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Shinohara System of Construction (8909)

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Real Estate (JASDAQ)

Stronger outlook for earnings growth.

- In 1Q FY05, revenues advanced 80% y/y to Y3.91 billion, and recurring profit moved into the black. The major positive was strong performance in the mainstay rental apartment sales business.

- We anticipate sustainable earnings growth, given ongoing favorable progress in property acquisition, as well as a broader customer base as a result of business area expansion and the introduction of non-recourse loans. In addition, the business tie-up with re-plus (8936) implies the possibility that studio apartment sales will become a new earnings driver.

- We expect full-FY05 recurring profit to grow 51% y/y to Y900 million. Given ongoing solid performance, there is a strong possibility that recurring profit will exceed the initial company target of Y700 million. From a medium-term perspective, we forecast annual average profit growth of around 25%.

Market Data (consol)

Share price	(Y; 29 Aug)	362,000
Market cap	(Y mil; 29 Aug)	9,953
EV	(Y mil; 29 Aug)	14,376
Shares outstanding*	(000; 3/05)	27
Foreign ownership	(%; 3/05)	5.8
EBITDA	(Y mil; 3/06 F)	1,150
	(Y mil; 3/07 F)	1,340
ROE	(%; 3/05)	22.2
ROA	(%; 3/05)	3.5

Investment Indicators (consol)

P/E	(X; 3/06 F)	18.8
	(X; 3/07 F)	16.3
P/CF	(X; 3/06 F)	16.6
	(X; 3/07 F)	14.6
EV/EBITDA	(X; 3/06 F)	12.5
	(X; 3/07 F)	10.7
P/B	(X; 3/05)	4.71
Dividend yield	(%; 3/06 F)	0.48
Web site	http://www.shinoken.com	

F: DIR forecasts.
*Parent.
EV = market cap + interest-bearing debt – liquidity on hand.
EBITDA = operating profit + depreciation.
ROE = net income / shareholders' equity.
ROA = net income / total assets.

Income Summary (Y mil; y/y %)

	Year to	Revenues		Op profit		Rec profit		Net income		EPS (Y)	CFPS (Y)	DPS (Y)
Consol	**3/02**	4,796	(32)	293	(70)	271	(73)	121	(57)	166,915	256,580	5,000
	3/03	5,715	(19)	366	(25)	314	(16)	169	(40)	29,524	42,103	7,500
	3/04	8,515	(49)	475	(30)	388	(24)	204	(21)	31,875	43,281	6,000
	3/05	12,498	(47)	745	(57)	597	(54)	391	(92)	28,350	33,208	3,250
	3/06 F	18,200	(46)	1,080	(45)	900	(51)	530	(36)	19,277	21,823	1,750
	3/07 F	22,200	(22)	1,270	(18)	1,050	(17)	610	(15)	22,187	24,733	1,750
	3/06 CP	15,846	(27)	NA		704	(18)	412	(5)	14,827	17,346	1,750

F: DIR forecasts. CP: Company projections.
Note: 2-for-1 stock split at end-March 2005.

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Business Overview

Serve to help customers build assets

The firm's mainstay business is to sell rental apartments to those seeking to build assets. While the firm used to operate mainly in Fukuoka prefecture, it has now expanded its operations to Tokyo, Nagoya, and Sapporo, with around 50% of total sales generated in Tokyo. Furthermore, it has commenced planning, marketing and management of studio apartments for investment purpose, mainly operated by Nissho Harmony (unlisted), which became a wholly owned subsidiary in July 2003.

In addition, the firm extends loans to those purchasing its properties, manages such properties on behalf of owners, and other related businesses including supplying LP gas, as well as operating convenience stores and Japanese-style pub chains.

Its business model at first glance resembles that of studio apartment sellers in that both offer properties for investment. However, these studio apartment dealers focus on investment yields as a matter of sales strategy, while Shinohara stresses the benefits of asset building for customers in the years ahead. Its idea is to purchase land and building through monthly rental income. Indeed, the firm provides customers with support to be owners of properties including land eventually – asset formation, while monthly rental income allows customers to repay loans.

1Q FY05 Results

Achieved profitability at recurring level

1Q FY05 results were revenues of Y3,913 million (up 80% y/y), operating profit of Y251 million (up 19X), recurring profit of Y213 million (in the black), and net income of Y143 million (in the black).

Its mainstay rental apartment business was favorable, aided by full contributions from the Nagoya branch, which started operations in January 2004, and broadened its customer base through the introduction of a non-recourse loan service by tying up with Tokyo Star Bank (unlisted). The number of properties sold was 14 low-rise apartment buildings (vs. 1 unit in 1Q FY04), 3 high-rise buildings (0), 20 plots of land (20), and 16 studio apartments (11).

