus on the replacement, reconstruction and renovation of homes. On the basis of this long-term outlook, the Sumitomo Forestry Group intends to leverage its strengths as a wood expert to respond to diverse needs concerning housing and living and thereby build a business base for sustainable growth.

CONTENTS

Using the recyclable resource timber, our BF (Big Frame) Construction Method—Japan's "Wooden Continuous Beam Type rahmen Structure" —uses only large cross-sectional posts and beams to firmly support the vertical load (building dead load, etc.) and horizontal load (lateral shaking from earthquakes, etc.) through a newly-developed steel-joint technology.

OUTLOOK FOR THE DETACHED HOUSING INDUSTRY

Ratio of House Ownership by Age



(Ministry of Internal Affairs and Communications, National Census 2000)
*House Ownership: A housing wholly or partially owned by the household living there.

PRESENT MARKET ENVIRONMENT

Diminished Owner-Occupied Housing Market in an Adjustment Phase

After the collapse of the bubble economy in 1991, housing starts in Japan reached a peak of 1.63 million in fiscal 1996 when the consumption tax rate was raised, and then dropped dramatically to 1.14 million in fiscal 2002. Since then, amidst falling land prices, low interest rates, establishment of the housing acquisition promotion tax system, and growth of real estate funds, factors including the condominium boom and the expansion of the house rental market have driven the market, and in fiscal 2005, new housing starts rose 1.5% year on year to 1.24 million and remained steady. However, the owner-occupied housing market, which is the chief domain of the Group, has been on a persistent downtrend since fiscal 1996 when housing starts stood at 630,000. By fiscal 2005, this figure had fallen to 350,000, which represented a 4.0% decline from the preceding year. Despite these adverse conditions, the Group raised its share of owner-occupied housing starts from 1.86% in fiscal 1996 to 2.76% in fiscal 2005 while maintaining annual sales of more than 9,500 units, and thus has actually increased its presence in the market. From an analysis of both the "flow" market of newly-built houses and the "stock" market of existing houses described below, we at Sumitomo Forestry have taken the view that the currently diminished environment of the owner-occupied housing market represents an adjustment phase that will continue for the time being. Though this is a harsh environment, we are steadily implementing proactive structural reforms in line with our vision of the future.

LONG-TERM OUTLOOK

It appears that new housing starts will gradually decline from the current annual level of 1.15–1.20 million units to 1 million units beginning in 2015 due to the increase in housing stock and vacant houses and the decline in the number of households. Japan's housing market has been sufficient in quantitative terms but given that population has been declining since fiscal 2005, it is inevitable that the housing market will shrink moderately over the long term. However, it also appears that the amount of housing investment will follow increase slightly when looking at housing investment as a whole, owing to the increase in investment in remodeling and renovations. Even though housing is sufficient in quantitative terms, peoples' values toward housing are changing due to transitions between life stages and changes in life styles and the social environment. At the same time, it is expected that in their pursuit of the ideal home, people will increasingly demand higher quality in housing and obtain it by relocating, replacing, reconstructing, or renovating homes. This demand is in step with economic recovery, and should gradually emerge. Therefore custom-built houses which leverage their strength in free design are expected to regain their presence in the market with Sumitomo Forestry leading the way.

OUTLOOK FOR THE FLOW MARKET (NEW HOUSE CONSTRUCTION MARKET)

With Falling Land Prices, the True Worth of Homebuilders will Come into Question

During the era of the bubble economy around 1990, ordinary wage earners found it extremely difficult to purchase detached houses (though they might have been able to afford to buy condominiums) in city centers due to the sharp rise in land prices. In fact, land inflation dominated peoples' interest in terms of their motivation for purchasing detached houses, something far from the primary purpose of enjoying an affluent residential lifestyle. However, with the subsequent collapse of the bubble economy, land prices fell back to proper levels, and with the recovery of the economy, the employment and income environments improved, which sharply

Stock of Houses Built before 1980 and after 1981

(10 Thousands units)

