

## Bridge Report Sangetsu Co., Ltd. (8130)

 Shousuke Yasuda, President	Company	Sangetsu Co., Ltd.	
	Code No.	8130	
	Exchange	First Section, Tokyo and Nagoya Stock Exchanges	
	Industry	Wholesale (Commerce)	
	President	Shousuke Yasuda	
	HQ Address	1-4-1 Habashita, Nishi-ku, Nagoya-shi	
	Business Description	Sangetsu was founded in 1849 and is Japan's largest trading company specializing in interior products. It conducts development and sales of interior decorating products, including wallcoverings, curtains, flooring materials, and chair upholstery. Sangetsu has top share of wallcovering, and is the industry's leader in the curtain, vinyl and textile flooring materials.	
	Year-end	March end	
	URL	<a href="http://www.sangetsu.co.jp/english/index.html">http://www.sangetsu.co.jp/english/index.html</a>	

### — Stock Information —

Share Price	Shares Outstanding	Market Cap.	ROE (actual)	Trading Unit	
¥2,913	38,099,226 shares	¥110.983 billion	4.6%	100 shares	
DPS (Est.)	Dividend Yield (Est.)	EPS (Est.)	PER (Est.)	BPS (actual)	PBR (actual)
¥75.00	2.6%	¥115.49	25.2x	¥3,146.70	0.9x

\* Stock price as of closing on November 21, 2014. Number of shares issued at the end of the most recent quarter excluding treasury shares.

### — Consolidated Earnings Trends —

(Unit: Million Yen)

Fiscal Year	Sales	Operating Income	Ordinary Income	Net Income	EPS (¥)	Dividend (¥)
March 2010	108,579	5,646	6,046	3,137	78.20	75.00
March 2011	112,118	7,161	7,530	4,242	105.75	75.00
March 2012	118,518	7,095	7,180	4,151	103.46	75.00
March 2013	123,150	8,020	8,393	4,806	120.52	78.00
March 2014	131,978	8,952	9,475	5,459	143.30	75.00
March 2015 Est.	133,000	7,300	7,700	4,400	115.49	75.00

\* Estimates are those of the Company.

This Bridge Report presents various information about Sangetsu Co., Ltd. including an overview of the Company, its characteristics and strengths, and its business strategies.

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## Key Points

- Sangetsu Co., Ltd. is Japan's largest trading firm specializing in interior decorating products. It deals in wallcoverings, floorings, curtains, etc. While its main function is a trading company, the Company also performs design, planning and development of products as a "fables company." Sangetsu also boasts of a business model that yields stable earnings and top share of its major product markets. The Company maintains a goal of achieving ROE in excess of its cost of its capital at an early stage as part of its midterm business plan.
- Sales rose by 4.4% year-on-year to ¥63.9 billion during the first half. Fortification of marketing functions, publication of new product catalogs and other efforts targeting clients in the home refurbishment and non-residential realms were successful, and contributed to increases in sales of all business segments. Revisions in sales pricing allowed gross income to grow, but structural reforms, business structure fortifications, and compensation revisions contributed to an increase in sales, general and administrative expenses of 7.5% year-on-year and a subsequent decline in operating income of 4.4% year-on-year.
- Full year earnings estimates call for sales to rise by 0.8% year-on-year to ¥133.0 billion. Weak demand in the wake of the rush to buy ahead of the consumption tax hike is expected to cause sales during the second half to decline, but full-year sales are expected to record a slight increase. The establishment of new offices and distribution facilities as part of the business structure fortifications and other improvement efforts are expected to raise sales, general and administrative expenses and cause operating, ordinary, and net incomes to decline by 18.5%, 18.7% and 19.4% year-on-year respectively. The same level of dividend as the previous term of ¥75.00 per share is expected to be paid at the term end, for a dividend payout ratio of 64.9%.
- 2014 is identified as the year of Sangetsu's "3<sup>rd</sup> Founding Phase," and a new "Mid-term Business Plan(2014-2016), Next Stage Plan G" has been created to determine a new direction and vision for Sangetsu to pursue. The goal of this Plan is to "fortify the business structure to capture future growth over the next three years and to prepare the way for the next stage of growth."
- In addition to earnings expansion and stability, Sangetsu will pursue a management strategy that emphasizes balance sheet efficiency and seeks to achieve high rates of ROE in excess of its cost of capital at an early stage. Sangetsu has established goals of flexibly implementing share buybacks, achieving reductions in capital of between ¥10.0 to ¥20.0 billion over the next three to five years, and raising its consolidated comprehensive return ratio to over 100%.
- While the recently announced capital strategy has gathered considerable attention in the market, it is believed that profit margin (Net income to sales ratio) needs to be improved along with this capital strategy in order to achieve the 8% to 10% ROE target described later in this report. Therefore, the most important factor is the fortification of existing businesses, including efforts to strengthen products in the non-residential realm and expand sales of refurbishments (Home and non-residential), in addition to strengthening of the Company's business structure. Furthermore, a close watch should be kept on progress in the achievement of the "Mid-term Business Plan(2014-2016), Next Stage Plan G."

## 1. Company Overview

Sangetsu Co., Ltd. is Japan's largest trading company, specializing in wallcoverings, carpets, curtains and other interior decorating products. In addition to its function as a trading firm, the Company also operates as a "fables" company with planning and development functions for interior decorating products. Sangetsu boasts of a business model that is able to produce stable earnings and top market share in its main product realms. The Company maintains a goal of raising ROE to



above its cost of capital at an early stage as part of its midterm business plan.

<Corporate History>

Sangetsu was founded in 1849 under the original name of “Sangetsudo” to sell various traditional Japanese interior decorating products including scrolls, wall scrolls, folding screens, sliding doors, partitions, and other products made of cloth and paper. The founding family changed the name to Sangetsu Co., Ltd. in 1953 along with its conversion to a corporation. From the latter half of the 1970s onwards, the business was expanded into Tokyo, Fukuoka, Osaka and other parts of Japan. In 1980, Sangetsu was listed on the Second Section of the Nagoya Stock Exchange, and later in 1996 its shares were also listed on the First Section of the Tokyo Stock Exchange. Currently, Sangetsu is expanding its operations into overseas markets and has established itself as the largest total interior decorating product provider within Japan, with a widely recognized brand of interior products.

Shousuke Yasuda was appointed as the first President who is not from the founding family of Sangetsu in April 2014. He will direct the Company during its third stage of growth entitled “Our Third Founding Phase,” following on the heels of the original first phase of founding and the second phase when the company became a publicly listed corporation.

<Corporate Philosophy>

Sangetsu maintains a corporate motto of “integrity,” and endeavors to uphold the “Three Principles of Sangetsu,” which are described below, in all of its business activities. In addition, Sangetsu seeks to contribute to society through the provision of products with high value addition that enriches customers’ home environments and lives.

