COMPANY RESEARCH AND ANALYSIS REPORT

Prospect Co., Ltd.

3528

Tokyo Stock Exchange Second Section

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FISCO Ltd. Analyst

Noboru Terashima

FISCO Ltd.

http://www.fisco.co.jp

Index

Summary

A conglomerate that conducts a wide range of businesses centered on real estate and including construction, investment advisory, and renewable energy-related businesses

The origins of Prospect Co., Ltd. <3528> (hereafter, also "the Company") are found in Inami Kigyo Co. Ltd., which conducted a textile business. But in 1994, it withdrew from the textile business and changed its main business to a real estate business (primarily sales of condominiums). After that, it was temporarily a member of the DAIKYO <8840> Group, which is a major condominium developer. But it left it and started independent management in 2007, and Mr. Curtis Freeze, who was the owner and president of former Prospect Co., Ltd., which had invested in the Company as a fund, was appointed as the representative director and president in 2010. Since then, it has used M&A to expand its business, such as a public works construction business and custom-made homes business, and currently it is engaged in a wide range of businesses, including a real estate development business (condominium sales, land and buildings, custom-made homes), an asset management business, a public works construction business, and a renewable energy business, including solar power generation.

1. FY3/18 1H consolidated results

In the FY3/18 1H consolidated results, net sales were ¥3,486mn (down 12.6% year on year (YoY)), the operating loss was ¥1,006mn (compared to a loss of ¥367mn in the same period in the previous fiscal year), the ordinary loss was ¥295mn (a loss of ¥550mn). Due to the recording of a gain on negative goodwill of ¥2,420mn on The Prospect Japan Fund Limited (TPJF) being made a subsidiary, the net profit attributable to owners of the parent was ¥1,903mn (a loss of ¥568mn). Although the Company recorded an operating loss, in many of its businesses, sales are concentrated in 2H, so in practically every fiscal year it records a loss in 1H, and this is not a particular cause for concern.

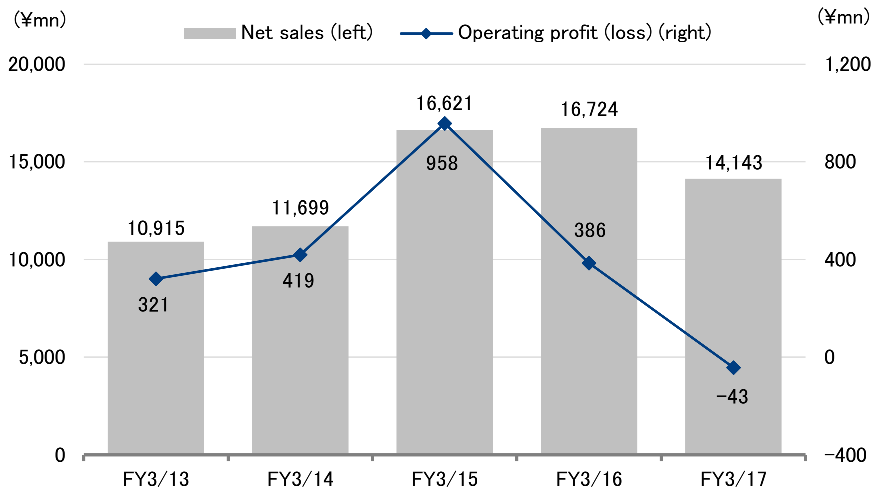
2. Outlook for FY3/18: No Company forecasts

The Company does not announce full fiscal year forecasts as it conducts a finance-related business (asset management) and as the timing of the deliveries (the recording of sales) in the condominium business and the forecasts for sales of land and buildings are uncertain. However, many of its businesses' sales are concentrated in 2H, so it seems highly likely that the operating loss will become an operating profit for the full fiscal year.