	Survey in 1998		Survey in 2003		Compared to 1998	
	Total	House Ownership	Total	House Ownership	Total	House Ownership
Total Housing Stock	4,392	2,647	4,686	2,867	294	220
Built before 1980	2,122	1,408	1,760	1,220	-362	-188
Built after 1981	2,271	1,239	2,927	1,646	656	408

(source) Ministry of Internal Affairs and Communications (2003 Housing and Land Survey)

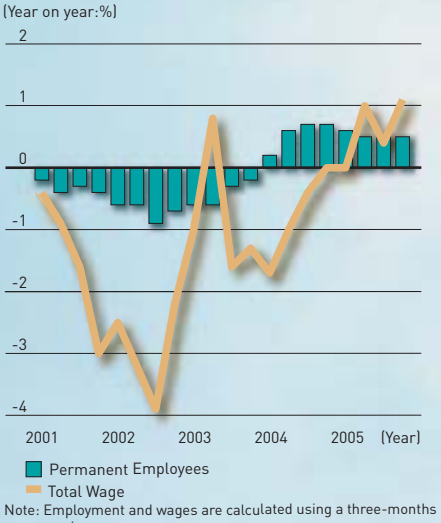
Estimate of the Number of Wooden Detached Houses in Need of Seismic Upgrade

(10 Thousands units)

Research Agency	Degree of danger	The total number of wooden houses that need antiseismic reinforcement	The number of detached houses that need antiseismic reinforcement
Survey Result by Architectural Institute	Insufficient quake resistance	1,221	1,165
Mokutaikyo	Danger of partial or complete collapse	1,409	1,373
Reinforcement Business Cooperative Union	Could be totally destroyed	1,493	1,437

(source) Daily Timber Newspaper

Trends in Employment and Wages



Note: Employment and wages are calculated using a three-months moving average.
(source) Health, Labour and Welfare Ministry (Monthly Labour Survey)

increased the purchasing power of consumers for detached houses. Against such a backdrop, we believe that the time will come when the true worth of home-builders, and therefore, the attractiveness of houses themselves, will come into question. From this perspective, it can be said that even though the absolute number of first-time homebuyers will shrink, the impact of the demographic wave described above will lead to a diversification of demand regarding housing, with some desiring a comfortable home where the family can live over the years and others stressing individuality. We predict that those housing companies capable of addressing the diverse values of consumers will increase their share in the market. A market structure of declining numbers of detached houses and expanding numbers of condominiums, a structure based on the massive supply of condominiums, will likely come to an end.

The Expected Demand for Detached Houses to Replace Condominiums

A development which merits attention is potential demand starting around 2010 from second-time homebuyers among the children of the baby boomers who play a prominent role in the current condominium boom. Second-generation baby boomers are those who were born in the first half of the 1970's and make up a large proportion of the population, numbering approximately 9.8 million. In Japan, the traditional pattern of people's residential life has been to start with a rented house, move to a condominium, and then finally purchase a detached house in a bedroom community (a so-called housing *sugoroku*.) If this pattern continues, second-generation baby boomers are likely to begin selling their condominiums in city centers, whose liquidity is comparatively high, starting around the mid-2010s when they are aged 40 to 45. This should promote a conspicuous trend toward the purchase of detached houses as highly-valued assets that can be passed along to succeeding generations.

OUTLOOK FOR THE MARKET FOR EXISTING STOCK (EXISTING HOUSES)

Huge Potential Demand for Home Renovation and Reconstruction

Much of the current housing stock consists of houses built during the era of high economic growth before 1980 when emphasis was placed on relieving the housing shortage, leading to decrepit or obsolete houses due to a lack of adequate maintenance. Furthermore, despite the introduction of the new earthquake resistance standards after the major revision of the Building Standards Law in 1981, which set standards for earthquake resistance performance, many existing houses built before 1981 still do not meet the standards. The number of wooden houses that require earthquake resistance reinforcement is estimated at 12 million to 15 million. These houses constitute a huge potential demand for home renovation and reconstruction. In particular, the government establishes a tax system to promote earthquake retrofit in fiscal 2006 to appropriately update the housing stock market. Demand for renovation and reconstruction, however, will not focus solely on deteriorated portions of houses. Needs vary widely as people transit to new life stages and their lifestyles diversify. Such needs include the need for effective use of space, enhancement of comfort, and accommodation of the elderly. Since wooden houses account for more than 90% of the approximately 26 million units of detached housing stock in Japan, the Group, with our exhaustive knowledge of wood, cannot afford to overlook this growth market.