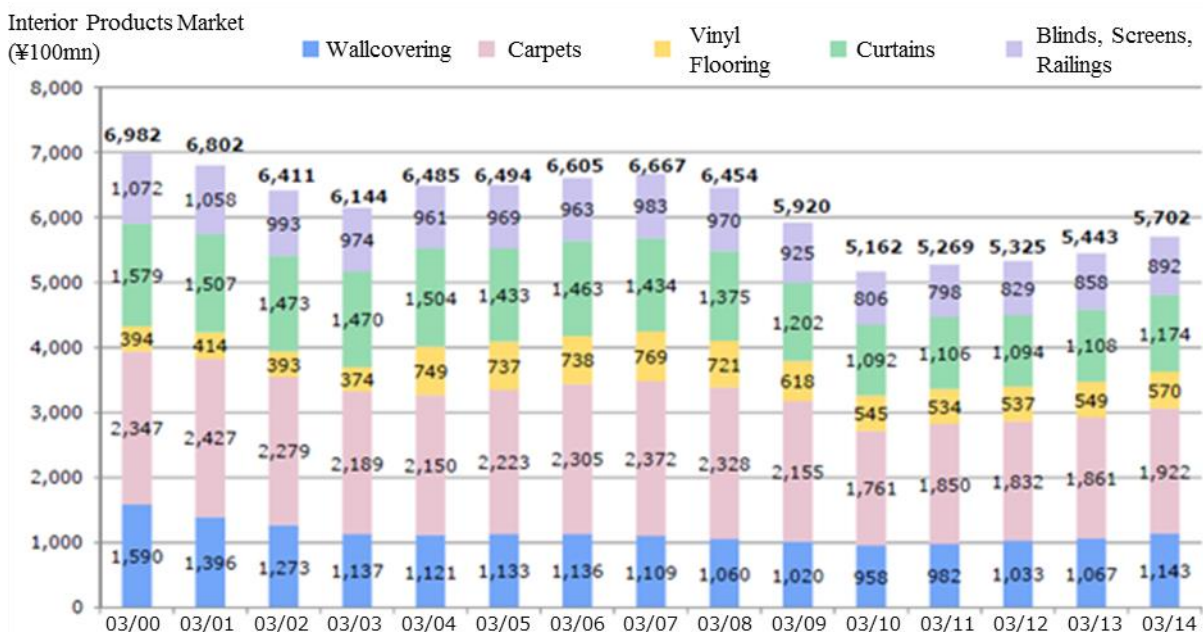
< Three Principles of Sangetsu >

Creative Design
Highly Reliable Quality
Fair Pricing

<Market Environment>

◎ Overview

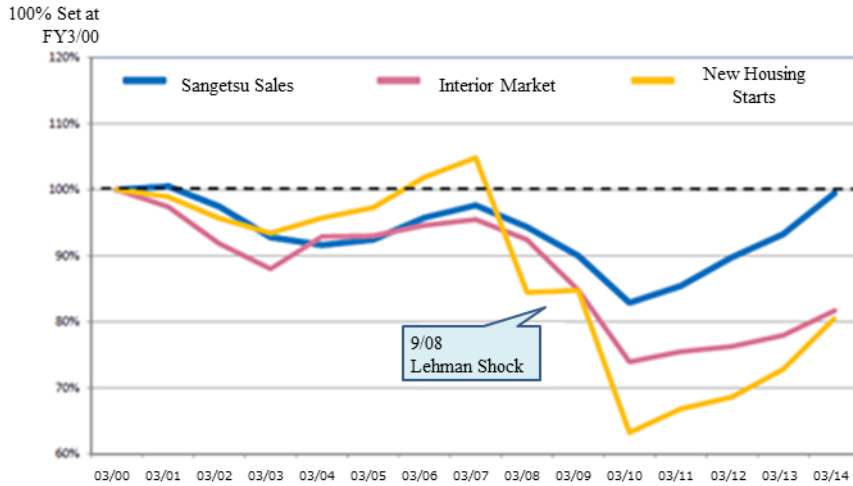
The market environment for the main wallcovering and flooring products is strongly influenced by trends in the Japanese construction market. Declines in new housing start arising from declining population and changing family structures within Japan, and deflationary trends have depressed sales of the interior products market as shown in the graph below.



(Source: Sangetsu)

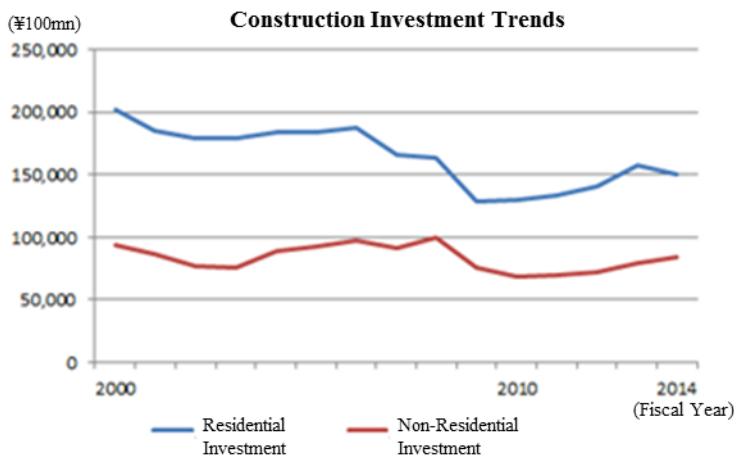
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At the same time, the graph below shows the correlation between sales of Sangetsu relative to sales of the Japanese interior market and new housing starts (Ministry of Land, Infrastructure, Transport and Tourism data). Sales of both Sangetsu and the Japanese interior market show a close relationship to trends in new housing starts. And despite the inability of housing starts and the interior market to recover to the pre-Lehman shock levels, Sangetsu's sales have been able to recover to its most recent peak level achieved in 2000.

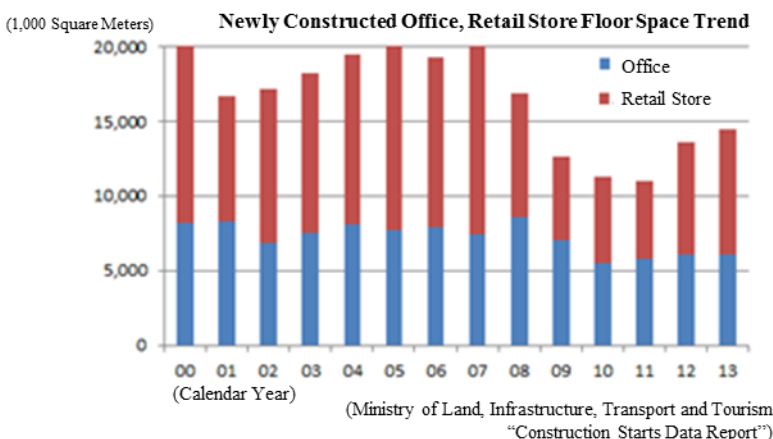


(Source: Sangetsu)

This strong recovery is attributed to Sangetsu's efforts to cultivate business in the non-residential realm.



