Lehto Group Plc's Business Review 1 January–30 September 2019

January–September net sales down by 18.8%, operating loss EUR 41.9 million

This is not an interim report as specified in the IAS 34 standard. The company complies with half-yearly reporting according to the Finnish Securities Markets Act and discloses business reviews for the first three and nine month periods of the year, in which key information regarding the company's financial situation and development will be presented.

The financial information presented in this business review is unaudited. Figures in brackets refer to the corresponding period of the previous year, unless otherwise stated.

GROUP	7-9/2019	7-9/2018	1-9/2019	1-9/2018	1-12/2018
Net sales, EUR million	151.5	198.0	397.8	489.9	721.5
Change in net sales, %	-23.5%	163.4%	-18.8%	46.1%	20.7%
Operating profit, EUR million	-14.4	8.2	-41.9	21.9	37.2
Operating profit, % of net sales	-9.5%	4.2%	-10.5%	4.5%	5.2%
Profit for the period, EUR million	-13.4	6.4	-36.1	17.2	28.7
Order backlog at period end, EUR million	652.5	696.3	652.5	696.3	655.6
Earnings per share, EUR	-0.23	0.11	-0.62	0.30	0.49
Cash and cash equivalents, EUR million	31.0	48.0	31.0	48.0	53.4
Interest-bearing liabilities, EUR million	262.8*	122.2	262.8*	122.2	115.9
Equity ratio, %	24.1%	42.0%	24.1%	42.0%	42.7%
Net gearing ratio, %	206.7%	48.9%	206.7%	48.9%	38.5%

**) Interest-bearing liabilities include EUR 80.7 million in lease liabilities in accordance with IFRS 16.*

Compared to the corresponding period of the previous year, Lehto Group's net sales for January–September declined by 18.8% to EUR 397.8 (489.9) million. Net sales grew slightly in the Housing service area and declined in the Business Premises and Social Care and Educational Premises service areas.

The operating loss was EUR 41.9 million (operating profit of EUR 21.9 million), or-10.5% (4.5%) of net sales. The key factors behind the operating loss were the losses of EUR 25.4 million from complete renovation operations, losses of EUR 8.6 million from operations in Sweden and losses from individual projects in the Social Care and Educational Premises service area.

The Group's order backlog stood at EUR 652.5 million (EUR 655.6 million on 31 December 2018). The order backlog increased in the Business Premises service area, but declined in the Housing and Social Care and Educational Premises service areas. A construction project is included in the order backlog once the project contract has been signed or, in the case of developer contracting projects, once the decision to begin construction has been made and the contract has been signed.

NET SALES BY SERVICE AREA, EUR MILLION	1-9/2019	1-9/2018	CHANGE	1–12/2018
Business Premises	125.0	190.5	-34.4%	267.3
Housing	228.7	218.9	4.5%	336.3
Social Care and Educational Premises	44.1	80.5	-45.2%	117.8
Total	**397.8**	**489.9**	**-18.8%**	**721.5**

Lehto's CEO Hannu Lehto:

"In the third quarter, the result was still in the red. The main reasons for the loss were the same that we have wrestled with throughout the year: problems in complete renovation projects, the difficulties encountered in the Swedish project, and individual loss-making projects in the Social Care and Educational Premises service area.

At the end of the review period, we handed over two of the three most loss-making complete renovation projects. The handover of the third took place in late October after the end of the review period. By the end of October, two-thirds of the Swedish project had been delivered. It is expected that the final part will be handed over by the end of this year. The handover of the most loss-making project in Social Care and Educational Premises is anticipated to take place in November.

We have had to pay our dues for longer and in greater amounts than we previously estimated. We have taken corrective actions during the whole year, focusing on two main issues: thorough preparation and design of projects as well as management of the project implementation phase. The majority of project costs are determined at the design stage, and work on site cannot significantly rectify design errors.

We have already managed to steer the ship in the right direction. After we have completed the loss-making projects that are now on the final stretch, we have no new disappointing projects ahead of us. Our concerted efforts to develop the project preparation and implementation phases are starting to bear fruit. The margins of ongoing projects seem to be stabilising at a healthy level. Our development efforts are also reflected in quality: during the autumn, we have delivered several zero-defects projects, indicating the good overall quality of our operations.