The firm achieved profitability at the recurring level. This is attributable to an improved gross margin from 17.3% to 17.9% on successful COGS reduction efforts, and a decline in the SG&A cost ratio from 16.7% to 11.4% on enhanced marketing efficiencies.

Quarterly Earnings Trends (Y mil) **Chart 1**

	1Q FY04	2Q	3Q	4Q	1Q 05
Revenues	2,174	2,131	7,140	5,358	3,913
Rental apartments			5,704	4,797	3,365
Real estate rental management			864	378	339
Financial service			54	19	19
Other			516	165	189
Operating profit	13	123	255	490	251
Rental apartments			151	482	202
Real estate rental management			276	93	101
Financial service			14	3	4
Other			36	26	35
Recurring profit	-19	96	166	431	213
Net income	-14	83	136	255	143

Source: Company materials; compiled by DIR.

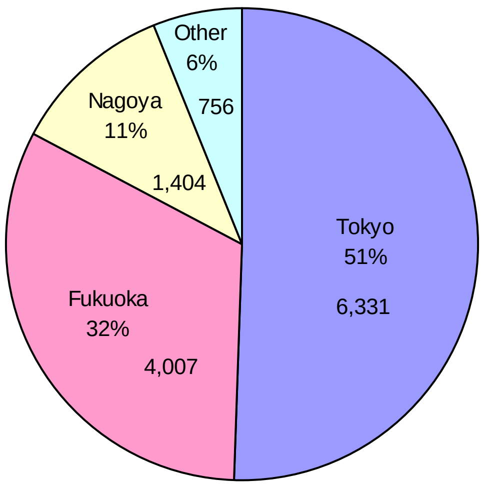
Medium-term Prospects

As a matter of strategy, management has implemented three important measures which, we believe, should help the company develop growth potential. They are 1) geographical expansion, 2) utilization of non-recourse loans, and 3) entry into studio apartment sales.

Geographical expansion helps customers find diversified investment

The company opened a branch in Tokyo (January 2001), Nagoya (January 2004), and Sapporo (January 2005). Obviously, expanded operating areas help the company to enhance marketing. In particular, it serves customers to diversify their properties for investment. For instance, with the opening of the Sapporo branch, the company can approach its customers living in Tokyo to invest in properties in Sapporo. Management intends to further broaden its operating areas, centering on cities with a population of 1 million or more—new branches in such cities as Sendai, Osaka, and Hiroshima are currently being considered.

FY04 Geographical Breakdown of Revenues (Y mil; %) **Chart 2**

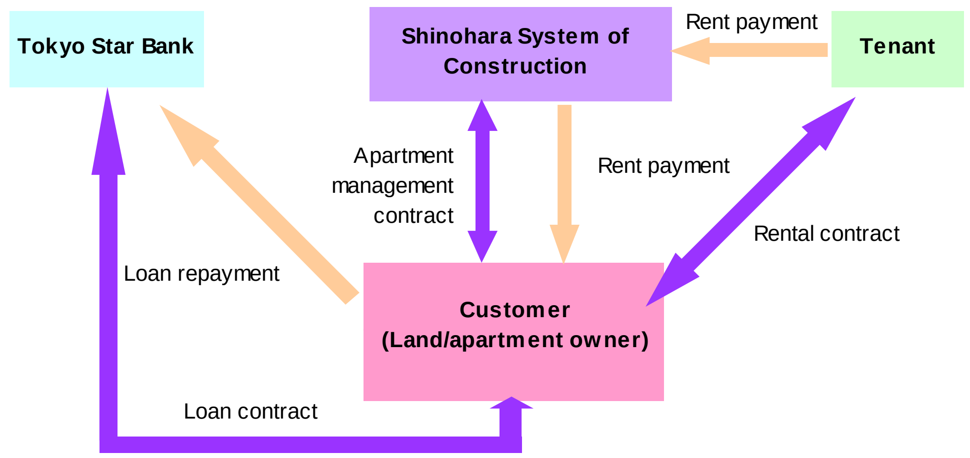


Source: Company materials; compiled by DIR.

Utilization of non-recourse loans expected to drive growth

In a bid to expand its customer base, the company has commenced extending non-recourse loans to customers, tying up with Tokyo Star Bank. Typically, the company's customers are corporate employees aged in their 30s or 40s—those who earn regular cash flow in the form of salaries, which is a necessary condition for banks to extend loans. With offering non-recourse loans, however, the company is able to develop customers who have difficulty borrowing money from banks—those who do not earn stable income or a sufficiently large amount of income. This is because non-recourse loans are extended based on the profitability of properties used as collateral, not the credit capability of borrowers. Also, such loans help existing customers invest in more properties in addition to those already owned, because, unlike regular-type loans, they do not call for a credit line. Thus, non-recourse loans benefit customers as well. Upon default, borrowers cannot be held responsible for any amount in excess of the value of the collateral sold, even if the value of such collateral falls below the level it had or that has been anticipated for it at the time of the loan. This serves to diminish risks involved in managing apartments (i.e., lower occupancy rate).