(Source: Ministry of Land, Infrastructure, Transport and Tourism)



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The Ministry of Land, Infrastructure, Transport and Tourism reports that while private sector construction investments of non-residential structures were less than that of residential structures, they had recovered to the levels seen in 2000. Furthermore, construction of large floor space office buildings has also recovered to close to 15,000,000 square meters.

Moreover, the Research Institute of Construction and Economy issued a report entitled “Outlook for Construction Investment Based upon a Construction Economy Model” (October 22, 2014) that calls for continued growth of 7.6% and 2.4% year-on-year growth in private sector non-residential investments during fiscal years 2014 and 2015 respectively, following on the heels of 11.1% year-on-year growth recorded during fiscal year 2013.

Aging of the population due to declining birthrates is contributing to a long-term decline in new housing starts and overall difficult conditions. However, the approach of the 2020 Tokyo Olympics is expected to contribute to favorable conditions to continue in the private sector non-residential construction market for the foreseeable future.

## ◎ Competitors

In addition to Sangetsu, there are three publicly traded competitors that operate in the interior decorating market.

(Units: Million Yen, Times)

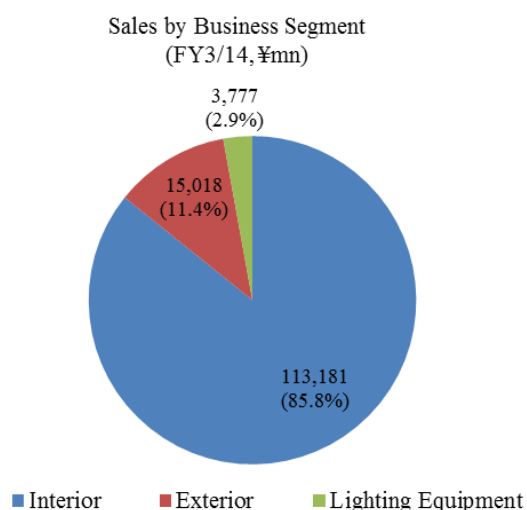
Stock Code	Company	Sales	YY Change	Operating Income	Operating Margin	YY Change	Market Cap	PER	PBR	ROE
3501	Suminoe Textile Co., Ltd.	92,000	4.2%	3,500	3.8%	+9.6%	23,046	9.2	0.7	7.3%
7971	TOLI Corp.	91,400	1.9%	2,850	3.1%	+11.7%	16,306	9.1	0.6	5.2%
<b>8130</b>	<b>Sangetsu</b>	<b>133,000</b>	<b>0.8%</b>	<b>7,300</b>	<b>5.5%</b>	<b>-18.5%</b>	<b>110,983</b>	<b>25.2</b>	<b>0.9</b>	<b>4.6%</b>
9827	Lilycolor Co., Ltd.	37,200	5.3%	230	0.6%	+53.3%	1,658	33.2	0.3	1.2%

\* Estimates of those of the respective companies. Market capitalization is based upon the closing share price on November 21, 2014.

While operating income is the highest amongst this group, Sangetsu’s ROE ranks third highest amongst its peers. This may be one factor behind the PBR, which trades below 1 time. Consequently, Sangetsu’s efforts to improve ROE should be watched closely.

## <Business Description>

The main businesses include planning, development and sales of wallcovering, curtains, fabric chairs and other interior products. Sangetsu boasts of a “fabless operation” and does not maintain any manufacturing facilities, but its capabilities exceed that of typical trading firms and all of the products it sells are planned, designed and developed in-house. In addition, Sangetsu provides exterior products and lighting fixtures through its subsidiary.



## ① “Interior Business”

(FY3/14: Sales and Operating Income of ¥113.181 and ¥8.842 Billion)

### ◎ Main Products

<b>Wallcovering</b>	Sangetsu's main product, used in a wide range of residential and non-residential applications. High functionality products have become popular in recent years that are resistant to staining, odor absorbing, and scratch resistant. Also, wallcoverings with colorful designs are being used to decorate all or part of walls in homes to add an accent to interiors, and collaboration with rental property management companies being promoted for the development of products to raise the value addition of rental properties.
<b>Cushioned Flooring</b>	Sheeted floor materials that are used in both residential and retail store applications, and commonly used in apartments and condominiums. They boast of wood grain, stone, and a wide range of other motif designs and have cushioning function for use in a wide range of applications.
<b>Long Vinyl Sheets</b>	Sheet formed flooring materials used in commercial applications including medical and welfare institutions, and educational institutions. This product boasts of high levels of safety and sanity functionality, and is designed to reduce maintenance costs by being easy to keep clean. It also has been designed with the environment in mind and helps to reduce the environmental burden.
<b>Inlaid Sheets</b>	Sheet formed flooring materials used in medical and welfare institutions, and educational institutions. Uniquely manufactured with design patterns printed through entire flooring material so patterns will continue to show even after being worn down. They do not require wax for easy maintenance, and thereby reducing maintenance costs and environmental burden.
<b>Floor Tiles</b>	Tile formed vinyl flooring materials in 45 centimeter square sections used in a wide range of applications including apartments, condominiums, educational institutions, and commercial facilities. Manufactured with wood and stone motifs, with highly detailed embossed printing processes used to show highly detailed designs.
<b>Carpets, Carpet Tiles</b>	Textile flooring materials used in a wide range of applications including ryokans (i.e. Japanese inns), hotels, residential and office facilities. Multiple colorful designs with high functionality, formed in 50 centimeter square tile sections for easy installation and superior maintenance.
<b>Curtains</b>	All of the curtains sold by Sangetsu are custom made, and boast of the ability to create unique designs and custom sizes of curtains to match room decorations in which they are used. In addition to highly fashionable designs and heavy materials, mirror-like insulating characteristic lace curtains, which make it difficult to see inside from the outside and reduce the amount of heat transferred into the rooms, have also become popular.

