


## Bridge Report Sangetsu Corporation (8130)

### — Stock Information —

 Shosuke Yasuda, President	Company	Sangetsu Corporation			
	Code No.	8130			
	Exchange	First Section, Tokyo and Nagoya Stock Exchanges			
	Industry	Wholesale (Commerce)			
	President	Shosuke 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 a top share of wallcoverings, and is the industry's leader in the curtains, vinyl and textile flooring materials.			
	Year-end	March end			
	URL	http://www.sangetsu.co.jp/company/ir/english/index.html			
Share Price	Shares Outstanding	Market Cap.	ROE (actual)	Trading Unit	
¥1,973	67,177,349 shares	¥131.122 billion	5.6%	100 shares	
DPS (Est.)	Dividend Yield (Est.)	EPS (Est.)	PER (Est.)	BPS (actual)	PBR (actual)
¥50.00	2.6%	¥87.29	22.2 x	¥1,587.86	1.2 x

\* Stock price as of closing on November 21, 2016. Number of shares issued at the end of the most recent quarter excluding treasury shares.

ROE and BPS are based on the previous year.

### — Consolidated Earnings Trends —

(Unit: Million Yen)

Fiscal Year	Sales	Operating Income	Ordinary Income	Net Income	EPS (¥)	DPS (¥)
March 2011	112,118	7,161	7,530	4,242	52.87	37.50
March 2012	118,518	7,095	7,180	4,151	51.73	37.50
March 2013	123,150	8,020	8,393	4,806	60.26	40.50
March 2014	131,978	8,952	9,475	5,459	71.65	37.50
March 2015	132,050	8,031	8,506	4,402	58.35	41.25
March 2016	133,972	9,112	9,463	6,393	89.92	47.50
March 2017 Est.	137,000	8,000	8,600	5,900	87.29	50.00

\* DPS of March 2013 included commemorative dividend of ¥3.

\* Estimates are those of the Company. 2 for 1 stock splits were conducted in April 1, 2015.

\* From the current fiscal year, the definition for net income has been changed to net income attributable to parent company shareholders (Abbreviated as parent net income).

This Bridge Report provides a review of the first half of fiscal year March 2017 earnings overview for Sangetsu Corporation

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## Key Points

•Sales rose by 1.1% year-on-year to ¥64.9 billion during the first half of fiscal year March 2017 on the back of increases in sales of the three business segments, and with strong sales of various materials in the interior business. Efforts to reduce the cost of sales allowed gross income margin to improve by 0.5% points and gross income to rise by 2.9% year-on-year. However, a rise in sales, general and administrative expenses arising from costs associated with the start of the business process outsourcing (BPO) in the current term and M&A related expenses could not be absorbed and caused operating income to decline by 22.0% year-on-year to ¥3.5 billion. However, this result was ¥100 million better than estimates. The booking of ¥100 million from equity accounting method allowed ordinary income to decline by a slightly smaller margin than operating income of 16.7% year-on-year to ¥3.9 billion. The relocation of the logistics facilities led to the booking of ¥60 million in extraordinary loss, but the termination of the retirement benefit scheme due to the shift from a defined benefit to defined contribution system contributed to the booking of ¥100 million in extraordinary profit and allowed net income to fall by a smaller margin of 11.0% to ¥2.8 billion.

•In light of the first half performance, full year earnings estimates have been revised downwards. The revised estimates call for sales to rise by 2.3% year-on-year to ¥137.0 billion. While estimates have been revised downwards, near-term trends in new housing starts remain strong and business arising from large interior renovation projects in the Tokyo metropolitan region are expected to increase, along with the positive influence of the introduction of new housing and various facility flooring materials catalogs and products. Estimates also call for operating income to decline by 12.2% year-on-year to ¥8.0 billion. The downward revision to sales implies that the gross income will decline by ¥950 million over initial estimates, and sales, general and administrative expenses are expected to rise due to the booking of business process outsourcing of order taking function and additional expenses associated with M&A. Dividend forecasts remain unchanged, with ¥25.00 per share (¥2.5 more than the previous term) dividends expected to be paid at the end of both the interim and full year periods for a full year dividend of ¥50.00 and a dividend payout ratio of 57.3%.

•And while attainment of the Medium Term Business Plan targets now appears to be difficult given the downward revision to full year earnings, Sangetsu's efforts to steadily promote its business strategy for the future should be followed closely. Amidst the difficult market conditions, the Company's efforts to improve its overall group structure including its subsidiaries, M&A activities including the M&A of Koroseal, and the period at which the earnings contributions from Fairtone and Sangetsudo (Shanghai) becomes evident should also be closely monitored.

## 1. Company Overview

Sangetsu Corporation is the largest among all Japanese trading companies specializing in wallcoverings, carpets, curtains and other interior decorating products. Being a trading firm, the Company also operates as a “fables company” that plans and develops 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.

The Sangetsu Group includes the following two companies: Sungreen Co., Ltd., a dedicated distributor of exterior products, and Yamada Shomei Lighting Co., Ltd., a planner, designer, manufacturer, and distributor of lighting equipment.

## <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. Sangetsu Corporation was incorporated in 1953 by the founding family. 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.

Shosuke 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 established a new corporate philosophy including a new brand philosophy in April 2016 that will enable it to take on the challenge of implementing reforms necessary to take it to its next stage of growth.

A new “brand philosophy” has been added to the “corporate creed,” “corporate mission,” and “Three Principles of Sangetsu” to create an expanded corporate philosophy.