Repair Cost per Household by Age of Householder

(Ratio calculated by setting the average of total householders as 100.)

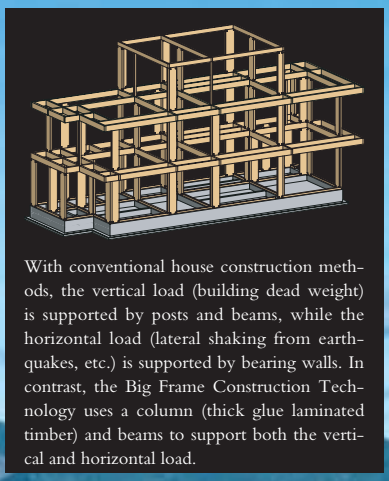
Age	< 29	30 — 39	40 — 49	50 — 59	60 — 69	70 <
Repair and Maintenance Cost	60.3	81.5	86.0	108.7	218.2	271.8

(source) Ministry of Internal Affairs and Communications, National Census 2000

THREE STRENGTHS TO LEAD THE GROUP TO SUCCESS

As pointed out earlier, an expansion of flow in the housing market cannot be expected in the future because of factors including the sufficiency of stock and the declining population. However we believe that the Group can open new paths to growth as Japan's top custom-built wooden house company by further improving its three strengths as described below, and by communicating these strengths to as many customers as possible. In addition we will make the most of the effort for customers to build a long-term relationship of trust.

"Big Frame Construction Method"



With conventional house construction methods, the vertical load (building dead weight) is supported by posts and beams, while the horizontal load (lateral shaking from earthquakes, etc.) is supported by bearing walls. In contrast, the Big Frame Construction Technology uses a column (thick glue laminated timber) and beams to support both the vertical and horizontal load.

BF steel joint developed on the basis of scientific analysis: By using a screw shape, looseness and warping are eliminated by increasing the surface area of contact with the wood stronger joints.

1. PRODUCT STRENGTH

Differentiation by Means of Our Dream-Fulfilling Unique Technologies

The natural blessing of wood has a deep connection with home life in Japan. Since our founding, the Group has been associated with forests for more than 300 years, and we have been seeking the benefit of wood for warmth and richness to residential life.

One major accomplishment in 2005 was the Big Frame Construction Method which has obtained structural type approval from the Minister of Land, Infrastructure and Transport. This method has applied innovation to wooden three-story house structures. It integrates our unique "Wooden Continuous Beam Type rahmen Structure" and steel joint technology, and achieves high earthquake resistance and rigidity without the need for bearing walls with posts and beams. It is an innovative construction method that can reduce the number of required walls and structures to less than half compared with conventional construction methods. By adopting this new method, wide open spaces, such as three-story well-hole types, can be designed, which was difficult with previous methods. Even with the small building sites commonly found in city centers, the method exploits sites' maximum potential and creates large spaces that give a feeling of openness. What's more, the method provides a high degree of variability that anticipates the transition between life stages and allows the building to be passed along to second and third generations as a high-quality asset. It was precisely such customer oriented ideas that brought about the Big Frame Construction Method.

Another product, *MyForest*, which was launched in fiscal 2005, incorporates a wealth of innovative technologies in order to bring out the highly refined atmosphere of wood. One example is Pure Molt Floor recovered and restored from one hundred-year-old white oak whiskey barrels. This floor not only offers great texture, but also boasts superb resistance to scratching. This material, however, is extremely difficult to obtain. To solve this problem, Sumitomo Forestry developed straightening equipment, to straighten curved barrel staves. Through this equipment, the Company has been able to obtain a stable supply of solid straight-grain board made of elegant hundred-year-old oak, which is something that other companies have not been able to produce.