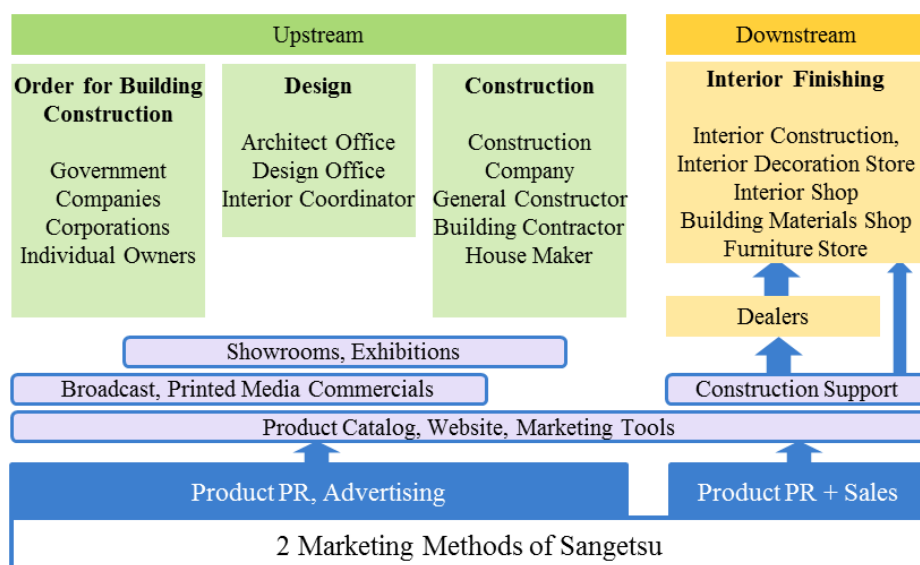
Sangetsu boasts of a diverse product lineup with about 13,000 different products in total. There are about 5,000 different wallcovering products alone. Product catalogs are updated every two years (Curtain product catalogs are updated every three years), with an existing product replacement rate for wallcovering of 50% to 55%, which compares with a 35% to 40% rate for its competitors.

Replacement of existing products is not a simple task. Disposal of products leads to wastes, but the disposal of existing products due to replacement with newly designed products is necessary to maintain the attractiveness of the product catalog and to satisfy customers. Therefore, the ability to maintain a balance between attractiveness and efficiency is highly important and is one of the strengths of Sangetsu.

### ◎Marketing Structure

In addition to the headquarters located in Nagoya, Sangetsu maintains 8 regional offices and 55 marketing offices throughout Japan, with 6 of these marketing offices also hosting showrooms.

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(Source: Sangetsu)

The downstream interior finishing process includes the final delivery of products, booking of sales, and receipt of cash. The main customers are interior construction companies and interior and building material shops that are serviced through dealers. Furthermore, public relations and advertising for products at the start of the process are also very important.

Therefore, Sangetsu conducts public relations and advertising for its products in its product catalog, television commercials and at its showrooms. In addition to these “passive” marketing activities, Sangetsu also conducts “proactive” marketing of its products through its corporate marketing division and its 400 marketing staff to provide and gather information and propose products to clients.

While the main marketing efforts are conducted through dealers, Sangetsu also conducts direct marketing to customers in the Nagoya and surrounding Chubu area, and the number of its directly accessed customers totals 6,000 in these regions alone. While the number of customers dealt with through dealers is not known, the total number of customers is estimated to amount to several tens of thousands nationwide.

## ◎ Distribution Structure

Sangetsu maintains a network of 13 distribution centers nationwide. Most all products are normally stocked at the Company’s distribution centers in Tokyo, Nagoya, Osaka and Kyushu, with the number of products shipped from these centers surpassing 60,000 per day and the out-of-stock ratio amounting to a low 0.13% (About 70 products) per day. Sangetsu’s nationwide distribution network makes “Just-in-Time” provision of products to match the interior construction schedules of our clients possible. Products are sourced from a wide range of over 100 supplier companies.

## ② “Exterior Business”

**(FY3/14 Sales and Operating Income of ¥15.018 Billion and ¥556 Million)**

Sungreen Co., Ltd., which was turned into a subsidiary in 2005, sells doors, fences, terraces and other exterior products within Japan.

## ③ “Lighting Business”

**(FY3/14 Sales and Operating Income of ¥3.820 Billion and ¥435 Million)**

Yasuda Shomei Lighting Co., Ltd., which was turned into a subsidiary in 2008, sells down lights, z-lights and other general lighting fixtures within Japan.

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## <ROE Analysis>

	FY3/12	FY3/13	FY3/14
<b>ROE(%)</b>	3.5	4.1	4.6
Net Income to Sales Ratio (%)	3.50	3.90	4.14
Asset Turnover Ratio (x)	0.84	0.88	0.93
Leverage (x)	1.18	1.19	1.20

<Reference: TSE First Section ROE by Industry>

	FY3/13	FY3/14
All Industries (Exc. Finance)	5.01	8.71
Manufacturing	4.55	8.62
Non-Manufacturing	5.69	8.85
Wholesale	10.40	10.60

\* Source: TSE Homepage "Earnings Data Review"

Sangetsu recorded an ROE ratio of 4.6%, which was lower than the averages for the Tokyo Stock Exchange First Section Market and the wholesale industry. As will be explained later in this report, the Company maintains a target of "achieving high levels of ROE that exceeds its cost of capital of 8% to 10% at an early stage" in its mid-term business plan.

Specifically, Sangetsu "seeks to reduce its capital from the end of March 2014 by ¥10.0 to ¥20.0 billion within three to five years" as part of its efforts to achieve a ROE ratio of 8% to 10% by fiscal year 2017 to 2019. Consequently, the Company will implement efforts to raise profitability in addition to this capital strategy.

## 2. Characteristics and Strengths

### ① Business Model Capable of Yielding Stable Earnings

Sangetsu is a pioneer in the realm of "fabless companies" that do not maintain their own manufacturing functions and therefore have lower fixed expense burdens because they don't have to carry facilities for the manufacturing process. In addition, the Company boasts of over 13,000 products, sourced from over 100 suppliers, supplied to several tens of thousands of customers, which diversifies risk in many ways. And while Sangetsu's may be considered as an economically sensitive company as its business and earnings performances are closely linked to trends in the construction market, the Company has never seen losses since its founding.

### ② High Market Share of Various Products

As the industry's largest company, Sangetsu boasts of high market shares in its various products as listed below.

Products	Market Size	Share
Wallcovering	¥114.1 bn	48.9%
Cushion Flooring	33.57 mn sq. meters	46.8%
Long Vinyl Sheets	25.44 mn sq. meters	33.8%
Inlaid Sheets	3.02 mn sq. meters	13.2%
Floor Tiles	19.31 mn sq. meters	30.0%
Tile Carpets	¥187.0 bn	6.3%
Curtains	¥115.3 bn	7.6%



### ③ “Creating,” “Proposing,” “Providing” “Creating”

While the actual manufacturing of products is not conducted in-house, Sangetsu performs the planning, design and development functions internally. The previous generation of Sangetsu management made aggressive investments for “unique designs,” one of the three principles of the Company. 20 in-house designers develop new and original versions of products based upon numerous basic designs. The cultivation of designers responsible for various products is done through participation in overseas exhibitions, communication with marketing staff, and discussions with outside design consultants as part of their on-the-job training. Furthermore, Sangetsu maintains a policy of aggressively taking the perceptions and opinions of younger designers and staff into consideration. Sangetsu also boasts of an overwhelming number of products of about 13,000 that far exceeds the number of products of its competitors. In addition, the Company conducts revisions of its products on a regular basis every 2 to 3 years with 28 categories of product catalogs, which far surpass those of its competitors.



