OBAYASHI

OBAYASHI CORPORATION
2nd Quarter: Summary of the Financial Results Briefing for Fiscal Year Ending March 31, 2022 (Teleconference) and Main Questions and Answers

Date/Time: Tuesday, November 9, 2021, 10:30 a.m. to 12:00 p.m.

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1. Revision of Financial Forecasts for Fiscal Year Ending March 31, 2022

An explanation was provided, based on the 2nd Quarter: Presentation on Financial Results (April 1 to September 30, 2021).

2. Financial Results for the Second Quarter and Forecasts for Fiscal Year Ending March 31, 2022

An explanation was provided, based on the 2nd Quarter: Presentation on Financial Results (April 1 to September 30, 2021).

3. Main Questions and Answers

(1) Revision of Financial Forecasts for Fiscal Year Ending March 31, 2022

Q: I have never encountered a case involving a provision for losses as large as 60 billion yen in the domestic building construction business. Please explain the essential reasons why your expectations were incorrect and resulted in a downward revision. Was it because of tough demands from customers whose results had deteriorated under COVID-19 or was it due to decisions to accept certain orders for strategic reasons, or other factors?

A: The reason is explained in the news release entitled “OBAYASHI CORPORATION Announces its Revised Financial Forecasts for FY2021.” The financial forecasts for the full year were formulated by adding progress on new project orders received in the current fiscal year to the forecasts of construction projects in hand by the project director of each construction office, as we have in the past. However, there were many large projects included in construction projects in hand this fiscal year that either had not yet begun or had just begun. It was also before the implementation budgets for these projects were formulated, and that was part of the reason why we were not able to sufficiently scrutinize projects that caused this downward revision. Large projects are increasing in the domestic building construction business and make a considerable contribution to achieving our plans for orders received and net sales, so we targeted orders for large projects with a positive focus on the future and this resulted in orders received being heavily weighted toward large construction projects.

Q: You mentioned the rise in construction material prices as a factor in this downward revision. However, I think that you determine the bidding price after obtaining estimates from suppliers and subcontractors. While there is a certain amount of time between bidding and procurement, why has the rise in construction material prices had such an impact?

A: The size of the impact differs depending on the timing of order receipt and the rise in construction material prices. Projects on which orders were received before construction material prices rose were substantially impacted, but projects on which orders were received after construction material prices rose were not impacted much because we were able to reflect an amount based on the market prices at the time the bids were submitted in the bid amount. In particular, the price of copper, aluminum, and other non-ferrous metals is currently increasing, in addition to steel frame. Some projects are impacted, depending on the timing of order receipt. The impact from the rise in construction material prices was one factor among multiple factors behind this downward revision, not the only factor.

Q: You mentioned that customers did not adopt the value engineering (VE) proposals as initially anticipated, which was one factor behind this downward revision. Please explain the background behind why the results differed from your expectations.

A: Recently, VE proposals have been requested by customers in nearly all bids. The general contractors are also presenting VE proposals to reduce costs even when a VE proposal is not requested by a customer. There is a considerable volume of VE proposals and these would also provide considerable cost reduction benefits to the contractor side if adopted. However, on these projects, the customers or the design firms were unwilling to incorporate such proposals into the specifications to that extent. Many VE proposals were not adopted and the impact on overall business results was also large because they were large construction projects.

Q: I think that the fact that cost estimates were not sufficiently accurate and that bidding prices were low as a result of the strategy of obtaining orders for strategic reasons were other factors behind this downward revision. I understand that the Company is taking steps to improve the accuracy of cost estimates, but are steps not being taken to stem the worsening construction losses accompanying strategic orders? Moreover, is there any significance in targeting orders for strategic reasons in a construction market that will shrink over the long term?

A: There are many elements included in receipt of orders on large construction projects for strategic reasons, including PR for our company's technological strengths, maintenance and expansion of the supply chain, and securing future maintenance and renovation work. In the future, we will reflect on these circumstances and narrow down the projects we target orders for, while simultaneously screening them more stringently and subjecting them to sufficient, careful scrutiny of the costs to avoid the occurrence of similar circumstances. Competition among the major general contractors on large projects is intensifying and we initially tried to compete on aspects unrelated to pricing on these proposals, but did not make headway as we had anticipated so we ultimately incurred losses. In the future, the marketing departments will obtain information on projects at the upstream stage and demonstrate our competitive strengths, not on pricing, but aspects unrelated to pricing such as providing excellent proposals that will lead to receiving orders.

