

Question & Answer at IR Meeting on Financial Results for FY2020 Q3

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[Presenters]	Masayuki Hyodo	Representative Director, President and Chief Executive Officer
	Masaru Shiomi	Representative Director, Managing Executive Officer, Chief Financial Officer
	Hiroyuki Sugai	Executive Officer, General Manager, Accounting Controlling Department
	Masahiro Yamane	General Manager, Investor Relations Department

List of Questions (Detailed Question & Answer follows)

<Q1>

- As to the initiatives for the FY2020, the effect of profit improvement is expected to be over JPY30.0 billion in the next two to three years. Please tell us the detail of this JPY30.0 billion.
- Regarding Ambatovy, the production plan had been revised to the one which has a higher probability of achievement. What is used to determine the higher probability of achievement?

<Q2>

- From the second to the third quarters, Metal Products has improved by about JPY4.0 billion and Transportation & Construction Systems by about JPY6.0 billion excluding one-off profits/losses. Please tell us how much automotive-related business has recovered, and whether recoveries in the other sectors are still slow.
- As to “acceleration of the replacement of assets”, among 400 groups of company, your plan is to withdraw from 100 companies based on the judgement that the expected recovery will not be achieved. Why the expected recovery cannot be achieved? And how these failures will be utilized in the future?

<Q3>

- Will all negative factors be booked in this fiscal year? Please let me know if there are concerned business left.
- The forecast of Infrastructure will be JPY3.0 billion in the fourth quarter, and it is decreasing gradually quarter by quarter. Will it be the same profit level in the next fiscal year?

<Q4>

- As to the 100 companies that have been selected for withdrawal, what kind of areas are most for asset replacement? The investment on next-generation energy sector is mentioned. Could you tell me what direction you are thinking in terms of amount of investment in the next medium-term management plan?

- Are you going to replace the assets while making investments on the same scale as the current medium-term management plan? Could you tell me your sense as to what sort of discussions you are having in terms of cash flow allocation and the amount of investment?

<Q5>

- Regarding “creation of new core businesses”, please tell us what kind of strength your Company has when you are promoting the next-generation energy business.
- It seems that the investments amount will not be reached to the level that was planned. Should we assume that free cash flow after dividends may exceed the plan? Also, although the deficit was reduced this time, one-off losses increased. How much have you reduced concerns on the balance sheet, when you plan investment and shareholder return in the next medium-term management plan?

<Q6>

- What kind of incentives should be provided for executive compensation, and how should executive compensation system be to avoid the failure of investment including impairment loss? Please let me know if you have any discussion toward the next medium-term management plan.

Question & Answer

<Q1>

Questioner 1: On page 9 of the presentation, it explains the initiatives for the FY2020. The effect of profit improvement is expected to be over JPY30.0 billion in the next two to three years compared to FY2019. Please tell us the detail of this JPY30.0 billion. For example, how did you estimate the effect of this mid-term, respectively, focusing on large-scale projects? I would like to see the probability of the estimate when analyzing it from the outside.

Shiomi: As for this earnings improvement of over JPY30.0 billion, in the current three-year medium-term management plan, we have been implementing the Full Potential Plan (FPP), which are the measures to improve the profitability of unprofitable businesses. However, changes in the business environment, particularly the COVID-19 pandemic, caused unexpectedly high levels of stress, which led to the large-scale impairment losses seen this fiscal year. In order to cope with this situation, we have been in a crisis-response mode this fiscal year, and as I have explained in the past, we have been working diligently to improve the profitability of unprofitable businesses.

As part of the FPP, we have the All Greens Project (AGP), which is the term we use internally. The FPP is an effort to properly realize the potential of the said project and bring it in line with the initial business plan. The AGP aims to make all the contents of business companies “green”. Since the fall of 2019, we have been working on the project with the intention to withdraw from those that cannot be returned to the original profitability in the short term.

For this purpose, we divided our group companies into about 400 groups of company and analyzed the revenues of each group individually. Of these, we have identified about 100 companies, as the ones we plan to withdraw. We are planning to replace the assets of 40 companies within this fiscal year, and for the remaining companies, we will continue to work diligently on the road to withdrawal while booking provisions within this fiscal year if possible.

Even if we do not go as far as to withdrawal, for those companies where we have certainty that we can bring them back to the level it should be, we have drawn a concrete roadmap and are working to make these earnings healthy within the next two to three years.

