Equities

25 June 2012 | 16 pages

Sekisui House (1928)

Maintaining Buy: Our answers to market doubts and concerns

■ Company Update

- **Conclusion** — In this report, we summarize our take on doubts and concerns we have fielded from investors with regard to our June 13 report, Sekisui House (1928) - Upgrading to Buy: Core ops doing well, China concerns priced in. We do not mean to gainsay the concerns of market players over the company's long-term investment discipline but we believe the shares are attractive over a medium-term investment horizon of a year or so as 1) we anticipate strength in the subcontracted homebuilding operations, even with the external environment opaque, and 2) we feel the risk of losses that could arise in the near term has been excessively factored in.
- **What would the earnings/share price impact of a consumption tax hike be?** — We think that an April 2014 hike in the consumption tax could cause earnings volatility of up to 20% or so. We also note the possibility that the shares could rise over the near term on expectations of a one-off spike in housing demand.
- **What has been the backdrop to recent orders?** — May built-to-order detached house orders fell in reaction to a big increase in the year-ago month but stayed firm on an actual basis. The rental houses segment is overshooting, so overall order progress looks to be in line with the full-year plan.
- **What is the risk of additional losses in urban redevelopment?** — We see limited likelihood of additional losses on held-for-sales real estate in the urban redevelopment segment, where valuation losses were booked in FY1/10.
- **Is investment discipline being maintained overseas?** — Sekisui House envisages the upper limit on the investment balance in the overseas segment at ¥220bn in the foreseeable future and it plans to keep future new investment within the range of funds recouped from previous investments. However, we would not dispute the validity of market players' concerns that losses that have been generated in the condominium and urban development segments will be replicated both in Japan and overseas.

Consol.	Sales		OP			RP		NP		EPS	PE
	¥M	YOY (%)	¥M	YOY (%)	OPM(%)	¥M	YOY (%)	¥M	YOY (%)	¥	X
1/11A	1,488,369	10.0	56,354	nm	3.8	56,271	nm	30,421	nm	45	15.7
1/12A	1,530,577	2.8	70,897	25.8	4.6	70,075	24.5	28,962	-4.8	43	16.5
1/13CE	1,650,000	7.8	80,000	12.8	4.8	79,500	13.4	42,000	45.0	63	11.3
1/13E	1,633,600	6.7	82,800	16.8	5.1	82,300	17.4	43,570	50.4	65	10.9
1/14E	1,716,500	5.1	94,200	13.8	5.5	94,700	15.1	51,840	19.0	77	9.2
1/15E	1,764,700	2.8	99,500	5.6	5.6	101,000	6.7	55,430	6.9	82	8.6

A: Actuals, E: Citi Research Ests, CE: Co. Ests, RE: Citi Research Revised Ests, CRE: Co. Revised Ests, NA: Not Available, NM: Not Meaningful

Buy	1
Price (25 Jun 12)	¥706
Target price	¥800
Expected share price return	13.3%
Expected dividend yield	3.5%
Expected total return	**16.9%**
Market Cap	¥474,198M
	US$5,896M

Price Performance
(RIC: 1928.T, BB: 1928 JP)

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

1928.T: Fiscal year end 31-Jan

Price: ¥706; TP: ¥800; Market Cap: ¥474,198m; Recomm: Buy

Profit & Loss (¥m)	2011	2012	2013E	2014E	2015E
Sales revenue	1,488,369	1,530,577	1,633,600	1,716,500	1,764,700
Cost of sales	-1,231,161	-1,255,253	-1,331,100	-1,394,600	-1,433,400
Gross profit	257,208	275,324	302,500	321,900	331,300
Gross Margin (%)	17.3	18.0	18.5	18.8	18.8
EBITDA	**72,738**	**88,932**	**101,800**	**115,200**	**120,500**
EBITDA Margin (%)	4.9	5.8	6.2	6.7	6.8
Depreciation	-16,383	-18,034	-19,000	-21,000	-21,000
Amortisation	0	0	0	0	0
EBIT	**56,355**	**70,898**	**82,800**	**94,200**	**99,500**
EBIT Margin (%)	3.8	4.6	5.1	5.5	5.6
Net interest	2,158	2,648	1,800	1,800	1,800
Non-op/Except	-2,242	-3,471	-2,300	-1,300	-300
Recurring profit	**56,271**	**70,075**	**82,300**	**94,700**	**101,000**
Tax	-23,371	-33,217	-35,730	-39,860	-42,570
Extraord./Min.Int./Pref.div.	-2,479	-7,896	-3,000	-3,000	-3,000
Reported net profit	**30,421**	**28,962**	**43,570**	**51,840**	**55,430**
Net Margin (%)	2.0	1.9	2.7	3.0	3.1
Core NPAT	30,421	28,962	43,570	51,840	55,430

Per share data	2011	2012	2013E	2014E	2015E
Reported EPS (¥)	45	43	65	77	82
Core EPS (¥)	45	43	65	77	82
EPS* (¥)	43	41	62	74	79
DPS (¥)	21	20	25	31	33
CFPS (¥)	126	39	41	85	96
FCFPS (¥)	93	-6	-26	18	30
BVPS (¥)	1,091	1,107	1,150	1,199	1,250
Wtd avg ord shares (m)	676	675	675	675	675
Wtd avg diluted shares (m)	676	675	675	675	675

Growth rates	2011	2012	2013E	2014E	2015E
Sales revenue (%)	10.0	2.8	6.7	5.1	2.8
EBIT (%)	nm	25.8	16.8	13.8	5.6
Core NPAT (%)	nm	-4.8	50.4	19.0	6.9
Core EPS (%)	nm	-4.7	50.4	19.0	6.9

