FY March 2024 Q1 Financial Results Announcement

Q&A Session

[Date]	August 1, 2023 (Tuesday) 16:30-17:30	
[Speakers]	Tetsuya Shigeta	Representative Director, Senior Executive Managing Officer, CFO
	Masao Kurihara	Managing Officer, General Manager of Global Controller Division
[Moderator]	Hideaki Konishi	General Manager of Investor Relations Division

<Q1>

Regarding the evaluation of the Q1 results, you explained that all segments are making steady progress, but given there were several one-time factors, I feel it is difficult to know how to evaluate the actual status and progress of each segment. From the outside, the Machinery & Infrastructure segment appears to have been particularly strong, while the Chemicals segment appears to have been weak in the Nutrition and Agriculture Business Unit with the methionine business being the primary cause. There seems to be a gap between your take on the quarter and how the results look from the outside. Please give us your take on the progress of each segment against the plan you set out at the beginning of the period. Also, if it is possible, please explain how this is linked to the forecasted 170 billion yen increase in base profit you aim to achieve by the end of the Medium-term Management Plan.

<Shigeta>

I will explain the results not only against the plan, but also against the trend following the previous fiscal year. First of all, the plan at the beginning of the period was based on the assumption that the pent-up demand after COVID-19 in the previous period would revert, and that volume and prices in trading and other businesses would also revert, and we also factored in trends we saw take place from Q3 to Q4 in the previous fiscal year. In Machinery & Infrastructure, especially in mobility and within that automotive, this was very strong, and although there was a slight decrease in profit, there is a sense that we are maintaining the good performance of Q3 and Q4. On the other hand, in Chemicals, in Nutrition & Agriculture and within that a reversion of fertilizer raw material prices led to drop in trading. The situation in each segment varies, but for example, even in segments and business units that got off to a relatively slow start in Q1, we will work on cost reduction and price pass-through to make up for it throughout the fiscal year. This is quite specific, but the fertilizer raw materials business is also seasonal. Although segments that had extremely good performance in the previous fiscal year may see a decrease this fiscal year, at the same time I also feel that we have achieved a significant level change in across each segment in terms of both results and base profit compared to pre-COVID-19 levels. Although we are only three months in since the start of the fiscal year, I have expectations that we will be able to achieve performance that exceeds the business plan we laid out at the beginning of the year.

Regarding your question on how the performance links to 170 billion yen increase in base profit over the three years of the Medium-term Management Plan, while some of the profit in Q1 will have contributed to this, I don't have any specifics I can refer to right now. We will explain this as profits accumulate in the future.

Regarding additional shareholder returns, I explained at the beginning of the fiscal year that we introduced a progressive dividend based on our expectation that we will increase base profits and the base part of our Core Operating Cash Flow. We would certainly like to achieve such increases and will also consider making share repurchases when we benefit from upside from a rise in commodity prices or through asset recycling, etc., which is in line with our position in the past regarding shareholder returns.

<Q2>

At the financials results session for media earlier today, you commented that you would consider revising your earnings forecast or consider additional shareholder returns from the Q2 onward and based on this positive tone I get the impression you don't see major risks in the operating environment. The price movement in equities suggests the market doesn't have concerns about a recession, but please tell me whether you have seen any signs of change, including, for example, things you have seen in the Q1 results or from feedback from the front lines.

<Shigeta>

Regarding risk factors, I believe that various risks and integrated risks are increasing in light of geopolitical and environmental issues, etc. However, concerns that the US will enter a serious recession this fiscal year are fading, and in Japan, dialogue with the market on monetary policy seems to be going well, so I don't think that we will face what you may call a crisis. On the other hand, with the prolonged economic slump in China, we must be vigilant in dealing with risks such as expectations of recovery not being met, as well as the prolonged economic stagnation in Europe.

In the Global South, where we have a strong earnings base, while we are determined to secure earnings and to make new growth investments, we are not unaware of risk factors, and in fact, we are concerned about integrated risks, but we will work to ensure that they will not lead to a downward swing in our performance.

As for feedback from the front lines, it is normal practice for us to take measures, including those to deal with matters such as new projects that have not got off to the best start or have not progressed as expected. In fact, factors of concern are reported in a highly transparent manner, and appropriate efforts are repeatedly made to avoid such losses, and the reality is that there are no small number of issues of concern. However, we are not currently aware of any situations that would require a huge impairment of assets.

<Q3>

In the business plan for this fiscal year, you expect a large decrease in profit due to energy cost and volume factors, but the decrease in profit in the Q1 results was limited. Do you expect the decrease in profit from cost and volume factors that you forecasted at the beginning of the term to appear in the Q2 and beyond? If so, is it your assessment that the Q1 results were not so good since the progress rate against the business plan is only over 20%? Or, considering the timing of dividend income, would you say that progress was in line with the plan?