### <Corporate Creed>

Integrity

### <Corporate Mission>

To contribute to society through interior design and strive to create daily culture of enrichment

### <Three Principles of Sangetsu>

Creative Designs, High Reliable Quality, Fair Price

### <Brand Philosophy>

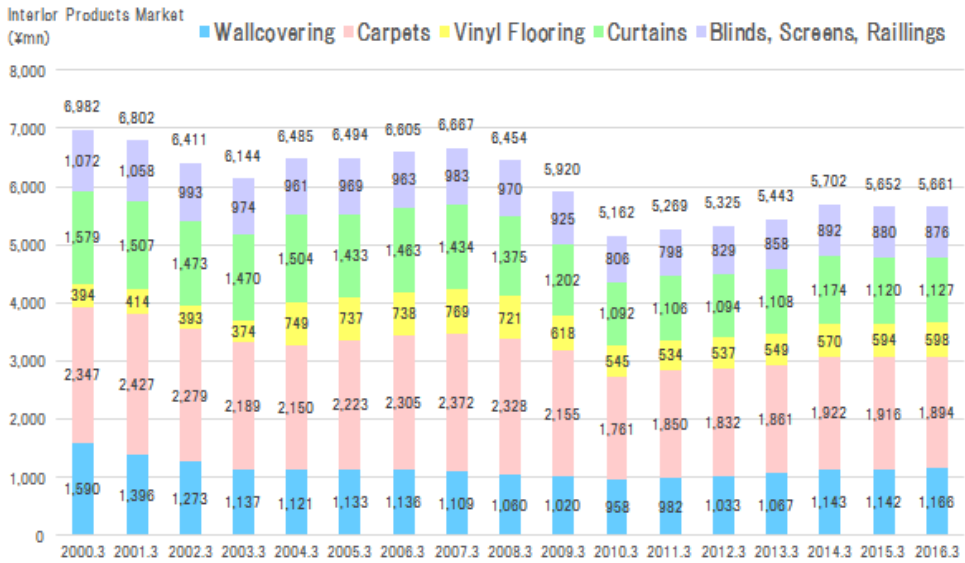
“Joy of Design” has been adopted as the brand statement, and “We provide the joy of design to those who create new spaces.” is the brand purpose.

Sangetsu endeavors to create new and entertaining value through cooperation with all of its stakeholders and by connecting interior product makers and users.

## <Market Environment>

### ◎ Overview

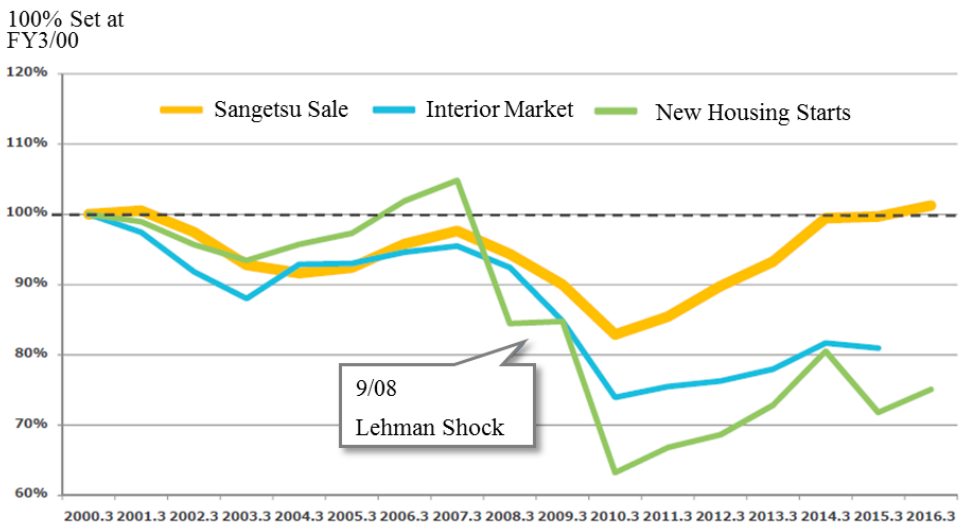
The market environment for the main wallcovering and flooring products is strongly influenced by trends in the Japanese construction market. Declines in new housing start arising from declining population and changing family structures within Japan, and deflationary trends have depressed sales of the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



\* Nippon Interior Fabrics Association  
 "2016 General State of the Interior Fabrics Business and Market Size Determination"

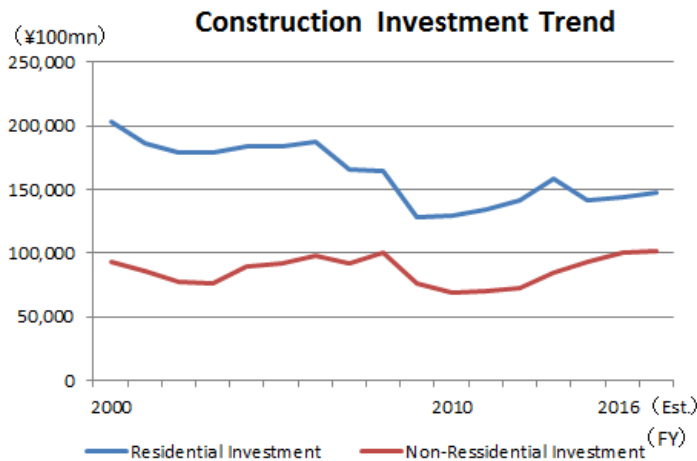
(Source: Sangetsu)

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. Moreover, 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.

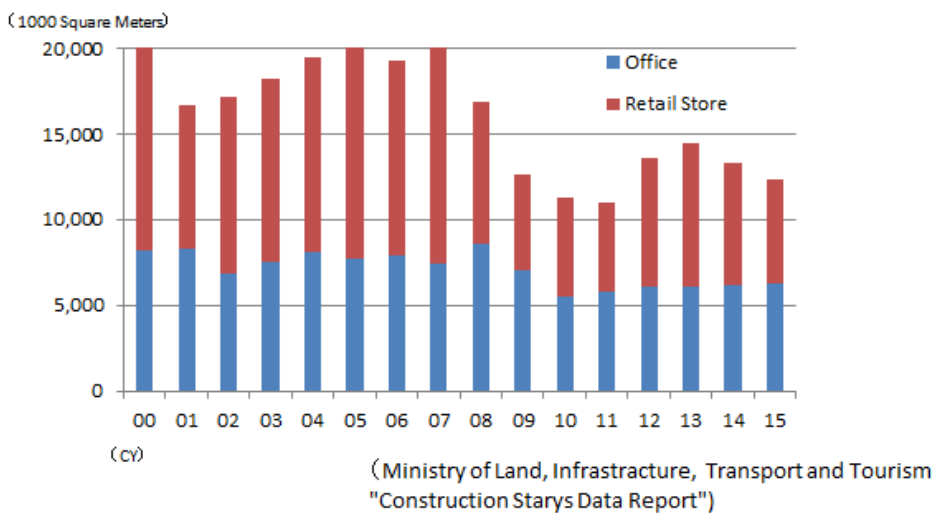


(Source: Sangetsu)

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



### New Constructed Office, Retail Store Floor Space Trend



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 of about ¥10 trillion. However, floor space of newly constructed office buildings has trended sideways, and floor space of retail buildings has once again begun to decline.