Key Points

- A conglomerate that conducts a wide range of businesses centered on real estate and including construction, investment advisory, and renewable energy-related businesses
- It is actively conducting M&A while developing the solar business as the growth driver

Trends in net sales and operating profit (loss)



Source: Prepared by FISCO from the Company's financial results

Company profile

Although it was originally a textile company, today it has become a conglomerate conducting a wide range of businesses, mainly real estate-related

The Company has a long history and its predecessor, Inami Kigyo Co. Ltd., was founded in Toyama Prefecture in 1937. It subsequently changed its corporate name to Carolina Co., Ltd., in 1961, and it was listed on the Tokyo Stock Exchange Second Section in the following year, 1962. Then on entering the 1990s, it withdrew from the textile business and shifted to its mainstay businesses of condominium sales, and at the same time it joined the DAIKYO Group, which is a major condominium developer.

After that, in 2007 it left the DAIKYO Group and started independent management. In 2010, Mr. Curtis Freeze, who was the owner and president of the former Prospect, which had invested in the Company as a fund, was appointed as the representative director, president and fund manager. In 2013, it made a wholly owned subsidiary of former Prospect through an exchange of shares. In the following year of 2014, it merged with this former company through an absorption merger, and at the same time, it changed its corporate name to the current name of Prospect Co., Ltd. During this period, it diversified its business through conducting M&As to make consolidated subsidiaries of Sasaki House Co., Ltd., and Kidoh Construction Co., Ltd., and it then launched a solar business in 2015. It also made a subsidiary of The Prospect Japan Fund Ltd., from an exchange of shares, in July 2017.

History

Year	Major event
1937	Inami Kigyo Co. Ltd., was established in Toyama Prefecture
1961	Changed corporate name to Carolina Co., Ltd.
1962	Listed on the Second Section of Tokyo Stock Exchange
1990	Changed how the name was written in Japanese
1991	Entered an alliance with the DAIKYO <8840> Group
1993	Began sales of the Morris condominium series (Series No.1 Morris Kawasaki)
1994	Withdrew from the textiles business
1994	Moved head office from Toyama Prefecture to Shibuya Ward, Tokyo
2000	Moved head office to its current location (1-30-8 Sendagaya, Shibuya Ward, Tokyo)
2001	Changed corporate name to Gro-Bels Co., Ltd.
2007	Left the DAIKYO Group and began independent management
2010	Mr. Curtis Freeze was appointed representative director and president
2012	Acquired all the shares and made a consolidated subsidiary of Sasaki House Co., Ltd.
2013	Acquired all the shares and made a consolidated subsidiary of (former) Prospect Co., Ltd.
2013	Entered into the overseas real estate-related business
2014	Acquired all the shares and made a consolidated subsidiary of Kidoh Construction Co., Ltd.
2014	Conducted an absorption merger with a subsidiary, former Prospect, and changed its corporate name to Prospect Co., Ltd.
2015	Launched the solar power generation business (the first project: Asago Tachiwaki Solar Power Plant)
2017	Acquired all the shares and made a subsidiary of The Prospect Japan Fund Ltd. though an exchange of shares

Source: Prepared by FISCO from the Company's website

Business overview

Is developing a wide range of businesses centered on real estate and including housing, construction, and renewable energy-related businesses

1. Main business activities

The Company discloses information on the following business segments; real estate development business, asset management business, public works construction business, renewable energy business, and others. The real estate development business is further broken down into condominium sales, land and buildings, and custom-made homes.

(1) Condominium sales (% of total net sales in FY3/17: 29.0%)
The same as general condominium developers, in this business the Company purchases land and constructs and sells condominium units. They are sold under the GRO-BEL brand, which is derived from the former company name. Net sales and segment profit fluctuate depending on the status of site purchases and other factors. It sold (delivered) 115 units in FY3/17.

(2) Land and buildings (% of total net sales in FY3/17: 16.0%)
This business includes the sales of residential land, detached housing, and buildings, but it mainly involves the sales of land and buildings that occur incidental to its sales of condominiums. For the land and buildings (including unfinished buildings) that are intended to be sold for condominiums, it mainly sells those properties in which it expects to achieve profits (profitability) above the target, and it does not purchase and sell land and buildings for which a sale (profits) were expected from the beginning.

(3) Custom-made homes (% of total net sales in FY3/17: 11.1%)

The main business area is Yamagata Prefecture, primarily for the construction outsourcing work and renovation work of detached housing carried out by Sasaki House, which it made a subsidiary through an M&A. Sasaki House has a history of more than 50 years in the residential housing business, but because it did not have a successor to take over its business, it sold all its shares to the Company and became its subsidiary. In FY3/17, it delivered 41 buildings.

