LEHTO

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Lehto Group Plc Business Review 1 January – 30 September 2022

Third quarter progresses as expected

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 regular 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.

Summary 1–9/2022

Group	7-9/2022	7-9/2021	1-9/2022	1-9/2021	1-12/2021
Net sales from continuing operations, EUR million	86.1	74.4	250.1	257.5	404.1
Change in net sales from continuing operations, %	15.8%	-26.2%	-2.9%	-27.5%	-21.8%
Operating result from continuing operations, EUR million	-6.4	-8.7	-27.9	-11.8	-28.3
Operating result from continuing operations, % of net sales	-7.4%	-11.7%	-11.1%	-4.6%	-7.0%
Result from continuing operations, EUR million	-7.4	-7.8	-31.0	-12.5	-29.9
Result from discontinued operations, EUR million	-0.1	0.1	32.5	0.3	-2.7
Result for the period, EUR million	-7.5	-7.8	1.6	-12.1	-32.6
Order backlog at period end, EUR million	246.4	474.1	246.4	474.1	444.2
Earnings per share, EUR	-0.09	-0.09	0.02	-0.14	-0.37
Cash and cash equivalents, EUR million	11.6	52.3	11.6	52.3	32.8
Financial liabilities, EUR million	38.7	63.3	38.7	63.3	45.8
Lease liabilities, EUR million	84.0	93.4	84.0	93.4	90.4
Equity ratio, %	32.8%	33.0%	32.8%	33.0%	27.2%
Net gearing ratio, %	117.2%	93.7%	117.2%	93.7%	113.8%
Equity ratio, excl. IFRS 16 lease liabilities, %	45.9%	45.7%	45.9%	45.7%	37.3%
Net gearing ratio, excl. IFRS 16 lease liabilities, %	28.6%	9.9%	28.6%	9.9%	14.4%

Discontinued operations include the pipeline renovations business sold in June 2022 and the Swedish operations that were wound up in 2021. The figures for the comparison periods have been adjusted accordingly.

Summary January–September:

- In January–September, net sales were down 2.9% on the previous year and amounted to EUR 250.1 (257.5) million. Net sales fell in the Business Premises service area, but grew slightly in the Housing service area.
- The operating result from continuing operations was EUR -27.9 (-11.8) million. This operating loss was primarily the result of continuing losses in several business premises projects and the penalty fees imposed due to the termination of certain contract agreements.
- The result after taxes for the review period was EUR 1.6 (-12.1) million. The result was improved by the earnings impact of the sale of the pipeline renovations business, amounting to around EUR 30.9 million.
- At the end of the period, there were 1,662 (1,988) apartments under construction, the majority of which are related to projects for institutional investors.
- Cash and cash equivalents totalled EUR 11.6 (52.3) million at the end of the review period.
- Interest-bearing liabilities excluding IFRS 16 lease liabilities amounted to EUR 38.7 (63.3) million.
- The order backlog declined to EUR 246.4 million (EUR 444.2 million on 31 December 2021). The order backlog decreased in both service areas due to low order intake, stricter project selection and the termination of projects in the order backlog. As previously reported by the company, Lehto has canceled or agreed to cancel the contracts or pre-contracts of six projects. The total value of the projects is approximately EUR 125 million, and EUR 73 million of them were previously recorded in the order backlog. As a result of the increase in construction costs, their projected margin was negative.
- A financing package amounting to around EUR 50 million was implemented during the review period. Its key elements were:
  - Divestment of the pipeline renovations business (approximately EUR +29 million).
  - A new RCF credit facility from the banks (approximately EUR +13 million).
  - RS financing from banks for ongoing and new construction projects (approximately EUR +26 million).
  - The issuance of the convertible bond (approximately EUR +15 million).
  - Repayment of the previous RCF credit facility and bilateral loans (approximately EUR -32 million).
  - The financing package significantly improved the company's liquidity and financial standing.

Net sales by service area, EUR million	7-9/ 2022	7-9/ 2021	Change Q3	1-9/ 2022	1-9/ 2021	Change	1-12/ 2021
Housing	53.6	33.8	58.9%	146.3	143.6	1.9%	254.3
Business Premises	32.5	40.6	-20.0%	103.7	113.9	-8.9%	149.8
Total	**86.1**	**74.4**	**15.8%**	**250.1**	**257.5**	**-2.9%**	**404.1**

The impact of the divested pipeline renovations business has been eliminated from the net sales of the Housing service area for all reported periods.