Moreover, the Research Institute of Construction and Economy issued a report entitled “Outlook for Construction Investment Based upon a Construction Economy Model” (October 27, 2016) that calls for growth of 0.8% and 0.0% year-on-year in private sector non-residential investments during fiscal years 2016 and 2017 respectively, following on the heels of 5.6% year-on-year growth recorded during fiscal year 2015. However, new construction starts on a floor space basis are expected to rise by 5.7% and 3.5% year-on-year for offices and retail stores respectively.

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

# Bridge Report



## ◎ 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.	95,400	-2.2%	1,540	-39.7%	1.6%	18,559	14.3	0.5	7.3%
7971	TOLI Corp.	92,300	+0.5%	4,400	+15.0%	4.8%	23,011	7.7	0.8	8.2%
<b>8130</b>	<b>Sangetsu</b>	<b>137,000</b>	<b>+2.3%</b>	<b>8,000</b>	<b>-12.2%</b>	<b>5.8%</b>	<b>131,091</b>	<b>22.2</b>	<b>1.2</b>	<b>5.6%</b>
9827	Lilycolor Co., Ltd.	32,850	-10.0%	95	-87.4%	0.3%	1,463	73.0	0.2	0.9%

\* Estimates are from those of the respective companies. Market capitalization is based upon the closing share price on November.21, 2016.

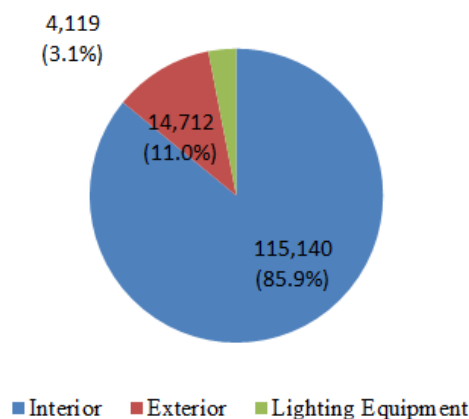
Since the previous report publishing, Sangetsu, Suminoe Textile, and Lilycolor revised down in their estimates of sales and operating income. TOLI revised down in sales and up in operating income.

In such situation, only Sangetsu's PBR is over one time.

## <Business Description>

The main businesses include planning, development, and sales of wallcovering, floor covering, curtains, upholstery 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.

**Sales by Business Segment**  
(FY3/16, Unit: ¥mn)



## ① "Interior Business"

(FY3/16: Sales and Operating Income of ¥115.140 and ¥8.873Billion)

## ◎ 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>Cushion Vinyl Sheet</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.





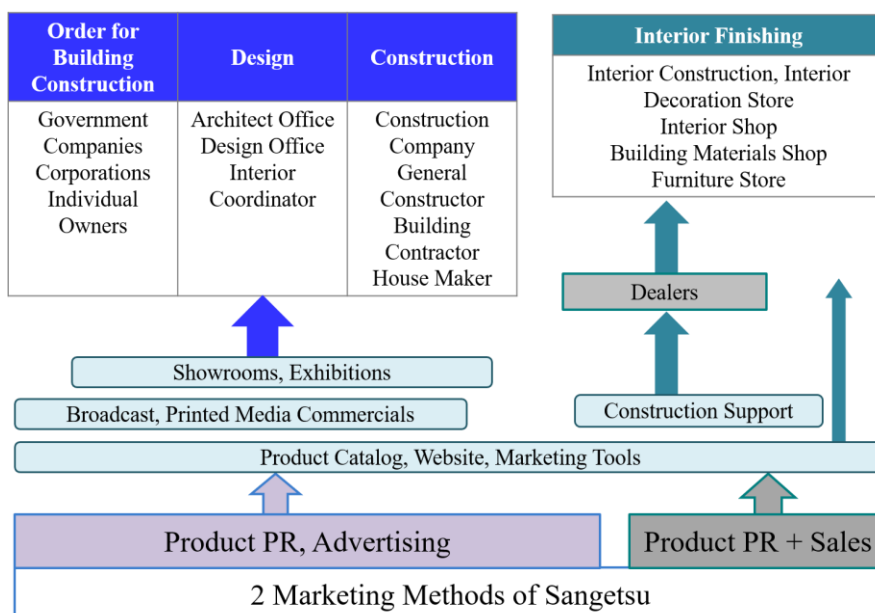
<b>Vinyl Sheets</b>	Sheet formed flooring materials used in commercial applications including medical and welfare institutions, and educational institutions. This product boasts of high levels of safety and sanity functionality, and is designed to reduce maintenance costs by being easy to keep clean. It also has been designed with the environment in mind and helps to reduce the environmental burden.
<b>PVC Floorings</b>	Sheet formed flooring materials used in medical and welfare institutions, and educational institutions. Uniquely manufactured with design patterns printed on 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>Luxury Vinyl 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 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 and Carpet 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 53 marketing offices throughout Japan, with 9 of these marketing offices also hosting showrooms.



(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 customer 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 Fukuoka, 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 seldom asks their clients for backordering because the out-stocks are covered by surrounding distribution centers immediately.

Sangetsu’s nationwide distribution network makes “Just-in-Time” provision of products to match the interior construction schedules of its clients possible. Products are sourced from a wide range of over 100 supplier companies.