Balance Sheet (¥m)	2011	2012	2013E	2014E	2015E
Cash & cash equiv.	151,988	174,524	143,862	139,490	140,074
Accounts receivables	35,545	36,530	40,000	40,000	40,000
Inventory	550,433	616,330	666,786	676,386	685,986
Net fixed & other tangibles	436,520	449,568	473,568	495,568	517,568
Goodwill & intangibles	9,809	14,331	14,330	14,330	14,330
Financial & other assets	157,013	154,545	155,442	157,342	160,242
Total assets	**1,341,308**	**1,445,828**	**1,493,988**	**1,523,116**	**1,558,200**
Accounts payable	149,714	138,537	148,537	148,537	148,537
Short-term debt	27,454	62,103	62,103	62,103	62,103
Long-term debt	184,550	132,660	132,660	132,660	132,660
Provisions & other liab	241,561	362,155	370,879	365,879	365,879
Total liabilities	**603,279**	**695,455**	**714,179**	**709,179**	**709,179**
Shareholders' equity	737,255	744,195	772,631	805,759	839,843
Minority interests	774	6,178	7,178	8,178	9,178
Total equity	**738,029**	**750,373**	**779,809**	**813,937**	**849,021**
Net debt	**60,016**	**20,239**	**50,901**	**55,273**	**54,689**
Net debt to equity (%)	8.1	2.7	6.5	6.8	6.4

Valuation ratios	2011	2012	2013E	2014E	2015E
PE (x)	15.7	16.5	10.9	9.2	8.6
PB (x)	0.6	0.6	0.6	0.6	0.6
EV/EBITDA (x)	6.7	5.0	4.4	4.1	3.9
FCF yield (%)	13.2	-0.9	-3.7	2.6	4.2
Dividend yield (%)	3.0	2.8	3.5	4.4	4.7
Payout ratio (%)	47	47	39	40	40
ROE (%)	4.2	3.9	5.7	6.6	6.7

Cashflow (¥m)	2011	2012	2013E	2014E	2015E
EBITDA	72,738	88,932	101,800	115,200	120,500
Working capital	-8,173	-82,739	-43,926	-9,600	-9,600
Other	20,496	20,113	-30,402	-48,260	-45,970
Operating cashflow	**85,061**	**26,306**	**27,472**	**57,340**	**64,930**
Capex	-21,936	-30,510	-45,000	-45,000	-45,000
Net acq/disposals	0	0	0	0	0
Other	947	-12,418	2,000	2,000	2,000
Investing cashflow	**-20,989**	**-42,928**	**-43,000**	**-43,000**	**-43,000**
Dividends paid	-8,786	-12,165	-15,134	-18,712	-21,346
Financing cashflow	**-60,132**	**38,002**	**-15,134**	**-18,712**	**-21,346**
Net change in cash	**3,354**	**17,541**	**-30,662**	**-4,372**	**584**
Free cashflow to s/holders	**63,125**	**-4,204**	**-17,528**	**12,340**	**19,930**

Note: Consolidated data. * EPS: NP/Est Shares OS.

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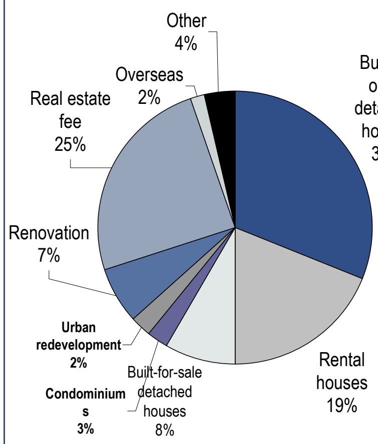
Investment Dashboard

Reasons to Buy

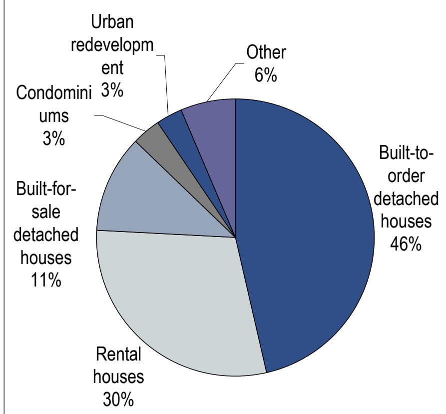
- We think Sekisui House can deliver exceptional earnings momentum for the sector (annual FY1/13-FY1/15 growth rate of 12%) as it maintains high margins in the built-to-order detached houses and rental houses segments and eliminates losses in condominiums and overseas operations
- We see RoE improving to 5.7% in FY1/13 and 6.6% in FY1/14 from 3.9% in FY1/12. Given this, we think the shares are being too undervalued at their current historical lows

Consolidated sales breakdown (FY1/12)



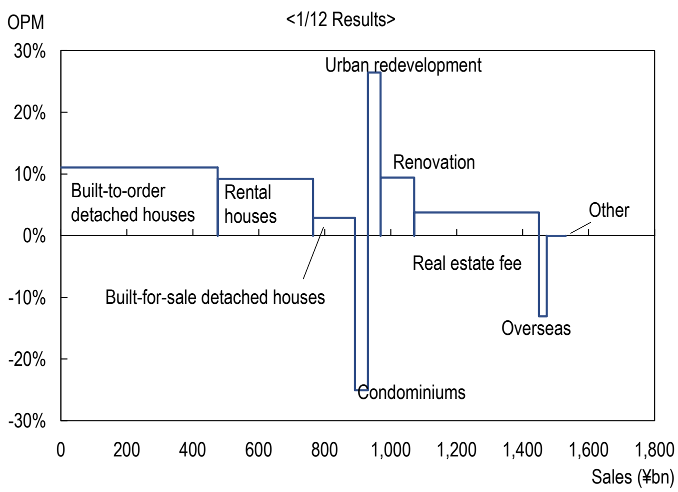
Source: Company data.

Parent sales breakdown (FY1/12)



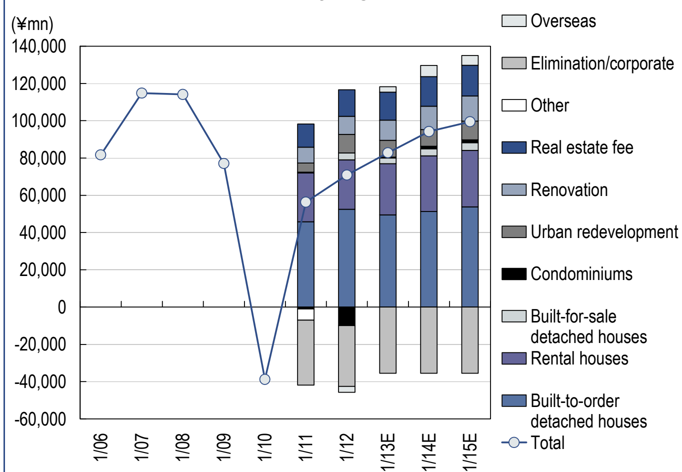
Source: Company data.