(Source: Sangetsu)

### “Provide”

As mentioned earlier in this report, Sangetsu normally maintains inventories of all of its products so that they can be provided on a “Just-in-Time” basis using their nationwide distribution network. However, the Company is required to conduct speedy processing techniques as product orders are placed so that loss rates can be limited to avoid the maintenance of excess inventories and reduced efficiencies. Some wallcoverings are produced in rolls as long as 50 meters, and Sangetsu cuts these rolls into shorter segments when orders are placed for shipment. The remaining segments of wallcovering are then cut to match other orders to eliminate losses. This type of custom-made cutting technology has been cultivated over the long years of experience in the interior decorating business and is an important factor that differentiates Sangetsu from its competitors.



(Source: Sangetsu)

## “Propose”

Nearly one third of all employees or some 400 work in marketing functions at Sangetsu, the largest marketing function within the industry. These marketing staff are assigned to 63 offices located throughout Japan and conduct proposal-based marketing to clients. Sangetsu also staffs its six showrooms with 64 employees. In addition, 51 interior designers create design boards that combine samples of various products for customers to use when choosing interior products. This high level of proposal-based marketing capability is unmatched within the industry and sets Sangetsu apart from its competitors.



(Source: Sangetsu)

## 3. First Half of Fiscal Year March 2015 Earnings Overview

### (1) Earnings Overview

(Units: Million Yen)

	1H FY3/14	Share	1H FY3/15	Share	YY Change	Divergence from Estimate
Sales	61,301	100.0%	63,981	100.0%	+4.4%	+3.2%
Gross Income	17,161	28.0%	17,962	28.1%	+4.7%	+5.8%
SG&A	13,056	21.3%	14,037	21.9%	+7.5%	+0.8%
Operating Income	4,105	6.7%	3,924	6.1%	-4.4%	+28.7%
Ordinary Income	4,399	7.2%	4,218	6.6%	-4.1%	+29.8%
Net Income	2,691	4.4%	2,156	3.4%	-19.9%	+10.6%

### Sales Rise, Profits Fall on Marketing Function Fortification

Sales rose by 4.4% year-on-year to ¥63.9 billion. Fortification of marketing capability to designers and other clients, and publishing of new catalogs allowed sales of both the refurbishment and non-residential realms of the interior business (Wallcovering, floorings, curtains and other products) to see higher sales. All business segments saw higher sales. The revisions in product sales pricing taken in response to a rise in materials costs due to the rise in crude oil prices contributed to a 4.7% year-on-year increase in gross income. However, expenses arising from structural reforms, facilitation of the operating structure, and revisions in compensation contributed to a 7.5% year-on-year increase in sales, general and administrative expenses and caused operating income to decline by 4.4% year-on-year. Impairment loss arising from the assumption of the sale of real estate including an employee dormitory and non-current asset retirement loss contributed to a 19.9% year-on-year decline in net income. Because of the stronger than expected growth in sales and improvement in gross income margin, profits actually surpassed estimates.

Increases in labor expenses arising from organizational fortifications, distribution costs due to increases in the number of customers, publishing costs for the new product catalog, domestic travel expenses, and other costs associated with structural reforms contributed to a ¥750 million increase in costs. Special compensation, fees arising from organizational structure facilitation, repair and refurbishment expenses for office and distribution facilities, IT system restructuring expenses, impairment loss and other one-off expenses contributed to a ¥1.11 billion increase in costs. If the increased cost had been attributed to the structural reforms only, profits would have been in line with the previous year's levels.

**(2) Business Segment Trends**

(Unit: Million Yen)

	1H FY3/14	Share	1H FY3/15	Share	YY Change
<b>Sales</b>					
<b>Interior</b>	52,701	86.0%	54,633	85.4%	+3.7%
<b>Exterior</b>	6,990	11.4%	7,512	11.7%	+7.5%
<b>Lighting</b>	1,614	2.6%	1,867	2.9%	+14.1
<b>Adjustment</b>	-5	-0.0%	-32	-0.1%	-
<b>Total</b>	61,301	100.0%	63,981	100.0%	+4.4%
<b>Operating Income</b>					
<b>Interior</b>	4,102	7.8%	3,641	6.7%	-11.2%
<b>Exterior</b>	209	3.0%	260	3.5%	+24.4%
<b>Lighting</b>	-207	-	30	1.6%	-
<b>Adjustment</b>	0	-	-8	-	-
<b>Total</b>	4,105	6.7%	3,924	6.1%	-4.4%

\* Share of operating income is the same as operating income margin.

**① Interior Business**

	1H FY3/14	Share	1H FY3/15	Share	YY Change
<b>Wallcoverings</b>	26,400	50.1%	27,105	49.6%	+2.7%
<b>Floorings</b>	17,590	33.4%	18,311	33.5%	+4.1%
<b>Curtains</b>	3,707	7.0%	4,002	7.3%	+8.0%
<b>Others</b>	5,003	9.5%	5,215	9.5%	+4.2%
<b>Total</b>	52,701	100.0%	54,633	100.0%	+3.7%

**<Wallcoverings>**

Sangetsu ran television commercials as part of its strategy of promoting a shift from lower-priced, high-volume products to medium-priced medium-volume products in order to raise profitability. Also, a new catalog was published along with this strategy of promoting medium-priced products. Despite the weak operating environment brought on by the decline in new housing starts, successful price hikes allowed sales to grow and enabled Sangetsu to maintain its share of the markets. Profit margins, which had fallen due to the increase in raw materials pricing, entered a recovery phase from July onwards.

**<Floorings>**

Fortification of marketing efforts for flooring materials used in residences, offices, commercial facilities, educational institutions, medical institutions, nursing care facilities and other various facilities were undertaken as part of the restructuring of the marketing structure. In addition, new editions of two product catalogs were published. Reviews of product pricing strategies, including a price hike implemented from September 1, 2014, and the ability to achieve higher sales allowed profit margins to improve.

**<Curtains>**

Fundamental reviews of sales promotions, product development and product catalog strategies were undertaken. At the same time, the ability to conduct proposal-based sales was fortified through expanded cooperation with marketing staff. Revised pricing strategies released in the new product catalog published in October 2013 contributed to an expansion in sales. On a half-year basis, the current term was the first time that pricing has risen by a large margin since the September 2002.

**<Sales, General and Administrative Expenses>**

Increases in distribution expenses arising from the installation of new facilities and due to expansion in the number of

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clients, and implementation of reviews of offices and distribution facilities in line with the midterm business plan contributed to increases in maintenance and repair expenses. Efforts to fortify human resources caused labor and training expenses to rise.

## ② Exterior Business

Sales of the main realm of fences, car ports and sun rooms rose from previous first half. Sangetsu fortified its exterior product lineup with products made in-house during 2013. In the Tokyo and surrounding Kanto region, a new branch office was opened in Yokohama. Sales derived from the Tokyo and Kanto region rose by 1.4 times from the previous first half.

