Q2 Financial Results Briefing for the Fiscal Year Ending March 2021
Q & A

[Date]	November 2, 2020	
[Speakers]	Tatsuo Yasunaga	Representative Director, President, and CEO
	Takakazu Uchida	Representative Director, Executive Vice President, and CFO
	Tetsuya Shigeta	Managing Officer, General Manager of Global Controller Division
[Moderator]	Masaya Inamuro	General Manager of IR Division

<Q1>

Have you learned useful lessons from the impact of and the response to COVID-19? What was the impact of COVID-19 on the first-half results, and how much of the impact do you expect to have on the revised full-year forecast? Please also tell us what changes there were since the initial forecast.

<Yasunaga>

First, lessons from the impact and response related to COVID-19. The first point: We had been promoting paperless operations considerably since before COVID-19 to simplify the processes or review overlapping tasks within the company. We were also aiming to use this attempt for data-driven management, and our attempt was sharply accelerated through COVID-19, and it has become firmly established within the company. Through this, the balance between remote working and teamwork by coming to the company is optimized according to the way each work is done at each in-house organization.

Furthermore, what I have said worked well particularly at overseas companies, where our main operations are located. When there were effects of lockdowns on key industries or there were worries over damage to the responsibility for a lifeline for customers, our overseas subsidiaries and affiliates firmly contributed to the maintenance of customers' production activities and infrastructures as they efficiently used their trading functions and properly managed logistics. Through this, we were able to generate the firm profits in the trading business, as I explained earlier.

Another point is also related to data-driven management. I think that the productivity of each business and each employee has become more visible. As a matter of course, we have adopted proper measures and allocated resources without hesitation to businesses where the impact of COVID-19 has become serious and prolonged. I believe that we have been able to respond flexibly in this way.

Another point is rather closer to CSR than direct contribution to profits. We have a domestic affiliate called Aim Service, a food service company. Using Aim Service and others, we provide meals to hospitals, medical facilities, nursing homes, schools, and other public service organizations.

In an attempt to energize people involved in health care, the MITSUI Group improved meal menus, and provided a free meal service at certain dates. Or, through the provision of masks and medical supplies, we received words of appreciation indirectly and directly. That was a good example of how we felt that we were contributing to the development of society in our domestic businesses.

On the other hand, I will introduce the numerical impact of COVID-19. At the beginning of the fiscal year, we considered that there will be downward pressure of around JPY200 billion on our total performance plan. A breakdown shows a downside of JPY100 billion in resources, mainly due to market conditions, and a downturn of about JPY100 billion in non-resources due to loss of demand, a revision to the supply chain, and a considerable drop in production plans.

After the half-year period, the market conditions are more favorable as the iron ore price was firm and the oil price did not fall as much as we had anticipated. As a result, the resource field incurred a negative effect of around JPY50 billion, which is better than we had initially expected. Therefore, there was a negative impact of around JPY50 billion in the resource field.

In non-resources, there are still areas in which the impact has become more serious and prolonged. Meanwhile, there have been some signs of recovery in the trading business I have just mentioned, or automobiles and ships in the mobility business. On the other hand, aircraft and railways in the mobility business have been seriously affected.

Integrating such items would result in a downward effect in non-resources worth some JPY90 billion, against the planned JPY100 billion, representing an improvement of around JPY10 billion. In other words, the downward pressure we had anticipated for a total of JPY200 billion resulted in JPY140 billion.

You may say that there should be an improvement of JPY60 billion from the initial plan. As I mentioned in the presentation, however, we need to review the portfolio over minute segmentation of time, and we will not hesitate to reclassify the portfolio accordingly. So, as we are not able to preclude the possibility of one-time profit and loss associated with this work, we left the forecast at the beginning of the year unchanged at JPY180 billion.

<Q2>

You cited the possibility of one-time profit and loss as a reason why you left your forecast of profit after tax unchanged from the initial plan for the full year ending March 2021. Is it better to be aware of the risk of a large-scale impairment in the second half of the fiscal year? Or is there the need to be conscious of a downturn in the full-year plan?