## ② “Exterior Business”

**(FY3/16 Sales and Operating Income of ¥14.712Billion and ¥367 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”

**(FY3/16 Sales and Operating Income of ¥4.119 Billion and ¥ -128Million)**

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

## <ROE Analysis>

	FY3/12	FY3/13	FY3/14	FY3/15	FY3/16
<b>ROE(%)</b>	3.5	4.1	4.6	3.7	5.6
Net Income to Sales Ratio (%)	3.50	3.90	4.14	3.33	4.77
Asset Turnover Ratio (x)	0.84	0.88	0.93	0.91	0.95
Leverage (x)	1.18	1.19	1.20	1.21	1.24

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 the fiscal year 2017 to 2019. Consequently, the Company will implement efforts to raise profitability in addition to this capital strategy.



## <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 do not have to carry facilities for the manufacturing process. Besides, 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. Moreover, 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 “Creating,” “Proposing,” “Providing”

#### “Creating”

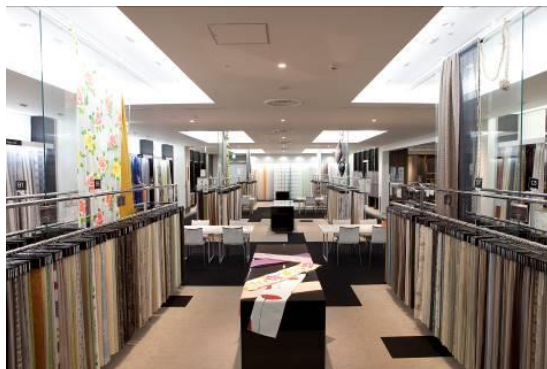
While the actual manufacturing of products is not conducted in-house, Sangetsu performs the planning, design and development functions internally. The previous generation of Sangetsu management made aggressive investments for “unique designs,” one of the three principles of the Company. 25 in-house designers 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 more than 30 types of catalogs, which far surpass those of its competitors.



(Source: Sangetsu)

#### “Proposing”

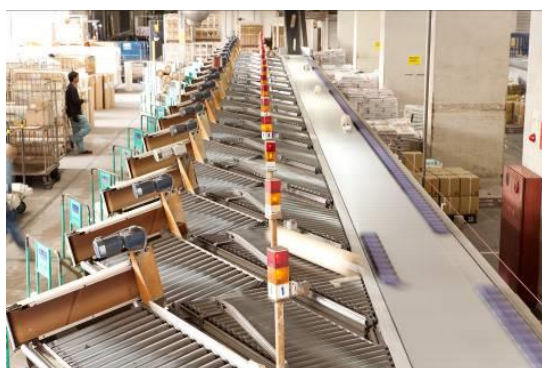
Nearly one third of all employees or some 450 work in marketing functions at Sangetsu, the largest marketing function within the industry. These marketing staffs are assigned to 63 offices located throughout Japan and conduct proposal-based marketing to clients. Sangetsu also staffs its nine showrooms with 45 employees. In addition, about 40 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)

## “Providing”

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. Generally, 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)

## 2. First Half of Fiscal Year March 2017 Earnings Overview

### (1) Earnings Overview

(Units: ¥mm)

	1H FY3/16	Share	1H FY3/17	Share	YY Change	Divergence from Est.
Sales	64,256	100.0%	64,989	100.0%	+1.1%	-2.4%
Gross Income	18,829	29.3%	19,382	29.8%	+2.9%	-1.9%
SG&A	14,269	22.2%	15,824	24.3%	+10.9%	+0.7%
Operating Income	4,559	7.1%	3,558	5.5%	-22.0%	-11.7%
Ordinary Income	4,762	7.4%	3,964	6.1%	-16.7%	-7.6%
Net Income	3,225	5.0%	2,869	4.4%	-11.0%	-3.1%

### Slight Rise in Sales, Profits Decline, Fall Below Estimates

Sales rose by 1.1% year-on-year to ¥64.9 billion on the back of growth in all three business segments, along with strong growth in various materials in the interior business. Gross income margin improved by 0.5% points year-on-year due to efforts to reduce cost of sales, and gross income rose by 2.9% year-on-year due to the higher sales. However operating income declined by 22.0% year-on-year to ¥3.5 billion due to Sangetsu’s inability to absorb expenses associated with the transition of business process outsourcing and M&A activities. The booking of ¥160 million in equity accounting method profit from Wavelock Holdings Co., Ltd. allowed ordinary income to see a smaller margin of decline of 16.7% year-on-year to ¥3.9 billion. While the relocation of distribution facilities led to the booking of an extraordinary loss of ¥60 million, the switch from a defined benefit to defined contribution type retirement plan and the termination of the retirement benefit scheme contributed to a ¥100 million extraordinary profit to be booked and allowed net income to fall by an even smaller margin of 11.0% year-on-year to ¥2.8 billion.

### (2) External Environment

The number of units and floor space of new housing starts rose by strong 6.0% and 4.1% year-on-year respectively during the period between April to September 2016.

At the same time, Sangetsu estimates that large refurbishments, which are highly sensitive to fluctuations in the overall economy, trended weakly and fell by 9.0% year-on-year.

And the negative influence of the decline in floor space of non-residential construction starts and subsequent declines of 10.4% and 6.5% year-on-year in fiscal years March 2014 and 2015 contributed to continued negative growth in interior construction work in the first half of the current term, particularly in the Tokyo metropolitan region.

### (3) Business Segment Trends

(Units: ¥mn)

	1H FY3/16	Share	1H FY3/17	Share	YY Change
<b>Sales</b>					
<b>Interior</b>	55,119	85.8%	55,715	85.7%	+1.1%
Wallcoverings	27,450	49.8%	27,480	49.3%	+0.1%
Floorings	19,137	34.7%	19,560	35.1%	+2.2%
Fabrics	3,642	6.6%	3,640	6.5%	-0.0%
Others	4,889	8.9%	5,010	9.0%	+2.6%
<b>Exterior</b>	7,185	11.2%	7,254	11.2%	+1.0%
<b>Lighting</b>	1,973	3.1%	2,051	3.2%	+4.0%
<b>Adjustments</b>	-22	-	-33	-	-
<b>Total</b>	64,256	100.0%	64,989	100.0%	+1.1%
<b>Operating Income</b>					
<b>Interior</b>	4,496	8.2%	3,365	6.0%	-25.2%
<b>Exterior</b>	152	2.1%	203	2.8%	+33.8%
<b>Lighting</b>	-85	-	-4	-	-
<b>Adjustments</b>	-3	-	-6	-	-
<b>Total</b>	4,559	7.1%	3,558	5.5%	-22.0%

\* Share of operating income is the same as the operating income margin. The fabric category of sales includes both curtains and chair upholstery.

