OBAYASHI

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OBAYASHI CORPORATION
2nd Quarter: Summary of the Financial Results Briefing for Fiscal Year Ending March 31, 2023 (Online Conference) and Main Questions and Answers

Date/Time: Tuesday, November 8, 2022, 10:30 a.m. to 11:30 a.m.

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1. Financial Results for Second Quarter and Full-Year Forecast for FY 2023.3, and Toward "Accelerating Company-wide Transformation"

An explanation was provided, based on the "2nd Quarter: Presentation on Financial Results (April 1, 2022 to September 30, 2022)."

2. Main Questions and Answers

(1) Regarding the Revision of Financial Forecasts for Fiscal Year Ending March 31, 2023

a. Domestic Building Construction Business

Q: You have explained that the profit margin of the domestic building construction business was lowered due to higher material costs. After the major downward revision a year ago, the inflation climbed and the yen depreciated further, and I wonder if they have certain impacts. Were you able to increase the contract amount to cope with higher material prices through negotiations with the clients, or was it that the main factor for the revision a year ago was due to the agreed contract amounts, such as too low order prices, and was not due to higher material prices?

A: Concerning the increase of the contract amount in response to higher material costs, we are still in the process of negotiating with our clients for many projects, however, the number of projects where the clients have agreed to raise the contract amounts has been increasing. In the meantime, some projects are suffering from higher material costs, which are reflected in the forecasts this time. For key materials, we are taking measures such as placing orders in advance.

Q: Please tell me how you are incorporating the impact of the higher material costs in the projected profit margin in the domestic building construction business. You have explained that you are expecting further price hikes in the future, but may I understand that, unless the material prices go up further than your expectation, there is no downside risk in the projected profit, or have you incorporated some of the material price hikes beyond your expectation?

A: The budget for the construction projects is determined based on the market prices. We are not using the guessed prices as we do not know for sure if the prices are going up or down. Accordingly, if the material prices further go up, the profit margin may go down further. For projects that are affected by the rising material prices, it is imperative for us to get understanding of our clients for increases of the contract amounts. Accordingly, we are in the process of negotiation with them. We are not sure how the material prices change in the future, as it is a matter of the market.

b. Domestic Civil Engineering Business

Q: Please tell me the background for lowering the forecast for non-consolidated gross profit rate of completed construction contracts of the domestic civil engineering business for the full fiscal year, revising the forecast for the second half downwards to 12.3% as against the actual margin rate of 16.0% for the first half.

A: The margin rate for the second quarter of the previous fiscal year was low due to the deterioration in profitability of certain large-scale projects and posting of provision for loss on construction contracts, and in the absence of such factors, the actual figure for the second quarter of this fiscal year increased. In addition, we were able to have the contract amounts increased for certain projects, and accordingly, our profit grew substantially, achieving the high margin rate of 16%. In the meantime, for the second half of the current fiscal year, there will be only a small number of completions of projects at the Tokyo Main Office, which tend to be large in scale, in comparison to average years. Also, certain highly profitable projects were completed in the first half and the on-site support costs are expected to rise in the second half in compliance with the revised Labor Standards Act. Accordingly, we expect the margin rate to be low. For the full fiscal year, although some projects are ahead of and others behind the schedule, the net sales of completed construction contracts are generally in line with the plan. However, there are some large-scale projects with high profitability whose progress is delayed due to circumstances of the clients. Furthermore, the profitability of certain projects is reduced due to revisions to construction costs and processes. Overall, these factors will have negative impacts on the profit margin for the second half. We are also expecting an increase in the on-site support expenses as we are promoting measures to be compliant with the revised Labor Standards Act, which is another factor for the downwards revision of the expected gross profit of the completed construction contracts for the full fiscal year. Due to these factors, the forecast for the non-consolidated performance of the domestic civil engineering business for the full fiscal year is revised downwards by 2.5 billion yen from the figure released on August 10 to 37 billion yen.

c. On-site Support Expenses

Q: Please clarify if the increase in the on-site support expenses in both the domestic building construction business and domestic civil engineering business, which is revised upwards from the forecast at the beginning of the fiscal year, is attributable to labor shortage, increases in the work volume, or other factors.