Business portfolio



Note: Does not include eliminations. Source: Company data.

OP by segment

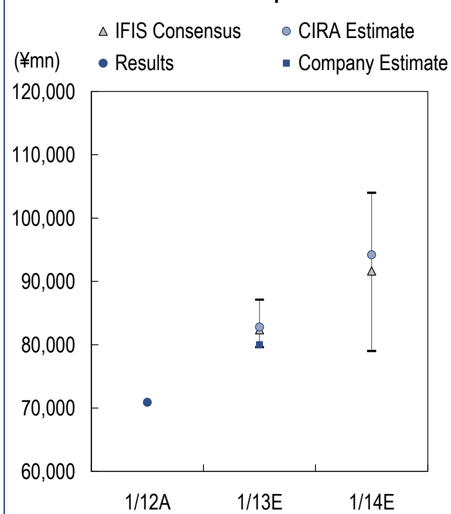


Source: Company data, Citi Investment Research and Analysis.

Alternate scenario: A more bullish case

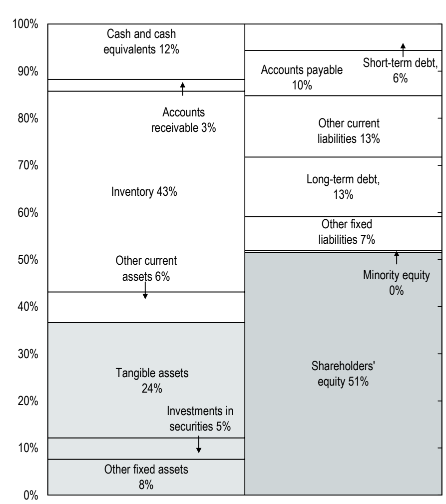
- New housing starts overshoot our assumption
- The deterioration in Chinese real estate conditions is only slight and the Chinese operations contribute to earnings growth in line with the company plan
- If the above scenarios materialize, we would raise our earnings forecasts and target multiple and derive a theoretical share price of ¥1,000

OP forecast comparison



Source: Company data, IFIS (June 25), Citi Investment Research and Analysis.

Balance sheet (end-FY1/12)



Source: Company data.

Share price drivers	Company overview
■ Profit trends ■ Monthly orders ■ Housing prices ■ Real estate market activity ■ Chinese real estate prices	Sekisui House is Japan's largest builder of detached houses (15,882 units in FY1/11) and third-largest builder of condos (22,922). The company's main business is the production and sale of mid- to high-end prefab steel frame homes, wood homes, and condos. Sekisui House entered the urban development business in earnest in 1987 with the Rokko Island City project. From FY1/06 to FY1/09 it booked large profits on the sale of stakes in Akasaka Garden City, Tokyo Midtown, and other projects. Main developments currently owned are Hommachi Garden City, Garden City Shinagawa Gotenyama, and Grand Front Osaka. Sekisui House has accelerated its development overseas since is started acquiring land in Australia in 2009. At end-FY1/12, Sekisui House forecasts it will have overseas real estate for sale of ¥180bn (Australia c¥80bn, China c¥80bn, US and other regions c¥20bn), which would be the largest overseas investment among Japanese housing companies.

Valuations

		Rating		Price	Mkt	FY1E=	EPS		PER (x)		PBR (x)	OPM		EV/EBITDA (x)		RoE	
Code	Company				Cap		FY1E	FY2E	FY1E	FY2E	FY1E	FY1E	FY2E	FY1E	FY2E	FY1E	FY2E
Housing&Construction																	
1808.T	Haseko Corp	2	JPY	52.00	1.0	3/13	7.5	8.7	6.9	6.0	1.1	4.5%	5.0%	7.6	6.0	17.6%	17.1%
1878.T	Daito Trust	2	JPY	7,160.00	7.1	3/13	636.4	682.3	11.3	10.5	3.2	7.2%	7.2%	5.3	4.8	31.3%	28.8%
1925.T	Daiwa House	2	JPY	1,056.00	7.6	3/13	99.2	109.0	10.6	9.7	0.9	6.3%	6.3%	1.7	1.9	8.5%	8.7%
1928.T	Sekisui House	1	JPY	710.00	5.9	1/13	64.5	76.8	11.0	9.2	0.6	5.1%	5.5%	4.5	4.1	5.7%	6.6%
5332.T	TOTO	1	JPY	558.00	2.4	3/13	38.5	46.4	14.5	12.0	1.0	4.5%	5.1%	4.3	3.8	7.1%	8.1%
5938.T	JS Grp	1	JPY	1,563.00	5.7	3/13	114.2	150.6	13.7	10.4	0.8	4.0%	5.2%	6.4	5.2	6.2%	7.7%
5947.T	Rinnai	2	JPY	5,180.00	3.2	3/13	389.3	424.0	13.3	12.2	1.5	10.9%	11.4%	4.5	3.8	12.0%	11.8%
Real Estate																	
8801.T	Mitsui Fudosan	1	JPY	1,433.00	15.6	3/13	64.3	70.4	22.3	20.4	1.1	9.4%	9.8%	12.6	12.9	5.2%	5.4%
8802.T	Mitsubishi Est	1	JPY	1,348.00	23.3	3/13	36.8	57.5	36.6	23.4	1.4	14.6%	16.6%	nm	14.7	4.0%	6.0%
8804.T	Tokyo Tatemono	1	JPY	288.00	1.5	12/12	26.3	19.7	11.0	14.6	0.6	15.8%	12.2%	10.0	11.2	5.9%	4.3%
8815.T	Tokyu Land	1	JPY	377.00	2.5	3/13	33.4	41.2	11.3	9.2	0.8	8.5%	9.7%	nm	13.2	7.2%	8.3%
8830.T	Sumitomo Realty	1	JPY	1,835.00	10.8	3/13	111.7	124.1	16.4	14.8	1.4	21.1%	21.3%	nm	nm	10.3%	10.5%
8933.T	NTT Urban	1	JPY	60,300.00	2.5	3/13	3,187.3	3,059.7	18.9	19.7	1.2	16.8%	15.8%	13.9	14.6	6.2%	5.8%
3231.T	Nomura Real Est	1	JPY	1,384.00	3.3	3/13	107.2	138.8	12.9	10.0	0.8	10.8%	11.3%	14.0	13.0	6.3%	7.7%

Note: Share prices as of the June 22 close.
Source: Company data, Citi Investment Research and Analysis.