(4) Asset management business (% of total net sales in FY3/17: 1.2%)

This is an investment advisory business that conducts the fund management (mainly for Japanese shares) that was previously conducted by former Prospect. However, in August 2017, the Company used shares in The Prospect Japan Fund Ltd., which was one of the management funds, as compensation to acquire that company for shareholders (investors). Therefore, currently, the investor in this fund is the Company itself.

(5) Public works construction business (% of total net sales in FY3/17: 40.5%)

The business includes the promotion projects and the pre-stressed concrete (PC) construction works carried out by the subsidiary Kidoh Construction. Most of the projects are public investment work projects, and in particular it has the leading technological expertise for small tunnels (with a diameter of 4m or less). In the future, demand for infrastructure establishment and maintenance is expected not just from within Japan, but also from the Southeast Asia region.

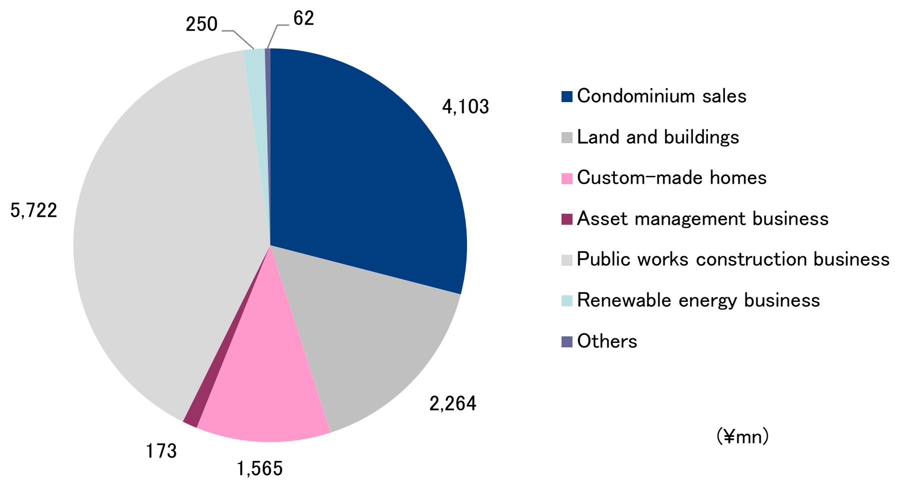
(6) Renewable energy business (% of total net sales in FY3/17: 1.8%)

The business model entails acquiring the rights for and investing in solar power generation, and selling the power it generates to electric power companies. On the point of generating profits (cash flows) from acquiring rights and conducting investment, it can be said that the approach in this business is the same as for a rental building business. As of the end of September 2017, it had 5 operational plants (the ratio of power generated according to the Company's share, 9.22MW), and it was developing 6 plants (49.12MW).

(7) Others (% of total net sales in FY3/17: 0.4%)

This business mainly entails renting the condominiums owned by the Company.

Net sales by segment (FY3/17)



Source: Prepared by FISCO from the Company's financial results

2. Features, strengths, and competitors

(1) The "investment" approach

As mentioned previously, at first glance the Company seems to be developing its businesses in different fields. But in fact, fundamentally they are all based on the same approach, of acquiring (purchasing) land, rights, projects, and so on, and then investing (capital) in them, and collecting the profits at a later date. This point can be said to be a feature of the Company's business development.

(2) Business diversification (the portfolio approach)

On the other hand, the Company conducts various businesses, such as for custom-made homes and construction, via the subsidiaries it has acquired through M&A. The reason why it conducted these M&A is that in the custom-made homes and public works construction businesses, it can recover its investment in a relatively short period of time compared to in its other businesses such as condominium sales, and they can be said to be suitable for diversifying business risk and the time spans for recouping its financial investment. In other words, currently the Company conducts its various businesses based on a portfolio approach, rather than simply diversifying on a line extending from its existing businesses or into related fields. This can also be said to be one of its features.