Our housing sales have remained at a good level. In January-September, we sold 1,434 housing units, 1,157 in developer-contracting projects and 277 in contract projects. As a result of good sales development and fewer housing start-ups, the number of unsold housing units under construction has declined significantly during the financial period.

Our approach to improving the company's profitability has proven to be effective – we will continue this work. The net working capital freed up during the last months of the year will stabilise the balance sheet and financing."

Outlook for 2019

On November 1, 2019 Lehto updated its estimate of net sales and operating result for 2019. The view published at that time is unchanged.

Lehto estimates that the Group's net sales in 2019 will be lower than in 2018 (2018 net sales EUR 721.5 million). Although the company estimates its fourth-quarter operating profit to be positive, the second-half operating profit is expected to be negative due to the third-quarter operating loss (operating loss January-June 2019 EUR -27.5 million).

The main factors affecting net sales and operating profit for the second half of the year are the continuing losses of complete renovation projects in the third quarter, the delayed completion of some housing projects for the year 2020 and the decline in the average margin of housing projects.

The main risks related to the development of net sales and operating profit are increased completion costs of projects, delays in completion of some housing projects for the year 2020, weakening of sales in Housing sector and declining sales prices, and possible penalties for delayed complete renovation projects.

The previous outlook, published in half-year report, on 15 August 2019 was as follows:

Lehto estimates that the Group's net sales for 2019 will be at level of 2018 or lower than on year 2018 (EUR 721.5 million in 2018) and that full year 2019 operating profit will be negative due to strongly negative first half of 2019 (operating profit EUR 37.2 million i.e. 5.2% of net sales in 2018).

Business development in the review period

BUSINESS PREMISES

Net sales in the Business Premises service area declined by 34.4% from the comparison period to EUR 125.0 (190.5) million. The decline in net sales is due to a decrease in the number of projects and the smaller average size of projects. The decline in net sales was also impacted by delays in the start-up of larger projects for which a contract has already been signed.

A total of 19 projects were completed during the review period (25 in 1-9/2018), the largest of which was the Retail Park in Laajalahti, Espoo. At the end of the review period, 16 projects were under construction, most notably Ideapark in Seinäjoki and a logistics centre in Kerava.

The order backlog of the Business Premises service area at the end of the review period was EUR 179.5 million (EUR 167.6 million on 31 December 2018). In June, Lehto and Fennovoima signed a contract for the design and construction of an administrative building and plant office for the Hanhikivi 1 nuclear power plant. The contract is valued at about EUR 30 million.

Lehto has been developing the Hippos2020 project in collaboration with the City of Jyväskylä, Fennia Asset Management Ltd and other investors. On 29 March 2019, Fennia Asset Management Ltd announced that it will no longer continue developing the project. However, Lehto and the City of Jyväskylä will continue and are seeking a new main financier. A project company has been set up for the project. It is responsible for the costs of the development work. The project involves the standard risks associated with property development, such as acquiring tenants.

Complete renovation operations

Four significantly loss-making complete renovation projects burden Lehto's result for 2019. One of these projects was completed in May 2019 and two at the end of September 2019. The fourth was completed and handed over to the client at the end of October.

Due to problems with the implementation of these projects, it is possible that Lehto might incur further costs from these projects in the last quarter of the year in the form of supplementary work and penalties for delays, for instance.

HOUSING

During January–September, net sales in the Housing service area rose by 4.5% on the comparison period to EUR 228.7 (218.9) million. Housing sales periods were longer than last year and the greater supply of housing in the market has reduced housing prices somewhat. Raw material and subcontracting costs have risen slightly since last year, due to which the average margin on housing projects saw a slight year-on-year decline. As from the beginning of 2019, the Housing service area has included housing under complete renovation. The comparative information has been adjusted accordingly.