Q: After the Company has decided to target receipt of a strategic order on a specific large construction project, could you conceivably withdraw from bidding mid-course due to profitability if it turned out that you were competing with a major company in the same industry?

A: We emphasize profitability in submitting bids and it is conceivable that we would withdraw from bidding mid-course, depending on the competitive circumstances.

Q: Large construction is increasing as a percentage of orders received in the domestic building construction business. The Company incurred a loss when large projects accounted for over 45% of total orders received this time. Do you think that the percentage of large construction projects was too high? If that is the case, how are you planning to achieve balance in the future, on small to medium-sized projects as well? Also, do you have sufficient information on small to medium-sized projects?

A: As you indicated, large projects have come to comprise a larger percentage of construction orders received. During the first half, large projects having a contract value of 10 billion yen or more comprised nearly half of the number of orders received. It is not the case that there is a proper percentage of large construction orders; we think it is essential to utilize limited resources effectively by stringently screening each project and bidding after we identify which projects to target orders for. Moreover, we have a considerable amount of information on construction plans for small and medium-sized projects, but declined to bid some small to medium-sized projects because we had received orders for large projects. In the future, we will therefore conduct activities aimed at receiving orders in a manner that enables us to build a portfolio that is balanced in terms of project size. This will also contribute to maintaining and improving diversity in construction technologies.

Q: You explained that the Company was making progress generally according to plan at the time of the first quarter results, but ended up with this large downward revision. In light of the size of the downward revision, was the Company aware of a certain amount of risk at the order receipt stage? What circumstances arose during the three months of the second quarter that led to the downward revision of the full-year forecasts?

A: On large projects, the length of time between securing priority negotiation rights and beginning construction is extremely long, and can be one year or longer in some cases. The point is to forecast the rise in commodity prices to a certain extent when submitting a bid. In these construction projects, we were too optimistic about the projected risk of rising commodity prices and the higher than expected rise in construction material prices resulted in losses. Moreover, the VE proposals we presented in the course of negotiations with customers over these past few months were not adopted as anticipated, and this led to a failure of profits to rebound when construction began. Placement of performance-based orders for design and build projects differs from specification-based orders. How to achieve the performance demanded by the customer was left up to the designer and builder at the time of bidding. This led to different interpretations between the Company and the customer of whether the required level was met, whether the project stayed within the scope of the estimate, and other factors at the detailed design stage, and that had an impact on losses.

Q: When losses have occurred to this extent there have been cases in which the losses continued in the future. This is also the case at other companies. Are you not worried about this?

A: We have secured profits on construction projects other than the projects on which we posted a provision for losses this time, so these circumstances will not persist.

Q: You mentioned that you increased the stringency of preliminary screening of projects you are bidding on. Were the steps taken sufficient? What has changed from before?

A: The screening standards were revised to more stringent standards in business plan committee meetings after sufficient consideration of the causal factors and corrective measures. The lesson we learned this time is being shared with the entire company, and we find it difficult to believe that similar circumstance will arise in the future.

Q: Was the provision of roughly 60 billion yen a conservative estimate, considering the fact that the next Medium-Term Business Plan will begin next fiscal year?

A: The amount of the provision for loss on construction contracts posted is the amount that can be reasonably anticipated at the present time, in accordance with accounting rules. As stated in the news release entitled "OBAYASHI CORPORATION Announces its Revised Financial Forecasts for FY2021," the loss estimate does not incorporate projected improvement in profitability from acquiring additional construction projects or reduction in procurement costs in the future.

(2) Next Medium-Term Business Plan

Q: You are targeting operating income of 100 billion yen or more in fiscal year ending March 31, 2023. Will you be able to achieve that?