## ③ Lighting Business

Various measures are being implemented in order to establish a stable earnings foundation, including improvements in corporate governance, improvements in employee motivation, reductions in product numbers, and fortification of inventory management. Sangetsu will focus its efforts upon strengthening its product lineup with the clearly identified focus upon clients within the “non-residential” segment of the market in mind. This business turned to profits due in part to the expansion in gross income and to the insurance payments related to the heavy snowfall recorded in February 2014.

## (3) Financial Condition, Cash Flow

### ◎ Balance Sheet

(Units: Million Yen)

	3/14 End	9/14 End		3/14 End	9/14 End
Current Assets	91,313	100,386	Current Liabilities	20,914	17,524
Cash, Equivalents	18,919	22,480	Payables	14,389	12,722
Receivables	45,496	40,827	Noncurrent Liabilities	5,101	5,661
Marketable Securities	15,002	24,003	Retirement Benefits	3,654	4,215
Inventories	10,950	12,299	Total Liabilities	26,016	23,186
Noncurrent Assets	54,590	43,946	Net Assets	119,887	121,147
Tangible Noncurrent Assets	30,304	29,737	Shareholders' Equity	118,667	119,038
Intangible Noncurrent Assets	346	340	Total Liabilities, Net Assets	145,903	144,333
Investments, Others	23,938	13,868	Total Interest Bearing Liabilities	114	104
<b>Total Assets</b>	<b>145,903</b>	<b>144,333</b>	<b>Equity Ratio</b>	<b>82.2</b>	<b>83.9</b>

Increases in cash and equivalents, marketable securities, and inventories contributed to an increase in current assets of ¥9.0 billion from the end of the previous term. At the same time, declines in investment securities caused investments and other assets and noncurrent assets to decline by ¥10.0 and ¥10.6 billion, respectively. Total assets fell by ¥1.5 billion from the end of the previous term to ¥144.333 billion.

Declines in accounts payables led to ¥3.3 billion decline in current liabilities and a ¥2.8 total drop in total liabilities to ¥23.186 billion over the same period. Net assets rose by ¥1.2 to ¥121.147 billion on the back of increases in retained earnings. Equity ratio also rose by 1.7% points from the end of the previous term to 83.9%.

### ◎ Cash Flow

(Units: Million Yen)

	1H FY3/14	1H FY3/15	YY Change
Operating Cash Flow	6,385	3,591	-2,794
Investing Cash Flow	-2,113	1,433	+3,546
Free Cash Flow	4,272	5,024	+752
Financing Cash Flow	-1,584	-1,441	+143
Cash, Equivalents	15,697	15,917	+220

# Bridge Report



The net inflow of operating cash flow declined due to a decline in the margin of increase in inventories. Investing cash flow turned from a net outflow in the previous first half to a net inflow during the current first half due in part to a decline in marketable securities acquisitions. The margin of net inflow of free cash flow increased. Both financing cash flow and cash and equivalents remained basically unchanged from the previous first half.

## 4. Fiscal Year March 2015 Earnings Estimates

### (1) Earnings Estimates

(Units: Million Yen)

	FY3/14	Share	FY3/15 Est.	Share	YY Change	Divergence from Estimates	Attainment Rates
Sales	131,978	100.0%	133,000	100.0%	+0.8%	+3.9%	48.1%
Gross Income	36,055	27.3%	37,100	27.9%	+2.9%	-	48.4%
SG&A	27,102	20.5%	29,800	22.4%	+10.0%	-	47.1%
Operating Income	8,952	6.8%	7,300	5.5%	-18.5%	+2.8%	53.8%
Ordinary Income	9,475	7.2%	7,700	5.8%	-18.7%	+2.7%	54.8%
Net Income	5,459	4.1%	4,400	3.3%	-19.4%	0.0%	49.0%

\* Estimates are those of the Company.

### Estimates Revised Upwards, Call for Sales to Rise, Profits to Decline

As described earlier in this report, sales of products to non-residential applications rose during the first half and exceeded initial estimates. And while difficult conditions are anticipated during the second half, sales during the full year are expected to exceed estimates. Both operating and ordinary incomes are also expected to exceed estimates due to the higher sales and despite increases in expenses expected to arise from impairment losses and sales, general and administrative costs due to business restructuring. Consequently, earnings have been revised upwards.

During the full year, sales are expected to rise by 0.8% year-on-year to ¥133.0 billion despite the expected decline in second half sales resulting from the rush to purchase products during the previous second half ahead of the consumption tax hike. Expenses from the improvements in distribution facilities and offices conducted as part of Sangetsu's business restructuring, various consulting fees associated with the midterm business plan, and the publication of new product catalogs are expected to lead to increases in sales, general and administrative expenses and cause operating, ordinary, and net incomes to decline by 18.5%, 18.7% and 19.4% year-on-year respectively. The same level of dividend as in the previous term of ¥75.00 per share is expected to be paid, and would represent a dividend payout ratio estimate of 64.9%.

### (2) Business Segment Trends

(Units: Million Yen)

	FY3/14	Share	FY3/15 Est.	Share	YY Change
<b>Sales</b>					
Interior	113,181	85.8%	113,500	85.4%	+0.3%
Exterior	15,018	11.4%	15,500	11.7%	+3.2%
Lighting	3,820	2.9%	4,000	2.6%	+4.7%
Adjustment	-42	-0.0%	-	-	-
<b>Total</b>	131,978	100.0%	133,000	100.0%	+0.8%
<b>Operating Income</b>					
Interior	8,842	7.8%	6,900	6.1%	-22.0%
Exterior	556	3.7%	500	3.2%	-10.1%
Lighting	-435	-	-100	-	-
Adjustment	-11	-	-	-	-
<b>Total</b>	8,952	6.7%	7,300	5.5%	-18.5%

\* Share of operating income is the same as operating income margin.

Sales of all business segments are expected to surpass the previous year's levels. A refined marketing strategy tailored to match clients' requirements, respective areas of demand and products, and product development are expected to contribute to both an improvement in profitability and to maintenance of market share. Sangetsu will also implement efforts to establish a sustainable and stable earnings foundation for Yamada Shomei Lighting and expand the business of Sungreen in the Kanto region.

## 5. Mid-term Business Plan,2014-2016: Next Stage Plan G

Sangetsu identifies 2014 as its "Third Founding Phase" and has created the "Mid-term Business Plan (2014-2016) Next Stage Plan G" to define the vision to be pursued and direction to be taken in the coming years. The targets included in this plan entail "corporate restructuring and fortification, investments and preparations for future growth, and preparations to cultivate development of business over the next three years."