CEO Juuso Hietanen

"The third quarter began with support from the financing solution implemented in late June, and our financial performance in July–September was in line with our expectations. Net sales in January–September were slightly down on the comparison period and the operating result was negative. The result was particularly burdened by factors that have already been mentioned, that is, several loss-making business premises projects and the penalty fees arising from the termination of certain projects.

We are currently focusing on improving the profitability of our operations. Both service areas have introduced new operating models that improve our project preparation and reduce risks.

The general market situation is challenging. Although there are uncertainties relating to demand, we are already seeing some stabilisation in the prices of building materials. We are seeking to reduce market-related risks, mainly by confirming procurement prices before starting up a project and by focusing more strongly on investor sales in housing construction, thereby ensuring sales and better cash flow.

After the end of the review period, in early October, we launched adjustment measures to achieve total cost savings of approximately EUR 6–7 million for 2023. It is expected that majority of the cost savings will be generated by personnel costs. As part of these measures, the company launched change negotiations with the aim of achieving savings equivalent to approximately 80 person-work-years. The measures also include an energy-saving programme that is seeking energy savings of about 15 per cent at Lehto's construction sites and factories."

Outlook for 2022

Lehto's previously published outlook for 2022 remains unchanged.

Lehto estimates that net sales from continuing operations in 2022 will be slightly lower than in 2021 (EUR 404.1 million in 2021) and the operating result from continuing operations will be a loss of about EUR 15–20 million.

This outlook is based on the company's estimate of the progress of ongoing construction projects, construction projects to be started and sold in 2022, and the current outlook on trends in the housing market.

The significant uncertainty surrounding both net sales and the operating result in 2022 is related to the completion of sales contracts for certain construction projects during 2022. The company's outlook expects these transactions to be completed during 2022, and they will have a significant impact on the Group's operating result.

Development of the business environment during the review period

Development of the business environment

In its review published in August 2022, the Ministry of Finance's construction trends group (Raksu) predicted that construction will return to a more normal level after the current boom. Although construction is expected to grow by another 2–4 per cent this year, a decline of 3–5 per cent is forecast for the following year.

According to Eurostat statistics, the annual inflation rate in Finland stood at 7.9% in August 2022. Rising inflation has weakened consumer confidence and raised interest rates, which has in turn contributed to uncertainty in the construction market. According to Statistics Finland, construction costs in August 2022 had increased by 6.8% year-on-year. However, Raksu anticipates that material availability will improve and the rise in construction prices will slow down.

In its business cycle review published in October 2022, the Confederation of Finnish Construction Industries RT predicted that construction would grow by 2 per cent this year, supported by the existing work backlog and continued good performance in housing construction. Next year, construction is expected to decrease by 2 per cent as new construction and infrastructure construction decline.

RT estimates that apartment building startups will decrease by about 17.5% in 2022 from the record high of 2021 (35,400 apartments) and will then fall by a further 16% in 2023 (to 24,600 apartments). According to RT's housing production survey, housing startups will decrease noticeably towards the end of the year. The survey indicates that developer-contracted housing production in 2022 will decrease by about a third compared to last year and the previous survey conducted in May. The reason for this is lower demand from consumers and small investors.

Housing

In the Housing service area, Lehto builds new blocks of flats in growth centres and implements care homes and assisted living facilities around Finland. Operations focus on growing university towns, where Lehto wants to enable households with low and medium incomes to live in high-quality housing. These customers include private persons, private and institutional investors, and funds. Housing projects are implemented using either wood or concrete, and employ the company's own concepts. Low-carbon solutions are considered to be an even more important competitive factor in the development of the concepts going forward.

The Housing business is based on Lehto's own project development, in which the company acquires a plot or the leasehold to a plot, and then designs the property. Some projects are implemented as business-to-consumer projects, in which the company builds a property and then sells individual units to consumers or small investors. Others are carried out as business-to-investor projects, in which the entire construction project is sold to an institutional investor.

Most of Lehto's current housing projects are concrete apartment buildings and are built using the kitchen/bathroom modules developed and manufactured by Lehto. These modules include the main electricity, water, heat, ventilation and sewerage solutions for the apartment and building. The modules are completely prefabricated at Lehto's own factories and transported to the construction site, where they are lowered into the building through the roof and connected to each other. This patented building method speeds up construction, improves quality and produces cost savings.

