COMPANY RESEARCH AND ANALYSIS REPORT

Prospect Co., Ltd.

3528

Tokyo Stock Exchange Second Section

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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, the Company withdrew from the textile business and changed its main business to a real estate business (primarily sales of condominiums). After that, the Company was temporarily a member of the DAIKYO <8840> Group, which is a major condominium developer. But it left the Group and started independent management in 2007. Mr. Curtis Freeze, the owner and president of the 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, the Company has used M&A to expand its business to incorporate 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), an asset management business, and a renewable energy business, including solar power generation. (Mr. Curtis Freeze resigned from his post of representative director on December 13, 2018 to take responsibility for the confusion caused by the delay in submitting the Company’s earnings report for the second quarter (the first half) of the fiscal year ending March 31, 2019. Going forward, Mr. Freeze will be responsible for leadership of projects in his new post of director and Chief Investment Officer (CIO).)

1. FY3/19 1H consolidated results

Looking at the Company’s FY3/19 1H consolidated results*, net sales were ¥3,380mn (down 3.1% year on year (YoY)), the operating loss was ¥1,907mn (compared to a loss of ¥1,006mn in the same period of the previous fiscal year), and the ordinary loss was ¥1,483mn (compared to a loss of ¥295mn in the same period of the previous fiscal year). The net loss attributable to owners of the parent was ¥1,569mn (compared to profit of ¥1,869mn in the same period of the previous fiscal year). The most significant reason for the operating loss was the recording of a large valuation loss by The Prospect Japan Fund Limited (TPJF), which became a subsidiary in July 2017, due to a drop in stock prices. However, this loss was not accompanied by an outflow of cash, but mostly comprised a valuation loss valuation. Therefore, the impact on cash in hand was minimal. All other business segments performed largely in line with forecasts.

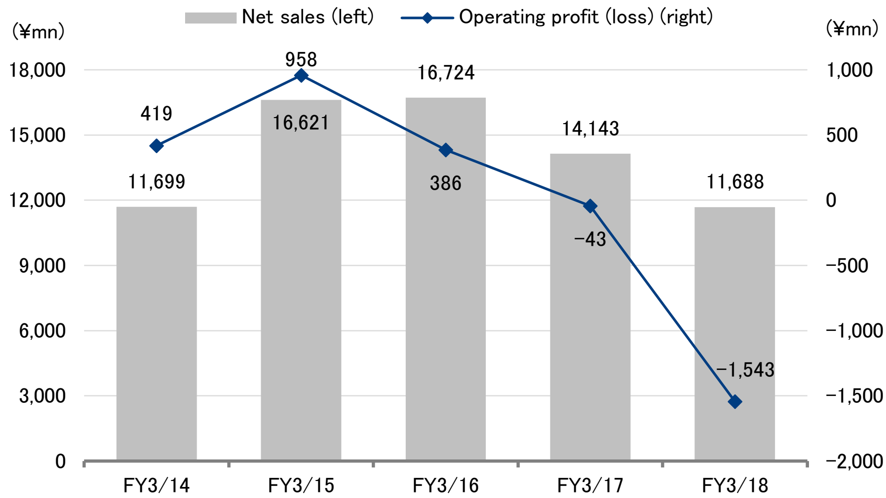
2. Outlook for FY3/19: No Company forecasts, No changes to dividend forecast

The Company has noted that it proactively employs M&A initiatives as part of its business diversification strategy and that one of its key segments is the asset management business. Because these activities are highly susceptible to the impact of fluctuations in economic conditions and the market environment, the Company believes that it is highly impractical to accurately estimate its ordinary business performance and disclose forecasts. Therefore, the Company has decided not to disclose forecasts. In line with this policy, the Company has not disclosed its consolidated business forecasts for the full year. Based on sluggish business performance in FY3/19 1H, the Company might post an operating loss on a full year basis. However, the main reason for the underperformance in FY3/19 1H was a loss on valuation. Therefore, the Company’s earnings might improve on a full year basis depending on the general stock price level at the fiscal year-end. Meanwhile, the Company is highly likely to record a profit on a non-consolidated basis (i.e., secure a source of funding for dividends) and could also possibly fill its bottom-line loss with the sale of assets of some sort. Considering these and other factors, the Company is expected to meet its commitment to pay an annual dividend.

