Q3 Financial Results Briefing for the Fiscal Year Ending March 2022

Q & A

[Date]	February 3, 2022(Thu.)	16:30～17:30
[Speakers]	Takakazu Uchida	Representative Director, Executive Vice President, CFO
	Tetsuya Shigeta	Managing Officer, GM of Global Controller Division
[Moderator]	Masaya Inamuro	GM, IR Division

<Q1>

Please tell us whether the annual dividend of 105 yen per share (+10 yen compared to the previous forecast) and the annual dividend of 120 yen per share for the next fiscal year announced this time can be regarded as minimum dividend, considering the fiscal year after the next, and whether it was judged that the core cash generation ability has improved based on the current performance and the future. Please tell us the basis of your confidence in your ability to generate core cash.

<Uchida>
The year-end dividend for this fiscal year is expected to be 60 yen. This is of course subject to be resoluted at the general shareholders' meeting after finalizing our annual financial statements, but you can take it as the minimum dividend. Also, taking into account the stability of the dividend, we will formulate our business plan with the determination to start the next fiscal year with an interim dividend of 60 yen, which will result in an annual dividend of 120 yen and you can recognize that it is practically a minimum dividend for the next fiscal year. As the next fiscal year will be the final year of the Medium-term Management Plan, we will review the capital allocation and shareholders return policy in the next Medium-term Management Plan. That is why we have not used the word "minimum" here. However, it is safe to say that we have committed ourselves to the market for 105 yen for this fiscal year and 120 yen for the next fiscal year, unless there is an extreme event.

A rationale for this is that the figures for Mineral & Metal Resources and Energy are quite strong. In particular, LNG dividends and the rise in oil prices in the E&P business have certain impacts. Additionally, Cameron project, which has been in operation since 2019, has reached full production and has positioned itself to make contribution. By utilizing the LNG cargoes coming out from this project as well as other own LNG equities, we have demonstrated our trading function and this has also contributed to a considerable amount of profits. Although this is partly due to a sharp rise in the market price of gas, it has become possible to make a stable contribution to profits in the future.

Other than Mineral & Metal Resources and Energy, each of the Machinery & Infrastructure, Chemicals, Lifestyle, Innovation & Corporate Development, and Iron & Steel Products segments proved strong and in aggregate have achieved more than 300 billion yen in Core Operating Cash Flow and in profit for the period as well. Of course, there is a tailwind from the current business environment, but there were also our efforts to strengthen existing businesses to contribute to the improvement of earnings. We are convinced that each of these segments, to a certain extent, will remain steady for mid- to long-term, thus we have made this decision to increase the dividend.

<Q2>

When considering sustainability for the next fiscal year, please tell us your thoughts on concerns other than uncontrollable factors such as fluctuations in resource prices, by referring to the business environment. In addition, your Russia's country risk exposure is relatively large, and I think you are conducting various simulations such as economic sanctions that may be imposed in the future. Please explain the concerns including the situation in Russia in the next fiscal year. For example, there may be a risk of not able to receive LNG dividends.

<Uchida>

I would like to talk about the trends of resources prices and the economic outlook. I think there is some debate in the market as to whether the current inflationary economic situation is temporary or will continue for some time. Although there are very high level of uncertainty about the future outlook and various factors such as the expansion of the Omicron variant, the environment in our main business domains continues to be steady. In some areas, we see some slow downs, but I think the strong environment will continue for a while within such ups and downs. Of course, there is a risk factor that the balance between the US monetary policy and the stock market will collapse and cause an adjustment, though the main scenario is that this situation will continue to the end of 2022. For example, in the IMF's recent review of GDP, the global economy is expected to gradually slow down from this year to next, but the absolute level is higher than the average level of the past few years, and the global economy is on a recovery track. The inflationary trend is also complicated by a number of factors other than the effects of COVID-19, such as labor shortages and tightness. In light of this, I do not have the impression that it will return to the pre-COVID-19 situation easily, even if the pandemic settles down. As for the geopolitical risks in Russia and Ukraine, we have been conducting business in various parts of the world, and geopolitical risks are something that we are very familiar with, and are watching the impact of the related sanctions on each of our businesses in detail. We are taking measures for required actions from the phase of building up a project, and we also promote projects with the cooperation of the related authorities, thus we are aware that we need to be very careful and pay close attention to various aspects.