Investment points

In this report, we summarize our take on the shared doubts and concerns we have fielded from several investors with regard to our June 13 report, Sekisui House (1928) - Upgrading to Buy: Core ops doing well, China concerns priced in. We do not mean to gainsay the concerns of market players over the company's long-term investment discipline but we believe the shares are attractive over a medium-term investment horizon of a year or so as 1) we anticipate strength in the subcontracted homebuilding operations, even with the external environment opaque, and 2) we feel the risk of losses that could arise in the near term has been excessively factored in.

1) What would the earnings/share price impact of a consumption tax hike be?

We think that an April 2014 hike in the consumption tax could cause earnings volatility of up to 20% or so. We also note the possibility that the shares could rise over the near term on expectations of a one-off spike in housing demand.

We forecast steady order growth

We model order growth in detached houses of 2.4% in FY1/13 and 3.5% in FY1/14. In leased houses, we model an order decline in FY1/13 of 1.9% (+3.7% excluding temporary housing) and order growth in FY1/14 of 3.7%.

Difficult to factor in the impact of a consumption tax hike as things stand, but…

As the outlook for the passage of the bills related to the unified social security and tax reform bills remains murky, we do not factor the impact of consumption tax hikes into our calculations above. Also, according to media reports, the government and the MLIT are looking into additional housing acquisition support measures together with the planned April 2014 hike in the consumption tax (to 8% from 5%) and it is difficult as things stand to factor into our earnings forecasts a demand spike ahead of the consumption tax hike and a decline in demand thereafter.

… if the government follows through on the tax hikes, there could be a demand spike through September 2013

However, if the government follows through on the consumption tax hike in line with the current bills, we think there could well be a demand spike through September 2013. We would not expect a demand spike around April 2014 because in subcontracted housing construction the current tax rate of 5% will be applied as a special exemption of contracts are signed six months or more before the change in the tax rate. Indeed, when the consumption tax was last raised, in April 1997 (to 5% from 3%) the demand spike peaked in September 1996 (Figure 1).

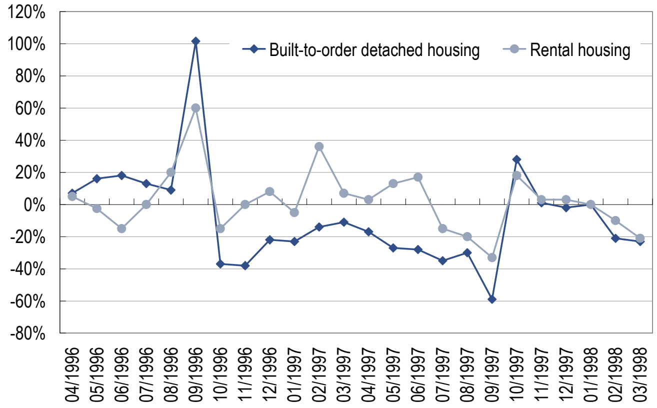
We think OP volatility could be up to 20%

Although the size of the demand spike will likely be influenced by housing acquisition measures, if we assume volatility in new build demand on the tax hike of 5% or 10%, then OP could exhibit volatility of around 10% or 20% versus our forecasts in FY1/14 and FY1/15 (Figure 3).

As before, the shares could rise over the near term

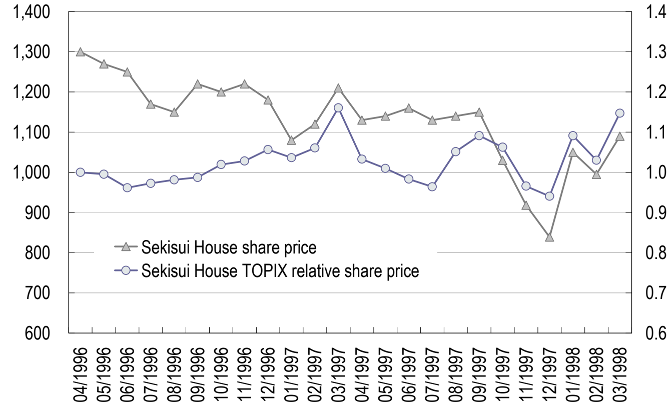
The macro environments are different and no simple comparisons can be made, but when the consumption tax was last hiked, Sekisui House shares turned in almost consistent outperformance versus TOPIX between June 1996 and March 1997 (Figure 2). This time around too we think that Sekisui House, which has relatively robust construction abilities will see a one-time spike in housing demand lead to order growth and note that this could lead to a near-term rally in the shares.

Figure 1. Sekisui House: Order growth rates, 1996-1998



Source: Company data, Citi Investment Research and Analysis.

Figure 2. Sekisui House: Share price, 1996-1998



Source: Nikkei Quick, Citi Investment Research and Analysis.

Figure 3. Sekisui House: Estimate of earnings impact from consumption tax hike

Scenario	(1)	(2)	(3)
Assumption	No change in new housing demand due to tax hike	5% change in new housing demand due to tax hike	10% change in new housing demand due to tax hike
Sekisui House built-to-order housing orders YoY	FY1/2014: +3.6% FY1/2015: +0.0%	FY1/2014: +8.9% FY1/2015: -10.0%	FY1/2014: +13.5% FY1/2015: -17.8%
Sekisui House Operating profit (¥mn)	FY1/2014: 94,200 FY1/2015: 99,500	FY1/2014: 104,600 FY1/2015: 88,900	FY1/2014: 112,600 FY1/2015: 80,800

Note: Subcontracted housing = Detached houses + leased houses.
Source: Company data, Citi Investment Research and Analysis.

2) What has been the backdrop to recent orders?

May built-to-order detached housing orders fell in reaction to a big increase in the year-ago month but stayed firm on an adjusted basis. The rental houses segment is overshooting, so overall order progress looks to be in line with the full-year plan.

Detached houses in negative territory recently, but in line with plan

May detached houses orders were below the year-ago level for the second straight month, with cumulative orders up 3% YoY. However, the decline in May was in reaction to the tough year-ago comparison (+15%) and we understand that on a real value basis, it was ahead of the best three months for FY1/12. When Sekisui House drew up its start-of-period plan, it anticipated a YoY decline in May and YoY increases in June and July and the company says that current order progress is in line with plan.