Non-recourse Loans to Individual Customers **Chart 3**



Source: Company materials; compiled by DIR.

Studio apartments likely to be new driver

In July 2003, the company made Nissho Harmony (a realtor specializing in condominium sales and management) its subsidiary, and since then, studio apartment sales have been growing favorably. In FY04, condominium sales totaled Y3,236 million, of which 46% (Y1,491 million) were sold by Nissho Harmony—54% (Y1,745 million) were wholesaled to studio apartment providers. In July 2005, the company entered a tie-up with re-plus (8936) with respect to real estate operations. This allows the company to find a stable source of buying demand for the properties it develops. The tie-up involves no overlapping businesses with Nissho Harmony's, while it has enabled the company to broaden the service lineup on a group-wide basis in such areas as rental management and gas supply. Accordingly, we believe the tie-up will prove positive for the company in various aspects.

Sales and Earnings Forecasts

FY05 Estimates

We forecasts revenues at Y18.2 billion (up 26% y/y), operating profit at Y1.08 billion (up 45%), recurring profit at Y900 million (up 51%), and net income at Y530 million (36%). Mainstay rental apartment sales are projected to amount to 280 units (220 a year earlier), of which low-rise buildings will likely show particularly strong growth to 190 units (138). On top of continuing greater customer demand for 'asset building,' full-year contribution from the Nagoya operations as well as the newly-opened Sapporo outlet should contribute to raising revenues and earnings.

The anticipated change in revenue mix will probably cause the cost of sales ratio to rise, but this should be offset by the improved SG&A expense ratio. Thus, we expect the operating profit margin to be more or less flat with the year-earlier 5.9%.

FY06 Estimates

We forecast revenues at Y22.2 billion (up 22% y/y), operating profit at Y1.27 billion (up 18%), recurring profit at Y1.05 billion (up 17%), and net income at Y610 million (up 15%). Due partly to full-year contributions from the Sapporo outlet, rental apartment sales are projected to rise to 350 units. Going forward, we expect new branch openings to drive apartment unit sales growth for some time. Given increased positives from the tie-up with re-plus, sales would grow more strongly than currently anticipated.

As long as new branches continue to be opened, profit margins are unlikely to improve. Nonetheless, we expect the recurring margin to be maintained at 4.7% or so. Medium-term profit growth is assumed at 25% per year.

Balance Sheets (consol; Y mil; % of total) **Chart 4**

	FY00		FY01		FY02		FY03		FY04	
Assets										
Current assets	**1,495**	(49.3)	**2,061**	(55.5)	**3,653**	(68.2)	**8,163**	(81.5)	**10,361**	(84.4)
Cash and cash equivalents	316		554		987		1,444		2,776	
Accounts receivable	153		47		309		1,704		1,174	
Operating loans	338		596		1,107		1,423		1,555	
Securities	-		-		-		-		-	
Inventories	472		793		1,167		3,488		4,740	
Other	217		72		88		119		133	
Allowance for doubtful accounts	-1		-1		-5		-15		-17	
Fixed assets	**1,536**	(50.7)	**1,651**	(44.5)	**1,700**	(31.8)	**1,852**	(18.5)	**1,916**	(15.6)
Tangible fixed assets	1,343	(44.3)	1,440	(38.8)	1,480	(27.6)	1,510	(15.1)	1,514	(12.3)
Buildings	530		592		576		576		563	
Land	705		705		736		739		739	
Other	108		143		168		195		212	
Intangible fixed assets	79	(2.6)	65	(1.8)	51	(1.0)	137	(1.4)	130	(1.1)
Investment and other assets	114	(3.8)	144	(3.9)	168	(3.1)	204	(2.0)	271	(2.2)
Total assets	**3,032**	(100.0)	**3,712**	(100.0)	**5,354**	(100.0)	**10,016**	(100.0)	**12,277**	(100.0)
Liabilities										
Current liabilities	**1,073**	(35.4)	**1,490**	(40.1)	**2,134**	(39.9)	**5,351**	(53.4)	**7,119**	(58.0)
Accounts payable	325		275		548		1,099		1,541	
Short-term borrowings	393		519		1,129		3,500		4,601	
Long-term borrowings due within one year	-		-		-		40		40	
Other	355		696		457		712		937	
Long-term liabilities	**1,360**	(44.9)	**1,247**	(33.6)	**1,949**	(36.4)	**3,258**	(32.5)	**3,043**	(24.8)
Bonds	47		35		200		630		590	
Long-term borrowings	1,052		878		1,420		2,206		1,968	
Other	261		334		329		422		485	
Total liabilities	**2,434**	(80.3)	**2,737**	(73.7)	**4,084**	(76.3)	**8,609**	(86.0)	**10,163**	(82.8)
Shareholders' equity										
Capital	130		260		317		317		567	
Capital surplus	45		178		249		249		499	
Retained earnings	422		536		702		839		1,189	
Treasury stock	-		-		-		-		-141	
Total shareholders' equity	**598**	(19.7)	**974**	(26.2)	**1,269**	(23.7)	**1,407**	(14.0)	**2,114**	(17.2)
Total liabilities and shareholders' equity	**3,032**	(100.0)	**3,712**	(100.0)	**5,354**	(100.0)	**10,016**	(100.0)	**12,277**	(100.0)
Equity / assets ratio (%)	19.72		26.24		23.70		14.05		17.22	
Interest-bearing debt / total assets (%)	49.21		38.58		51.34		63.66		58.64	
Current ratio (%)	139.33		138.32		171.18		152.55		145.54	
Fixed assets / (long-term liabilities + shareholders' equity) (%)	78.45		74.34		52.83		39.70		37.15	
Accounts receivable / average monthly sales (months)	0.51		0.12		0.65		2.40		1.13	
Accounts payable / average monthly sales (months)	1.07		0.69		1.15		1.55		1.48	
Inventories / average monthly sales (months)	1.56		1.98		2.45		4.92		4.55	
ROE (%)	NA		15.39		15.07		15.25		22.21	