#### ① Interior Business

##### Sales Rise, Profits Decline

Sangetsu conducted aggressive efforts to appoint young designers from outside of the Company to work on product development, and to sell catalogs that respond to the diversifying needs of the market for multiple products. In addition, the Company also began sales of a chair upholstery catalog called “UP” and newly promoted marketing of interior products that feature highly attractive designs and functionality.

##### <Wallcoverings>

In light of the lackluster demand for refurbishment, sales trended sideways. While weakness in the medium price range products contributed to a decline in pricing, sales volume rose by 3%.

The high value added product catalog called “Reserve” was published in May. The proposal of “Living with Pets”, “Playing with Children” and three other concepts for interior coordination that enable consumers to express their tastes has allowed this catalog to be received strongly. Furthermore, strong sales activities to companies conducting refurbishment services using the refurbishment catalog called “Reform Selection”, which proposes solutions to raise the value addition of rental housing space including cloth patterns that act as accents to interiors, has contributed to sales growth.

##### <Flooring Materials>

Sales of carpet tiles and floor tiles have trended strongly on the back of efforts to capture new construction and refurbishment demand in the realm of non-residential construction, including commercial facilities, hotels, and offices. At the same time, weak demand for long flooring sheets led to a 24.3% year-on-year decline in sales from medical facility applications.

Sangetsu is also putting efforts into cultivating the self-owned home, rental property and condominium applications for flooring including general residential use cushion flooring called “H-FLOOR” and condominium hall and patio use

non-slip flooring sheet “Non Skid” catalogs. The “H-FLOOR” catalog features products designed by three up-and-coming designers, and their unique designs have been favorably received.

## <Fabrics>

Sangetsu is implementing efforts to expand sales through exhibitions and seminars at interior shops leveraging the various coordinated interiors proposed in the curtain catalogs published in the previous term “SanWink” and “AC Curtain Fabrics”. Moreover, the chair upholstery catalog “UP”, that went on sale from September proposes materials with new designs and maintenance characteristics, is being aggressively leveraged in marketing to furniture manufacturers and construction companies.

## ② Exterior Business

Sales remained in line with the previous term, but profits rose by 30%.

Amidst intensifying competition with competitors, Sangetsu focused its efforts on strengthening its marketing structure. These efforts have been effective and led to strength in the Kanto region surrounding Tokyo.

## ③ Lighting Business

Sales rose and the margin of loss contracted.

By conducting sustained specialized marketing solutions from last year, orders from lodging and public facilities expanded. In addition, the marketing structure has been fortified through synergies effect derived from sharing of information with Sangetsu’s corporate customer marketing division.

## (4) Financial Conditions, Cash Flow

### ◎ Summarized Balance Sheet

(Units: ¥mn)

	End 3/16	End 9/16		End 3/16	End 9/16
Current Assets	88,825	84,862	Current Liabilities	22,716	24,330
Cash, Equivalents	29,802	24,932	Payables	15,969	18,528
Receivables	45,574	41,557	Noncurrent Liabilities	7,986	7,529
Marketable Securities	300	3,800	Retirement Benefits	6,816	5,928
Inventories	11,714	12,900	Total Liabilities	30,702	31,860
Noncurrent Assets	50,395	53,985	Net Assets	108,517	106,987
Tangible Assets	31,003	33,614	Shareholders’ Equity	108,058	107,023
Intangible Assets	1,295	2,058	Treasury Stock	-1,748	-1,753
Investments, Others	18,095	18,312	Total Liabilities, Net Assets	139,220	138,848
<b>Total Assets</b>	<b>139,220</b>	<b>138,848</b>	Capital Adequacy Ratio	77.9%	77.0%

Due to a shift in time deposits to low risk short term instruments, cash and equivalents declined and marketable securities rose. A decline in accounts receivables contributed to a ¥3.9 billion decline in current assets from the end of the previous fiscal year. While fixed assets rose by ¥3.5 billion due to the renewal of the logistics facilities, total assets declined by ¥0.3 billion to ¥138.8 billion.

Increases in accounts payables contributed to a ¥1.6 billion rise in current liabilities. Declines in retirement benefit scheme related costs allowed noncurrent liabilities to contract by ¥0.4 billion from the end of the previous fiscal year, but total liabilities rose by ¥1.1 billion to ¥31.8 billion. Net assets fell by ¥1.5 billion to ¥106.9 billion due to a decline in retained earnings. Capital adequacy ratio also fell by 0.9% points to 77.0%.



# Bridge Report



## ◎Cash Flow

(Units: ¥mn)

	1H FY3/16	1H FY3/17	YY Change
Operating Cash Flow	6,236	8,186	+1,950
Investing Cash Flow	8,849	-9,937	-18,786
Free Cash Flow	15,085	-1,751	-16,836
Financing Cash Flow	-4,464	-3,932	+532
Cash, Equivalents	26,162	22,288	-3,874

Declines in accounts receivables and increases in accounts payables caused the net inflow of operating cash flow to expand. Acquisition of assets associated with the renewal of the logistics center, installation of a new backbone system, and payment of consignment fees associated with the start of the business process outsourcing caused investing and free cash flows to turn negative. Declines in the value of treasury stock acquisition allowed the margin of net outflow of financing cash flow to contract. Consequent to these changes, cash position declined.

## (5) Topics

### ◎ United States Wallcovering Manufacturing, Distributor Company Acquired

Sangetsu acquired 100% of the shares of the United States wallcovering manufacturing and sales company Koroseal Interior Products Holdings, Inc. on November 14, 2016 (To become a subsidiary of the newly established Sangetsu USA).