I cannot go into the specific business here, but I can say that the improvement effect can be expected to exceed JPY30.0 billion. We are also working diligently to achieve turnarounds for large-scale projects. If we include these factors, we can expect an increase in revenue to exceed JPY50.0 billion.

Questioner 1: The difference between the JPY30.0 billion, which will be accumulated through FPP, and JPY50.0 billion is coming from turnaround of the large projects, including Ambatovy and so on. Is this correct understanding?

Shiomi: Exactly as you understand.

Questioner 1: About the Ambatovy, part of this large projects. When the additional impairment was announced in the timely disclosure near the end of January, I believe that the production plan had been revised to have a higher probability of achievement as a result of a study by an outside organization. What is used to determine the high probability of achievement?

Sugai: For the impairment test, a third party was brought in not only for the production plant but also for the mining operation, so that a precise plan could be created. In the middle of page 7, it says that “adjustment of the business/production plan reflecting past production performance”. In the past, we were able to achieve up to 40,000 tons, and we discussed with the operation team and judged the level we should be able to achieve. In the first quarter, the reason of impairment loss was due to “suspension of operation and the reduction in mid- to long-term price forecast of nickel”. In the third quarter this time, we reviewed the production plan, and we revised our production downward from just under 50,000 tons to just over 40,000 tons, which resulted JPY30.0 billion of impairment loss.

As to resumption of the project, almost all of the expat, including our own dispatched staff, have already returned to the region, and we are taking all possible measures to aim the restart around March.

<Q2>

Questioner 2: It was good that the third quarter results showed a slight recovery in Metal Products and Transportation & Construction Systems. We are seeing a significant recovery in the automotive-related sector in other Japanese trading companies. From the second and third quarters, Metal Products has improved by about JPY4.0 billion and Transportation & Construction Systems by around JPY6.0 billion excluding one-off profits/losses. Can you tell us how much automotive-related business has recovered, and whether recoveries in the other sectors are still slow?

Sugai: You are right that the automotive-related business is recovering. Our worldwide manufacturing operations were pretty much at a standstill for the first quarter. The countries such as India, Mexico, and Indonesia resumed production in late May. The effect of those resumption started to appear in around the second quarter of the current fiscal year, and automobile sales have also seen the recoveries, and we can say that it has been returning to pretty much normal level. Now, more automobiles are produced which caused the shortage of semiconductors, and production is slightly stagnant due to the shortage of materials at the moment, but I think we can say that production has returned to that level.

For example the steel sheets handled at our steel service centers that we supply to the automotive industry, as China begins to recover, the steel service centers in Southeast Asia, especially in Thailand, are returning to a certain level. This is having a considerable positive effect on the Metal Products as well as on Transportation & Construction Systems.

Questioner 2: The JPY4.0 billion in Metal Products that has recovered is mostly automotive-related, and should I understand tubular products and other products have not returned yet?

Sugai: Generally that is correct. As for the Metal Products, the tubular products has not returned much. Steel sheets are back more, and this is not only for automobiles, but also for the home appliances. We handle a lot of these products, and we have seen a recovery in office appliance. Therefore, we expect them to continue to contribute to the business.

Questioner 2: This is about “acceleration of the replacement of assets” in the initiatives for FY2020. Among 400 groups of company, your plan is to withdraw from 100 companies based on the judgement that the expected recovery will not be achieved. Why the expected recovery cannot be achieved?

I wonder whether you do not have a function good enough to recover the Company, or you thought you would be able to do it, but you could not. Or outlook was simply wrong because the outlook for the external environment has changed from the time you entered. I think the 100 companies this time are failures rather than withdrawals, but I would like to know why you have failed, and how these failures will be utilized.

Shiomi: In the future asset management and strategic management, we have created new Strategic Business Units, SBUs, for each business line, separate from 6 segments. In this way, we will achieve ROIC firmly in excess of WACC. In order to achieve it, we will make sure that the precise KPIs and KAI are set, and the Company-wide council will follow up on them. We are going to check thoroughly whether the business or SBU has any impact of the changes in the business model or environment to make sure it doesn't become too late. So, based on our reflections, we are preparing for the situation by firmly implementing a more rigorous PDCA cycle.

Questioner 2: Are all of these 100 companies in the red? Or is it just that they have not returned to normal but have profit contribution? Since you mentioned that profit contribution will be JPY30.0 billion by accelerating asset replacement, does that mean that many companies are in the red?