During the review period, a total of 1,434 (1,204) housing units were sold, 1,157 in developer contracting projects and 277 in contract projects. On 30 April 2019, Lehto Group Plc's subsidiary Lehto Asunnot Oy and the German company DWS Real Estate GmbH ("DWS"), which is part of the Deutsche Bank Group, signed an agreement according to which Lehto will build and sell a portfolio of 542 apartments for DWS. The portfolio will contain six separate projects located in Espoo, Turku, Kirkkonummi, Riihimäki and Jyväskylä. Of these, the Riihimäki project (51 units) was completed and sold in August 2019. The other projects are under construction and will be completed in 2019-2020. In accordance with the contract, Lehto will sell the apartments leased, and the portfolio's final sale price will be determined by the actual occupancy rate and rental prices. The projects will be handed over to clients individually on completion, at which point each project will also be paid for. Lehto will handle all financing and bank loans for the projects during the construction phase.

SOLD HOUSING UNITS DURING THE REVIEW PERIOD	1-9/2019	1-9/2018	1-12/2018
Contract	277	598	758
Developer contract	1,157	606	1,171
Sold housing units during the review period, total	**1,434**	**1,204**	**1,929**

During the review period, 1,487 (1,517) new housing units were completed and at the end of the review period, 2,670 housing units were under construction (3,322 on 31 December 2018). The number of unsold housing units under construction declined and amounted to 967 at the end of the review period (1,715 on 31 December 2018). Unsold housing units include 491 units in the DWS portfolio. Most of the completed and ongoing housing projects are developer contracting projects located in the Helsinki Metropolitan Area and other Finnish growth centres: the Tampere, Turku, Jyväskylä and Oulu regions. The largest housing construction projects currently in progress are in Kaivoksela in Vantaa and in the centre of Oulu.

The table below presents the number of housing units under construction. Contract projects include not only contracts ordered by clients, but also housing construction projects developed by Lehto in which the company sells the entire share capital of the established housing cooperative to the client during the project.

HOUSING UNITS UNDER CONSTRUCTION	1-9/2019	1-9/2018	1-12/2018
Contract	1,095	968	1,263
Developer contract	1,575	2,168	2,059
Housing units under construction, total	**2,670**	**3,136**	**3,322**
of which sold	1,703	1,483	1,607

UNSOLD (AVAILABLE OR RESERVED)	1-9/2019	1-9/2018	1-12/2018
Under construction	967	1,653	1,715
Completed	89	31	72
Unsold, total	**1,056**	**1,684**	**1,787**
including DWS units	491	0	462

The number of completed and unsold housing units stood at 89 at period end (72 on 31 December 2018).

The Housing service area has taken over the well-organised and profitable pipeline renovations previously carried out by the now-discontinued Building Renovation service area. Demand for pipeline renovations remained good, with seven pipeline renovation projects completed during the review period, and nine under construction at period end.

In March, Lehto launched the Deco wooden apartment building concept, which makes it possible to build a four-storey wooden building as a space element solution. The concept provides good support to the company's strategy, as it effectively harnesses industrial manufacturing and standardised solutions, for instance. Product development was largely also driven by demand and megatrends such as ecology and Finnishness. Lehto's wooden blocks of flats are built using domestic wood materials, primarily at the company's factories in Finland.

The construction of wooden blocks of flats is also interesting due to the changes in the business environment, as such projects are currently supported, such as by zoning plots suitable for this purpose in key locations in growth centres. In addition, wooden blocks of flats are an excellent match for current additional and complementary construction projects.

At the beginning of June, Juha Höyhtyä, M.Sc. (Civil Eng.), MBA, was appointed as the new Executive Vice President of the service area and as a member of the Group's Executive Board. Mr Juha Höyhtyä has long experience of the construction business. He has worked for the construction company Lemminkäinen for a total of 24 years both in Finland and abroad. Most recently, he served as CEO of Telinekataja Oy, in which position he worked for approximately four years. Pasi Kokko, the previous head of the service area, left Lehto's employ at the turn of March and April.

During the review period, the availability and terms of financing became more stringent, especially in investor-driven housing projects.

The order backlog of the Housing service area at the end of the review period was EUR 420.5 million (EUR 428.0 million on 31 December 2018).

