
Kao Group First Three Months of Fiscal 2018 Conference Call Q&A Session Summary

Date: Friday, April 27, 2018

Respondents:

Kenichi Yamauchi, Executive Officer, Senior Vice President, Accounting & Finance

Hideo Makino, Vice President, Financial Controllers

Mitsuhiro Watanabe, Vice President, Investor Relations

1) Sales of the Cosmetics Business in Japan decreased 1.7%. What were the conditions in each of the price segments?

Excluding the *Curél* brand, which has been included in the Cosmetics Business from fiscal 2018, the 1.7% decrease in sales would have been a decrease of about 4%. Excluding the impact from the difference in timing of recording provisions for returns compared with the same period a year earlier, sales of Kanebo Cosmetics and Sofina both decreased by low single digits.

The markets for the high-price and low-price segments grew, while the mid-price segment market shrank compared with the same period a year earlier. The mid-price segment accounts for a large portion of the Kao Group's Cosmetics Business in Japan. In the high-price segment, *RMK*, *SUQQU* and *est the lotion* performed well, posting mid-single-digit growth.

In Japan, packaging for some cosmetics products contains the manufacturer's suggested retail price (PP) and some does not (NPP). Among low-price self-selection cosmetics, sales of *KATE* makeup decreased slightly compared with the same period a year earlier because we are in the process of replacing PP products with NPP products, but we expect a recovery later this year. With the inclusion of new and improved products to be launched in the second quarter and thereafter, we intend to achieve our announced forecast for fiscal 2018.

Is the growth in the high-price segment due to demand from Japanese consumers, or inbound demand from visitors to Japan from China and other countries?

Demand from Japanese consumers is growing in the high-price segment, but inbound demand accounts for a large proportion of *SUQQU* and *RMK* sales, with more than half of *SUQQU* sales in Japan coming from purchases by visitors to Japan. The Kao Group's sales in the high-price segment, which is particularly subject to inbound demand in Japan, are still small, so we need to cultivate this segment. We expect to explain our strategy at a later date.

Since operating income from *Curél* increased by approximately 1 billion yen, how much were sales? If the operating margin was 20% or higher, doesn't that mean that sales were weak?

Sales of *Curél* are growing not only in Japan, but outside Japan as well. When we announced our results for fiscal 2017, we said that annual sales of *Curél* were a little more than 25 billion yen, with an operating margin of 20% or higher, and growth in sales of about 20%. Sales also grew substantially in the first quarter of fiscal 2018.

2) How have sales of baby diapers grown in Japan, through cross-border e-commerce, in China and in Indonesia? Has the increase in retail prices of *Merries* in Japan had an impact on sales?

There has been a minor negative impact on retail sales in Japan due to our prices being

Kao Group First Three Months of Fiscal 2018 Conference Call Q&A Session Summary

higher than our competitors, but cross-border e-commerce grew and total sales were basically on par with the same period a year earlier. Exports to Russia were affected by inventory adjustments but are expected to recover in the second quarter and thereafter.

Sales in China were slightly weak due to inventory adjustments by some e-commerce retailers, but we are aiming for recovery in the second quarter and thereafter, with double-digit growth for the year.

Sales in Indonesia grew more than 30%, the same as they did last year. However, because the price range is for the mass segment, the contribution to operating income was small.

By what percentage did sales decrease in China?

In China, sales decreased by double digits due to the impact of initial shipments associated with reforms of the sales structure there in the same period a year earlier, among other factors.

3) I think the substantial decline in inbound sales of *suisai* and other products was a factor in the weak sales of cosmetics in Japan last year. Will *SUQQU* and *RMK* increase inbound sales in the future? What is the scale of inbound sales?

The Kao Group's inbound sales in fiscal 2017 were estimated to be a little more than 18 billion yen, with cosmetics accounting for just under 60% of that amount. Inbound sales of cosmetics decreased, while inbound sales of *Curél*, *Bioré* and other skin care products grew. (Note: *Curél* was classified as a skin care product until fiscal 2017, but has been included in the Cosmetics Business as of fiscal 2018.)

Inbound demand remains strong in fiscal 2018. A review of stores that estimate inbound sales showed that inbound sales totaled about 25 billion yen in fiscal 2017. Inbound sales in the first quarter of fiscal 2018 were a little over 6 billion yen, growing more than 20% compared with the same period a year earlier. Cosmetics, including *Curél*, *SUQQU*, *RMK* and *est the lotion*, accounted for about 70% of this amount.

For the revised inbound sales figure of approximately 25 billion yen for fiscal 2017, can we assume that the proportion accounted for by cosmetics was also just under 60%?

The proportion of cosmetics was slightly higher.