<Shigeta>

Currently, we expect that the effects of an increase in costs and a decrease in volume that we forecasted for at the beginning of the fiscal year, that they will emerge from Q2 and beyond. On the other hand, based on this outlook, we are proceeding with measures regarding cost and volume in each project. For example, in the NWS LNG project, where in the business plan we had expected a decrease in volume, we have raised production volume compared to the plan and are taking other measures to contain any reduction in profit as much as possible.

In terms of progress against the plan, we believe that we are well on track to achieve what we set out, taking into account the timing of dividends and seasonal factors such as increased demand for LNG during the winter season.

<Q4>

I believe iron ore prices are showing resilience. What is your outlook for the prices here?

<Konishi>

I think iron ore prices are showing resilience. In terms of supply and demand trends, crude steel production in China, for example, is not that bad. In addition, the projects we are participating in are on the left hand side of the cost curve, so we can secure solid margins at current prices. In our business plan, we had forecasted that iron ore prices would show resilience, as would margins in the iron ore business. This outlook remains unchanged at the present time.

<Q5>

I have the impression that trading is a bit weaker in the Chemicals segment in general. In your explanation, you mentioned that prices for grains as well as chemicals have declined. Please tell us whether overall trading profits are beginning to be weaker than you had expected for the full year and what your forecast is for Q2 and beyond for each of the areas of chemicals, energy, iron and steel products, and grains.

<Shigeta>

Within the Chemicals segment, we are currently seeing an overall weakness in each of the three business units, whereas in the previous fiscal year there was a tailwind due to pent-up demand. Rather than it getting worse, we expect to see margins gain and improve in the future. As for the external environment, we frankly see that the difficult situation will continue for some time.

We hope to capture profits from the economic recovery in China and the Southeast Asian region once the volume of goods and sales prices reverse. In anticipation of this, we are working with our partners and customers to reduce costs and secure margins, so we are not concerned that we will be making losses here.

In Energy, the base will be firm as we will steadily fulfill long-term contracts, which account for a large portion of our business, and beyond that, if opportunities for spot sales on a volume basis increase due to strong production and other factors, we will aim for further upside by demonstrating our trading function.

As for LNG trading, we believe that a decrease in profit is inevitable given the large profit contribution of Cameron LNG in the previous fiscal year, due to strong production. On the other hand, we are considering efforts to secure a certain level of profit across the year by demonstrating our functions.

Iron & Steel Products have been strong for the previous two fiscal years, and we are specialized in trilateral trade in addition to trade originating from and destined for Japan. In addition to profits from several investment businesses, we will pursue profitable opportunities by monitoring supply and demand, and we hope to achieve our plan by trading as well.

Grain business, which includes United Grain and other based businesses, is affected by grain prices, which is an international market commodity. Higher volatility creates more profitable opportunities, so we will be conscious of this. While anticipating a difficult environment, we will aim to earn a solid profit from trading. In terms of food, the market is expected to continue to fluctuate due to climate change in some parts, while firmly contributing to the maintenance of the supply chain, we would like to target upside in response to market trends.

<Q6>

A peer company announced a 300 billion yen share repurchase in their financial results for the fiscal year ending March, 2023, 200 billion yen of which was not based on shareholder returns as a percentage of profit, but attributed to an improvement to their balance sheet. Your company has similarities in terms of financial position, etc., and so I think that a decline in ROE is inevitable if you only use a ratio of shareholder returns to Core Operating Cash Flow, which you have set at around 37%, and don't take into account equity size into the calculation. In this context, please tell us again your approach to shareholder returns, including how you plan to maintain ROE.

<Shigeta>

Our company began share repurchases from 2014 and has continuously increased the volume. This is in line with our policy of being conscious of capital efficiency as well as our emphasis on shareholder returns.

As you pointed out, in order to keep ROE at a high level, it is necessary to consider how much equity we should hold and how to increase the R (profit) portion, and also how much leverage to apply to this. Net DER remains at its lowest level, at 0.49x for this fiscal year, but as management, we are now in a position to pursue a balance among these three factors: the enhancement of base profit through growth investments, the level of equity with a focus on capital efficiency, and leverage by looking at the whole balance sheet, and we are still looking at a further increase in profit.

Therefore, we are discussing this at the management level as well, thinking that we can bring each of them to a better direction while keeping a close eye on the balance among them. I understand your point well. We will continue to place importance on responding to such opinions so that the market will look at us in a more favorable light.

<Q7>

I think that approximately 1 trillion yen of Management Allocation remained at the end of the previous Medium-term Management Plan and is being passed on to the current Medium-term Management Plan.

At that time, there were concerns over financial instability in the US in March, and financial stability was required on your part, but I think there is a growing view that this has eased somewhat. I think we are now in a situation where you can be a little firmer than you were back then in terms of your thinking about what the net DER should be. The net DER fell to 0.49x at the end of June 2023, but what level is being discussed internally as an appropriate one?