An increasing share of Lehto's housing production comprises apartment buildings that are constructed using wooden elements. Apartments in this product family are manufactured as space elements in the company's own factories in Finland – the interior surfaces of the apartment are fully finished when it leaves the factory. Space elements are self-supporting modules that are built at the factory and assembled on site. Wooden apartment buildings involve significantly more industrial prefabrication than concrete apartment buildings. Thanks to this, the on-site schedule can be significantly shorter than in concrete construction.

Lehto also develops, designs and builds care homes and assisted living units for both care operators and municipalities. These construction projects are implemented either under ordinary construction contracts or as investment transactions, where Lehto signs a lease agreement with the service operator and sells the completed property to a party that invests in properties in the sector. The majority of care homes are 1–2-storey concrete or wooden buildings. Going forward, care homes and assisted living units will expand Lehto's offering in larger project packages in city centres and suburban areas.

Business development in the review period

Net sales in the Housing service area grew by 1.9% from the comparison period to EUR 146.3 (143.6) million. The relative proportions of net sales accounted for by consumer and investor projects were approximately the same as in the comparison period.

459 (1,265) apartments were sold in the review period. The number of apartments sold to consumers was slightly lower than in the comparison period, but the number of apartments sold to investors was significantly lower as commercial negotiations were delayed due to the tightening economic environment.

Sold housing units during the review period	1-9/2022	1-9/2021	1-12/2021
To investors	270	1,050	1,529
To consumers	189	215	319
Sold housing units during the review period, total	**459**	**1,265**	**1,848**

During the period, 794 (641) housing units were completed and the construction of 454 (1,185) new units was started. The startups were units in Southern and Northern Finland sold to investors. There were 1,662 (1,988) housing units under construction at the end of the review period.

Housing units under construction	1-9/2022	1-9/2021	1-12/2021
Under construction at the beginning of the period	2,002	1,444	1,444
+ started up during the period	454	1,185	1,835
- completed during the period	-794	-641	-1,277
Housing units under construction, total	**1,662**	**1,988**	**2,002**

At the end of the review period, 270 (293) housing units were either under construction or completed yet unsold. Of these, 49 (27) were completed, unsold apartments. Although Lehto's current focus is on investor sales, the company still aims to launch selected consumer projects. In an investor project, all the housing units are considered to have been sold at the time of signing the contract agreement.

Unsold housing units	**1-9/2022**	**1-9/2021**	**1-12/2021**
Under construction	221	266	430
Completed	49	27	26
Unsold housing units, total	**270**	**293**	**456**

The Housing service area's order backlog stood at EUR 173.8 million at the end of the review period (EUR 242.3 million on 31 December 2021). The housing production order backlog includes the proportion of investor projects that have been started but have not yet been recognised as net sales. A consumer project is included in the order backlog once the decision to start construction has been made and the contract for the project has been signed.

Demand for housing construction weakened during the review period. General economic uncertainty, inflation and rising interest rates have dampened consumer confidence and created uncertainty among institutional investors as well. The final contracts and construction site startups for several projects are scheduled for the fourth quarter of 2022 and early 2023.

During the review period, agreements were signed for four housing projects sold to investors, as well as for care homes and assisted living facilities as part of housing projects. The availability and price of financing is still slowing down startups of projects for consumers.

The volume of care home construction was lower than in the comparison period due to a decrease in the number of projects. One (3 in 1–9/2021) care home was completed during the period. At period-end, two (2) assisted living facilities were under construction as part of a housing construction project. Care home and assisted living projects are in the negotiation phase as both individual sites and as part of larger projects in city centres and suburban areas. Lehto expects demand for care homes and assisted living to rise in the longer term.

On 28 April 2022, Lehto announced that it will sell its pipeline renovations business. The transaction was completed on 14 June 2022 with a final purchase price of EUR 31.5 million. The transaction comprised the entire share capital of Remonttipartio Oy, a wholly owned subsidiary of Lehto, including approximately EUR 2.8 million cash reserves. In this report, the pipeline renovations business is presented as a discontinued operation and the figures for the 2021 comparison year have been adjusted retrospectively to reflect this.