#### \* Koroseal Corporate Overview

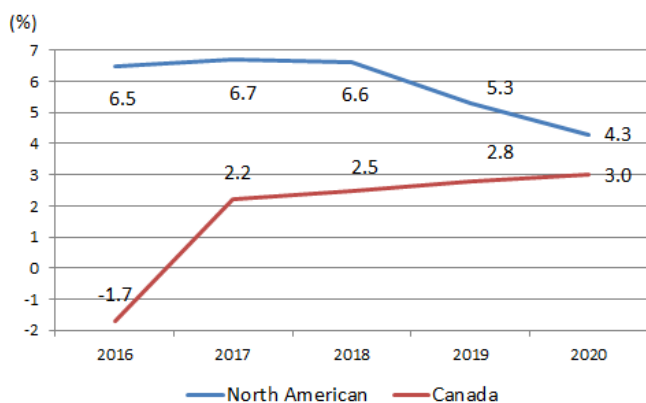
Company Name	Koroseal Interior Products Holdings, Inc
Headquarter Location	Ohio, United States
Established	1956
Clients	Over 10,000 companies, average order value of US\$1,250
Product Numbers	SKU of about 12,000, 36 brands
Main Financials	Sales: US\$148.2 million, Operating income: US\$9.5 million

Koroseal manufactures and sells wallcovering materials including wall paper, white board type presentation surface wall covering (Accounting for 39% and 15% of sales) and others. In addition, Koroseal boasts of a wide-ranging marketing structure with the largest sales force of 125 staff for strong coverage of decision-making staff responsible for the selection of interior materials at architectural design offices and construction companies. With regards to manufacturing capabilities, Koroseal maintains a manufacturing plant and logistics center in Louisville, Kentucky. Louisville is highly convenient from a logistics standpoint because of the fact that the United Parcel Service, Inc. maintains a major logistics facility in the city.

## \* Market Environment

The North American non-residential market segments of hotels, offices, and commercial facilities are all expected to trend strongly in the future.

North American Non-Residential Construction Market Growth Forecasts



(Source: OXFORD ECONOMICS)

While wallcovering shipments in the North American market total 110.00 million square meters per year and amount to only one sixth of that in Japan (670.00 million square meters), on a value basis it amounts to about half of the Japanese market because of the higher value addition and pricing of products sold there.

## \* Differences Between the Two Companies

	Sangetsu	Koroseal
Earnings	<ul style="list-style-type: none"> <li>◇ Sales: ¥115.1 billion</li> <li>◇ Gross Margins: 31.6% (FY3/16)</li> </ul>	<ul style="list-style-type: none"> <li>◇ Sales: ¥14.8 billion</li> <li>◇ Gross Margins: 42.5% (FY12/15)</li> </ul>
Markets	◇ Residential, Non- Residential	◇ Non-Residential only
Non-Residential Market Sales Activities	<ul style="list-style-type: none"> <li>◇ Sales activities to distributors, interior contractors</li> <li>◇ Activities targeting property owners, architectural companies, general contractors</li> </ul>	<ul style="list-style-type: none"> <li>◇ Sales activities to distributors, interior contractors</li> <li>◇ Activities targeting property owners, architectural companies, general contractors</li> </ul>
Marketing Structure	<ul style="list-style-type: none"> <li>◇ Marketing staff: 420</li> <li>◇ Sales per marketing staff: ¥280 million</li> </ul>	<ul style="list-style-type: none"> <li>◇ Marketing staff: 125</li> <li>◇ Sales per marketing staff: ¥118 million</li> </ul>
Product Lineup	<ul style="list-style-type: none"> <li>◇ Wallcovering materials: 4,900, Flooring materials: 2,400, Fabrics: 5,200, Total: 13,000</li> <li>◇ 100% of sales are OEM manufactured products</li> </ul>	<ul style="list-style-type: none"> <li>◇ Wallcovering materials: 12,000</li> <li>◇ 74% of sales are in-house manufactured products</li> </ul>

## \* Objective of Koroseal Acquisition

### ① Enter United States Non-Residential Market

As described earlier in this report, the United States non-residential market is expected to trend strongly in the future. Koroseal is the United States' top wallcovering materials company with one of the largest sales forces. And similar to Sangetsu, Koroseal conducts aggressive marketing and specification activities, and maintains a large number of high quality customers and suppliers.

Therefore, the M&A of Koroseal is expected to provide Sangetsu with a strong access route allowing it to gain entry to the United States market.

### ② Strengthen Procurement Capabilities

The addition of the United States' top non-residential wallcovering company Koroseal to the Sangetsu Group will also



strengthen Sangetsu's overall procurement structure.

As described in President Shosuke Yasuda's interview later in this report, the interior products is an inefficient business due to the diverse range of customer needs and the wide variety of products that must be carried in small lots to satisfy customers. Therefore business scale must be captured to realize efficiencies. In this regard, the M&A of Koroseal represents an opportunity to strengthen Sangetsu's negotiating power with materials manufacturers.

## 3. Fiscal Year March 2017 Earnings Estimates

### (1) Earnings Estimates

(Units: ¥mn)

	FY3/16	Share	FY3/17 Est.	Share	YY Change	Margin of Revision	Attainment Rate
Sales	133,972	100.0%	137,000	100.0%	+2.3%	-2.1%	47.4%
Gross Income	39,527	29.5%	40,500	29.6%	+2.5%	-2.3%	47.9%
SG&A	30,415	22.7%	32,500	23.7%	+6.9%	+0.2%	48.7%
Operating Income	9,112	6.8%	8,000	5.8%	-12.2%	-11.1%	44.5%
Ordinary Income	9,463	7.1%	8,600	6.3%	-9.1%	-9.5%	46.1%
Net Income	6,393	4.8%	5,900	4.3%	-7.7%	-6.3%	48.6%

\*Estimates are those of the Company

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

In light of the first half earnings performance, Sangetsu has chosen to revise its full year earnings estimates downwards and now calls for sales growth of 2.3% year-on-year to ¥137.0 billion. While sales growth estimates have been revised down, new housing starts remain strong, large interior refurbishment projects in the Tokyo metropolitan region are trending firmly, and positive effects are anticipated from the introduction of new products and publishing of new catalogs for flooring materials for residential and non-residential applications.