<Q3>

Q3 results for Machinery & Infrastructure, Chemicals, and Lifestyle were strong compared to those of Q2. Please explain the characteristics of what improved in the second half of the fiscal year.

<Uchida>

Since Q3 results include some one-time factors such as the sale and valuation gain of PHC, I think that profit level of Q3 has remained more or less flat from Q2. Iron & Steel Products business in U.S., Chemicals, and Mobility are generally steady, and in Lifestyle segment, IHH is showing remarkable growth and recovery. Therefore, I would not say that our profitability will accelerate further, but it has unexpectedly maintained the same level in Q3, while I had an impression that the market would gradually settle down from Q2.

<Q4>

Regarding the base earnings for next fiscal year, can we assume 200 billion yen per quarter considering the current level of profit?

<Uchida>

If we can achieve 200 billion yen per quarter, it would be 800 billion yen for the full year, which is the same level as this fiscal year. We will look into this closely in our business planning process. While margins are expanding due to higher commodity prices and tighter supply and demand in our trading businesses, it depends on the economic trends, but our profits could decrease when the market normalizes. However, we do not think that we will return to the pre-Covid 19 level immediately, at least during the next fiscal year.

<Q5>

I have the impression that the earning power in non-resources businesses is accelerating under Covid-19 pandemic. Please share your internal analysis on this.

<Uchida>

Even before Covid-19 since the previous Medium-term Management Plan, all employees have been working intensively on improving the profitability of our existing businesses and optimizing our business portfolio, as well as new investments. In the first year of Covid-19, we had some difficulties in each business area, but we also implemented a very severe restructuring and portfolio transformation. Since the second half of last fiscal year, our financial results have been a little stronger because we were able to capture global pent-up demand in certain business areas. We will continue to closely monitor the strength and sustainability of the pent-up demand, along with the fiscal and economic stimulus measures of each country.

<Q6>

I understand that the reason why the dividend level was raised for fiscal year ending March 2023 is because the non-resource segments has structurally become profitable, but I also think that it is not be easy without some improvement in the forecast of resource segments. Assuming that you originally expected the price of iron ore to fall below USD100 in the next fiscal year, please explain whether there is any change in the outlook.

Uchida

First of all, we do not disclose the specific level of the price forecast for iron ore. As for the medium- to long-term outlook, in terms of supply and demand, the levels of steel production in China are currently declining to some extent, while on the supply side, Vale production is recovering, thus our forecast is that supply and demand balance will remain weak. Although the recent trend seems to be slightly different, there is no change in the outlook for loosening of the supply and demand balance in the medium- to long- term. In terms of crude oil, our medium-term outlook ranges from USD70 to USD90 which do not largely deviate from previous forecast.

As for shareholders return, we have continued to buy back our own shares and the total number of common stock issued will be approximately 1.6 billion excluding treasury stock, when the current buyback program is completed. We have been working on our Medium-term Management Plan with an awareness of the per-share indices, and when we set the dividend at JPY120, the total dividend amount will be approximately JPY200 billion. On the other hand, Core Operating Cash Flow is expected to be JPY1.09 trillion for the current period, and in light of this, and taking the trends of commodity prices into consideration, we believe that we have sufficient capacity to provide stable and sustainable returns to our shareholders at the dividend level of JPY120. For your information, the current status of capital allocation is shown on page 8 of the presentation material, although it is not an elaborate accumulation since it is Q3. At present, in addition to the existing investment of about JPY1.5 trillion, we are expecting to allocate approximately JPY300 billion over the current three years to growth investment, although some decisions have not yet been made. By including the dividend of JPY120 for the next fiscal year, the additional allocation for returns will be about JPY340 billion.

That is to say we are allocating approximately JPY640 billion as management allocation, which is getting closer to the level we explained at the announcement of Medium-term Management Plan. On the other hand, Core Operating Cash Flow is based on JPY2 trillion for three years, so naturally there is an upside here, as it would be about JPY1.7 trillion in the first two years. Lastly, asset recycling is approximately JPY650 billion, which is at the minimum level of the range. As recycling of Paiton power generation business has not been counted in this figure, there is a reasonable amount of surplus in this cash flow allocation. As a result, we believe that we have sufficient financial capacity to promote projects-pipeline growth investment, especially in Strategic Focus, and sufficient downward resistance, sustainability and flexibility in shareholder returns.