Mr Tero Karislahti, 39, was appointed as Executive Vice President of the Housing service area and as a member of Lehto Group's Executive Board as of 10 June 2022. Karislahti has a master's degree in technology and 18 years' experience in a variety of positions in the YIT construction group. Since 2015, Karislahti has been working in management positions in housing construction, including as regional director.

Business premises

During the review period, Lehto updated its business premises strategy. Business functions have been scaled down significantly: for instance, life-cycle functions will be discontinued. Lehto will carry out school, hotel and office construction on a limited basis in projects where it can harness design and implementation solutions based on Lehto's expertise.

Going forward, Business Premises will build projects for growing market sectors, such as for the needs of industry, storage and logistics. In addition, the service area builds hall-type business buildings and selected multifunctional buildings, for which there is expected to be a growing need in the largest growth centres and dense urban structures. Sports halls are also included in the product range. The Business Premises service area focuses geographically on market areas in the growth triangle (the region between the Helsinki Metropolitan Area, Tampere and Turku) and the Oulu region.

Business development in the review period

The service area's net sales experienced a year-on-year decrease of 8.9% to EUR 103.7 (113.9) million. Net sales decreased as the number of projects declined.

Nine business premises projects were completed and handed over during the review period (9 projects in 1–9/2021). At the end of the period, 11 (19) projects were under construction, most notably a local service centre in Kivistö, Vantaa; a twin tower in Malmi, Helsinki; an office building for Fennovoima in Pyhäjoki and a pulp warehouse at the Port of Kemi. In October, after the end of the review period, Fennovoima's office building was handed over to the client.

The order backlog declined to EUR 72.5 million (EUR 202.0 million on 31 December 2021). The decrease in the order backlog was due to the low number of new project contracts and the termination of contracts or preliminary contracts for six projects worth a total of EUR 125 million. EUR 73 million from these contracts had already been recorded in the order backlog. As a result of the increase in construction costs, their estimated project margin constituted a loss. The termination of low-margin or loss-making project contracts will pave the way for profitable business.

Lehto has been developing the Hippos2020 project with the City of Jyväskylä. Uncertainties related to the project have increased due to the coronavirus crisis and the weakening of the general economic situation, but Lehto and the City of Jyväskylä are still developing the project.

Lehto has implemented operational changes to improve project risk management in the Business Premises service area, and mobilised them in practice under the leadership of the service area's new EVP from the beginning of 2022. The company has also implemented structural and operational changes aimed at reducing its cost level. When evaluating prospective projects, Lehto has also paid particular attention to their suitability with respect to the company's resources and strategy. The effects of these changes are already strongly evident in operational activities, but it will take some time for them to have a visible effect on the financial figures in long-term project business.

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, primarily for its own use. Products are also sold in small quantities outside the Group.

The major share of the factory production comprises kitchen-bathroom modules for concrete-frame apartment buildings, space elements for wooden apartment buildings and large roof elements for large business premises. In addition, Lehto manufactures external wall elements, aluminium doors, windows as well as kitchen and other fixtures at its factories.

Lehto has production facilities in Oulainen, Hartola, Siikajoki and Ii, totalling about 50,000 m². At the end of the review period, 212 people worked in factory operations (253 on 31 December 2021). Lehto's current factory and equipment capacity enables the company to produce larger quantities as industrial manufacture increases during the strategy period.

Balance sheet and financial position

Consolidated balance sheet, EUR million	**30 Sept 2022**	**30 Sept 2021**	**31 Dec 2021**
Non-current assets	44.9	55.4	49.2
Current assets			
Inventories, excluding IFRS 16 assets	121.4	129.9	108.3
Inventories, IFRS 16 assets	79.4	89.2	86.6
Current receivables	69.2	97.7	90.1
Cash and cash equivalents	11.6	52.3	32.8
Total assets	**326.7**	**424.5**	**367.0**
Equity	94.8	111.4	90.9
Financial liabilities	38.7	63.3	45.8
Lease liabilities	84.0	93.4	90.4
Advances received	37.5	87.5	32.4
Other payables	71.6	69.0	107.4
Total equity and liabilities	**326.7**	**424.5**	**367.0**

The balance sheet total fell slightly from the 2021 closing date to EUR 326.7 million. The equity ratio improved during the review period, as equity grew following the divestment of the pipeline renovations business and the issuance of the convertible bond.