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 renewable energy-related 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 was listed on the Tokyo Stock Exchange Second Section in 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 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 TPJF 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
2018	Mr. Masato Tabata was appointed representative director and president

Source: Prepared by FISCO from the Company's website

Business overview

The Company 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 FY3/18: 41.9%)

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) 137 units in FY3/18.

(2) Land and buildings (No net sales were recorded in FY3/18

This business includes the sales of residential land, detached housing, and buildings, but it mainly involves the sales of land and buildings that occurs 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) was expected from the beginning. Consequently, net sales for FY3/18 have not been recorded.

(3) Custom-made homes (% of total net sales in FY3/18: 12.6%)

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 FY3/18, it delivered 40 buildings.

(4) Asset management business (% of total net sales in FY3/18: 1.3%)

This is an investment advisory business that conducts the fund management (mainly for Japanese shares) that was previously conducted by the former Prospect. However, in July 2017, the Company acquired 100% of the listed shares in TPJF, which was one of the management funds, in a share-for-share transaction. Therefore, currently, the investor in TPJF is the Company itself.

(5) Public works construction business (% of total net sales in FY3/18: 39.2%)

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.

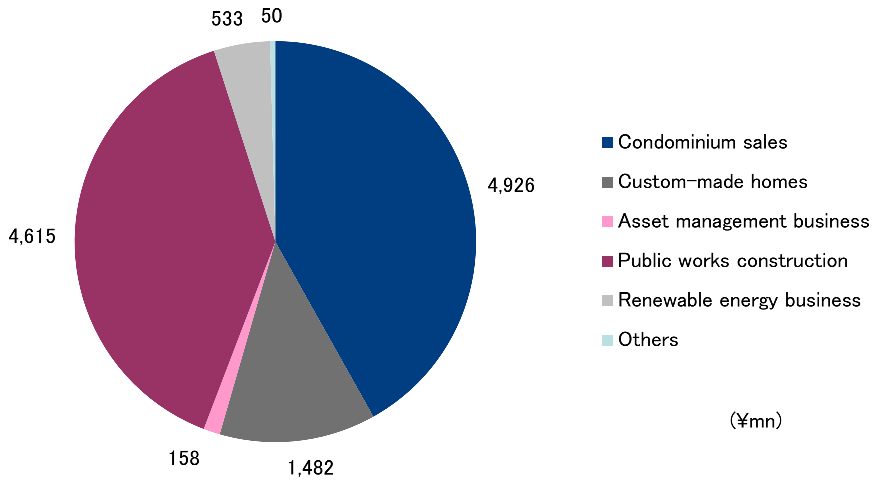
(6) Renewable energy business (% of total net sales in FY3/18: 4.5%)

The business model entails acquiring the rights for and investing in and developing solar power generation projects, and selling the power it generates to electric power companies. On the points of generating profits (cash flows) from acquiring rights and conducting investment, or from selling equipment, 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 2018, it had seven operational plants (the ratio of power generated according to the Company's share, 18.90MW), and it was developing four plants.

(7) Others (% of total net sales in FY3/18: 0.4%)

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

Net sales by segment (FY3/18)



Note: No net sales of land and buildings were recorded.
Source: Prepared by FISCO from the Company's financial results

2. Business features

(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.

Results trends

In FY3/19 1H, the recording of a valuation loss at a subsidiary produced a large operating loss, but there was no cash outflow

● FY3/19 1H results*

* The latest earnings announcement has coincided with revisions to certain figures for FY3/18 1H. All figures used in this report are revised figures.