SOCIAL CARE AND EDUCATIONAL PREMISES

The net sales of the service area decreased by 45.2% year-on-year to EUR 44.1 (80.5) million. Net sales for the period under review were fairly evenly divided between care homes and schools/daycare centres. A total of six (23) new care homes and three (one) schools were completed in the reporting period. At the end of the review period, there were 12 (13) care homes, two daycare centres, five (three) schools and one healthcare centre under construction.

Demand for schools and daycare centres remained at a good level. Lehto negotiated on numerous school projects and signed seven new contract agreements during the review period. The profitability of the school projects implemented during the review period has been relatively weak and some of the projects are loss-making. Lehto has put a great deal of work into improving the project preparatory phase and management in this service area, and operations are now more clearly targeted at developing Lehto's own product concepts and more efficient use of the company's own manufacturing. During the review period, there were indications that the profitability of projects that have undergone the new project assessment process is improving.

Construction of care homes and assisted living facilities declined during the review period. Care home projects are most likely being delayed by uncertainties caused by the operational challenges faced by care operators and general political discussion on issues such as caregiver staffing. In spite of the current weak level of demand in the care home market, Lehto estimates that business will continue to be brisk in care and service construction over the coming years, and Lehto is further developing its standardised concepts for all customer segments in this service area. The result for the review period is burdened by one heavily loss-making care home project, which has caused a loss of about EUR 4.4 million in the operating result for the period.

The order backlog of the Social Care and Educational Premises service area at the end of the review period was EUR 52.5 million (EUR 60.0 million on 31 December 2018), of which EUR 34.5 million is from daycare and school projects and EUR 18.0 million from care homes and assisted living facilities.

SWEDISH OPERATIONS

During the review period, the Swedish unit focused on the completion of the ongoing modular daycare centre project. There have been significant problems in coordinating factory production and on-site work phases and fulfilling the requirements of the customer. As a result, the project will post a loss. Swedish operations had a negative impact of EUR 8.6 million on the Group's operating result for January-September. The project is expected to be completed in November 2019.

On 5 March 2019, Thomas Perslund took up his position as the new Managing Director of Lehto Sverige. He has earned a name for himself in Swedish construction thanks to his leading roles in projects for Stockholm's Friends Arena, Oscar Properties, NCC and the City of Stockholm. He has more than 20 years of experience in the field.

FACTORY PRODUCTION

The use of prefabricated products lies at the core of Lehto's business. Lehto manufactures a variety of building modules and elements at its own production facilities for its own use. Lehto has production facilities in Oulainen, Hartola, Humppila, Siikajoki and Ii, totalling about 50,000 m².

During the review period, personnel capacity was reduced in factory production. Lehto engaged in employee cooperation negotiations in May-June, as a result of which 51 employees were terminated and 53 laid off temporarily. In addition, it is estimated that another 30 employees will be laid off in autumn 2019. It was decided that about 20 employees would be retrained for new tasks.

In September, Lehto started new employee cooperation negotiations that also covers factory operations personnel. The negotiation decisions are published on 7 November 2019.

Balance sheet and financing

CONSOLIDATED BALANCE SHEET, EUR MILLION	30 SEP 2019	30 SEP 2018	31 DEC 2018
Non-current assets	55.4	34.3	37.7
Current assets			
Inventories	403.1	230.2	238.2
Current receivables	117.8	133.9	139.0
Cash and cash equivalents	31.0	48.0	53.4
Total assets	**607.3**	**446.5**	**468.3**
Equity	112.2	151.5	162.4
Financial liabilities	182.1	122.2	115.9
Lease liabilities	80.7		
Advances received	142.4	85.5	88.3
Other payables	89.9	87.3	101.8
Total equity and liabilities	**607.3**	**446.5**	**468.3**

Lehto adopted the new IFRS 16 Leases standard as of 1 January 2019. Adoption of this standard does not have a significant impact on Lehto's net sales or operating result, but affects several balance sheet key indicators, such as net gearing ratio (which will increase) and equity ratio (which will decrease). The changes to key indicators caused by adoption of the standard do not have an unfavourable impact on Lehto's covenants.