(3) The influence of the president

One more major feature and strength of the Company is the presence of Mr. Curtis Freeze, the representative director and president. As Mr. Freeze was previously a fund manager in an asset management company, he has considerable insights in and experience of aspects such as investment return, risk diversification (portfolio), and financing, and the Company is currently utilizing these insights and experience for its management. In addition, he is from the United States where a feature of management is quick decision making, but it is not the case that he is an autocratic president. The Company has one more representative director, Mr. Masato Tabata, who is the managing director. In this point, it can be described as having a well-balanced management structure, which can also be said to be another of the Company's features and strengths.

Results trends

Recorded an operating loss in FY3/18 1H, but this was as expected

● FY3/18 1H results

(1) Profit and loss conditions

In the FY3/18 1H consolidated results, net sales were ¥3,486mn (down 12.6% YoY), the operating loss was ¥1,006mn (compared to a loss of ¥367mn in the same period in the previous fiscal year), the ordinary loss was ¥295mn (a loss of ¥550mn), and the net profit attributable to owners of the parent was ¥1,903mn (a loss of ¥568mn). By segment, sales and profits decreased in every business other than in the condominium sales, the custom-made homes, and the renewable energy businesses, while the extent of the decrease in profits was particularly large in the public works construction. Also, due to the recording of a gain on investments in capital of ¥711mn, the extent of the ordinary loss was greatly reduced YoY.

The Company recorded an operating loss, but the tendency for its mainstay businesses, including condominium sales, custom-made homes, and public works construction, is for sales to be concentrated in 2H, and consequentially it often records an operating loss in 1H. Therefore, the results in the 1H are not a particular cause for concern.

FY3/18 1H results

(¥mn, %)

	FY3/17 1H		FY3/18 1H		
	Amount	Ratio to sales	Amount	Ratio to sales	YoY
Net sales	3,989	100.0	3,486	100.0	-12.6
Gross profit on sales	602	15.1	661	19.0	9.8
SG&A expenses	969	24.3	1,668	47.9	72.1
Operating loss	-367	-9.2	-1,006	-	-
Ordinary loss	-550	-13.8	-295	-8.5	-
Quarterly net loss attributable to owners of the parent	-568	-14.2	1,903	54.6	-

Source: Prepared by FISCO from the Company's financial results

(2) Conditions by segment

FY3/18 1H results by segment

(¥mn, %)

	FY3/17 1H		FY3/18 1H			
	Amount	Ratio to sales	Amount	Ratio to sales	Change	% change
Net sales	3,989	100.0	3,486	100.0	-503	-12.6
Condominium sales	230	5.8	766	22.0	536	233.0
Land and buildings	299	7.5	0	0.0	-299	-100.0
Custom-made homes	419	10.5	476	13.7	57	13.4
Asset management business	174	4.4	132	3.8	-42	-23.9
Public works construction business	2,699	67.7	1,798	51.6	-901	-33.4
Renewable energy business	132	3.3	293	8.4	161	121.3
Others	33	0.8	18	0.5	-15	-44.3
Operating profit (loss)	-367	-9.2	-1,006	-	-639	-
Condominium sales	-152	-	-40	-	108	-
Land and buildings	30	-	0	-	-30	-100.0
Custom-made homes	-66	-	-55	-	11	-
Asset management business	62	-	19	-	-43	-68.6
Public works construction business	70	-	-5	-	-75	-
Renewable energy business	63	-	116	-	53	83.1
Others	21	-	5	-	-16	-73.3
(Company-wide expenses, etc.)	-395	-	-1,046	-	-	-

Source: Prepared by FISCO from the Company's financial results

a) Condominium sales

In 1H, the Company completed new contracts for 77 units with a value of ¥3,015mn (91 units, ¥2,974mn), and delivered 24 units (6 units). As a result, net sales were ¥766mn (¥230mn) and the segment loss was ¥40mn (segment loss of ¥152mn).

