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OBAYASHI CORPORATION
Summary of the Financial Results Briefing Conference for FY2023 2nd Quarter (April 1, 2023 to September 30, 2023)

Online conference held on Tuesday, November 7, 2023, from10:30 to 12:00

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1. Financial Results for Second Quarter / Full-Year Forecast for FY2023 / Management Issues

An explanation was provided, based on the Presentation on Financial Results FY2023 2nd Quarter (April 1, 2023 to September 30, 2023) .

2. Main Questions and Answers

(1) Impact of the accident in Yaesu

Q: You said that the impact of the accident in Yaesu has not been factored in. What kind of risks, such as additional costs, delay on completion, and compensation for the delay, should we expect from the accident?

A: We are taking seriously the fact that we caused a serious occupational accident in which six persons fell victim, including two who lost their lives. We would like to express our sincere condolences and respond to the bereaved families and victims with utmost sincerity and consideration. To make sure that we would never cause such accidents again, we will ensure construction is carried out with utmost priority on safety, more than ever, by once again placing the awareness that “we do not compromise on safety” at the base.
We are yet to resume work at the construction site. Investigations by the police and the labor standards inspection office are continuing, and the scope of the damage requiring repair is also unconfirmed. For this reason, we cannot say how much expense we would incur or how long it would take to resume construction work at this point. We hope to disclose some information at the announcement of the third-quarter financial results in February next year.

Q: You have revised the forecasts upward, although the impact of the accident in Yaesu is unknown. Is there a possibility that you would revise the full-year forecasts downward once the impact becomes clearer?

A: We cannot discuss the impact of the accident in Yaesu because we do not have a clear idea of the scope of repair, the timing of resumption, and other matters. However, at this point, we don’t think it would fall under the requirement for timely disclosure.

(2) Domestic Building Construction Business

Q: The progress in the profitability of the non-consolidated building construction business appears to be underperforming the plan. Can you recover it? Or, is the situation too difficult for you to achieve the plan, as labor costs and material prices have been rising?

A: The profitability for the first half of the fiscal year declined year on year due to the progress in large-scale projects with low profitability for which provision for loss on construction contracts had been recorded through the previous fiscal year and projects that were affected by the impact of price hikes continuing from FY2021 as well as the impact of the rise in labor costs. The profitability slightly fell below the plan due to multiple projects that did not make as much progress as expected. However, this impact is temporary and is expected to be eliminated within the current fiscal year. Therefore, we think it would not affect the full-year forecast.

Q: Do you expect the gross profit margin on completed construction contracts of building construction projects to rise from the next fiscal year?

A: While the impact of the projects for which provision for loss on construction contracts have been recorded is expected to last till FY2024, we assume the gross profit margin on completed construction contracts to rise as the profitability of the projects for which we received orders recently has been increasing.

Q: What is the trend in profitability at the time of receiving orders for the domestic building construction business in the first half?

A: Profitability at the time of receiving orders has also been improving, propped up by robust construction demand. Demand for redevelopment in urban areas and logistics facilities has been steady, and more recently, we have received a large number of inquiries related to shifting production bases back to Japan, especially for semiconductors, storage batteries, pharmaceuticals, data centers, and others subject to government subsidies. There are cases where we regrettably have to decline, even if clients specifically bring projects to us, because of the limitation of our construction capacity. There also was the impact of considering our construction capacity and profitability, and many projects whose sales we started recording in the second quarter contributed to profits, along with which gross profit margin on completed construction contracts also rose.

The rate of progress in the first half was 37% compared with the full-year target for orders received, but we feel that we can fully achieve the target as there are project orders that we are highly likely to receive. With the scale of projects becoming larger, some projects are worth more than 100 billion yen in construction costs per project, and the orders received for a single fiscal year fluctuate significantly depending on the term in which large-scale projects are recorded. Therefore, instead of being overly concerned about whether we can achieve the plan for orders received in a single year, we should consider leveling the value of completed construction work and focus on receiving orders in a planned manner. The construction market is steady, and the situation is expected to continue for two or three more years.

Q: The construction order environment has become favorable, and competition among major general contractors appears to have eased. What is behind this situation? What is the reason for increased profitability at the time of receiving orders: is it because the number of bidders has gone down, or is it because companies have raised their profitability target? Also, have there been changes to profitability at the time of receiving orders depending on facility type?

A: Companies appear to be narrowing down orders due to their respective construction capacity and response to the revised Labor Standards Act of Japan from FY2024. The situation must be similar for all major general contractors. If you look at bidding also, all five major general contractors used to participate, but this has now come down to two to three, and there are some cases where none of the five participates. Construction capacity seems to be tight at all companies. We expect this situation to continue for a while. We have also been narrowing down target projects as early as possible from the stages of estimation and bidding.

The capacity is even tighter at mechanical and electrical (M&E) subcontractors than at general contractors. One precondition at the stage of narrowing down target projects is whether we have M&E subcontractors lined up.