A plan presentation by our expert design head at the "Sumai Haku" housing fair: Following the presentation, many visitors requested sketches.

Pre-cut timber: The connected part of timber pre-cut by machine is jointed using a traditional, ancient Japanese method. Strength is increased through the latest structural fittings.

2. PLANNING CAPABILITIES AND CREATIVITY IN FREE DESIGN

Creating Homes that Embody the Values of Customers

The strengths of the Group in custom-built wooden houses include exhaustive knowledge of wood and the planning capabilities and creativity of free design to build entirely from scratch residential spaces that match each customer's ideal. Of the Group's 3,600 employees (non-consolidated, detached housing business) about 1,700 are architects. These expert assemble a dedicated team to handle design, construction, interiors and other tasks for each order received. This specialist team works to closely meet the needs of each customer and strives to create a completed home that embodies the values and completely matches the ideal of the customer. These teams can also handle difficult requests from customers, such as how to provide efficient floor planning with guarding each person's privacy. Such problems can be overcome using design skills gained through many years of experience that observe both the physical and psychological aspects of people.

In addition, the Company considers the demographic changes of decreasing birth rates and the aging of the population and provides solutions based on our unique idea of universal design. This means that in order to create homes where each family member can spends life in safety, convenience and comfort, a place where they can live over a long period of time, we respond to customers' personal requests down to the millimeter, from the width of hallways to the height of ceilings. Our full-time staff is also involved in technical development at the Tsukuba Research Institute.

3. COMPREHENSIVE STRENGTH

Generating Vertical Synergies from Upstream to Downstream

As a total housing and living-related business company, the Group conducts a wide spectrum of wood-related operations. These include our Forestry Business, which owns and manages forests; our Timber and Building Materials Business, which provides optimal raw materials from countries around the world, processes or manufactures; our New House Construction Business, which builds freely-designed houses; and our Housing Stock Business, which restores freshness and functionality to living spaces. These businesses form a unique corporate group capable of providing integrated support for the entire life cycle of homes from upstream to downstream. Downstream, we track consumers' needs. Upstream and mid stream we procure optimal raw materials at low cost and rapidly develop products that meet market demand based on up-to-date information in the distribution market. This vertical comprehensive strength could rightly be termed the characteristic synergy of the Group.

The following is an example of how this synergy enhances our comprehensive strength. Sumitomo Forestry was the first company in the housing industry to use Japanese cypress laminated timber as a standard for posts and ground sill. We chose Japanese cypress because it is famous for its strength as the material used to support the Horyu-ji Temple, Japan's oldest wooden structure, for 1,300 years. Japanese cypress is indeed an extremely expensive wood, but we have managed to bring the cost down using our upstream resources. For example, we supply materials at low cost by effectively using Japanese cypress logs that are not long enough for solid posts through processing to make glue laminated materials, and by overcoming such flaws as bowing. In addition, pre-cut factories nationwide at the midstream level, which are business partners in the timber and building materials distribution business, perform processing tailored to customers' specifications. In this way, our vertical comprehensive strength allows high-priced Japanese cypress (laminated timber) to be used as a standard housing material.

PUTTING THE CUSTOMER FIRST

Whenever customers submit applications for housing construction, we at Sumitomo Forestry follow the principle of putting the customed first of our code of conduct and assemble a team of professionals in areas including design, production and interiors to transform the customer's ideal home into reality. Even after the home is completed, we continue a sustainable relationship of trust with the customer through our efficient after-sales support system.

Application System → Surveys → Proposal →

"The Sumitomo Forestry Home" model home

Application System

Once we receive the ¥50,000 application fee, we assemble a dedicated team comprised of experts in sales, design and interiors. The team then begins to gather information through discussions with customers on subjects including exteriors, overall home layout, interiors, and outdoor layout to enable us to create an ideal home which fully satisfies the customer.