A: For the domestic building construction business, one of the factors is an increase in the cost of temporary workers. Such costs include an increase in the external human resources for supporting the on-site work from off-site sections, and expenses for concierges for educating on-site staff on the information and computer technologies (ICT). If ICT gets widely spread, we expect the expenses for the digital concierges to decrease. The increase in the costs of temporary workers is attributable to the reform of working practices in order to decrease overtime hours and to achieve five-day workweek on the site, and the resulting temporary shortage of human resources on site. As the available external human resources are being depleted, the costs of external new graduates, who are not yet experienced in the work, are incurred during the training period.

In the domestic civil engineering business, one of the major factors is that we are managing the on-site work, trying to achieve full compliance with the revised Labor Standards Act one year ahead of the enforcement. We are developing a system so that some of the on-site work can be supported by external human resources or by staff members of the head or branch offices. Particularly, in the civil engineering projects, the document formats are different from client to client. We also must prepare a vast amount of documents and photos for inspection, and we started trying contracting such work out. If the practice starts to be a norm from the next fiscal year onwards, the on-site productivity will improve, the overtime hours will decrease, and the costs of temporary workers will be posted instead. Please consider that the current increase in the costs of temporary workers is temporary while trying the new practice.

e. Selling, General and Administrative Expenses

Q: One of the factors for the downwards revision of the forecasts this time is the increase in the selling, general and administrative expenses. I have never seen such a big revision during a fiscal year in the past. Please tell me in detail what the major factors are, whether this is a one-off jump, and whether the expenses are likely to continue soaring in the next fiscal year onwards.

A: Let me explain the reasons for the increase in the selling, general and administrative expenses separately for human resources and for others. Concerning the increase in the human-resources expenses, the business has been booming as the demand for construction work remains at a high level. We are enhancing of the support functions of the head office and branch offices for supporting the on-site work, increasing human resources-related investment including securing sufficient human resources and increasing the number of employees through recruitment of new graduates, mid-career recruitment and recruitment of specialists, giving in-person and online training for fostering employees and developing their capabilities, providing opportunities for them to voluntarily participating in educational programs, and enhancing programs for employees to study in Japan and overseas and promoting exchange programs. These measures are among factors contributing to increases in human resources expenses. The increase in other expenses is mainly attributable to rises in digital-related investment expenses. Specifically, expenses are increasing for implementation of the business process reengineering and associated investments for reviews and revisions of the business processes and integration with digital technologies. The digital-related investment expenses were taken into account from the beginning of the fiscal year. However, with progresses of such projects, it has become clear that it will cost more than originally expected. Accordingly, we revised our estimate at this stage.

We expect that the human resources-related expenses in the selling, general and administrative expenses will continue rising from the next fiscal year onwards, as the government and Japan Federation of Economic Organizations are asking companies to raise wages. Moreover, we recognize that human resources-related investments are necessary outlays, and we believe the current level of expenses will continue for some time. Concerning other expenses, we had some one-off expenses this year, such as the "Obayashi Vision Showcase" project to celebrate the 130th anniversary of the Company. Because no major one-off expenses are expected for the next fiscal year, we expect the expenses will decrease slightly. For the time being, we will have to incur expenses for responding to the current state of various affairs, but will solidly prune unnecessary expenses. When we are planning the budget for the next fiscal year, we will rigorously review expense items in detail.

(2) Status of Business Divisions

a. Domestic Building Construction Business

Q: You are expecting that earnings and profit margin of the domestic building construction business will be higher for the next fiscal year than for the current fiscal year. Please let me know the reasons for the better earnings and profit margin for the next fiscal year under the circumstance of current ratio of unprofitable projects on carried-forward contracts and soaring prices.