Overall, Sekisui House is winning orders at a pace that matches the full-year plan

In operations other than detached houses (FY1/13CE sales weighting of 29%), we understand that rental houses (17%) are ahead of plan, built-for-sale detached houses (8%) are falling short of plan, and that renovation (8%) and condominiums (3%) are in line with plan. We think that Sekisui House is winning orders at a pace that overall is broadly in line with the full-year plan.

Figure 4. Sekisui House: YoY growth rate in monthly orders

	Total	Built-to-order detached houses	Built-to-order low-rise apartments	Build-for-sale detached houses	Built-for-sale condos	Remodelling
02/11	-2%	2%	28%	-13%	-55%	31%
03/11	-9%	1%	-11%	-19%	-53%	4%
04/11	0%	6%	5%	-24%	-52%	9%
05/11	7%	15%	29%	-16%	-27%	20%
06/11	6%	-1%	22%	-8%	13%	23%
07/11	3%	0%	13%	-19%	19%	11%
08/11	8%	3%	23%	-23%	15%	-6%
09/11	-6%	5%	20%	-20%	-62%	1%
10/11	-8%	-17%	11%	-38%	-14%	10%
11/11	-3%	-5%	1%	-19%	-20%	-9%
12/11	10%	2%	-3%	-23%	157%	7%
01/12	-1%	-1%	9%	-28%	21%	1%
02/12	3%	11%	-7%	-23%	10%	2%
03/12	15%	12%	14%	-19%	123%	31%
04/12	2%	-6%	8%	8%	143%	5%
05/12	0%	-7%	1%	-3%	42%	6%
02/12-05/12	4%	3%	6%	-11%	74%	11%
FY1/12A	--	-2%	9%	-20%	-17%	--
FY1/13CE	--	6%	2%	4%	0%	--

Note: Fiscal year numbers include subsidiaries but monthly numbers do not, so they are not strictly comparable.
Source: Company data, Citi Investment Research and Analysis.

3) What is the risk of additional losses in the urban redevelopment business?

Sekisui House posted valuation losses in FY1/10 on real estate for sale in the urban redevelopment business. We believe there is limited possibility of additional losses.

We estimate the book value of office-related projects at ¥130bn

Sekisui House is involved in four office-related urban redevelopment projects (Figure 5), and construction is complete in all of them. We estimate total project costs at about ¥180bn, but book value for the four projects looks to have been c¥130bn at end-FY1/12 as Sekisui House appears to have posted losses of ¥24bn on the Hommachi Minami project and ¥22bn in losses on the Shinagawa Gotenyama and Gotenyama SH Building projects in FY1/10.

Earnings in line with expectations when valuation losses were posted, cap rate flat or down slightly

Sekisui House assumes it will sell its urban redevelopment projects, so it posts them not as fixed assets but as liquid assets (real estate for sale) on its balance sheet. These projects undergo an appraisal by an external body each fiscal year. The Hommachi Garden City project is more or less fully occupied right now, and the Gotenyama SH Building is fully occupied. There has been progress in leasing space in the Hommachi Minami and Shinagawa Gotenyama projects, and we understand rents and other contract conditions are in line with earnings expectations when the valuation losses were posted. Also, cap rates in Shinagawa and along Osaka's Midosuji line (where these projects are located) are the same as or slightly lower than when valuation losses were posted in FY1/10.

Market value for Hommachi Minami and Shinagawa Gotenyama unlikely to fall below current levels

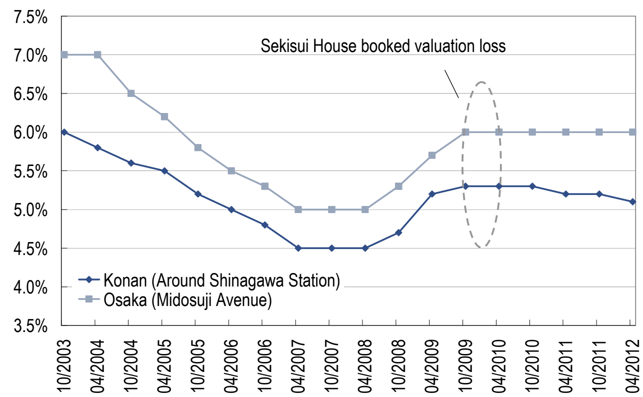
Assuming macroeconomic factors do not deteriorate sharply, we believe the market value for the Hommachi Minami and Shinagawa Gotenyama projects are unlikely to fall below current levels. We think this because 1) rents should be bolstered as office supply eases off in Tokyo and Osaka and 2) cap rates are falling extremely slowly as the real estate investment market picks up.

Figure 5. Sekisui House: Major urban redevelopment projects

Project	Hommachi Garden City	Hommachi Minami Garden City	Garden City Shinagawa Gotenyama	Gotenyama SH Building
Location	Osaka	Osaka	Shinagawa	Shinagawa
Purpose	Office, Hotel, etc.	Office	Office	Office
Land acquisition	2004	2006	2007	2007
Completion	06/2010	03/2011	02/2011	02/2011
GFA (m²)	50,000	47,000	64,000	20,000
Total cost (¥mn)	33,000	45,000	Total 100,000	
Booked valuation loss (¥mn)	0	24,000	Total 22,000	
Recent book value (¥mn)	33,000	21,000	Total 78,000	
Leasing situation	･4 commercial floors are already contracted ･17 hotel floors are already contracted ･Among 8 office floors, 7 floors are already contracted	･2 commercial floors are already contracted ･Among 21 office floors, 4 floors are already contracted	･Among 8 floors, 3 floors are already contracted	･All floors are already contracted by one tenant

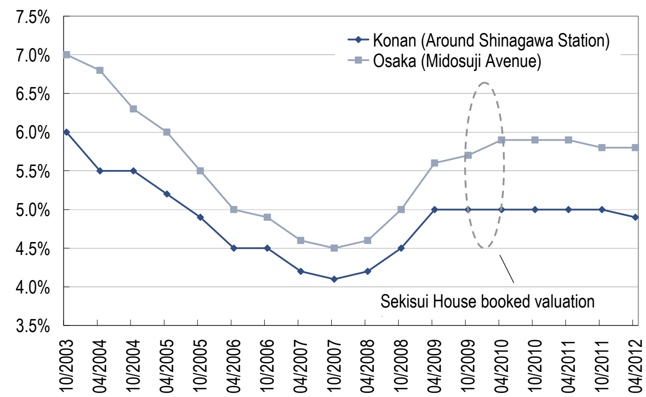
Note: Timing of land acquisition, total costs, and valuation loss figures are all our estimates.
Source: Company data, Citi Investment Research and Analysis.