<Yasunaga>

I am afraid that I have answered this question previously. First of all, in terms of our ability to procure funds, in other words, as we revised up our forecast of core operating cash flow by JPY80 billion, we will steadily increase our profitability every year by JPY550 billion, which is the figure we originally expected in the Medium-Term Management Plan. So far in the current fiscal year, it will not be as high as JPY550 billion, but it is recovering to a scale that can be expected to be JPY500 billion. This indicates that we are able to manage the impact of COVID-19 to a certain extent.

While we have this strong cash generating ability, as I mentioned earlier, the impact of COVID-19 is becoming increasingly serious. Moreover, there is consumers' awareness or the industrial world's awareness of ESG, which is regarded as one of political issues, partly due to the impact of COVID-19 for the medium and long term. While there are those issues, we have some areas whose portfolios need to be reorganized at a faster pace.

Specifically, they include the coal-related business and the Exploration and Production, or E&P business. Further, as I mentioned earlier, railways have been significantly affected. In these areas, I think we need to thoroughly review our portfolios and, in some cases, will not hesitate to exit.

As we have strong cash generating capacity, we are confident that we will be able to steadily achieve this JPY180 billion target at the beginning of the fiscal year. However, I wonder how we should look at the upside portion of our cash generating capacity.

After intensive discussions in the follow-up of the Strategy Meeting, we decided that we should firmly solidify the basis for future growth through the recombination of the portfolios. As a result, possible one-time profit and loss was factored into the profit forecast that was left unchanged.

<Q3>

Regarding the timeframe required for reviewing the portfolios, deciding the specific policy for reevaluating the businesses, and deciding the strategy. Do you start considering the timeframe soon while you look at the trends of COVID-19?

<Yasunaga>

As I mentioned earlier, we need to realign the portfolios within our business domains as the Chief Operating Officer of each Business Unit faces his own issues, or as the trend toward ESG accelerates in the future. Through such intensive discussions with each Business Unit, we have already shared a general direction on specific policies.

On the other hand, individual projects involve their business counterparts and partners, so in what ways do we ultimately determine the future directions as a result of reviewing those projects? As I mentioned earlier, we included possible effects of what we can implement during the current fiscal year in our estimated figures. In this sense, rather than looking at the trends, we are not wasting time, but have started to implement what we can do since we have set directions amid this business environment.

<Q4>

Please tell us about your policy for oil price trends while consultants and public organizations show different scenarios about long-term oil prices.

<Yasunaga>

I said that we are also reviewing the E&P business. However, it will take a little time on a long-term oil price assumption. The IEA has already announced its outlook, but we need to refer to figures from various external organizations to change our long-term oil price scenario.

Of course, the trends of the oil majors that are our partners also need to be considered. Moreover, for the medium to long term, we should grasp the transition from oil to gas, renewable energy and hydrogen as we realign the portfolio of hydrocarbon. For the foreseeable future, we believe that gas will replace coal and oil as transitional energy. In addition, we have already shared with on-site employees our policy to firmly promote hydrogen and renewable energy.

<Q5>

In the Lifestyle Segment, the red ink expanded in the second quarter from the first quarter. In particular, fashion and food have been weak points for Mitsui and their weaknesses are becoming even clearer amid the COVID-19 pandemic. No other peer in the trading firm industry incurred loss in the Lifestyle sector as a whole. Don't you have any drastic measure to cope with the loss?

<Yasunaga>

The biggest factor behind this expansion of loss in the Lifestyle Segment during the period was health care, which is our next Strategic Focus.

Unfortunately, in the mainstay IHH healthcare business, we had and have to give top priority to measures to combat COVID-19. This is a matter of course as a provider of health care, and through cooperation with the respective countries and government agencies that responded to COVID-19, we managed to implement our countermeasures against the pandemic.

As a result, the mainstay IHH business has had disruptions in normal health care operations, leading to considerable downward pressure on the figures for the first half. Fortunately, the impact of COVID-19 has been improving in the 12 countries where IHH operates. Although the situation is recovering in the second half, the deterioration in the figures by placing emphasis on the COVID-19 countermeasures in the first half is unlikely to recover easily in the full fiscal year.

Conversely, through this pandemic, the importance of medical institutions, and the problem of how to promote online operations at medical institutions have become clearer. It is necessary to vigorously promote contactless medical practices. Before COVID-19, IHH had used personal data of 6 million people to promote online operations and illness prevention and health problems. In short, COVID-19 revealed the problem of people with chronic diseases. As is the business, the serious risk hits where the problem is found.