Source: Company materials; compiled by DIR.
Note: 2-for-1 stock split at end-March 2005.

Income Statements (consol; Y mil; y/y %) **Chart 5**

	FY02		03		04		05 F		06 F	
Revenues	**5,715**	(19.2)	**8,515**	(49.0)	**12,498**	(46.8)	**18,200**	(45.6)	**22,200**	(22.0)
Cost of sales	**4,429**	(18.5)	**6,820**	(54.0)	**10,110**	(48.2)	**14,950**	(47.9)	**18,400**	(23.1)
Gross profit	**1,285**	(21.2)	**1,695**	(31.9)	**2,388**	(40.9)	**3,250**	(36.1)	**3,800**	(16.9)
SG&A expenses	**919**	(20.0)	**1,220**	(32.8)	**1,642**	(34.6)	**2,170**	(32.2)	**2,530**	(16.6)
Royalty paid	32		33		32					
Advertising	88		177		261					
Personnel	421		511		658					
Commissions paid	19		28		31					
Depreciation	59		60		55					
Rent	46		60		82					
Taxes and public charges	18		37		42					
Other	236		314		481					
Operating profit	**366**	(24.9)	**475**	(29.8)	**745**	(56.8)	**1,080**	(45.0)	**1,270**	(17.6)
Non-operating income	7		22		25		20		20	
Interest and dividend income	0		0		0					
Other	7		22		25					
Non-operating expenses	60		109		173		200		240	
Interest expenses and discounts	39		96		119					
Other	21		13		54					
Recurring profit	**314**	(15.9)	**388**	(23.6)	**597**	(53.9)	**900**	(50.8)	**1,050**	(16.7)
Extraordinary gains	-		4		12					
Extraordinary losses	-		-		0					
Pretax income	314	(25.6)	393	(25.2)	610	(55.2)	900	(47.5)	1,050	(16.7)
Taxes	144		189		219		370		440	
Net income	**169**	(39.7)	**204**	(20.7)	**391**	(91.7)	**530**	(35.5)	**610**	(15.1)
EPS (Y)	29,524.24		31,875.15		28,350.39		19,276.93		22,186.66	
Book value per share (Y)	197,774.54		219,164.54		153,813.39		-		-	
DPS (Y)	7,500.00		6,000.00		3,250.00		1,750.00		1,750.00	
Shares outstanding end-FY (shrs)	6,420		6,420		13,747		27,494		27,494	
Depreciation	72		73		67		70		70	
% of sales										
Cost of sales	77.5		80.1		80.9		82.1		82.9	
Gross profit	22.5		19.9		19.1		17.9		17.1	
SG&A expenses	16.1		14.3		13.1		11.9		11.4	
Operating profit	6.4		5.6		6.0		5.9		5.7	
Recurring profit	5.5		4.6		4.8		4.9		4.7	
Net income	3.0		2.4		3.1		2.9		2.7	

Source: Company materials; compiled by DIR.
Note: 2-for-1 stock split at end-March 2005.
F: DIR forecasts.

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2: Outperform TOPIX/benchmark index by 5-15% over the next six months.
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The statements in the two preceding paragraphs are made as of August 1, 2005.

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