Operating income is expected to decline by 12.2% year-on-year to ¥8.0 billion. This decline is attributed to an expansion in the margin of decline in gross income of ¥95 million over initial estimates, and due to the lower sales and other additional sales, general and administrative expenses, including outsourcing fees associated with the business process outsourcing, logistics facilities consolidation expense, and additional M&A related fees arising from acquisitions. Dividend forecasts remain unchanged and call for dividend payments of ¥25.00 per share at the ends of the interim and full fiscal year, representing a ¥2.5 per share increase from the previous term and total full year dividend payment of ¥50.00 per share. Dividend payout ratio is expected to be 57.3%.

### (2) Business Segment Trends

(Units: ¥mn)

	FY3/16	Share	FY3/17 Est.	Share	YY Chnage	Margin of Revision	Attainment Rate
<b>Sales</b>							
<b>Interior</b>	115,140	85.9%	11,800	86.1%	+2.5%	-2.2%	47.2%
<b>Exterior</b>	14,712	11.0%	14,850	10.8%	+1.0%	-2.3%	48.8%
<b>Lighting</b>	4,145	3.1%	4,170	3.0%	+0.7%	-0.6%	49.2%
<b>Adjustment</b>	-26	-	-30	-	-	-	-
<b>Sales, Total</b>	133,972	100.0%	137,000	100.0%	+2.3%	-2.1%	47.4%
<b>Operating Income</b>							
<b>Interior</b>	8,873	7.7%	7,590	6.4%	-14.4%	-10.9%	44.3%
<b>Exterior</b>	367	2.5%	410	2.8%	+12.7%	-13.8%	48.8%
<b>Lighting</b>	-128	-	-0	-	-	-	-
<b>Adjustment</b>	0	-	-	-	-	-	-
<b>Operating Income, Total</b>	9,112	6.8%	8,000	5.8%	-12.2%	-11.1%	44.5%

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

#### **4. Progress in the Medium Term Business Plan “Next Stage Plan G”**

Progress in attainment of goals of the Medium Term Business Plan are outlined below.

##### **<Strengthening of Value Chain>**

###### **◎ Orders Placement Tasks partially Shifted to Business Process Outsourcing**

Sangetsu takes orders from its distributors over three main channels including “telephones”, “online systems”, and “facsimiles”, but will begin outsourcing its facsimile orders from January 2017. The complete outsourcing of facsimile orders is expected to be completed by June 2017.

While Sangetsu currently employs 170 employees including temporary staff to deal with facsimile orders, the complete outsourcing of this service will allow it to reallocate staff to focus on marketing activities to architect design offices, property owners, and house makers, and to conduct specification marketing activities that can contribute to earnings.

##### **<Product, Function Fortification>**

###### **◎ Logistics Facilities Reorganized**

The logistics and marketing facilities have been separated, and aging facilities have been renewed with state of the art facilities to create a supply chain management structure that optimizes logistics function and makes shipments more efficient.

The logistics function has been concentrated in the two facilities of the Chubu and Kita Kanto Logistics Centers, with the facilitation of the shipping functions and maintenance being performed at these two centers.

###### **◎ Construction Capability Strengthened**

Sangetsu acquired 100% of the shares of the construction and interior finishing businesses spun off as a new company from Toyobo Fairton Co., Ltd., a subsidiary of Toyobo Co., Ltd., in December 2016 to become a 100% owned subsidiary. Fairton operated for 33 years since its founding and boasts of strong experience and track record serving general contractors, office equipment manufacturers, office architectural design companies and other clients.

In addition, Fairton has established the ability to handle construction internally by creating the “Toyobo Fairton Co., Ltd. Safety Association” in the regions of Tokyo and Osaka.

Fairton boasts of employees with bountiful experiences in construction management, and their capabilities are expected to allow Sangetsu to strengthen its construction capabilities and acquire orders for construction related to hotels and other non-residential facilities.

##### **<Regional Expansion>**

###### **◎ Newly Established Showroom**

Regional showrooms have been newly established in three locations including Sendai, Okinawa, and Kanazawa.

These showrooms are expected to allow Sangetsu to capture opportunities for sales of high value added products by allowing local builders, construction and refurbishment companies, and architects to see samples and experience products at these local showrooms.

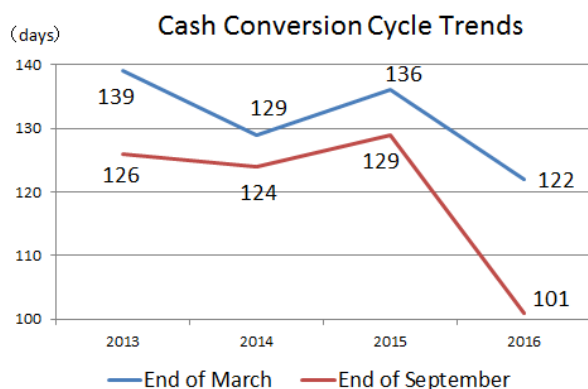
During the first half of fiscal year March 2017, the number of client visitations overall has risen by 20% year-on-year.

#### **5. Interview with President Shosuke Yasuda**

We asked President Shosuke Yasuda about Sangetsu’s near term business conditions, overseas business deployment strategy and progress in its overall business strategy.

##### **\* Earnings Trends during the Current Term**

- While full year earnings estimates have been revised downwards, Sangetsu has been able to maintain market share in each of its product areas and we have maintained healthier business conditions than our competitors despite the increasingly severe market environment.
- In addition, Sangetsu is focusing upon its ability to create cash flow, and we have been able to steadily improve our key management benchmark of cash conversion cycle (CCC) over the past three years.



※ Cash Conversion Cycle: The number of days required to recover cash from procurement to sales, with the lesser number of days reflecting an improvement in the ability to generate cash.

