OBAYASHI

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OBAYASHI CORPORATION
4th Quarter: Summary of the Financial Results Briefing for Fiscal Year Ended March 31, 2021 (Teleconference) and Main Questions and Answers

・ Date/Time: Wednesday, May 12, 2021, 4:00 to 5:20 p.m.

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1. Consolidated Results for Fiscal Year Ended March 31, 2021

An explanation was provided, based on 4th Quarter Financial Results (April 1, 2020 to March 31, 2021).

2. Full-year Consolidated Forecast for Fiscal Year Ending March 31, 2022/Promoting ESG Management, etc.

An explanation was provided, based on the 4th Quarter: Presentation on Financial Results (April 1, 2020 to March 31, 2021).

3. Main Questions and Answers

(1) Regarding the Order Environment for the Company

Q: You mentioned that competition is intensifying for receiving orders on large projects in the domestic building construction business. To what extent has profitability declined on projects at the time orders are received? The forecast for fiscal year ending March 31, 2022 shows a 2.3-point decline in the gross profit margin on completed constructions contracts. Has profitability declined on orders received to the same extent?

A: The profitability on projects at the time orders are received is not disclosed and I cannot provide a quantitative response. However, the competitive environment for receiving orders on large construction projects has intensified compared to past fiscal years and this is causing a decline in profitability at the time orders are received.

Q: Is profitability on mid-and small-sized projects at the time orders are received declining in the domestic building construction business?

A: Profitability of mid- and small-sized projects at the time orders are received is trending on par with past fiscal years.

Q: Please explain changes in demand by purpose for orders received for domestic building construction.

A: The impact from COVID-19 has resulted in growth in construction demand for data centers, logistics facilities, and medical supply manufacturing facilities, while demand has fallen for accommodation and commercial facilities. The Company also had projects in which construction plans were canceled or postponed.
Moreover, a look at the Company's orders received for fiscal year ended March 31, 2021 by purpose, growth in orders received in the office area was driven by large development projects, which are seeing continued demand despite the COVID-19 pandemic, while orders received for factories and amusement facilities declined.

(2) Regarding Financial Forecasts

Q: Please tell us why the gross profit margin on completed construction contracts will decline by 2.3 points in the fiscal year ending March 31, 2022 forecast for domestic building construction. Is this because the overall level of profit will decline due to intensifying competition of orders received, the profit level on some large construction projects accepted strategically is being driven lower, or the result of rising costs due to rising material prices?

A: Construction on large projects in hand is progressing, but the profitability on some projects is not good and our view is that the profits will fall below the profit level in fiscal year ended March 31, 2021. Improving the profit margin is a pressing issue and we will move forward on various initiatives to restore the profit level, even if by a modest amount. Such initiatives include reassessment of procurement, value engineering (VE) proposals, and negotiating increases in contract amounts.

Q: The domestic civil engineering forecast for fiscal year ending March 31, 2022 appears conservative. Please tell us the reasons for the decline in profit on revenue growth compared to fiscal year ended March 31, 2021.

A: In fiscal year ended March 31, 2021, we made steady progress on highly profitable large construction projects and also made progress on shrinking costs. Moreover, design changes on multiple large construction projects led to the recognition of higher than expected amounts added to contracts and these factors resulted in a substantial increase in the profit margin. However, the factors boosting profits were events specific to certain projects and were not caused by an increased level of profit in the domestic civil engineering business. Hence, while we expect an increase in revenue accompanying growth in the number of construction projects in hand, for which we received good orders last fiscal year, we expect the level of profits to underperform last fiscal year, when profits were supported by special factors.

Q: I understand that profitability on construction projects typically improves as progress is made on completing construction. Is it possible that gross profit on completed construction contracts for large construction projects in hand in the domestic building construction business will improve as they near completion around 2023-2024?

A: For many projects, profits on construction will steadily improve as the project nears completion. The timing of completion for large construction projects in hand is two to three years from now. At present, it is difficult to anticipate improvement in the profit level.

Q: You explained that progress on low-margin large construction projects in the domestic building construction business will lower gross profit on completed construction contracts in fiscal year ending March 31, 2022. Will the level of profit in fiscal year ending March 31, 2022 extend beyond this fiscal year, based on the construction terms of large projects?