As for profitability by facility type, the profitability of offices is not high in general, but they become stock for the future as we can expect renovation works after construction. On the other hand, we can secure relatively higher profitability from logistics warehouses, data centers, and pharmaceutical plants, as customers request to operate them as soon as possible.

Q: Inquiries from the manufacturing industry must be at their peak now. How do you think the current situation, where the share of the manufacturing industry in the domestic building construction business is 30 to 40%, will change in the future?

A: We expect this situation to continue for a while. Looking at construction plan information, we are not sure about semiconductors due to their large fluctuations. However, we have lined up projects for storage batteries, data centers, and others for seven to eight years from now, and we expect the current share situation to continue for a while.

(3) Domestic Civil Engineering Business

Q: You have explained that the gross profit margin on completed construction contracts of non-consolidated civil engineering construction came to 14.8% as you received an order for a design change project, which had been expected for the second half. At the same time, the profitability for the second half is 10.8% when calculated from the full-year forecast. So, is my understanding correct that profits have been outperforming the plan?

A: In the first half, profits improved due to design changes to large-scale projects and cost reduction in addition to the progress in the abundant construction projects in hand. At this point, it does not require us to revise the full-year profit forecasts. Still, the full-year profit forecasts are the bottom line, as we have been explaining from the beginning of the fiscal year. We will continue to improve profits in the second half through measures such as the acquisition of design change projects and cost reduction.

(4) Acquisition of MWH

Q: Please explain the acquisition of MWH in detail. We understand the company is located in Colorado, but does it have business all over the U.S.? Did you have future participation in the water concession business in mind when you acquired it?

A: With respect to its operating area, we would like MWH to cover the entire U.S., unlike the local general contractors the Group had acquired in the past. In the U.S., securing water infrastructure is one of the social challenges, and the market is growing. If the PPP method is going to be used as the general method for placing orders in the future, we would like to work on it by leveraging Obayashi Group's strengths, including its creditworthiness.

Q: Regarding the financial performance of MWH, its operating income appears to be 1 to 3% most recently. What are its profit levels under normal conditions, and are you considering any future measures for improving profits?

A: As for MWH's business performance, its net sales have been in the $500million level and operating margin in the 2% level. It is not so different from other companies in the same industry in North America. In the future, we will improve business performance by acquiring highly profitable projects and reducing costs within the scope of CMGC contracts. Further, in the U.S., it is required to provide a 100% performance guarantee against the contracted value. As MWH becomes a Group company, it can use the credit tied to the net assets and, therefore, is expected to grow. Also, by Obayashi Group companies forming a JV supporting the type of work MWH need, the Group will be able to take in the sales and profit of the JV.

(5) Capital Policy

Q: The presentation material states that you would "explore the best capital policy including various options such as dividend increases and share buy-backs" regarding shareholder returns. Is my understanding correct that it means shareholder returns will not be excluded as you review the framework of the Medium-Term Business Plan? Is it appropriate to understand that you are taking a more in-depth approach than in the past, also considering the requests by the Tokyo Stock Exchange? Given the impact of the changes in the business environment, the situation is that it has become difficult to meet the profit target of the Medium-Term Business Plan and you appear to have no extra cash flow. Are you planning to use the cash you gained from the sale of cross-shareholdings?

A: Our shareholder return policy is around 3% in DOE in the Medium-Term Business Plan 2022, and we are examining it by keeping all options open. As we grow as a group, we are looking at the capital efficiency of each business and discussing the ideal balance sheet for the Obayashi Group as a whole, as well as the appropriate level of equity, which we have accumulated from the time of the Medium-Term Business Plan 2017, while discussing the future capital policy within the company.

Q: Regarding shareholder returns, you have said that you would "explore the best capital policy including various options such as dividend increases and share buy-backs" by considering the changes in the business and management environment. What specifically do you mean by the changes in the business and management environment? Are you reviewing shareholder returns because you have cash flow to spare?

A: The business has undergone changes, such as rising prices and the renewable energy market, from the time we were planning the Medium-Term Business Plan 2022 in late 2020 to 2021, and we believe we have to respond to these changes. We are also facing questions from the market regarding the improvement of capital efficiency in the management of the Obayashi Group. Since Medium-Term Business Plan 2017, we have been strengthening the balance sheet. Going forward, we need to assess the capital efficiency of each business and consider the Group's ideal balance sheet. Then, after the growth investment, if there is a surplus equity capital, we think we need to consider allocation to shareholder returns.

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Q: Does it mean that you are not satisfied with the current capital efficiency and will reduce assets as much as you can and return the surplus to shareholders?

A: Capital efficiency is not everything, but it is a very significant factor. The capital required for each business differs from the capital cost required by the market, and we will scrutinize each of these. At the same time, the current balance sheet has strengths for the Group as a whole, especially when carrying out business in North America. Including that point of view, we would like to consider the capital policy while examining the balance sheet.

(6) Reduction of Cross-Shareholdings

Q: You are making good progress in the sale of cross-shareholdings. Do you think you can achieve the sales target earlier than March 2027? Please explain the schedule of the sale of cross-shareholdings.