Calculation method:  $CCC = \text{Inventory turnover days} + \text{Accounts receivables recovery days} - \text{procurement liabilities recovery days}$

- While the sales and net income targets of ¥140.0 billion and ¥6.3 billion in the fiscal year March 2017, the final year of the “Medium Term Business Plan (2014-2016) Next Stage Plan G”, have been revised downwards, Sangetsu will continue to implement efforts to beat these targets.

#### \* Overseas Business Deployment

- The acquisition of Koroseal will play an important role in Sangetsu’s overseas business deployment.
- The interior business is an inefficient business due to the complexity of the market that requires a product lineup with a wide variety of products in small numbers to satisfy the diverse needs of customers. Therefore, the securing of market scale is important for this business.
- Therefore, we believe there is a need to secure procurement and sales functions in overseas markets in addition to Japan. The acquisition of the top company in the United States will provide strong synergies in diversifying our procurement function and strengthening our sales channels. Furthermore, the high profitability of Koroseal was yet another factor behind our decision to acquire it.
- The local company established in China called “Sangetsudo (Shanghai)” in April 2016 has begun aggressive marketing activities to book orders from November starting with six marketing employees.
- Our efforts in China to provide high quality Japanese wallcovering materials have been welcomed by Japanese architectural design and interior construction companies operating locally. And while our China business has only just been started, we will facilitate our logistics function to steadily expand business there.

## 6. Conclusions

Unfortunately, Sangetsu revised down its full year estimates and the achievement of its final year targets of the Medium Term Business Plan now appears difficult. However, attention should be paid to the Company’s efforts to steadily implement its business strategy. In the short term, while the market conditions face difficulty, attention should be paid to how the Sangetsu Group, which consists of continuously improving subsidiary companies, will improve its performance. Other highlights that should be watched include the M&A of Koreseal and the potential for contributions to earnings above expectations over the medium to long term, and the contributions derived from the acquisition of Fairton and the establishment of Sangetsudo (Shanghai).

## <Reference 1: Medium Term Business Plan “Next Stage Plan G”>

Sangetsu identifies 2014 as its “Third Founding Phase” and has created the “**Midterm 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 the 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>	<ul style="list-style-type: none"> <li>◇ Expand operations, improve earnings of consolidated companies</li> </ul>
<b>Full-Scale Overseas Business Deployment</b>	<ul style="list-style-type: none"> <li>◇ Develop products specifically for the overseas markets</li> </ul>

### <Specific Measures>

Target Stakeholders	Target Realms	Specific Measures
Employees	Internal Structures	<b>1) Facilitate a corporate structure that allows employees to actively participate in business management</b> A) Organizational review B) Human resources 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.

### <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.

In addition to the 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 in the absence of sales because of the startup of 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 Achieve Between 2017~2019

Based upon this midterm business plan, the next midterm business plan is expected to end in the 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%.”

## <Reference2: Regarding Corporate Governance>

### ◎ Organization type and the composition of directors

Organization type	Company with audit and supervisory committee
Directors	10 directors, including 4 external ones

### ◎ Corporate Governance Report

The company submitted the latest corporate governance report on Nov. 21, 2016.

## <Reasons for Non-compliance with the Principles of the Corporate Governance Code (Excerpts)>

The company implements each principle of the Corporate Governance Code.

## <Disclosure Based on the Principles of the Corporate Governance Code (Excerpts)>

Principles	Disclosure contents
【Principle 1-4 So-called strategically held shares】	<p>1. Policy on strategic shareholding Our company believes that cooperative relationships with a multitude of companies are essential in the processes of manufacturing, development, sale, construction, and distribution of our products in order to constantly expand our Interior Business and Housing-related Business. We make decisions on shares to strategically hold for the medium- to long-term by comprehensively judging from various perspectives, considering companies with which we should newly forge relationships and companies with which we should continue to strengthen relationships as our clients for business strategies. In our company, strategically held shares are discussed and reviewed every year at a meeting of the board of directors.</p> <p>2. Attitude toward exercise of voting rights Our company respects the management policy of every company which we invest in and exercises our voting rights as needed after having interaction and communication through a wide range of channels and making comprehensive judgment as to various aspects including medium- to long-term improvement of such companies, their attitude to shareholder return, and their efforts at corporate governance and CSR.</p>

<p>【Principle 5-1 Policy on constructive communication with shareholders】</p>	<p>Aiming to establish good relationships with shareholders by encouraging constructive communication with them and striving for information disclosure and interaction with high transparency, our company proactively performs IR activities as follows:</p> <ul style="list-style-type: none"> <li>• In our company, the Chief Executive Officer manages the implementation of IR activities.</li> <li>• Our company has established the Public Relations and IR department for rational communication with our shareholders and swift IR activities.</li> <li>• The Chief Executive Officer, the executive in charge, and the Public Relations and IR department carry out interviews with both Japanese and overseas institutional investors, and analysts, upon their request, to interact with them.</li> <li>• Although the Public Relations and IR department is primarily in charge of IR activities, other departments including the Finance and Accounting department, Management Audit department, and General Affairs department cooperate with the Public Relations and IR department to provide information with higher effectiveness.</li> <li>• Our company announces our financial statements, arranges financial results briefings for investors, and participates in IR events for individual investors hosted by stock exchanges and the like to hold explanatory meetings.</li> <li>• Our company publishes on our website explanatory material we used at the above-mentioned events and the like (the English-version of such material is also published as needed).</li> <li>• Our company creates an integrated report for every fiscal year and publishes such reports both in Japanese and in English through our website.</li> <li>• Our company conducts activities which contribute to enhancement of our shareholders' understanding about various items, including our management strategy, business environment, business progress, and financial information, through direct communication and material published on our website.</li> <li>• Our company responsibly utilizes opinions obtained from interaction with our shareholders and investors for administrative improvement through The Public Relations and IR department.</li> <li>• Our company properly deals with management of insider information in accordance with the regulations for management of insider trading (regulations for prevention of insider trading), by assiduously managing unpublished material facts.</li> </ul>
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# Bridge Report



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