### <Basic Policy>

<b>Business Restructuring</b>	<ul style="list-style-type: none"> <li>◇ Replace, newly create distribution, office facilities</li> <li>◇ Restructure IT systems</li> <li>◇ Expand investments in human resources</li> </ul>
<b>Interior Business Fortification</b>	<ul style="list-style-type: none"> <li>◇ Expand sales of refurbishment (Residential, non-residential)</li> <li>◇ Fortify non-residential use products</li> <li>◇ Fortify flooring products</li> <li>◇ Restructure the curtain related business</li> </ul>
<b>New Business Development</b>	◇ Expand operations, improve earnings of consolidated companies
<b>Full-Scale Overseas Business Deployment</b>	◇ Develop products specifically for the overseas markets

### <Specific Measures>

Target Stakeholders	Target Realms	Specific Measures
Employees	Internal Structure	<b>1) Facilitate a corporate structure that allows employees to actively participate in business management</b> A) Organizational review B) Personnel structure reforms C) Review organization operational rules D) IT system restructuring
Clients, Suppliers	Products, Marketing	<b>2) Business strategy restructuring</b> A) Expand existing businesses B) Promote growth strategies
Shareholders, Society	Capital Markets, CSR	<b>3) Improve the reputation amongst stakeholders</b> A) Capital and IR strategies B) Societal contribution activities C) Environmental management

In addition, Sangetsu will promote the four specific measures mentioned below as part of "4) Diffusion of Our Corporate Philosophy and Principles" strategy.

## ◎ Progress in Achieving Various Measures

### 1) Facilitate a Corporate Structure that Allows Employees to Participate in Business Management

<b>A. Organizational Reviews</b>	<ul style="list-style-type: none"> <li>✓ Transitioned to a new organizational structure on July 1</li> <li>✓ Introduced business structure that clearly defines responsibility for earnings</li> <li>✓ Fortified headquarter functions</li> <li>✓ Established new, overseas business divisions</li> </ul>
<b>B. Personnel System Reforms</b>	<ul style="list-style-type: none"> <li>✓ Under consideration of introducing a new personnel system that increases employee motivation; Scheduled to be introduced in April 2015</li> <li>✓ Will increase number of female marketing staff</li> </ul>
<b>C. Organizational Operation Reviews</b>	<ul style="list-style-type: none"> <li>✓ Fortified earnings, management efficiency by function, including headquarters, branch offices, divisions, product catalogs, and products</li> <li>✓ Fortified risk management function</li> <li>✓ Conducted transfer of authority through company rule reviews</li> </ul>
<b>D. IT System Restructuring</b>	<ul style="list-style-type: none"> <li>✓ Introduced new operating systems</li> <li>✓ Salesforce to be introduced as a new marketing management system from January 2015; Will fortify marketing by mobilizing marketing staff, efficiency improvements</li> <li>✓ Under consideration of introducing new backbone system</li> </ul>

### 2) Business Strategy Restructuring

<b>A. Expand Existing Interior Business</b>	<ul style="list-style-type: none"> <li>✓ Currently reviewing product development (Planning, design) and implementing efforts to restructure branding strategy</li> <li>✓ Creation of an optimized distribution structure underway</li> </ul>
<b>B. Promote Growth Strategy</b>	<ul style="list-style-type: none"> <li>✓ Consideration of new channels for new products, business realms underway</li> <li>✓ Pursuing synergies within the Sangetsu Group</li> <li>✓ Selection of key overseas markets underway</li> </ul>

### 3) Improve Corporate Reputation with Stakeholders

Based upon the identification of ongoing improvements of corporate value as the basic means of returning profits to shareholders, Sangetsu has sought to implement a stable level of dividends. (The combined total dividend payout over the past five years amounts to over 70%) In addition, the Company has implemented a management strategy that places a priority upon safety of its balance sheet in addition to sales growth and profitability. However, Sangetsu recognizes the necessity of making a shift in its management strategy that favors efficiency of the balance sheet and considers cost of capital in addition to safety and expansion of earnings in light of the recent Japanese capital market conditions. Consequently, the Company announced a capital strategy as detailed below on November 7, 2014.

<b>Basic Principle</b>	<ul style="list-style-type: none"> <li>➤ Realize higher ROE in excess of cost of capital at an early stage, with a medium- to long-term ROE target of 8% to 10%</li> <li>➤ Secure capital needed for stability and growth, implement efficient usage of operating capital, improve capital efficiency</li> <li>➤ Fortify shareholder return strategy to ensure a sustained level of returns over the medium- to long-term</li> </ul>
<b>Capital Strategy based upon Next Stage Plan G</b>	<ul style="list-style-type: none"> <li>➤ Raise consolidated comprehensive shareholder return to average over 100% over the 3 years from 2014 to 2016</li> <li>➤ Reduce capital by ¥10.0 to ¥20.0 billion in 3 to 5 years from end of FY3/14, with an eye to market conditions</li> <li>➤ Improve medium- to long-term shareholder returns, flexibly acquire treasury stock, consider and implement increases in dividends, with ¥3.0 billion purchase of treasury stock as the first step in this plan</li> </ul>

While investments are necessary to secure midterm growth and maintenance of reserves needed to respond to fluctuations in the economy, Sangetsu is not expected to make any large investments or conduct any large scale M&A activities during the next several years. While a shift from a fabless company to one that maintains a “manufacturing division”

may be possible in order to expand the scale of its business and raise earnings generation capability over the long term, Sangetsu is expected to focus its attention upon strengthening its partnerships with the companies in which it has minority stakes over the near term. Therefore, Sangetsu may adopt an aggressive shareholder return strategy due to the lack of need for large amounts of cash reserves. However increasing the volatility of the Company's share is not in the best interests of either the Company or its shareholders, and efforts will be made to implement not one-off but "sustained shareholder returns," which is deemed important, over a period of between 3 to 5 years.

### <Targets>

#### ◎ Targets to Be Achieved Between 2014-2016

Sales	¥140.0 Billion
Net Income	¥6.3 Billion

Sangetsu endeavors to achieve record high levels of profits while at the same time conducting anticipatory investments to facilitate a structure that can achieve sustained growth.

(Units: Billion Yen)

	Consolidated	Interior	Exterior	Lighting
Sales	140.0	120.0	16.0	4.0
Gross Income	38.8	35.5	2.1	1.2
SG&A	29.3	26.5	1.6	1.2
Operating Income	9.5	9.0	0.5	0
Ordinary Income	9.7	9.2	0.5	0
Net Income	6.3	6.0	0.3	0

In addition to refurbishment of existing businesses and promotion of large scale renovation of hospitals and nursing care facilities in the interior business, a shift to high value added products and efforts to achieve higher sales are expected to be promoted. Sales, general and administrative expenses are expected to increase due to efforts for new business development and overseas business deployment. Based upon the assumption of limited expansion in the exterior business, Sangetsu is expected to prioritize the establishment of a stable business foundation for the lighting business. Consequently earnings are not expected to grow.