Figure 6. Expected yields for A-class buildings



Source: Japan Real Estate Institute, Citi Investment Research and Analysis.

Figure 7. Cap rates for A-class buildings



Source: Japan Real Estate Institute, Citi Investment Research and Analysis.

4) Is investment discipline being maintained overseas?

For now the company expects its overseas investment to be no more than about ¥220bn, with future investment paid for using capital recouped from previous investments. However, we cannot deny market concerns that in the long term losses could recur, both in Japan and abroad, in the condo and urban redevelopment segments.

Sekisui House plans to fund future overseas spending with capital recouped from earlier investments . . .

As of end-April 2012, total overseas investment stood at ¥208.9bn (¥84.4bn in Australia, ¥68.3bn in China, ¥37bn in the US, ¥19.2bn in Singapore). According to Sekisui House, total overseas investment is likely to rise to about ¥220bn at end-FY1/13 due to construction spending in Australia and additional land acquisition in China. Sekisui House plans to fund future overseas spending with capital recouped from earlier investments.

. . . but Sekisui House has invested stable cash flow in low-margin development projects in the past

At the same time, Sekisui House has in the past invested stable cash flow generated by its domestic subcontracted housing operations (detached housing and rental housing) in low-margin investments, which has damaged overall corporate value. As noted above, the firm posted valuation losses in FY1/10, particular for

large-scale redevelopment projects that it acquired land for in the mid-2000s, and this resulted in its first consolidated operating loss since listing. In addition, Sekisui House has been markedly slow to dispose of unprofitable inventory in its condo segment, despite a decline in prices since 2008. Therefore, this segment remained in the red at the operating level in FY1/12.

After we upgraded the stock, we received feedback from a number of investors regarding Sekisui House's past failures

After we upgraded Sekisui House from Neutral to Buy in our June 13 report, many investors said to us that while they feel the shares do appear currently undervalued even considering all near-term risks (China business, etc.), they also feel that in the long term development losses like those seen in the past are likely to emerge from somewhere unless there is a clear change in management policy. As such, they feel that the shares are unlikely to recover to a PBR of, say, 1x.

We cannot deny these market concerns

Unfortunately, we have not seen any changes in management that would enable us to clearly deny these concerns. Of course, we believe further advances into overseas housing markets where growth is expected are vital, but one should always keep in mind the risk that development-related losses could push down overall profits should there be price fluctuation.

We recommend Sekisui House as a medium-term rather than ultra long-term investment, but even in an uncertain macro-environment the stock's ETR is more than 16%

Therefore, we do not recommend Sekisui House as an investment for the ultra-long term (five or ten years, say), but rather recommend it for a period of about one year. This is because 1) even in an uncertain macroeconomic environment we expect strength for domestic subcontracted housing operations, which account for about 70% of OP, and 2) we believe the risk of near-term losses has been excessively priced in. Our target price of ¥800 corresponds to a FY1/13E PBR of just 0.70x, but also suggests an ETR of more than 16%.

Figure 8. Sekisui House: Key consolidated data (¥mn)