A: Construction began on many large projects in hand last year and this year. These projects will be completed in three to four years and immediate improvement in the level of profits will be difficult, but I think some of these projects will see improvement in profits mid-way through construction as a result of procurement efforts and other factors. We will strive to improve profitability by shrinking costs, in addition to improving profits through additions and changes.

Q: Does the domestic civil engineering forecast for fiscal year ending March 31, 2022 include factors that will boost the level of profit, such as design changes?

A: Unlike fiscal year ended March 31, 2021, in which design changes to large construction projects ordered two to three years ago were concentrated, few large projects will be completed in fiscal year ending March 31, 2022 and we cannot expect design changes, so they have not been incorporated in the forecast.

Q: What is the reason for the 7.6-billion-yen increase in non-consolidated selling, general and administrative expenses in fiscal year ending March 31, 2022?

A: We are expecting a 2.5-billion-yen increase in personnel expenses accompanying the change in employee composition. In addition to this, we also expect a 5-billion-yen increase in R&D and digital transformation (DX) expenses, expenses for changes in office layout, rebranding, and other expenses that were planned before COVID-19.

Q: From the viewpoint of future operating income, is the 150-billion-yen goal set in Medium-Term Business Plan 2017 a level that the Company would be able to reach if not for the impact from COVID-19, or is it a level that would be difficult to reach even without the impact from COVID-19? Please also tell us about the ROE level.

A: I think it will be difficult to achieve the goal of 150 billion yen stated in Medium-Term Business Plan 2017 as forecast for fiscal year ending March 31, 2022. The impact from COVID-19 is not the main reason for the decline in profit level, so I can say that 150 billion yen is on the high side for the level of operating income in the future. The profit level will decline, while equity will increase as profit is accumulated, so we think that ROE will decline.

It will be difficult to maintain the high profit level seen in the domestic building construction business over the past several years in the future. However, we intend to invest another 110 billion yen this fiscal year in addition to the 370 billion yen in capital investments over the past four years, compared to the 400-billion-yen goal for investment in growth set in Medium-Term Business Plan 2017 to prepare for such conditions and strengthen the revenue base. We will aim for operating income of 150 billion yen or higher over the medium and long term by using these advance investments to raise the base level of profitability.

Q: The forecast for domestic civil engineering orders received in fiscal year ending March 31, 2022 is 280 billion yen, which is lower than last fiscal year. However, this exceeds the level of two to three years ago. Please explain why.

A: We expect the domestic civil engineering market to trend flat in general. In railway construction, which is one of our main markets, we anticipate large construction projects in the Greater Tokyo Area and subway projects to prepare for Osaka Expo 2025. We also expect road construction projects to increase the expressway to four lanes. Measures to improve national resilience and market expansion in the renewable energy area are also projected, so we foresee a continuing strong environment for receiving orders. Moreover, orders received in fiscal year ended March 31, 2021 exceeded the amount announced. The main reason for this was our success in obtaining the orders for construction of large public projects in competitive tender offers.

(3) Regarding Investment in Growth

Q: Roughly when will investments in growth contribute to profits? Also, what type of benefits are you anticipating?

A: The breakdown of investments includes investments in the real estate and renewable energy businesses, which contribute directly to profit, in addition to investments in R&D, DX, and other areas. As far as when the benefits from investment will emerge, it will be several years from now in the real estate business. In the renewable energy business, we are also planning to invest this fiscal year and these investments will likely take four to five years for the benefits to emerge. However, we expect such investments to enhance performance over the medium and long term.

Q: If you anticipate investment in the domestic construction business to be on the low side from a long-term perspective, I think that will necessitate initiatives such as even more active investment in the future to generate new revenue sources, develop technology, and improve productivity. Is the current level of capital expenditure sufficient?

A: Looking ahead 20 to 30 years, investment in domestic construction will certainly decline along with the decline in population. While capital investment to secure new revenue sources is important, I think M&A will also be an important element in the future in addition to capital investment and we will consider it.