Site survey

Surveys

Before closing the contract with the customer, we first conduct a meticulous survey of the site so that we can propose an optimal plan. These detailed surveys include inspection of the ground, measurement of the site, investigations of legal requirements, differences of elevation with adjoining land, and surrounding conditions. These thoroughgoing preliminary surveys allow us to present an accurate plan and estimate to the customer.

Meeting of dedicated staff

Proposal

Based on the customer's requests, the dedicated team carefully studies the plan from many angles and determines the course for building an ideal home. On this basis, the designer proposes an original plan, which on average is revised from three to five times until the customer's consent is given, at which time a construction contract is closed.

A lattice that lets through soft light and gentle breezes

Implementation Plan → Construction → After-Sales Support

In order to share our customers' vision of their ideal home, floor plans are hand-sketched on the spot

Implementation Plan

One of the strengths of the Sumitomo Forestry Group—the strength that characterizes our brand—is our ability to undertake the construction of custom-built homes based on a free design that meets all of the customer's requirements. Following closing of the contract, we invite the customer to our sample home gallery and hold detailed discussions regarding the exterior and interior design, fixtures and fittings, lighting, curtains and other features, and then design begins. Meanwhile, we conduct structural calculations, using our own CAD system. This enables us to assure the customer of the structural safety of the building and foundation.

The "Durable Floor Panel" plays a crucial role in dispersing the lateral shaking force of earthquakes without exerting a load on individual walls

Construction

Prior to the start of construction, the construction superintendent first visits the site to prepare advance measures to deal with every possible problem, including any inconveniences that construction may cause to the neighborhood, as well as parking spaces for construction vehicles. After setting up a stringent management system for each stage of construction, which may cover up to 170 items, we start construction with great care by utilizing our own multi-balance construction method using high-precision materials. In addition, we provide an exclusive Internet website for customers so that they can check the progress of construction at home.

Customer center

After-Sales Support

The Sumitomo Forestry Group has established a complete after-sales support service to help customers enjoy comfortable residential life and to enable us to build a relationship of trust with customers. This customer-first-oriented service includes a customer telephone center which answers questions from customers 24 hours a day, 365 days a year and a 60-year "long term support system", which includes regular inspections. Engineers are also available for consultations regarding home and facilities maintenance, renovation, gardening, and other matters.

REFORMS UNDERWAY IN MARKETING OPERATIONS

Creating ideal, custom-built homes through free design requires more effective community-based marketing to obtain the sincere support of customers. We are putting effort into reforming our marketing operations with a view to gaining the respect of customers in the community.

STRENGTHENING COMMUNITY-BASED MARKETING

Introduction of a New Marketing System

We are reevaluating the management system for marketing offices based in model homes as part of efforts to strengthen community-based marketing. Specifically, we have introduced a new marketing manager system in order to implement an in-depth marketing strategy tailored to each area. The marketing manager at each model home not only carry out their regular management duties, but also communicate closely with the community as the head of marketing operations to ascertain the real needs of customers. Under this new marketing system, marketing managers also identify competitors, determine the way to increase their visibility in the community and plan and implement a strategy for each area.

"*Machikado Ichiban*" in Tokyo's Setagaya ward

Sales-Oriented Model Homes

One of the company priority is creating channels to attract customers apart from general model homes. To take advantage of the anticipated rebound of reconstruction demand, we plan to establish sales-oriented model homes named *Machikado Ichiban*. For *Machikado Ichiban*, we will construct one model home on residential streets. These model homes will be open to the people of the community so that they can view the features of the house and see how they blend into the townscape and surrounding environment. The homes can also be used as cooking or English conversation classrooms or for community meetings. Through these *Machikado Ichiban* homes, we are both providing an opportunity for people in the community to experience the charm of Sumitomo Forestry homes and working to secure reconstruction demand.

Lattices create a pleasant connection with the outdoors