	1/2008A	1/2009A	1/2010A	1/2011A	1/2012A	1/2013E	1/2014E	1/2015E	1/2013CE
P/L									
Sales	**1,597,807**	**1,514,172**	**1,353,186**	**1,488,369**	**1,530,577**	**1,633,600**	**1,716,500**	**1,764,700**	**1,650,000**
YoY	0.1%	-5.2%	-10.6%	10.0%	2.8%	6.7%	5.1%	2.8%	7.8%
Built-to-order detached houses	--	--	381,000	455,239	475,330	475,100	485,000	494,100	485,000
Rental houses	--	--	236,000	277,659	289,027	288,500	300,600	305,900	285,000
Built-for-sale detached houses	--	--	197,000	146,470	127,123	127,000	127,500	127,500	127,000
Condominiums	--	--	52,000	77,185	39,681	48,000	53,600	51,600	48,000
Urban redevelopment	--	--	15,000	22,208	37,720	58,000	56,000	57,000	58,000
Renovation	--	--	78,000	91,443	102,180	120,000	130,800	141,300	130,000
Real estate fee	--	--	348,000	361,988	378,247	395,000	410,800	427,200	395,000
Overseas	--	--	--	--	24,264	60,000	90,200	98,100	60,000
Other	--	--	46,000	56,173	57,002	62,000	62,000	62,000	62,000
GPM	**20.6%**	**19.2%**	**11.6%**	**17.3%**	**18.0%**	**18.5%**	**18.8%**	**18.8%**	**18.2%**
Built-to-order detached houses	--	--	--	22.9%	23.6%	23.6%	23.5%	23.5%	23.8%
Rental houses	--	--	--	21.3%	21.5%	21.4%	21.3%	21.1%	21.6%
Built-for-sale detached houses	--	--	--	12.0%	14.2%	14.2%	14.7%	15.0%	14.2%
Condominiums	--	--	--	6.8%	-13.9%	12.1%	13.2%	14.3%	12.1%
Urban redevelopment	--	--	--	28.6%	29.5%	17.2%	17.9%	19.3%	15.5%
Renovation	--	--	--	22.8%	22.6%	22.0%	22.0%	22.0%	19.7%
Real estate fee	--	--	--	11.0%	11.7%	11.5%	11.5%	11.5%	11.5%
Overseas	--	--	--	--	17.3%	24.7%	26.3%	24.8%	24.7%
Other	--	--	--	9.4%	15.8%	13.7%	13.7%	13.7%	13.7%
Operating profit	**109,726**	**73,959**	**-38,754**	**56,354**	**70,897**	**82,800**	**94,200**	**99,500**	**80,000**
YoY	-1.7%	-32.6%	--	--	25.8%	16.8%	13.8%	5.6%	12.8%
Built-to-order detached houses	--	--	--	45,772	52,476	49,500	51,300	53,800	51,000
Rental houses	--	--	--	26,195	26,595	27,500	29,900	30,300	25,500
Built-for-sale detached houses	--	--	--	516	3,685	3,000	3,800	4,100	3,000
Condominiums	--	--	--	-1,009	-9,947	500	1,300	1,600	500
Urban redevelopment	--	--	--	4,812	9,974	9,000	9,000	10,000	8,000
Renovation	--	--	--	8,530	9,624	10,800	12,500	13,500	10,500
Real estate fee	--	--	--	12,429	14,260	15,000	15,900	16,500	15,000
Overseas	--	--	--	--	-3,176	3,000	6,000	5,200	3,000
Other	--	--	--	-6,016	-35	0	0	0	0
Elimination / Corporate	--	--	--	-34,876	-32,560	-35,500	-35,500	-35,500	-36,500
OPM	**6.9%**	**4.9%**	**-2.9%**	**3.8%**	**4.6%**	**5.1%**	**5.5%**	**5.6%**	**4.8%**
Built-to-order detached houses	--	--	--	10.1%	11.0%	10.4%	10.6%	10.9%	10.5%
Rental houses	--	--	--	9.4%	9.2%	9.5%	9.9%	9.9%	8.9%
Built-for-sale detached houses	--	--	--	0.4%	2.9%	2.4%	3.0%	3.2%	2.4%
Condominiums	--	--	--	-1.3%	-25.1%	1.0%	2.4%	3.1%	1.0%
Urban redevelopment	--	--	--	21.7%	26.4%	15.5%	16.1%	17.5%	13.8%
Renovation	--	--	--	9.3%	9.4%	9.0%	9.6%	9.6%	8.1%
Real estate fee	--	--	--	3.4%	3.8%	3.8%	3.9%	3.9%	3.8%
Overseas	--	--	--	--	-13.1%	5.0%	6.7%	5.3%	5.0%
Other	--	--	--	-10.7%	-0.1%	0.0%	0.0%	0.0%	0.0%
Recurring profit	**114,086**	**77,072**	**-38,758**	**56,271**	**70,075**	**82,300**	**94,700**	**101,000**	**79,500**
Extraordinary profit	175	0	6	134	0	0	0	0	--
Extraordinary loss	4,830	49,448	7,668	2,592	7,874	2,000	2,000	2,000	--
Net profit after tax	**60,352**	**11,516**	**-29,277**	**30,421**	**28,962**	**43,570**	**51,840**	**55,430**	**42,000**
Major indicators									
EPS (¥)	87.7	17.0	-43.3	45.0	42.9	64.5	76.8	82.1	62.5
EPS (Fully diluted) (¥)	87.7	17.0	-43.3	45.0	41.1	61.9	73.6	78.7	--
BPS (¥)	1,140	1,115	1,059	1,091	1,107	1,150	1,199	1,250	--
DPS (¥)	24	24	10	21	20	25	31	33	25
ROE	7.7%	1.5%	-4.0%	4.2%	3.9%	5.7%	6.6%	6.7%	5.7%
ROA	8.3%	5.5%	-2.7%	4.4%	5.1%	5.7%	6.3%	6.5%	5.6%
Shareholder's equity ratio	57.1%	54.3%	52.9%	54.9%	51.4%	51.7%	52.9%	53.9%	--
Debt Equity ratio (X)	0.21	0.33	0.37	0.29	0.35	0.34	0.33	0.31	--
Net Debt Equity ratio (X)	0.13	0.17	0.16	0.08	0.13	0.16	0.16	0.15	--

A: Actual. CE: Company estimates. E: Our estimates. NM: Not meaningful.
Source: Company data, Citi Investment Research and Analysis.

Sekisui House

Investment strategy

We rate the shares of Sekisui House Buy (1) with a target price of ¥800. We model annual OP growth of 12% from FY1/13 to FY1/15 as we think the firm will 1) maintain high margins in detached and rental housing and 2) eliminate losses in condo and overseas operations. This would be exceptional earnings momentum for the sector.

As a result, we see RoE improving to 6.6% in FY1/14 from 3.9% in FY1/12 and the 10-year historical average of 5.2% (excluding FY1/10, when the company posted a net loss). Given this, we think the shares are excessively undervalued.

in addition, we anticipate improved visibility on Chinese operations by year-end due to the commencement of sales at Suzhou and Taicang. We conservatively put selling prices at Suzhou, Taicang, and Wuxi at 30% below where they would have been at the time of the lot acquisitions and Shenyang at 20% below, but we see the impact on net assets as being limited. Some market players are fretting that the total investment in China of around ¥100bn will all be impaired but we see these excessive concerns as likely to be swept away when sales actually start.

Valuation

We use adjusted EV/EBITDA to value integrated housing makers. We calculate this as (market cap + interest bearing debt - cash on hand - marketable and investment securities)/(OP + depreciation + interest and dividend income).

We adopt EV/EBITDA for two reasons: 1) it measures real profit strength as it strips out the impact of extraordinary losses and 2) it reduces the impact of different accounting standards for things like retirement benefits.

We derive our ¥800 target price by applying an EV/EBITDA of 5.0x (Sekisui House has a 10-year range of 5.0x-9.0x) to our FY1/14 estimates.

Risks

Downside risks to our target price are 1) a larger-than-expected increase in materials and labor outsourcing costs; 2) lower-than-expected new housing starts, 3) rapid Chinese real estate market deterioration, giving rise to significant losses in built-for-sale condo projects.

If impacts from the above factors are larger than we expect, the share price could fail to achieve our target price.