We give the name of "nutrition health care" to the state before an illness, nutrition to maintain health, or illness prevention field, and we foresee an increase in the number of related jobs combined with medical treatments that would lead to a value chain. I believe how we can contribute to each of the 6 million patients with IHH will be the starting point for the next business.

Another factor is that we have firmly worked to strengthen the profitability of fashion and food companies by taking selective measures for them, while we are said to be weak in the fields. The biggest point in comparison with our competitors is that we do not have a large domestic earnings base.

Historically seen, why we do not have a domestic earnings base is because we decided to aim at Asia with larger growth potential than in Japan in terms of the B-to-C area when we reclassified our portfolio. We do not intend to change our basic strategy of aggressively focusing on the Asian market. I believe that this is important among our Strategic Focus and that we will continue working on.

On the other hand, we have to concede that we are lagging behind in Japan, where the market is relatively stable. In this environment, the COVID-19 pandemic is likely to trigger the trend from the real world to the virtual or online one. I believe that deregulation under the Suga Administration will give rise to structural reforms in various industries.

In this way, we will firmly develop new businesses in Japan as well. To this end, we have a group of existing businesses that have responded selectively and firmly to a number of issues in our domestic operations, including Aim Service that I mentioned earlier. We intend to explore a next step while using these resources platforms to the fullest extent possible.

<Q6>

Please tell us about core operating cash flow, which was revised upward, and your approach and policy for capital allocation in the future.

<Yasunaga>

As I mentioned earlier, we revised upward our core operating cash flow by JPY80 billion for the full fiscal year, and I believe that we are demonstrating our solid ability to procure funds.

Some differences between the figures for the first half and the second half are due to FVTPL, which was somewhat more weighted to the first half, and tax payment. For the second half, we assumed that costs would increase slightly in line with the economic recovery. In this sense, while we are able to procure cash near JPY500 billion, though there are seasonal factors, we think that the most important issue for this second half is to firmly implement structural reforms.

In this sense, while we place emphasis on portfolio reviews, we would like to reorganize our capital allocation again after the end of the current fiscal year. For the current year, we do not assume cash-out in line with the portfolio reviews, and we are aiming at profit for the year at JPY180 billion. Currently, as I repeatedly said, to implement structural reforms and reallocate our portfolios comes first.

<Q7>

While the share of the Iron Ore Business increases in the profit structure, the coal market has been sluggish due to restraints on coal imports amid the conflict between China and Australia. How are you looking at risk factors behind the decline in the iron ore price?

<Yasunaga>

We are concerned about the political conflict between China and Australia. However, partly due to the limited availability of other sources of iron ore, we believe that Australia's relative advantage will continue as alternative iron ore suppliers will not emerge in the foreseeable future. However, we are not optimistic about the iron ore price in the second half of the current year. I would like to say that we are seeing it somewhat conservatively.

On the other hand, we believe that China will keep securing alternative supply sources as there will be continuing demand for automobiles and infrastructures in the country, just as Japan has worked hard to diversify its energy supply sources. However, there are only a limited number of iron ore mines in the country. Although there are several mines, they have been left untouched due to high development costs. Consequently, even if a competitor with a high marginal cost comes out, our price advantage may not be impaired.

I am saying this from the standpoint of the medium term. On the other hand, for the long term, from the viewpoint of ESG, the steel industry is expected to shift more and more from blast furnaces to electric furnaces, which use scrap as a raw material, and to the direct reduction process. Our basic strategy is to think about the future growth of the Iron Ore business while keeping an eye on the long-term demand for such steel raw materials.

<Q8>

I hear that the Trading Business has been performing well. What do you think about the sustainability of the performance?

<Yasunaga>

As I mentioned earlier, there were such events amid the COVID-19 pandemic that supply sources could not operate stably due to lockdowns or the loading and unloading at ports was stagnated. In conjunction with these, there were fluctuations of supply and demand and commodities, particularly chemicals and petroleum products, remained highly volatile in the first half of the year.