A: In the domestic building construction business, we can project financial performance to a certain extent from the accumulation of projects which we have in hand or which we have received orders for. We have confirmed that there are no projects that will necessitate posting a provision for loss on construction contracts like the one posted this time. If we estimate future orders received or orders received and net sales on completed construction during fiscal year ending March 31, 2023, we see the ability to secure a certain level of profit. In addition to this, our past investment in growth of the development business and renewable energy business is expected to begin contributing to profit. We therefore think that 100 billion yen in operating income is achievable. While increases in the price of steel materials and various other construction materials and the price of crude oil are a concern, we will respond by procuring these early, securing the supply chain, and other measures.

Q: If the assumption of 100 billion yen in operating income in fiscal years ending March 31, 2023 and March 31, 2024 does not materialize, how do you intend to balance investment in growth and shareholder returns in your capital policy?

A: We project that we will be able to achieve the balance sheet goals for equity and the equity ratio in Medium-Term Business Plan 2017. We already have the internal reserves, so we think we will be able to provide stable shareholder returns in the next Medium-Term Business Plan as well.

(3) Financial Forecasts for Fiscal Year Ending March 31, 2022

Q: You have left the financial forecast for the domestic civil engineering business unchanged. Is there any risk of not achieving it? Some other companies are viewing the deterioration in performance of private railway companies as a risk.

A: Gross profit in the domestic civil engineering business declined in the first half. Unlike the first half of last fiscal year in which profits were boosted by design changes and cost reductions in some construction projects, design changes in large projects decreased in the first quarter and negotiations on design changes on some construction projects ran into difficulties in the second quarter of the fiscal year and we were unable to secure the additional contract amounts we had anticipated. The provision for loss on construction contracts posted on a few projects on top of this resulted in a decline in profitability. The reason for the decline in profit margin during the first half was circumstances caused by some a few projects, not a decline in the profit margin on construction projects in hand, so the impact the decline will have on the full-year forecast is limited. The civil engineering business has many public works projects. Design changes therefore typically increase toward the end of the fiscal year and the gross profit margin on completed construction also tends to increase along with such changes. In particular, the impact from the change in the timing of completion on multiple projects from the first half to the second half of this fiscal year resulted in a slippage of profit anticipated in the first half into the second half. We therefore anticipate an improvement in the profit margin during the second half that is greater than expected at the beginning of the fiscal year. We therefore think that the full-year forecast is achievable, and have left the forecast that was previously announced unchanged.

Q: I understand that the Company is being impacted by the worsening of the COVID-19 pandemic overseas. Will results improve from the second half into next fiscal year? Or will the impact be prolonged?

A: Economic activity is rebounding in North America despite the considerable number of people who are contracting the virus. In Southeast Asia, growth in infections is continuing in every country, and especially in Vietnam from July onward, where some projects have been suspended. However, we have been able to continue construction in Singapore, Indonesia, Taiwan, and other countries, and have left the previous announced full-year forecast unchanged.

In the overseas civil engineering business, progress on large construction projects in hand at the non-consolidated level has led us to project a year-on-year increase in both net sales and profit for the full year. While we expect growth in orders received at the non-consolidated level due to the rebound from COVID-19 in Asia, COVID-19 is causing delays in the timing of bid unsealing and order placement, and we are keeping an eye on the trend.

(4) Regarding the Order Environment for the Company

Q: You mentioned that you will narrow down large projects in the future. Are you thinking that the competition between major general contractors will continue at this intensity, or that competition will be eased by Obayashi's decision to narrow down the projects you participate in? I also think that there is competition with mid-sized general contractors on small to medium-sized projects. Will you capture share amid such competition in the future?

A: We will refrain from providing a response on how other companies are handling their businesses. Competition is intense on small to medium-sized projects as well, but we want to be able to receive orders by utilizing our technological strengths amid such competition. Having a good balance in orders received is also effective for allocating resources and training employees.

Q: Please explain the order environment for the domestic civil engineering business.

A: Regarding the future order environment, demand for renovation of expressways and building other infrastructure is strong in the public works projects, despite the uncertain conditions for private construction projects as railway companies, which are seeing performance deteriorate. Growth can also certainly be expected in the segment of the construction market related to the government's policy on strengthening national resiliency and renewable energy. We are forecasting flat or a slight increase in construction investment as a whole. However, there will be no change in the intense competition over orders experienced thus far.