Although there were no newly completed properties, sales of properties completed (completed stock) up to the previous fiscal year trended steadily, and as a result, net sales exceeded the previous fiscal year. With regards to the status of contracts for real estate for sales in-process, three buildings are currently for sale, and the Company is working to maintain its lineup of projects in good locations, such as near to train stations. In 2H, it plans to newly complete 3 buildings (120 units in total with net sales of ¥4,496mn).

b) Land and buildings

No contract results or sales results were recorded in 1H. (In the previous fiscal year, contracts were ¥173mn, net sales were ¥299mn, and segment profit was ¥30mn).

c) Custom-made homes

New contracts were made for 21 buildings worth ¥590mn (compared to 13 buildings worth ¥417mn in the same period in the previous fiscal year) and the Company delivered 11 buildings (9 buildings). As a result, net sales were ¥476mn (¥419mn), and the segment loss was ¥55mn (segment profit of ¥66mn).

In terms of the contracts results, the sluggishness in the housing market as a whole in Yamagata Prefecture is noticeable and the number of visitors to show homes is also decreasing. In this situation, the entire Company continued to strive for sales, which led to a rise in the number of contract buildings and an increase in orders. However, many were small houses and the unit price per building decreased.

d) Asset management

In this business, in which the Company manages securities relating to real estate and Japanese shares, it recorded net sales of ¥132mn (¥174mn in the same period in the previous fiscal year) and a segment profit of ¥19mn (segment profit of ¥62mn).

Reflecting the uncertainties about the futures of the Japanese stock markets and overseas economies, net sales and operating income both decreased slightly, although they did not change significantly. The results of TPJF, which was made a consolidated subsidiary in July 2017, are not reflected in the profit and loss items in the financial statements under review (because the “deemed acquisition date” is the end of September and only the balance sheet is consolidated).

e) Public works construction business

In 1H, the Company recorded net sales of ¥1,798mn (¥2,699mn in the same period in the previous fiscal year) and segment loss of ¥5mn (segment profit of ¥70mn).

As a result of the completion of large-scale decontamination projects and other projects in the Tohoku region that had been ordered (with the Company as the prime contractor) up to the previous fiscal year, both net sales and operating income greatly decreased YoY. However, orders are trending steadily for public and private sector construction projects, and both net sales and operating profit are progressing according to the business plan. Rather, it can be said that the high-profit structure up to the previous fiscal year was an irregular state.

f) Renewable energy business

In this business, in which the Company sells the power generated by the solar power generation facilities it manages to electric power companies, in 1H it recorded net sales of ¥293mn (¥132mn in the same period in the previous fiscal year) and segment profit of ¥116mn (¥63mn).

The five projects that are already operational are operating steadily, and in particular, the contribution of the Sanmu Higashi Project (Sanmu City, Chiba Prefecture, 5.0MW), which began selling power from the start of the current fiscal year, drove the sales and profit growth. Also, by the end of the current fiscal year, the Company plans to newly launch sales of power at 2 projects; at Sendai (Sendai City, Miyagi Prefecture, 1.9 MW) and at Tokujiro (Utsunomiya City, Tochigi Prefecture, 4.7 MW).

g) Others

In others, which mainly involves the rental to general tenants of the condominiums and other properties owned by the Company, it recorded net sales of ¥18mn (¥33mn in the same period in the previous fiscal year) and segment profit of ¥5mn (segment profit of ¥21mn).

The reasons for the declines in sales and profits were that earnings decreased YoY from the Minami Otsuka Project, which includes rental income relating to profit properties for the development of condominiums and which has already been transferred to real estate for development in-process, and from the Samon Town Project, from which tenants have been moving out. But both these developments were as planned.

(3) Financial position

The Company's financial condition continues to be stable. At the end of FY3/18 1H, total assets were ¥39,162mn, up ¥11,794mn on the end of the previous fiscal year. Current assets were ¥24,753mn, up ¥11,804mn, with the main factors being increases in cash and deposits of ¥583mn and in securities of ¥9,551mn on TPJF being made a subsidiary. Conversely, fixed assets were ¥14,408mn, down ¥10mn, which was mainly due to an increase in tangible fixed assets of ¥969mn, a decrease in intangible fixed assets of ¥97mn, a decrease in investments and other assets of ¥882mn (mainly an increase in contribution of ¥688mn and a decrease in long-term loans of ¥1,442mn).