In these circumstances, we used what we call virtual pipelines at trading companies, to connect refineries with chemical complexes or chemical complexes to our customers' tanks by way of our functions. We were highly evaluated by customers and we made profits through the functions.

These events have stabilized in the second half, partly because the world has become accustomed to the situation in response to COVID-19. Thus, specific factors in connection with the volatility are also decreasing. As a result, we do not expect that the strong performance seen in the first half will continue. In the first half, we were able to generate more than a certain amount of earnings by responding to the volatility and the state of emergency. Therefore, we assume that we will return to the earnings structure of our regular trading business in the second half.

On the other hand, we actually incurred loss on trading in LNG in the first half, partly because the impact of hurricanes led to a temporary shutdown of our Cameron plant. There will be no such event in the second half and the price of LNG is rising toward the winter. Therefore, I think that chemicals prices will stabilize, and there will be no negative factor for LNG in the second half of the current fiscal year.

<Q9>

How did the work styles of the President and other members of the management team change following COVID-19? How did you cover the decrease in business trips? In addition, could you please tell us about areas that have become more efficient than ever before?

<Yasunaga>

The number of my business trips in the previous year was 35 times, total of Japan and overseas, about three times a month. This fiscal year, however, I have made only three trips so far for a little more than six months. I have never been in Tokyo for such a long time, but I virtually visited about 66 countries on online business trips and went to main countries many times.

These included regular meetings with leaders at overseas subsidiaries or affiliates, and meetings with customers. I joke with them that we more frequently meet with each other amid COVID-19, including Mozambique, Cameron, Vale in Brazil, Nucor, which are our customers in the US, or European majors. We found that we could do what we need at web conferences to a considerable extent.

We wonder what we were doing on business trips before. On the other hand, Americans, French, and all other people say that they can talk virtually because they have met in real life and known each other personally.

Today's audience is the people we always meet at IR meetings on Financial Results. If you are present at this online meeting as a newcomer, you might have to read between the lines or might doubt what we have said. If this virtual setting continues for a long time, both speakers and participants will be concerned over the situation. However, we have come to understand that web meetings are enough to talk about what we are doing and what we did and determine what we are going to do in a similar manner to that at real meetings.

We will make the most of our experience in considering the number of future business trips, density, and number of people, but on the other hand, it is necessary to respect sympathy by meeting with people. In particular, when we carry out large-scale complex projects, I think it is very important in the end that top leaders have confidence in each other. So I think that going on selective business trips is necessary.

Moreover, it goes against efficiency to increase our in-house processes by staying in Tokyo longer than ever. As I mentioned data-driven management and digital transformation, I feel that there is still wide room that can be considerably simplified. I feel that the impact of COVID-19 has established a foundation for the practical application and social implementation of web conferences and various digital tools at an accelerated pace.

I think it will be possible to increase the productivity of employees and the company as a whole through these efforts.

<Q10>

When you exclude the impact of valuable asset recycling, what is your view of the level of competence in each of resources and non-resources in the current fiscal year?

<Yasunaga>

First, when we formulated the initial plan at the beginning of the year based on the assumption that COVID-19 will not occur, we thought that both will go almost 50/50. Although the non-resource field was said to be weak, we asked our on-site employees to make substantial efforts to improve the operations. In addition, we had cultivated pillars in non-resources, such as machinery, infrastructure and chemicals, so we thought that both could show performance on a 50/50 basis.

The impact of COVID-19 hit more on non-resources because demand disappeared more in the field than in resources, except for the coal business. In terms of costs, the ratio of competence of resources and that of non-resources has come to 2:1 or 6:4. In this sense, we believe that it is a continuing management challenge to firmly take steps to strengthen the non-resource field in the world with COVID-19 or the post–COVID-19 world.

<Q11>

Please tell us your investment stance on renewable energy. Higher valuations in this segment will require significant capital expenditures and business acquisitions. Please tell us about the investment discipline for business expansion in this field.

<Yasunaga>

As you said, amid the COVID-19 pandemic, each government has guided the people's mind particularly toward the environment from among ESG. Combining with pressure from the stock market, renewable energy is becoming a boom. In other words, I feel that something like renewable energy bubbles is occurring.