Shiomi: Not all of them are. In total of all of them, it will be the scale of about negative JPY10.0 billion.

<Q3>

Questioner 3: Will all negative factors be booked in this fiscal year? For example, if you look at the assets of goodwill at the end of FY2019, there were JPY290.0 billion, of which JPY70.0 billion was Fyffes. I think part of them was impaired, but there are still some left. Please let me know if you have other items that you are concerned about.

Shiomi: Given the scale of the impairment this time, we believe that we have been able to address the concerns that have been raised. Therefore, from the next fiscal year onward, we will work to achieve a V-shaped recovery from this bottom and then quickly return to a growth path.

Questioner 3: In the page 18 of the presentation material, which says “Quarterly Trend for Profit for the period attributable to owners of the parent excluding one-off profits/losses by Segment”, the forecast for Infrastructure will be JPY3.0 billion in the fourth quarter, and it is decreasing gradually quarter by quarter. Will it be the same profit level in the next fiscal year?

Sugai: This is due to the fact that the large-scale EPC construction has almost peaked out as we explained in the past. As construction is almost nearing completion, and the revenue has been posted on a percentage-of-completion basis, the profit we record is decreasing and this was reflected in this figure. Of course, this was a situation that we had known about for some time, so our response has been to change our focus from EPC to projects such as offshore wind farms in Europe or IPP. We are gradually seeing the results of these efforts, and is building a certain size of portfolio. We believe that we can get a better figure in the next fiscal year.

<Q4>

Questioner 4: On page 9 of the presentation material, it explains “initiatives for FY2020”. Of the 100 companies that have been selected for withdrawal, 40 companies will be exited this fiscal year and about 60 companies will be left for next year and onward. In what areas are most to be reviewed for asset replacement? How are you trying to change your investment portfolio? Please tell us what you are thinking about portion to reduce. Also, as to initiatives for medium term, the investment on next-generation energy sector is mentioned. Could you tell me what direction you are thinking in terms of the investment in the next medium-term management plan?

Shiomi: 40 companies are the businesses being reviewed in each business unit based on the AGP. There are a lot of small companies in Metal Products, and to some extent, this is reflected in the structural reform expenses. Although the amount is not so large, there are a lot in terms of the number of companies. We are reviewing them widely, so it is not a case of drastically reducing the business of any one particular business unit. This is being reviewed on an individual business plan basis. As for the definition of the medium term, it refers to the period from the next mid-term management plan and beyond. Although the business and economic environment is currently under a lot of stress due to the COVID 19 pandemic, the current situation, in which both the economy and the prevention of the spread of the disease are being promoted globally by the governments of various countries, will probably lead to a modest recovery. When the prevention of infections becomes somewhat predictable, in order to prepare for immediate recover in V-shape with the recovery to growth path, we would like to dramatically increase profitability by managing SBUs and creating new core businesses in the next medium-term management plan. This is our current plan.

Questioner 4: I have concerns about the scale of the investment for future. You are selling assets now, so I think you are getting a certain amount of fund back, but are you going to replace the assets while making investments on the same scale as the current medium-term management plan?

Of course, you would be strictly selective on your investment this time. In terms of increasing the amount of investment, not only your Company, but other trading companies as well, have not been able to make good investments. Could you tell me your sense as to what sort of discussions you are having in terms of cash flow allocation and the amount of investment?

Shiomi: We will explain our approach to cash flow in the next medium-term management plan again, but at this point, we do not intend to make any major changes to the current cash flow discipline, which we will proceed with investment including replacement investment based on the so-called basic profit cash flow earned by business units and the current depreciation. We will use the cash generated by each business unit to fund the expansion, and we are not planning any major changes to this structure at this time. However, we also think we should not expand the portfolio just in a similar manner. In order to go out into new core businesses and new growth areas, we need to put stress on the areas in which the Company should invest as a whole. Therefore, we are currently discussing the possibility of raising the Company-wide portion slightly, within the cash-in generated.

<Q5>

Questioner 5: On page 9, about “the creation of new core businesses”, if you are promoting the next-generation energy business, what kind of strength does your Company have? Are you just going to go where the opportunities are and allocate the management resources? In the current medium-term management plan, I believe you have been working on three fields using the Company-wide fund, so I would like to know how it relates to the review of those businesses. With all these new things such as AGP, FPP and SBUs coming up, whether the efforts may be spread out. Could you tell me about creation of new core business?