A: Concerning the material prices, although prices of some items are getting stabilized, there are other items whose prices are expected to go up from now. There are thus many uncertainties in this regard. We expect the ratio of construction contracts with provision for loss on construction contracts to net sales of completed construction contracts will be a bit higher for the next fiscal year. We cannot say for certain, but we expect the bottom line will be in line with the forecasts for the current fiscal year, though. Concerning the inflation, price hikes have been already discounted so far. As we are using the current market prices in making estimates for the orders to be accepted, the issue is the level of price increases in materials from now on. As with the current fiscal year, we will negotiate with the clients for increases in the contract amounts when the prices actually go up.

Q: Please tell me the outlook for net sales of completed construction contracts of the domestic building construction business. You have explained that you plan to be compliant with the reform of the working practice one year ahead. In so doing, is it your plan to further reduce orders received to be in line with the capacity? When the working practice reform is in place, is it possible for you to maintain the sales at the current level of about 1.1 trillion yen?

A: Until FY2027.3, we plan to manage the business in accordance to the Medium-Term Business Plan 2022, with consolidated sales of 2 trillion yen, operating profit of 100 billion yen, and sales of the domestic building construction business of 1.1 trillion yen. The total working hours will decrease due to the working practice reform, and we will offset the impact through enhancement of our productivity, by means of technological development and utilization of ICT. We are planning to increase the number of new recruits of the building construction division for the next year by 20% in comparison with ordinary years, and we are also asking suppliers and subcontractors to devise means to enhance their productivity. We seek to achieve the targets through these measures.

Q: The profitability at the time of receiving orders affects the future profitability. What was the status of profitability of projects received during the first half?

A: The amount of orders received in the domestic building construction business was 384.5 billion yen, which may seem small in comparison to our competitors. This is because, at the end of the previous fiscal year, we had a very large amount of orders to be carried forward, and we controlled receiving orders at an appropriate level. Accordingly, we do not think there is any issue in this respect. The rate of progress of orders received in the first half was 38%, which was in line with the original annual plan, and is a level close to about 40% in ordinary years. This year, in consideration of the lessons learned from the previous fiscal year when we posted provision for loss on construction contracts, we are reducing receiving orders for large projects with low profitability. We are also reducing accepting projects whose construction is supposed to start in a year or two in consideration of our construction capacity. In terms of profitability this fiscal year, as we are highly selective in choosing projects we participate in, we have been able to focus our in-house resources and our rate of successful biddings has improved substantially, and the profitability appears to be improving too. Of course, as the competition for large construction and redevelopment projects in the urban areas is very tough among major general contractors, the profitability of these projects is generally low, which could be a factor for lowering our overall profitability. All the companies appear to be selective, due to the construction capacity, and we are participating solely in biddings that we would like to win. Profitability of smaller and renewal projects has generally been very good, and we are fairly sure that our overall profitability will slightly improve in the future. Our concern is that, due to the construction capacity, we sometimes have to decline participation in biddings despite invitation from the clients.

Q: Please tell me about the order-receiving environment of the domestic building construction business in the future.

A: According to a research institute, the investment in private non-residential construction is expected to remain good, which is expected to increase 2% in FY2023 over FY2022. Among the non-residential lines, demand for large office buildings in good locations in urban areas is expected to remain good, despite poor financial performance of tenants due to the COVID-19 pandemic and poorer occupancy rate due to widespread practice of working from home. We have actually been receiving a lot of inquiries from major developers. Looking at capital investment of manufacturing companies, we are seeing an increasing number of construction plans, particularly of data centers and semiconductor-related manufacturing facilities, and still expect increased investment. It is estimated that the data center-related investments will continue increasing by 15 to 20% per annum over the next five years.