Q: There are concerns that profitability on construction will decline on domestic civil engineering projects due to deterioration in the performance of customers. How do you view the market?

A: At present, we are not seeing delays in construction or suspension of plans in railway-related construction. In other areas, we anticipate growth in projects related to onshore and offshore wind farms and other forms of green energy, and we intend to utilize Obayashi's technological strengths and the SEP (Self-Elevating Platform) vessel currently being constructed. Considered from the perspective of government policy, there will be 16 GW of onshore wind power, a one-trillion-yen market, and 10 GW of offshore wind power, a two-trillion-yen market, by 2030.

Q: Please explain the competitive environment for offshore wind farms. Won't the competitive environment intensify, considering the fact that there will be competition among companies that possess SEP vessels?

A: There aren't many previous examples in the offshore windfarm area, so some uncertainties exist about the competitive environment. What we do know is that three companies currently possess SEP vessels, and there are also three SEP vessels. Of course, we must consider that as the size of wind turbines increases, the size of wind turbines that can be assembled with SEP vessels and the scope of what can be accomplished by chartering vessels will change. Once the use of a vessel has been confirmed when an order is received, that vessel cannot be used for a different project at the same time. When we consider that fact, in addition to the fact that market will grow larger, this leads us to believe that it will not result in that much competition.

(5) Reduction of Cross-shareholdings

Q: Please explain the background behind the decision to reduce cross-shareholdings substantially.

A: This is not just a matter of the Institutional Shareholder Services Inc. (ISS) and Glass Lewis guidelines. We recognize that institutional investors in Japan are also moving to establish quantitative standards for cross-shareholdings. The demands for reducing cross-shareholdings are increasing in the capital markets. This includes the requirement to disclose the policy on cross-shareholdings in the Corporate Governance Code. We also concluded that we need to pursue reduction of cross-shareholdings from the perspective of improving asset efficiency in the next Medium-Term Business Plan.

Q: The Company's policy is to reduce cross-shareholdings by roughly 150 billion yen over the next five years from fiscal year ending March 31, 2023, with the goal of keeping cross-shareholdings within 20% of consolidated net assets. The ISS Proxy Voting Guidelines Benchmark Policy Recommendations for companies with cross-shareholdings of 20% or more of consolidated net assets will apply from next fiscal year. Will Obayashi be able to obtain its agreement on reducing cross-shareholdings in a five-year schedule?

A: Although we have established a five-year period in the next Medium-Term Business Plan, we will aim for 150 billion yen in reductions as quickly as possible. We understand that the ISS and Glass Lewis holding standards will be applied from the Ordinary General Meeting of Shareholders in June 2022. While we naturally cannot reduce cross-shareholdings by 150 billion yen by the next Ordinary General Meeting of Shareholders, we would like to obtain the understanding of shareholders and companies that provide advice on the exercise of voting rights by expressing our views and policy on reduction of the Company's cross-shareholdings.

Q: Did you decide on this policy under the impression that you will be able to obtain the understanding of railway companies, developers, and other customers on reducing cross-shareholdings? Or will you begin to discuss this with them from this point onward? Also, what impact do you think reduction will have on activities aimed at obtaining orders?

A: We have already approached some of the companies we hold shares in and they understand our policy. However, we need to provide additional clear explanations and need to gain their understanding on the specifics of selling shares, so we think this will take time. While we expect that obtaining the understanding of companies we hold shares in will be difficult in some cases, we will persist in clearly explaining this until we obtain the understanding of the company concerned on proceeding with a reduction in shares held. We also expect the market trend toward reducing cross-shareholdings to accelerate. We think the impact on activities aimed at obtaining orders will differ, depending on each customer.

Q: You mentioned that funds from the sale of cross-shareholdings will be invested in growth. Is it possible that the funds will be used for shareholder returns?

A: We want to use the funds from the sale of cross-shareholdings as capital for growth of the Obayashi Group. However, we are also carefully considering shareholder returns in the next Medium-Term Business Plan that is currently being formulated, and would like to explain this when we announce the next plan in March of next year.