(1) Profit and loss conditions

Looking at the FY3/19 1H consolidated results, net sales were ¥3,380mn (down 3.1% year on year (YoY)), the operating loss was ¥1,907mn (compared to a loss of ¥1,006mn in the same period of the previous fiscal year), and the ordinary loss was ¥1,483mn (compared to a loss of ¥295mn in the same period of the previous fiscal year). The net loss attributable to owners of the parent was ¥1,569mn (compared to profit of ¥1,869mn in the same period of the previous fiscal year).

The most significant reason for the substantial operating loss was the recording of a large valuation loss by TPJF, which became a subsidiary in July 2017, due to a drop in stock prices. However, this loss was not accompanied by an outflow of cash, but mostly comprised a valuation loss. Therefore, although the valuation loss had an impact on the bottom line on a consolidated basis, its impact on cash in hand was minimal. As mentioned later in this report, all other business segments performed largely in line with forecasts.

FY3/19 1H results

(¥mn, %)

	FY3/18 1H		FY3/19 1H		
	Amount	Ratio to sales	Amount	Ratio to sales	YoY
Net sales	3,486	100.0	3,380	100.0	-3.1
Gross profit on sales	661	19.0	-609	-18.0	-
SG&A expenses	1,668	47.9	1,297	38.4	-22.2
Operating loss	-1,006	-28.9	-1,907	-56.4	-
Ordinary loss	-295	-8.5	-1,483	-43.9	-
Net profit (loss) attributable to owners of the parent	1,869	53.6	-1,569	-46.4	-

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

(2) Conditions by segment

FY3/19 1H results by segment

(¥mn, %)

	FY3/18 1H		FY3/19 1H			
	Amount	Ratio to sales	Amount	Ratio to sales	Change	% change
Net sales	3,486	100.0	3,380	100.0	-106	-3.1
Condominium sales	766	22.0	1,472	43.6	705	92.0
Land and buildings	-	-	-	-	-	-
Custom-made homes	476	13.7	620	18.3	144	30.3
Asset management business	132	3.8	-1,233	-36.5	-1,365	-
Public works construction business	1,798	51.6	2,302	68.1	504	28.0
Renewable energy business	293	8.4	321	9.5	28	9.6
Others	18	0.5	19	0.6	0	4.3
(Adjustments)	-	-	-123	-	-	-
Operating loss	-1,006	-	-1,907	-	-901	-
Condominium sales	-40	-	53	-	94	-
Land and buildings	-	-	-	-	-	-
Custom-made homes	-55	-	-28	-	26	-
Asset management business	19	-	-1,386	-	-1,405	-
Public works construction business	-5	-	53	-	58	-
Renewable energy business	116	-	77	-	-39	-33.6
Others	5	-	4	-	-1	-22.8
(Company-wide expenses)	-1,047	-	-557	-	489	-

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

a) Condominium sales

In FY3/19 1H, the Company executed new contracts for 62 units with a value of ¥2,527 million (compared to 77 units, ¥3,015mn in the same period of the previous fiscal year), and delivered 37 units. As a result, net sales were ¥1,472mn and segment profit was ¥53mn.

b) Land and buildings

No contract results were recorded in FY3/19 1H. (Nor were there any contract results or sales results in the same period of the previous fiscal year.)

c) Custom-made homes

In this business, the Company performs construction of detached homes, as well as related renovation work and other activities, in its main business area of Yamagata Prefecture. In FY3/19 1H, new contracts were made for 36 buildings worth ¥976mn (compared to 21 buildings worth ¥590mn in the same period of the previous fiscal year), and 13 buildings were delivered. The Company recorded net sales of ¥620mn and a segment loss of ¥28mn (compared to the delivery of 11 buildings, net sales of ¥476mn and a segment loss of ¥55mn in the same period of the previous fiscal year).