We are ahead of our competitors in taking measures to work on data centers. In the future, we believe that demand for ultra large cloud-enabled data centers will increase that are similar to the projects that we are working on in Indonesia, Singapore, and other Asian countries. We are working with North American Regional Headquarters and Asia-Pacific

Regional Headquarters to share the human resources globally to be responsive effectively. In Japan, we have already worked on a fairly large number of large data centers.

Q: You have explained that there are a large number of big redevelopment plans. As there are a large number of projects whose construction is to be completed in 2027 and later, I wonder if you will give more importance on the profitability and if you may choose not to receive certain orders depending on the situation. I would like to know your targets and strategies in receiving orders, including the project in Shinjuku Area.

A: It is not that we will not work on large redevelopment projects. We will determine whether to participate in these projects in comprehensive consideration of factors, including our relationship with the client, profitability, and whether the form of agreement allows us to hedge the risk. There are a vast number of projects in the Metropolitan Area whose construction is to be completed in 2025 and later, and we are currently narrowing down which projects we should be targeting on.

b. Domestic Civil Engineering Business

Q: It appears that the profit margin of the domestic civil engineering business is somewhat lower than that of the competitors, including in the second half of the current fiscal year. Is it that there are certain projects whose profitability is not very good, or is it a matter of timing and that the profitability will recover from the next fiscal year onwards when sales of projects with good profitability are recorded?

A: We are not sure about the situations of competing companies, but in our case, the number of projects that could boost our overall profit, which were abundant from 2016 to 2020, has been decreasing, and we are focusing on enhancing the profit through improvement of the productivity and other measures. It is true that, for the current fiscal year, there were certain projects that reduced our overall profitability, but we believe the current level of profitability will continue in the next fiscal year onwards. We are working to enhance the gross profit margin of completed construction contracts by taking various measures comprehensively.

c. Real Estate Development Business

Q: You have explained that in the real estate development business disposition of assets progressed in the second quarter. Please tell me about your policy and plan for the next fiscal year onwards for sale and replacement of real estates and other fixed assets.

A: We sold a large property in the second quarter. Our policy for the real estate development business is to sell off as soon as possible the rental properties in the portfolio that are aged and degraded or that are not fit with the times and to invest the sales proceeds in new properties. Also, from the viewpoint of controlling the overall volume of assets, we will continue removing properties from the balance sheet, utilizing private-placement funds and REITs where applicable, and focusing on managing the sold properties to get management fees. We will continue replacing the properties in the future, but it is not a stage to tell specific volumes and amounts of sales and purchases in the next fiscal year or the year after next.

(3) Operating Profit

Q: Please tell me about your forecast for the next fiscal year in consideration of the revision to the financial forecasts for the current fiscal year this time. I wonder if it is rather difficult to achieve the operating profit of 100 billion yen for the next fiscal year as spelled out in the Medium-Term Business Plan 2022.

A: As explained, for the next fiscal year, we are seeking to maintain the profitability at the level of the full-year forecast for the current fiscal year for the domestic civil engineering business. In the domestic building construction business, we are reasonably sure that the profit for the next fiscal year will be somewhat better than the estimate for the current fiscal year. In such a situation, it is not possible to say at present whether the target consolidated operating profit of 100 billion yen can be achieved or not, but the entire Company will work hard together and take every possible measure to achieve the target.

(4) Other

Q: Concerning the e-MoRoad referred to on Page 16 of the 2nd Quarter: Presentation on Financial Results, do you think that it will have a ripple effect on the construction business in the future? Is it a business related to the comprehensive infrastructure? Let me know how you position the business.

A: e-MoRoad is still in the phase of substantiative experiment. It is a technology in the field of mobility, or basic infrastructure of the society, and accordingly, we do not think it possible to implement the technology in the society in the absence of standardization and relevant legislation and regulations. We are still in the stage of developing the technology, pondering on what kind of business models we should be developing in the future for this technology.