The most significant effects of applying IFRS 16 in the 30 September 2019 balance sheet are: an increase of EUR 80.7 million in financial liabilities, an increase of EUR 7.2 million in non-current assets, and an increase of EUR 73.5 million in inventories. Long-term plot leases for construction projects are presented under inventories. The equity ratio (taking lease liabilities into consideration) stood at 24.1% and the net gearing ratio was 206.7%. The adjusted equity ratio (without the lease liabilities under IFRS 16) stood at 29.2% and the net gearing ratio was 134.8%. Lehto applies a simplified approach during the transitional period, and will not adjust its comparison figures.

The other main changes in Lehto's balance sheet during the review period (that is, not related to IFRS 16) were an increase in inventories and an increase in financial liabilities to finance growth in inventories. Inventories grew due to the increase in the amount of housing production in progress, especially the construction of properties included in the DWS portfolio.

At the end of the review period, Lehto's cash reserves totalled EUR 31.0 million, and the company also had an undrawn credit facility of EUR 15.0 million at its disposal.

Lehto has a syndicated credit facility totalling EUR 75 million. The covenant levels of the RCF financing agreement were renegotiated with financiers during the review period. As a result of the negotiations, the right to use the full amount of the RCF has been limited.

The company expects that its financial situation will remain stable in the last quarter as net working capital becomes avaiable. Inventories are expected to decline when housing projects under construction are completed and the care home portfolio in the balance sheet is sold. In addition, the completion of loss-making projects will improve the financial position. Financial liabilities are also expected to decline during the last quarter.

Personnel

The average number of Group personnel during the review period was 1,502 (1,424 in 1-9/2018). The number of personnel at period end was 1,381 (1,531 on 31 Dec 2018). About half of the Group's personnel are salaried employees and half employees working at construction sites.

The company has a long-term share-based incentive plan in place. The aim of the plan is to combine the objectives of the shareholders and the key employees in order to increase the value of the company in the long term and to commit key employees to the company. The plan is directed at a maximum of 70 key employees and the rewards are paid after a restriction period of two years, partly in the company's shares and partly in cash. The cash proportion is intended to cover taxes and tax-related costs arising from the reward.

On 19 March 2019, Lehto carried out a directed share issue free of consideration related to the reward payment for the performance period 2016 of the incentive plan adopted in 2016. In the share issue, 58,691 new Lehto Group Plc shares were issued free of consideration to 25 Group key employees in accordance with the terms and conditions of the plan.

On 1 April 2019, Lehto announced that Kaarle Törrönen, Vice President, Human Resources, had been appointed to the Executive Board. He has worked for over 33 years in various leading HR and planning positions in the Finnish Defence Forces.

On 9 May 2019, Lehto announced that it would start adjustments at the Hartola and Oulainen factories. The aim was to balance capacity with short-term demand. The company thus started employee cooperation negotiations. According to preliminary estimates, it was expected that there would be significant changes in personnel's tasks or a reduction of no more than 70 person-years. As a result, 51 employees were terminated and 53 laid off temporarily. In addition, it was estimated that another 30 employees will be laid off in autumn 2019. It was decided that about 20 employees would be retrained for new tasks.

On 10 September 2019, Lehto announced that it would start employee cooperation negotiations on measures to improve profitability and to adjust its personnel and factory capacity. Lehto estimated that the ongoing employee cooperation negotiations may lead to a total reduction of up to 150 person-years, which aims at annual cost savings of approximately EUR 7 million. The issues to be negotiated may include redundancies, lay-offs, part-time work, changes to job tasks and reassignments, and related retraining.

Events after the review period

On 15 October 2019, Lehto announced that Hannu Lehto, Mikko Kinnunen and Esko Torsti had been appointed as members of the shareholders' Nomination Committee. The task of the Nomination Committee is to prepare proposals regarding members of the Board of Directors and their fees for the Annual General Meeting 2020.

On November 1, 2019 Lehto updated its estimate of net sales and operating result for 2019.

Vantaa, 6 November 2019

Lehto Group Plc
Board of Directors

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