d) Asset management business

In this business, the Company manages investments in Japanese shares and conducts related research activities, and undertakes real estate investment advisory and proxy services and real estate investments. In FY3/19 1H, the Company recorded a valuation loss on its securities due to a drop in stock prices. As a result, net sales were negative ¥1,233mn and the segment loss was ¥1,386mn (net sales of ¥132mn and segment profit of ¥19mn in the same period of the previous fiscal year). However, this valuation loss does not involve a cash outflow. If stock prices recover by the end of March 2019, it is possible that these valuation losses will not be recorded.

e) Public works construction business

In this business, the Company primarily conducts pipe-jacking projects and pre-stressed concrete (PC) construction work. In FY3/19 1H, the Company recorded net sales of ¥2,302mn and segment profit of ¥53mn (compared to net sales of ¥1,798mn and a segment loss of ¥5mn in the same period of the previous fiscal year).

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, it recorded net sales of ¥321mn and segment profit of ¥77mn.

As of September 30, 2018, the Company had seven projects in operation (Asago Project, Katori Project, Ushiku Project, Rikuzentakata Project, Sendai Project, Utsunomiya Tokujiro Project and Higashi Hiroshima Project). As a result, the Company's share of power generation at these projects was 18.90 MW. Currently another four projects (Sanbu Minami Project, Narita Kouzaki Project, Aidahikari Project in Okayama Prefecture and Kumamoto Yatsushiro Project) are under construction and are scheduled to successively start operations after they are completed.

g) Others

This business mainly involves the rental to general tenants of condominium and other properties owned by the Company. The Company recorded net sales of ¥19mn (¥18mn in the same period of the previous fiscal year) and segment profit of ¥4mn (¥5mn in the same period of the previous fiscal year).

(3) Financial position

The Company's financial condition continues to be stable. At the end of FY3/19 1H, total assets were ¥39,378 million, down ¥1,163mn from the end of the previous fiscal year. Current assets were ¥24,420mn, down ¥3,232mn. This decrease was mainly due to a decline of ¥5,072mn in cash and deposits, which was partly offset by an increase of ¥797mn in securities. Meanwhile, non-current assets were ¥14,958mn, an increase of ¥2,069mn. The main components of this change were an increase in property, plant and equipment of ¥2,085mn, a decrease in intangible assets of ¥77mn, and an increase in investments and other assets of ¥62mn.

Total liabilities were ¥17,186mn, up ¥1,863mn from the end of the previous fiscal year. The main factors included a decrease in notes and accounts payable of ¥161mn, an increase in short-term loans payable, etc. of ¥379mn and an increase in long-term loans payable of ¥1,910mn. Net assets were ¥22,192mn, down ¥3,026mn. This decrease was mainly due to a decline in retained earnings due to the recording of a net loss attributable to owners of the parent.

Balance sheets

(¥mn)

	End of FY3/18	End of FY3/19 2Q	Change
Cash and deposits	10,681	5,609	-5,072
Notes and accounts receivable - trade	481	360	-121
Securities	10,563	11,361	797
Real estate for sale	611	753	141
Real estate for sale in process	2,580	2,699	119
Real estate for development	640	307	-332
Current assets	27,653	24,420	-3,232
Property, plant and equipment	7,675	9,760	2,085
Intangible assets	881	804	-77
Goodwill	831	755	-76
Investments and other assets	4,331	4,393	62
Investments in capital	2,669	2,727	57
Long-term loans receivable	946	1,011	65
Non-current assets	12,888	14,958	2,069
Assets	40,541	39,378	-1,163
Notes and accounts payable - trade	1,024	862	-161
Accounts payable for construction contracts	1,038	1,038	0
Short-term loans payable, etc.	2,628	3,007	379
Current liabilities	7,314	7,222	-91
Long-term loans payable, etc.	7,155	9,053	1,898
Non-current liabilities	8,009	9,963	1,954
Liabilities	15,323	17,186	1,863
Net assets	25,218	22,192	-3,026