In reality, I believe that this area does not have much strong power to generate cash and that the premium for future expectations is larger. We are basically telling on-site officials to lower the grade of priority of buying brownfield properties, whose values have once increased, and rather to prioritize pursuing greenfield ones at grass roots level.

For example, an offshore wind power generation project is ongoing in Taiwan. Of course, we need to invest a large amount of human resources in the development at a grassroots level, but I think that it is necessary to launch these products firmly from scratch.

Even amid the COVID-19 crisis, we made an investment to expand hydrogen supply stations in California. Although transportation costs are still high for hydrogen, in environmentally conscious areas like California, mechanism that properly increases total supply of hydrogen is established and stakeholders such as federal and state governments, municipal bodies, vehicle users, manufacturers, pipeline operators, gas suppliers and gas service stations, support the supply system or ecosystem by bearing the burden of costs respectively. We intend to pursue new energy for local production and consumption where this kind of system can be implemented.

<Q12>

What do you think about the acquisition of your company's shares by Berkshire Hathaway?

<Yasunaga>

I think it would be better to hear the opinions of analysts. What I personally say, and this is what I said when Mr. Warren Buffett made this announcement, is that we should firmly accomplish our business plans.

This is of utmost importance, and I felt that officials at Berkshire Hathaway made a thorough analysis of the transformation and growth in our Medium-Term Management Plan. Through this process, we will steadily go ahead in the direction that we are heading for and implement what we are trying to do. This is the most important thing. By doing so firmly, they may purchase more shares depending on circumstances.

Another is synergy, on which we received various tips from them. We have been expanding our collaboration with DaVita, for example, a health care provider of which Berkshire Hathaway is the largest shareholder. In the future, we have to grow DaVita's Asian operations firmly in connection with IHH. We believe that this will also help to strengthen the synergy and relationship between Berkshire and Mitsui.

<Q13>

With the profitability in the non-resource field declining significantly, particularly in the Lifestyle Business, partly due to the impact of COVID-19, when will the outcome of the strengthening of management ability become visible from outside, excluding an improvement in the external environment in the future?

<Yasunaga>

At present, there are many group companies in which the enhancement of business management ability is working as their strengths. For example, Mitsui Sugar, which is an affiliate, has played a leading role in the industry reorganization. In this context, the company has shown a direction to firmly grow the overseas and non-sugar businesses as a way the new merged company should moving forward. Of course, the new merged company needs to achieve firm growth in the future, but, above all, I believe that it is an example of the strengthening of management ability that our group company is leading an industrial reorganization in Japan.

Not surprisingly, as I mentioned, as Japan transforms itself through digitalization and deregulation, I would like to use this kind of example as an opportunity to demonstrate and expand our presence. Moreover, as I mentioned data-driven management, we have been streamlining the actual management conditions at each group company, such as abolishing the monthly reports and wasteful internal reports, so that we grasp their management on a real-time basis.

Of course, it is important that each individual company achieves solid performance, but it is also important that each company's management conditions become visible so that the Chief Operating Officer of each Business Unit, who is the portfolio manager in each domain, can launch measures for management improvement as necessary and, in some cases, take next steps to further invigorate the industry in question. We are thoroughly promoting the visualization along with the strengthening of management ability of each company leader.

We believe that doing these things firmly amid the COVID-19 pandemic will help us to operate those business companies with strong presence when demand recovers after the pandemic.

<Q14>

You told us about your cash flow allocation philosophy, but I would like to ask you again. The previous Medium-Term Management Plan adopted the concept of linking basic operating cash flow to shareholder returns to a certain extent, and I understand that this approach has been somewhat inherited. My question is: Can I expect that the upward revision of core operating cash flow is likely to lead to stronger shareholder returns?

<**Yasunaga>**

Basically, we consider that core operating cash flow is our most important management KPI, and we have not changed our approach of linking it with shareholder returns.

On the other hand, while looking at the impact of COVID-19, we will implement the structural reforms we have mentioned earlier under the situation of co-existence with COVID-19. While looking at how these results will be reflected as figures in the second half of the fiscal year, we intend to have an opportunity to review shareholder returns for the full fiscal year again.

On the other hand, while we focus on cash flow, we worry that the moves of cash flow have not been in line with stock prices. We would like to ask for advice from you analysts. Thank you very much.

[END]