#### ◎Targets to Be Achieved Between 2017-2019

Based upon this midterm business plan, the next midterm business plan is expected to end in fiscal year March 2020 and maintains the themes of "realizing profitability of new, overseas businesses, and consolidated subsidiaries," "steadily expand earnings of the interior business," and "introduction of new capital strategy." In addition, the next plan maintains a "target of achieving ROE of 8% to 10%."

## 6. Interview with President Shousuke Yasuda

President Shousuke Yasuda was born in March 1950 and is 64 years old. He graduated from the Faculty of Economics of Hitotsubashi University and then entered Mitsubishi Corporation. In April 2004, he was appointed as the Executive Officer and General Manager of the Functional Chemicals Division of Mitsubishi Corporation, which conducted business with Sangetsu. Thereafter, he became a Managing Executive Officer of Mitsubishi Corporation, and then was appointed as an External Director of Sangetsu in June 2012. In June 2014, Yasuda became the first President of Sangetsu who is not a member of the founding family. We met with President Shousuke Yasuda to ask him about the background to his appointment as President, his mission, the main points of the midterm business plan, and how he plans on diffusing the corporate philosophy and principles of the Company.



## <Background to President Yasuda's Appointment, His Mission>

- Since the establishment of Sangetsu as an official corporation in 1953, the four Presidents who have led the Company have all been members of the founding family. However, the current Chairman states that the decision to appoint a non-family member as President was taken due to the “need to change Sangetsu in order for it to continue to survive” amidst the large changes in the business environment and the aging of the members of the founding family.
- While leadership of the top management is crucial, the “participation of each and every employee in business management at the frontline” is also another key factor.
- Therefore, my mission, as indicated in the mid-term business plan “Next Stage Plan G” and by our theme of “developing as a listed company that enables its employees to actively participate in management,” is to promote reforms of employee awareness and to make them conscious of the importance of taking responsibility for their activities in the development of our Company. Furthermore, Sangetsu will create a corporate environment that enables us to achieve a new phase of growth while at the same time placing a high priority on maintaining favorable relationships with all of our stakeholders, including our employees.
- While I was familiar to some extent with employees in my previous workplace before being appointed as President of Sangetsu, I was thoroughly impressed to find out in my communications with Sangetsu staff how “extremely diligent” they are. Their passion for their work is extremely strong.
- At the same time, they also lacked “aggressiveness” that might be conducive to gaining stronger business results. I believe that by taking on a more aggressive stance in the workplace that includes going the extra mile to take on challenges and tasks not called for by superiors or clients could contribute to a more effective working environment that is capable of yielding even better business results.

## <Regarding the Mid-term Business Plan>

- Improving the various skills of employees is crucial in the “creation of a corporate structure that allows employees to participate in management.” Consequently, we are making preparations for the introduction of personnel systems that increase the motivation of employees.
- Efforts will continue to be promoted to capture business opportunities in the “non-residential market” where demand for interior decorating products and services is strong. Furthermore, marketing efforts in the “rental and reform market” realm, where relatively high value added wallcoverings are used and the frequency of wallcovering replacement is high at between once every 2 to 3 years, will be strengthened.
- While the positive effects of “expansion in product numbers” and “expansion of business realms” through M&A activities are appearing, we believe that there are still significant amounts of latent synergies that have yet to be realized. In the lighting business, top line sales have yet to be boosted to a level where they adequately cover fixed costs, but it is clear that the synergies that can be derived from collaboration with the interior business are large. It indeed happened that in the construction project of the new terminal of Haneda Airport, as a result of the joint proposal by Sangetsu and Yamada Shomei Lighting, Sangetsu received orders for floorings and Yamada for lighting. Consequently, Sangetsu will focus its efforts to capture orders from specially ordered custom built homes and non-residential applications for both interior and lighting products.
- Creation of a foundation for the deployment of business in overseas markets is a major theme in the mid-term business plan. And given that competition in the interior decorating market within Japan is high, the opportunity to achieve higher levels of profitability and expand sales in overseas markets is significant. Currently, overseas sales amount to only ¥0.4 billion, but we seek to raise this to ¥5.0 billion in the future.
- In order to achieve these goals, we need to firmly establish our “brand.” Our current business is based on a slightly passive process of supplying products when they are ordered by customers, and we lack a strong brand presence. Based upon the establishment of an overseas business division in July, we will promote a proactive proposal based business model as part of our branding strategy. And while this strategy may take time to become effective, we will steadily promote efforts to firmly establish our brand.
- We are currently considering which markets to approach.
- In addition to our current shareholders, we seek to make changes to our capital strategy that can satisfy potential new investors, and will prioritize the sustainment of high levels of shareholder returns.

## <Diffusion of Our Corporate Philosophy and Principles>

- As described in the mid-term business plan, the key philosophies of “integrity” and “the three principles of Sangetsu” have been handed down from Sangetsu’s founding members. We will continue to promote and diffuse these philosophies.
- However, I believe that our top management conducted an excess level of “micro management” in the past that led employees to become overly passive in their business activities.
- It is my belief that these philosophies and vision can only be truly learned through both successes and failures in the process of taking on challenges by each and every one of our employees. I also believe that it is highly important for us to create an environment where employees themselves can actively participate in the management of our business.
- While I have only been President for about half a year, I have taken every opportunity to convey to our employees my belief in the “need for Sangetsu to change.”
- In addition, we have newly established a “communication support system” in order to promote better communication amongst our employees. This system provides partial subsidies for meals and other events where employees meet with members of other divisions to increase their communication. Furthermore, directors responsible for the respective business divisions often join these meals and events to further strengthen their lines of communication with employees.

## <Message to Investors>

- As the largest interior products and services company within the industry, we enjoyed a stable business which in turn stopped us from seeking out active lines of communication with external parties that are not directly involved with our business.
- Because the influence and voice of the interior decoration products industry is relatively weak, we need to improve and increase our influence to secure future growth and development. Therefore, we will promote communication with external stakeholders to gain their understanding of our Company and industry, and to be able to better respond to their needs.
- Furthermore, we need to strengthen our communication with our shareholders as part of our efforts to fortify businesses in which we maintain strong competitive positioning.
- We will promote measures to raise our shareholder returns while at the same time maintaining their stability for a medium- to long-term, and we ask for the continued support and understanding in our various business efforts.

## 7. Conclusions

While the response to the announcement of a new capital strategy has been strong, Sangetsu needs to improve its profit margin in addition to implementing a new capital strategy in order to achieve ROE of 8% to 10% as discussed previously in this report. Therefore, strong expectations are being placed upon new business and overseas business deployment. However, efforts to fortify the business foundations and expand sales of the refurbishment (Residential and non-residential) realm and to strengthen non-residential product lineup are highly important to bolstering existing businesses. Therefore, a close watch should be paid to progress in the achievement of the “Mid-term Business Plan Next Stage G.”

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