<Shigeta>

So far, no conclusion, policy, or consensus has been reached as to exactly what multiple is the appropriate level. Since we consider a variety of projects for growth investment, we don’t decide on a specific size of the balance sheet itself. We would like to think about leverage and appropriate equity levels through the current Medium-term Management Plan. I think we will probably settle on a ratio-based standard, but we would like to consider this as part of our efforts to raise the level of capital efficiency.

<Q8>

Please explain the background of the Mainstream impairment announced this time. Also, please confirm that the postponement of the sale of the Paiton power plant will not affect the full-year plan.

<Shigeta>

In Q1, Mainstream recorded an impairment loss on its renewable energy business in Chile. Although the Chilean business has faced difficulties, which led to this impairment, there is no change in our policy of having Mainstream, which has a global development pipeline, as a platform for the renewable energy business and expanding it by working on new development projects. The details of the impairment will be explained later by the GM of the Global Controller Division.

As for Paiton, we disclosed the postponement of sales completion, while we are just waiting for the contract parties to sign the agreement, so we need to wait a little longer.

<Kurihara>

In Mainstream's Chilean assets, under the country's power offtake system, the difference in the spot prices between power plants and the demand area is to be borne by the power generation companies. This price difference has been widening as spot electricity prices in demand areas have increased significantly, mainly due to the soaring cost of fuel since the Ukraine crisis.

Furthermore, fuel costs for thermal power generation for the purpose of grid stabilization are also borne by all power generation companies, and the situation is such that pure play renewable energy companies, including Mainstream, are bearing these losses. In light of these ongoing business uncertainties, Mainstream recorded an impairment loss on fixed assets, and we have incorporated this impairment loss to our earnings from equity method investments.

<Q9>

On page 7 of the presentation material, in the growth investments pipeline, there are various interesting projects lined up, especially under Global Energy Transition. Please tell us the timeline for commercialization of these projects.

<Shigeta>

For better understanding of the progress of growth investments laid out in the MTMP, we have inserted a new slide in the presentation material and listed those projects that are at the basic agreement level, in addition to those that investment decisions have already been made. Since we have already reached a basic agreement or concluded a joint development agreement, we would like to execute on projects in next-generation fuel, low-carbon metallics and iron making, battery minerals and materials, and CCS, sometime during this MTMP.

<Q10>

Regarding investments, particularly in terms of the 1.13 trillion yen of Management Allocation, you commented that the risk of US economy entering a serious recession is decreasing. Please explain whether the investment pipelines are increasing, and whether the company's mindset toward investments has changed, compared to the beginning of the fiscal year.

<Shigeta>

Investment opportunities have accumulated more than double the amount of the Management Allocation. We are now discussing the priorities, including competition among segments, and factors such as strategic significance, scarcity, and immediate profit impact, as well as whether the project is in a familiar area of business for us. In other words, whether we have our own expertise via existing businesses, or whether we have a strong relationship with a partner.

Our business model is to bolt on existing businesses as core businesses, expand into adjacent businesses, form them into business clusters, and then to grow, and extend those businesses. Since prices may fluctuate depending on economic trends, we carefully consider the timing of our investment decisions, but we have been accumulating investments over time, and there has been no change in our willingness to invest and the depth of our pipeline from the beginning of the fiscal year to the present.

<Q11>

Please explain, to the extent you are able to disclose, the impact of the steam release in the geothermal resources survey project in Rankoshi Town, Hokkaido, on your financial results.

<Shigeta>

We sincerely apologize for the inconvenience and concern this incident has caused to local residents, the local government, and other concerned parties.

We are taking the situation very seriously and are providing appropriate support to the operator Mitsui Oil Exploration Co. At the moment, our top priority is to control the steam release.

We have factored in costs that can be estimated at this time, such as pipeline installation costs for the transfer of treated water generated at the steam release site, engineering costs related to steam release control, and crisis management consulting costs. If there is any major impact on our financial results, we will announce it promptly.

<Q12>

The actual cash outflow for sustaining CAPEX and growth investments in Q1 was 235 billion yen. What is your expectation for the full year? Also, please introduce any projects that are expected to contribute to earnings in the current and next fiscal year.

<Shigeta ＞

Our policy of balancing cash inflows and outflows within the framework of our cash flow allocation remains unchanged. At the announcement of financial results ended March 2023, we explained that there are some projects in the pipeline that are likely to be executed in the fiscal year ending March 2024. Ultimately within the three-year period of this MTMP, we intend to achieve cash inflows and outflows of the amount indicated in the cash flow allocation.

In addition, we would like to make efforts to clearly indicate the timing of the start of contribution to earnings through quarterly disclosures and other means. For example, the new collaboration with Celanese is an existing business, so we can expect immediate contribution.

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