<Q7>

Please tell us about your earnings of the non-resources segments. I believe that your business performance has been improving from Q2 to Q3. These businesses are not as simple as the resource business where profits increase as the price of commodities rise, while resources prices become the purchase price of raw materials in some non-resources businesses. For example, in the Chemicals business, you may be able to pass the rise of crude oil prices on to product prices up to a certain level, however when the price reaches certain point, it becomes difficult to pass the price on. The level of oil prices has now risen to such point where you may need to be conscious about that. Do you see any signs of changes, or what is your outlook for the next fiscal year?

<Uchida>

We have not seen any such signs from Q2 to Q3. As you pointed out, there are some theories about the sustainability of commodity prices, but if we think about how long the current price level can be maintained, you may be right in a way. Although each segment is performing well, there are business domains where the recovery trend has been delayed due to the soaring cost of raw materials, such as in the food retail. In terms of material related businesses, there have been some adjustments, for example, in chemicals and steel products, but I do not have the impression that this is a trend that will peak out at once and then return to normal.

<Q8>

You mentioned that your company's function as a trading company have been used amid the disruption in the supply chain and boosted earnings. I understand that the trading function will continue to be maintained and will not have a negative impact, but to what extent do you expect trading revenues to increase this fiscal year?

<Uchida>

In Iron & Steel Products, in addition to logistics trading, we are also involved in the North American business and Gestamp, which were under downward pressure on earnings last fiscal year, and are in the process of improving. In Chemicals, in addition to trading, earnings from methanol, chlor-alkali, salt and other businesses are also a component of profit increase. In the case of Iron & Steel Products and Chemicals, I have the impression that trading business and operating companies each account for about half of the profit increase. In the case of Food, I have the impression that trading of grains and other products accounts for about half of the increase of profits. Trading is benefiting from a considerable tailwind in an inflationary market environment, so I hope you will bear in mind that whether this level is sustainable in the future will depend on the business environment and margins. However, in general, we are now in a position to take advantage of such an environment, and we believe that we have been able to demonstrate the results of our efforts to improve our trading functions.

<Q9>

We were able to confirm last autumn that the sale of Paiton approved at the buyer’s extraordinary shareholders' meeting. However, I do not think the gain on the sale was included in the revised yearly forecasts. This transaction will have a major impact on the cash allocation, GHG emissions, and periodic profit and loss. Could you explain about the current situation of this transaction?

<Uchida>

As you pointed out, the buyer’s shareholder approval at their shareholders' meeting was obtained. However, we are still in the process of fullfilling conditions precedent, such as obtaining approvals from the parties involved under the various contracts. Based on the current situation, we expect that the transaction would probably be closed in the early part of next fiscal year. Therefore, we continue to exclude the gain on the sale of Paiton from revised yearly forecasts. We will consider how to handle this when we formulate our business plan for next fiscal year and update our cash flow allocation.

<Q10>:

With regard to the cash flow allocation, please tell us whether there is room for further increase in the allocation as cash inflows are expected to rise in the next fiscal year. Also, how much do you expect to allocate to the Strategic Focus area?

<**Uchida**>

As I explained at the ESG Day held in December last year, we are making various efforts in the field of energy solutions. In addition, in the area of healthcare and nutrition, which is another Strategic Focus, I believe that the pieces are definitely starting to fall into place. From Q4, we have seen an increase in the number of projects, including those that will actually lead to cash outflows. Even in the feasibility study stage, I think we have clarified the areas we need to attack. I believe that we are in a position to pursue opportunities in a variety of fields in the future. We hope to provide an update on specific projects when we release our financial results in the end of the fiscal year.

<Q11>

The Australian coal business in the Mineral & Metal Resources segment generated JPY22.5 billion in only three months of Q3. Is this simply a matter of profit coming out due to price reason, or is there any other special factor? What would be the direction toward Q4 this fiscal year and next fiscal year considering the current coal price?

<Uchida>

The result of 3Q is a reflection of the fact that coking coal prices have remained high.

<Inamuro>

There is no particular issue in terms of operation.

<Uchida>

We think that the current price of coking coal is not at its sustainable level. Our intention is to formulate our business plan for next fiscal year while monitoring the market trend in Q4 for when we set the price assumption to be more conservative than the current level.

[END]