Shiomi: I would like to clarify that FPP and AGP, although these are internal terminology, are strategy and tactics for asset replacements as part of structural reform. On the other hand, as for new core businesses, we have identified three fields in the current medium-term management plan in order to invest in growth areas. These are the fields of technology x innovation, social infrastructure, and healthcare. We have been making investments in each of these fields during the period of this medium-term management plan, but this does not mean that we will go to the next ones after three years. Instead, we will continue to grow those fields while capturing the opportunities for investment and growth firmly.

In addition, due to changes in the business and social environment, we understand that next-generation energy, for example, will become an extremely important business area as we aim for sustainable management. Hydrogen is mentioned here, and it is our understanding that businesses and initiatives in this field will become increasingly important as we shift from fossil fuels and reduce carbon emissions.

In order to get into this field, we will leverage our strength of our core business, one of which is the tubular products business we have cultivated through our experience in fossil fuels. Our customers, including the major energy companies, are making great efforts to shift from fossil fuels to new energy sources. We have a strong partnership with these people, and we would like to make use of it to expand our business into new energy fields.

In addition, since we are an integrated trading Company, we have a variety of fields from upstream to midstream to downstream. The scene of energy utilization will also change depending on each business. We have many sales forces, business units, and business divisions that are involved in such business fields in our Company.

We would like to work on this new growth field through individual business units by coordinating cross-unit initiatives. We are still in the process of discussing some of these issues, so I will be able to explain the details in the next medium-term management plan. We, the entire organization would like to take such actions as part of our efforts to recognize growth areas in the creation for new core businesses. We are currently considering this.

Questioner 5: About the cash flow and balance sheet, mainly on page 15 of the material. Are we likely to see the kind of investments that are planned here for this fiscal year? It seems that the investments amount will not be reached to the level that was planned. If that is the case, should we assume that free cash flow and free cash flow after dividends may exceed the current year's plan?

Also, although the deficit was reduced this time as a result, one-off losses including impairment loss came out more than originally planned. How much will you have improved the concerns on the balance sheet, when you plan investment and shareholder return in the next medium-term management plan? Is it a situation where there are still some issues to be resolved?

Shiomi: As to execution of investments and loans, we have some new investments planned for the fourth quarter. I would like to refrain from going into specifics because of various business matters. We are now in February, and we would say it will be slightly less than the initial plan, however, we think that it is unlikely to be less by the scale of JPY100.0 billion, so our cash flow plan will be close to plan. Regarding the free cash flow after paying dividend, we think it may be likely to go little less than JPY200.0 billion in three-year total for current medium-term management plan.

As to the balance sheet burden, we have been looking at the balance between the core risk buffer and risk-adjusted assets, with the aim of keeping risk-adjusted assets within the core risk buffer. Unfortunately, we had to take a large amount of impairment losses this time, and both the asset side and the buffer side have been decreasing. At the end of the FY2019 when the risk buffer exceeded the asset side by about JPY240.0

billion. It is difficult to say exactly what the level will be, but we understand that the situation is that the risk buffer exceeds risk-adjusted assets.

In this context, the issue is the level of capital, and we recognize that the most urgent task for our financial structure is to recover the reduced capital as soon as possible, in other words, to make a solid profit, take in fast growth track, and straighten the balance sheet proportions.

<Q6>

Questioner 6: Please tell us what you think about executive compensation in the future. This time, as institutional investor, I have valued that you reviewed executive compensation considering the deficit results. But in your Company's case, even if the basic profit cash flow and profit for the year are zero or large scale impairment loss occurs, the regular monthly compensation is paid. What kind of incentives should be provided for executive compensation, or how should executive compensation system be to avoid the failure of investment including these impairment loss? Please let me know if you have any discussion toward the next medium-term management plan.

Hyodo: Although we have not made an official decision yet, but the direction we will take is to reduce the fixed portion of each month and greatly increase the portion linked to business performance. The direction we are taking is to change the remuneration system to one that is more performance-based.

Questioner 6: I encourage that you also include an item of shareholder return in the formula for remuneration system.

Hyodo: Thank you very much for your valuable comments.

Shiomi: Thank you all very much for your time. We have now the results up to the third quarter, and, although we only have two more months left, we will do our best to improve on these results as much as possible in the fourth quarter. Thank you all very much for your support as always. I would like to ask for your continuous support. Thank you very much for today.

[END]