(4) Regarding Shareholder Return

Q: You achieved the goal for equity in Medium-Term Business Plan 2017. Are you considering expanding shareholder return?

A: We achieved the Medium-Term Business Plan 2017 goal of 900 billion yen in equity in fiscal year ended March 31, 2021 and think we have achieved a sound financial structure. In Medium-Term Business Plan 2017, we have provided a stable return to shareholders with a dividend payout ratio of 20%-30% while increasing investment in growth and equity. We are currently discussing the policies on shareholder return and capital in the next Medium-Term Business Plan.

Q: You achieved the level of equity targeted in Medium-Term Business Plan 2017. Are you considering buy-back of treasury shares as a return to shareholders?

A: We understand that purchasing treasury shares has the effect of increasing the stock price over the short-term and also understand why shareholders want this. There are different approaches to rewarding shareholders: Through the purchase of treasury shares to provide short-term returns and by improving long-term profitability through investment. In Medium-Term Business Plan 2017, we have pursued a stronger revenue base over the medium and long term based on investment in growth. While our basic policy will not change in the future, we will engage in a series of internal discussions about dividends, purchase of treasury shares, and other matters as we formulate the next Medium-Term Business Plan.

Q: Some of the quasi-major general contractors are planning a large increase in dividends to provide a dividend payout ratio that exceeds 70%. What is your view of this?

A: I will refrain from commenting on the dividend policies of other companies but, generally speaking, we recognize that the basis of dividend policy is allocating profit while maintaining a balance between investment in growth and shareholder return. Our basic policy is to allocate cash to investment in growth and other purposes while paying consistent dividends and I assume they are pursuing a different strategy.

(5) Regarding Materials and Labor Prices

Q: The prices of steel and other materials are rising and I think it will be difficult to pass this through to the contract amount, given the increasingly intense competitive environment for receiving orders on large projects. Please explain the trends in material prices and the status of passing through price increases.

A: Steel prices are firm. There are also signs of an increase in the price of copper. The price of ready-mixed concrete is currently stable, but we are seeing signs of strength in the Tokyo area. The market for labor is currently calm and we do not see signs of pressure, but we cannot let down our guard because large projects are being scheduled in the Kansai area in the future. We calculate the construction costs based on the market price of materials and labor at the time we bid on a project, so the current market conditions are reflected in the bid price. However, the competitive environment on large projects is intense and some projects have low profitability even though we take the price of materials and labor into account.

Q: Material prices are increasing and the Company uses 600,000 tons of steel frame and rebar. If you multiply this by an increase in unit price of 10,000 yen/ton, you can assume the impact on costs to be around 6 billion yen. Please tell us to what extent increases in material prices have been incorporated in the forecast for fiscal year ending March 31, 2022.

A: When we calculate costs, we calculate the market prices for each project and reflect them in the bid amount. We do not lump them together nor procure 600,000 tons at once.

(6) Other Questions

Q: What are the strengths and features of general contractors as hydrogen-related business operators?

A: The issue is how general contractors should engage in hydrogen-related business to achieve the carbon neutrality demanded by society. The Company is pursuing the business of power generation using renewable energy, based on the philosophy of contributing to building a sustainable society. The hydrogen-related business is one of those initiatives. We are performing R&D and are conducting proof-of-concept trials in New Zealand and Oita Prefecture with the process from manufacturing hydrogen using power from renewable energy sources to supply in mind, and also extending to hydrogen-based power generation, depending on the case. This is currently in the verification stage and we are not yet certain what form commercialization will take in the future. At the present stage, we believe that accumulating the technology and knowledge for constructing related facilities and building a hydrogen supply chain are essential.

Q: Do you have a procurement strategy of prioritizing electric furnace materials and other low-carbon materials to achieve carbon neutrality?

A: We use environmentally friendly materials in projects designed & built by the Company after we obtain the understanding of the customer. For construction projects in which we are contracted for construction alone, we propose such materials to the design firm and customer and use them when we have obtained their approval. In addition to electric furnace materials, there is also Clean-Crete, a type of concrete that can reduce CO_2 emissions by approximately 70%. We are also using this at construction sites after obtaining the understanding of the designer and customer, just as we do for electric furnace materials.