A: We have been selling cross-shareholdings, but their value has grown due to share price rises. We had set a sales target amount of 150 billion yen in the Medium-Term Business Plan 2022. Still, in response to rising stock prices, we have reset the sales target amount so that cross-shareholdings will be 20% or less of consolidated net assets, and the marketing divisions have been leading the effort to request customers for their understanding. We will work on the sale to achieve the target as early as possible during the Medium-Term Business Plan period.

(7) Others

Q: Regarding your response to the revised Labor Standards Act, you mentioned that you have achieved 98% of the cap on overtime work. What impacts and changes do you expect to occur from FY2024 onwards?

A: We expect an impact on net sales of completed construction contracts resulting from a decline in the value of completed work amid requirements for response to work style reform, and we have been promoting active utilization of external human resources and outsourcing as countermeasures. We are also promoting the utilization of ICT and DX and labor-saving using robots to increase productivity and dispatching digital concierges to promote them at construction sites. The expense for supporting construction sites is on a rising trend as we are in a transitional period at the moment, but we believe the results of the measures will gradually become visible. Whether for building construction or civil engineering business, we would like to actively request clients through industry associations to ensure appropriate construction period and pass on the increase in labor costs to contract fees.

Q: You have launched the carbon neutrality consulting business. What strengths do you have as a carbon neutrality consultant? Can we expect scale expansion of renovation projects in the future?

A: We have been proposing various ideas in response to numerous inquiries from customers who did not know how to work on carbon neutrality, which is a social challenge. In this process, we received a request to serve as an advisor, so we decided to work on providing advice as a business. Going forward, we expect to grow the business by leveraging our know-how related to carbon neutrality, such as receiving orders for renovation projects in addition to orders for new projects.

Q: The construction industry has been cyclically improving and deteriorating in terms of profitability and is currently improving. Nevertheless, assuming that the order environment will eventually worsen, what is your idea of a contracting business, and what kind of initiatives do you have to handle it?

A: We do not think this order environment will last forever and recognize that tough times will eventually come. We established the Procurement Division in October this year to increase our cost competitiveness while we, as a company, still have the strength. Each branch has individually carried out procurement, but we will reduce costs by switching it to all-branch procurement with large procurement volumes and, at the same time, strengthen the supply chain. The division has started with steel beams, curtain walls, and M&E equipment, whose prices are rising, and we plan to gradually increase the number of items for all-branch procurement. We also would like to work on enhancing procurement capability and cost competitiveness by leveraging a give-and-take approach.

We also have to work on improving the terms and conditions of the contracts between clients and general contractors. This will be difficult without the cooperation of industry associations and other companies in the industry, and we are reviewing the contract terms and conditions, including improvement in conditions when prices are rising. Japan Federation of Construction Contractors is also putting efforts into this and has been explaining it with pamphlets, etc., to the industry organizations of clients. Recently, developers have also agreed to include clauses in the contracts to accept negotiations regarding the price increases.

Q: I am not seeing anything among investments in non-contractor business whose profit would grow. In which field are you trying to establish other engines, and at what time in the future?

A: We would like to increase profits not only in the contracting part, but also across all processes in the construction business. For example, in the upstream like building materials, such as Cypress Sunadaya Co., Ltd., with which Obayashi recently entered a capital alliance, and in the downstream such as Obayashi Facilities Corporation. That also includes PLiBOT and Oprizon. In the medium-to long-term, we have been making continued investments in startups and others so that they would sprout, but it takes time till they start contributing to business results.　On the other hand, markets, for example, the offshore wind power business including participation as a business operator, have become quite different from what we have expected as a new business portfolio at the beginning of the Medium-Term Business Plan 2022. We would like to create a business portfolio by responding to such changes while investing in areas where we have to, even if it takes time.

Q: Regarding the major general contractors’ market cap, one company has a 1.34 trillion-yen market cap, while the rest are approximately at the 900 billion yen level. What must Obayashi do to exceed 1 trillion yen in market cap and surpass other companies? What is your view on the market cap?

A: We are fully aware of the market cap. We are also monitoring the levels of the peers’ share prices, and if we see any discrepancies there, we also pay attention to the causes. On the other hand, we are not considering any short-term share price measures to catch up with that of other companies. We will be looking at how each of our businesses can improve profitability and capital efficiency in order to grow and increase the corporate value of the Group as a whole. This also applies to new businesses based on M&A and start-ups. We want to create businesses that will steadily increase the future cash flow of the Group and improve the corporate value. Without grouping ourselves with the five major general contractors, we are discussing where the Obayashi Group should aim for in the future, with a view on the global market including leading conglomerates.

Q: The ratio of votes approving the proposal to elect the Chairman of the Board and President at the General Meeting of Shareholders shows a declining trend, below 80% in 2023. What is your analysis of the decline in approval rate, and what countermeasures will you take?

A: We think it is due to the impact of overseas investors following ISS's voting policy if a company's cross-shareholdings exceed 20% of its consolidated net assets. So, we believe it is mainly due to the amount of cross-shareholdings.