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

(4) Cash flow conditions

In FY3/19 1H, net cash used in operating activities was ¥3,249mn. The main factors reducing cash were the recording of a loss before income taxes of ¥1,483mn, a decrease in provision for directors' bonuses of ¥725mn, a decrease in interest and dividend income of ¥342mn, a decrease in notes and accounts payable – trade of ¥329mn, and an increase in investment securities for sale of ¥1,119mn. Net cash used in investing activities was ¥2,877mn. The main uses of cash were the purchase of property, plant and equipment of ¥2,059mn and payments of loans receivable of ¥895mn, while the main source of cash was proceeds from sales of securities of ¥100mn. Net cash provided by financing activities was ¥1,105mn. The main cash inflow was an increase in long- and short-term loans payable of ¥2,304mn, while the main cash outflow was the payment of dividends of ¥1,719mn. As a result, during FY3/19 1H, cash and cash equivalents decreased ¥5,072mn, and the balance of cash and cash equivalents at the end of FY3/19 1H was ¥5,579mn.

Cash flow statements

(¥mn)

	FY3/18 1H	FY3/19 1H
Cash flows from operating activities	-410	-3,249
Profit (loss) before income taxes	2,227	-1,483
Depreciation	151	166
Gain on bargain purchase	-2,528	-
Loss (gain) on operation of investments in capital	-711	-85
Decrease (increase) in notes and accounts receivable - trade	328	137
Decrease (increase) in inventories	-651	-212
Increase (decrease) in notes and accounts payable - trade	-384	-329
Decrease (increase) in investment securities for sale	903	-1,119
Cash flows from investing activities	-285	-2,877
Purchase of property, plant and equipment	-1,948	-2,059
Proceeds from purchase of shares of subsidiaries resulting in change in scope of consolidation	1,680	-
Cash flows from financing activities	826	1,105
Net increase (decrease) in long- and short-term loans payable	1,157	2,304
Cash dividends paid	-503	-1,719
Net increase (decrease) in cash and cash equivalents	127	-5,072
Cash and cash equivalents at end of period	5,507	5,579

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

Outlook

Full-year business results for FY3/19 will mostly depend on the general stock price level.

1. FY3/19 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, although concerns remain that the Company could post an operating loss on a full year basis given the large operating loss it recorded in FY3/19 1H, the main reason for the operating loss was a valuation loss. Therefore, the general stock price level at the fiscal year-end will have a significant bearing on business results for the full fiscal year.

When assessing the Company's business results, as stated earlier, the Company's businesses are widely dispersed and there are some aspects where earnings can be recorded in a short time and other businesses where retrieval takes time. Moreover, retrievals are not always booked as net sales, sometimes being recorded as non-operating income, or as an extraordinary gain, so the financial statements should probably be evaluated looking at comprehensive profits, including extraordinary income or loss, or cash flows and not just on operating profit and loss or ordinary profit and loss.

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 (Russian forest products 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 feed-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.

As for current progress, in May 2018 the Company started site preparation work for a pellet manufacturing plant in Amursk in the Khabarovsk region of Russia, with plans to begin operating the plant by autumn 2019.

The medium- to long-term growth strategy

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 cyclical businesses that are affected by economic fluctuations.

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. Actively conducting M&A as well

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

No changes to the dividend outlook for FY3/19 at this time

The Company pays dividends in order to return profits to shareholders, but it has not formulated a specific basic policy for it. In FY3/18, it paid an annual dividend of ¥4 per share, and at this stage plans to pay an annual dividend of ¥3 per share for FY3/19.

Considering that TPJF's fiscal year ends in December, its business results have largely been finalized. Therefore, the Company will probably be unable to avoid recording a loss on a consolidated basis. However, the Company has not changed its dividend policy at this time, given that the loss it has posted is mostly due to a valuation loss that does not involve a cash outflow, and there are assets among the solar power generation projects the Company has undertaken for which investments can be recovered.

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