Total liabilities were ¥15,316mn, up ¥438mn on the end of the previous fiscal year. The main factors included a decrease in notes and accounts payable of ¥220mn, a decrease in accrued construction payment of ¥997mn, an increase in short-term borrowings, etc. of ¥2,505mn, and a decrease in long-term borrowings of ¥1,351mn. Net assets were ¥23,845mn, up ¥11,356mn. This was mainly due to increases in capital and the capital reserve on the issue of new shares (a share exchange) following TPJF being made a subsidiary

(4) Cash flow conditions

In FY3/18 1H, cash used in operating activities was ¥1,210mn, with the main income items being the recording of net profit before income taxes of ¥2,118mn, depreciation and amortization of ¥151mn, a decrease in accounts receivable of ¥328mn, and an increase in advances received of ¥294mn, while the main expenditure items included a gain on negative goodwill of ¥2,420mn, an increase in inventory assets of ¥651mn, a decrease in accounts payable of ¥ 384mn. Cash provided by investing activities was ¥ 969mn, with the main expenditure items including the acquisition of tangible fixed assets of ¥1,948mn, and the main income items including income of ¥2,935mn from the acquisition of the shares of a subsidiary following a change in the scope of consolidation. Cash provided by financing activities was ¥826mn, with the main items including income of ¥ 1,317mn from the increase in long- and short-term borrowings, and expenditure of ¥ 503mn for the payment of dividends. As a result, during the period, cash and cash equivalents increased ¥582mn, and the balance of cash and cash equivalents at the end of the period was ¥5,962mn.

Outlook

It is highly likely that it will achieve profitability in the FY3/18 full year results

1. FY3/18 forecast: There are no Company forecasts

The Company does not announce full fiscal year forecasts as it conducts a finance-related business (asset management) and as the timing of deliveries (the recording of sales) in the condominium business, and the forecasts for sales of land and buildings, are uncertain. However, many of its businesses' sales are concentrated in 2H, so it seems highly likely that the operating loss will become an operating profit for the full fiscal year.

2. New business development: Entering into the biomass business

Continuing on from its solar business within Japan, the Company has announced that it is entering into the biomass fuel (pellets) manufacturing business in Russia as its renewable energy business. It has launched a joint-venture company with Russia's RFP Group. Using as the raw material the sawdust and other such materials created within the timber manufacturing plants owned by the RFP Group, it will construct pellet manufacturing plants at sites adjacent to these timber plants, and it intends to export the pellets to biomass power generation plants in Japan. Customers are expected to mainly be biomass power generation plants that use fee-in-tariffs (FIT).

The Company expects to invest around ¥2.5bn to ¥3bn for the construction of a single plant, and going forward, it is aiming to construct several of these plants within Russia. It will announce the business plans alongside the progress made in the construction of the plants.

The medium- to long-term growth strategy

Is actively conducting M&A while developing the solar business as the growth driver

1. Among the existing businesses, the growth driver is the renewable energy business

As previously explained, the Company conducts various businesses, and while businesses such as the condominium sales, custom-made homes, and construction (promotion) businesses each stably generate cash flow, they are not expected to achieve dramatic growth within Japan, and rather, they are cyclic businesses that are affected by economic fluctuations. So they cannot be described as businesses that will significantly drive the Company's growth in the future.

Conversely, the solar business using FIT and the biomass power generation business can be expected to generate cash flow over the long term. It is anticipated that the biomass power generation business will grow to replace the solar business and become a major growth field in Japan in the future. Therefore, it would seem that by supplying the pellets that are the fuel used in this field, the Company can be expected to achieve growth for this business the same as or greater than that of its existing businesses.

2. Is also actively conducting M&A

The Company's M&A strategy is one more aspect that is supporting its growth. Previously, it has conducted M&A in the custom-made homes and construction fields. Going forward also, it plans to actively conduct them when it finds a candidate that satisfies its investment standards. It intends to raise the funds for M&A using methods that it deems to be optimal in each case, including from its own funds, borrowing, share exchanges, and issuing new shares.

Shareholder return policy

Its policy for returning profits to shareholders is to respond quickly to results trends in the future

The Company pays dividends in order to return profits to shareholders, but it has not formulated a specific basic policy for it. In the FY3/18, it plans to pay an annual dividend of ¥4, although management has stated that it will respond quickly to reflect in divided payments the results trends in the future.

Disclaimer