The equity ratio (taking lease liabilities into consideration) stood at 32.8% (27.2% on 31 December 2021) and the net gearing ratio was 117.2% (113.8% on 31 December 2021). The equity ratio without the lease liabilities under IFRS 16 stood at 45.9% (37.3%) and the net gearing ratio was 28.6% (14.4%).

Key financing agreements

Revolving credit facility (RCF)

Lehto signed an agreement for a new Revolving Credit Facility (RCF) with OP Corporate Bank plc and Nordea Bank Plc. The RCF amounts to EUR 13 million and is valid until 31 March 2024. The entire credit facility was in use at the end of the review period. The RCF includes securities, financial covenants related to EBITDA and minimum cash requirements, restriction on dividend payouts while the agreement is in force, and conditions related to the company's operations and the constitution and chairman of the Board of Directors.

Convertible bond

On 30 June 2022, Lehto offered the first tranche of its unsecured convertible bonds due June 2027 for subscription by institutional and other qualified investors. The convertible bonds are convertible into new and/or existing shares in Lehto and were issued in an aggregate principal amount of EUR 15 million.

In accordance with its undertaking announced on 29 June 2022, the biggest shareholder of the company, Lehto Invest Oy, subscribed for convertible bonds for an amount of EUR 8.0 million in connection with the convertible bonds' first tranche issue, and an additional subscription of EUR 2.0 million was announced on 29 September 2022.

The transaction aims to improve the financing position of the company and to facilitate the company's bank financing arrangement, and the proceeds from the convertible bonds will be used for general corporate purposes.

The convertible bonds are issued at 100% of their principal amount of EUR 20,000 per bond, and unless previously converted, repurchased or redeemed, will be redeemed at par at maturity with accrued interest. The convertible bonds carry a coupon of 6.00% per annum payable semi-annually in arrear in equal instalments on 30 June and 31 December each year, with the first interest payment date being 31 December 2022. In accordance with the terms and conditions of the convertible bonds, PIK interest of 4.00% per annum will be payable at maturity on the unconverted share.

The initial conversion price is EUR 0.40 per share, which corresponds to the closing price of the company's share on the stock exchange of Nasdaq Helsinki Ltd on 28 June 2022 The conversion price will be subject to adjustments for any dividends in cash or in kind, as well as customary anti-dilution adjustments, pursuant to the terms and conditions of the convertible bonds.

The shares underlying the special rights connected to the convertible bonds represent approximately 37.3% of the total number of Lehto's issued and outstanding shares immediately prior to the offering in maximum, subject to potential adjustments to the conversion price.

Aktia Alexander Corporate Finance Oy is the coordinator and financial advisor of the offering. Bird & Bird Attorneys Ltd is acting as the company's legal adviser.

VAT payment arrangement

In July 2020, Lehto made a payment arrangement with the Tax Administration for VAT liabilities amounting to around EUR 21.0 million. The VAT payment arrangement was made when the Tax Administration offered companies the possibility to prepare for any potential impacts of the coronavirus pandemic by loaning back VAT paid in spring 2020. The repayment period under the payment arrangement is 22 months and the first instalment was paid in September 2020. The interest rate on the payment arrangement is 2.5%. The last instalment was paid on August 2022, at which time the arrangement was concluded.

Personnel and remuneration

The average number of Group personnel during the review period was 915 (1,043 in 2021). The number of personnel at period-end was 736 (1,042 on 31 December 2021). Due to the divestment of the pipeline renovations business, the number of personnel decreased by 121. About half of the Group's personnel are salaried employees and about half work at construction sites.

On 25 March 2022, Lehto carried out a directed share issue related to the implementation of the incentive plan for key personnel. In the share issue, Lehto Group Plc granted 151,842 treasury shares to key employees covered by the incentive plan.

Events after the review period

After the end of the review period, on 4 October 2022, the company launched adjustment measures to achieve total cost savings of approximately EUR 6–7 million for 2023. It is expected that majority of the cost savings will be generated by personnel costs.

As part of these measures, the company launched change negotiations with the aim of achieving savings equivalent to approximately 80 person-work-years. The negotiations do not involve personnel on the company's construction sites.

The change negotiations will not have a significant impact on Lehto's result or financial position in 2022.

Vantaa, 26 October 2022

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