Appendix A-1

Analyst Certification

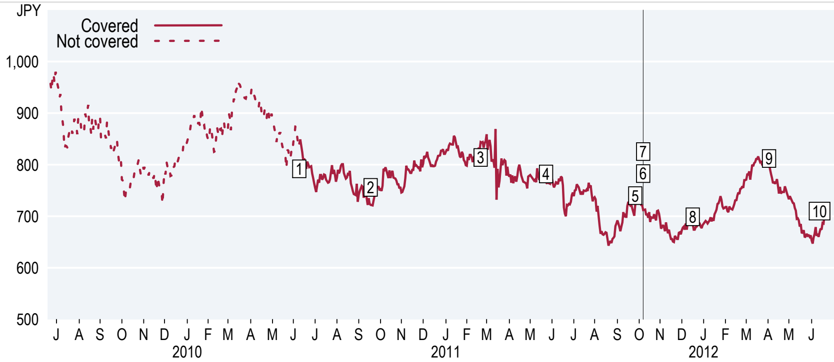
The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Sekisui House (1928)

Ratings and Target Price History
Fundamental Research

Analyst: Shusuke Terada
Covered since June 9 2010



Date	Rating	Target Price	Closing Price
1 9-Jun-10	2M	*900	841
2 17-Sep-10	2M	*800	722
3 21-Feb-11	2M	*850	844
4 24-May-11	2M	*800	766

Date	Rating	Target Price	Closing Price
5 27-Sep-11	2M	*780	722
6 7-Oct-11	Stock rating system changed		
7 7-Oct-11	*2	780	712
8 16-Dec-11	2	*760	685

Date	Rating	Target Price	Closing Price
9 3-Apr-12	2	*850	803
10 13-Jun-12	*1	*800	669

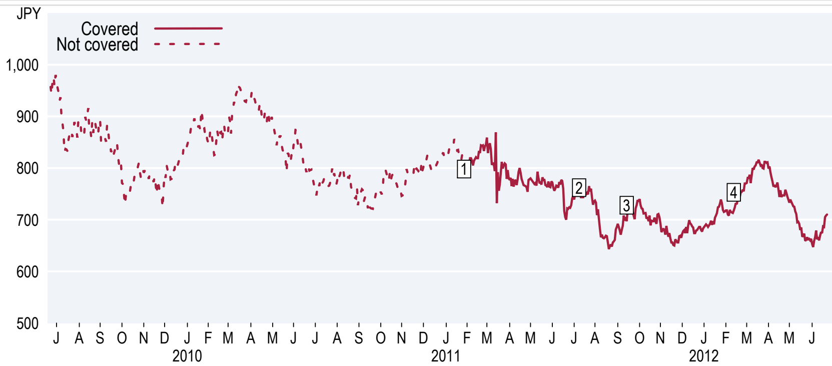
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Sekisui House (1928)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Shusuke Terada
Covered since June 9 2010



Date	Rating	Target Price	Closing Price
1 27-Jan-11	*ADD LP	-	809
2 8-Jul-11	*REM LP	-	756

Date	Rating	Target Price	Closing Price
3 14-Sep-11	*ADD LP	-	697
4 13-Feb-12	*REM LP	-	718

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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	12 Month Rating			*Relative Rating*		
Data current as of 31 Mar 2012	**Buy**	**Hold**	**Sell**	**Buy**	**Hold**	**Sell**
Citi Investment Research & Analysis Global Fundamental Coverage	52%	37%	11%	10%	79%	10%
% of companies in each rating category that are investment banking clients	44%	42%	40%	47%	42%	43%

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Relative three-month ratings: CIRA may also assign a three-month relative call (or rating) to a stock to highlight expected out-performance (most preferred) or under-performance (least preferred) versus the geographic and industry sector over a 3 month period. The relative call may highlight a specific near-term catalyst or event impacting the company or the market that is anticipated to have a short-term price impact on the equity securities of the company. Absent any specific catalyst the analyst(s) will indicate the most and least preferred stocks in the universe of stocks under consideration, explaining the basis for this short-term view. This three-month view may be different from and does not affect a stock's fundamental equity rating, which reflects a longer-term total absolute return expectation. For purposes of NASD/NYSE ratings-distribution-disclosure rules, most preferred calls correspond to a buy recommendation and least preferred calls correspond to a sell recommendation. Any stock not assigned to a most preferred or least preferred call is considered non-relative-rated (NRR). For purposes of NASD/NYSE ratings-distribution-disclosure rules we correspond NRR to Hold in our ratings distribution table for our 3-month relative rating system. However, we reiterate that we do not consider NRR to be a recommendation.

Prior to October 8, 2011, the firm's stock recommendation system included a risk rating and an investment rating. **Risk ratings,** which took into account both price volatility and fundamental criteria, were: Low (L), Medium (M), High (H), and Speculative (S). **Investment Ratings** of Buy, Hold and Sell were a function of CIRA's expectation of total return (forecast price appreciation and dividend yield within the next 12 months) and risk rating. Additionally, analysts could have placed covered stocks "Under Review" in response to exceptional circumstances (e.g. lack of information critical to the analyst's thesis) affecting the company and/or trading in the company's securities (e.g. trading suspension). Stocks placed "Under Review" were monitored daily by management and as practically possible, the analyst published a note re-establishing a rating and investment thesis. For securities in developed markets (US, UK, Europe, Japan, and Australia/New Zealand), investment ratings were:Buy (1) (expected total return of 10% or more for Low-Risk stocks, 15% or more for Medium-Risk stocks, 20% or more for High-Risk stocks, and 35% or more for Speculative stocks); Hold (2) (0%-10% for Low-Risk stocks, 0%-15% for Medium-Risk stocks, 0%-20% for High-Risk stocks, and 0%-35% for Speculative stocks); and Sell (3) (negative total return). For securities in emerging markets (Asia Pacific, Emerging Europe/Middle East/Africa, and Latin America), investment ratings were:Buy (1) (expected total return of 15% or more for Low-Risk stocks, 20% or more for Medium-Risk stocks, 30% or more for High-Risk stocks, and 40% or more for Speculative stocks); Hold (2) (5%-15% for Low-Risk stocks, 10%-20% for Medium-Risk stocks, 15%-30% for High-Risk stocks, and 20%-40% for Speculative stocks); and Sell (3) (5% or less for Low-Risk stocks, 10% or less for Medium-Risk stocks, 15% or less for High-Risk stocks, and 20% or less for Speculative stocks).

Investment ratings are determined by the ranges described above at the time of initiation of coverage, a change in investment and/or risk rating, or a change in target price (subject to limited management discretion). At other times, the expected total returns may fall outside of these ranges because of market price movements and/or other short-term volatility or trading patterns. Such interim deviations from specified ranges will be permitted but will become subject to review by Research Management. Your decision to buy or sell a security should be based upon your personal investment objectives and should be made only after evaluating the stock's expected performance and risk.

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Citigroup Global Markets Japan Inc.	Shusuke Terada; Yoshizumi Kimura

OTHER DISCLOSURES

The subject company's share price set out on the front page of this Product is quoted as at 25 June 2012 03:00 PM on the issuer's primary market.

This Product has been modified by the author following a discussion with one or more of the named issuers/issuers of the named securities.

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