Is my understanding correct that the 70% proportion accounted for by cosmetics in the first quarter of fiscal 2018 is even higher than it was in the first quarter of fiscal 2017?

Yes. Inbound sales of cosmetics have grown. In particular, sales of *SUQQU* and *RMK* have grown substantially.

You say that you have made your strategy clearer by sorting out what to focus on in the mid-price segment. In fiscal 2018, will the improvement in operating income through measures such as more efficient use of selling, general and administrative (SG&A) expenses be greater than the growth in sales?

That's right. We will increase sales and operating income by focusing on low-price

Kao Group First Three Months of Fiscal 2018 Conference Call Q&A Session Summary

self-selection cosmetics such as *Curél*, *free plus* and *KATE*, which are growing. For the mid-price segment, where the market is shrinking and sales are weak, we will narrow down our focal brands and use expenses more efficiently in ways such as shifting to digital marketing and e-commerce. Our reforms in the mid-price segment and initiatives for the high-price segment will take more time.

4) In the Fabric and Home Care Business, you said that although competition was stiff for laundry detergents and fabric softeners, they were able to hold their own, but have they recovered their share in e-commerce?

In e-commerce, demand for large-size items is growing, so we are taking measures including investment in production facilities to deal with our lag in launching such items compared with our competition. Laundry detergents managed to make a comeback. Fabric softeners are struggling, but we intend to restore their strength with improved products in the second quarter and thereafter.

I thought that lower prices for natural fats and oils would have been a factor that increased profit, but operating income still decreased. Were high raw material costs still the reason for lower operating income?

In terms of raw materials, although prices of natural fats and oils have declined, prices for crude oil and many petrochemical raw materials have been rising, which was a factor in the decrease in operating income.

What was the loss on disposal of property, plant and equipment, which decreased operating income by about 1 billion yen?

Loss on disposal of property, plant and equipment increased in the first quarter compared with the same period a year earlier due to the timing of construction and other factors, but we do not expect it to have a significant impact on full-year results.

5) SG&A expenses decreased by 4 billion yen in the first quarter. This significant decline offset a decline in gross profit, thus increasing operating income slightly. Will this profit structure change in the second quarter and thereafter in this fiscal year?

In the first quarter, advertising expenses and sales promotion expenses each decreased by approximately 2 billion yen from the same period a year earlier. From the second quarter onward, we may use advertising expenses timed to launches of new and improved products and other factors, but we will control those expenses while monitoring sales. Since using sales promotion expenses more efficiently from last year has been effective in reducing those expenses, we expect the decrease in the first quarter to remain until the end of fiscal 2018.

Gross profit has been decreasing due to a slight decline in selling prices in Asia, an increase in freight and logistics expenses included in cost of sales due to the application of IFRS 15, and an increase in depreciation of facilities. Excluding the impact of the fluctuation of raw material prices, we expect gross profit to improve if sales volume increases over the course of the year.

It is disappointing that sales growth was so small compared with the increase in operating income in the first quarter. Is there any need to be concerned about this?

Kao Group First Three Months of Fiscal 2018 Conference Call Q&A Session Summary

We believe there is no need to worry. We anticipate that progress will slightly exceed our original expectations. We aim to achieve the announced forecast for fiscal 2018.

6) In what segments are selling prices declining in Asia? In what context do these declines occur?

Merries baby diapers are affected if the e-commerce price drops due to activities of resellers in China, but the impact is not great. We are taking measures to deal with this.

In the Human Health Care Business, operating income increased despite a considerable decrease in sales in the first quarter, so I suppose the impact is not so great, but according to your competitors, prices for pulp and other materials are rising. Can we expect further growth in operating income if sales increase in the second quarter and thereafter?

We expect raw material prices to rise somewhat. We will aim for increases in sales and operating income.

7) Changes in raw material prices are forecast to have a net impact of negative 4 billion yen in fiscal 2018, and they had a net impact of negative 1 billion yen in the first quarter. If raw material prices rise further, what is your expected time frame for passing on the increase to selling prices?

In the Chemical Business, when prices for natural fats and oils decrease, we are asked to reduce our product prices, but the timing is difficult to plan. It depends on whether we can pass through the prices in tandem with the timing of the fluctuations in raw material prices.

If the prices of petrochemical raw materials rise, it will be a factor reducing operating income in the Consumer Products Business, where such costs cannot be passed through to selling prices. It will be challenging if the crude oil price exceeds 70 U.S. dollars a barrel.

Raw material costs increased by 1 billion yen in the first quarter of fiscal 2018. Should we expect a 1 billion yen increase each quarter?

We expect a gradual increase in raw material costs. It is possible that the increase will be 5 or 6 billion yen for the year.

8) What is behind the 1-percentage-point increase in consumer purchase prices for household and personal care products in Japan? Do you expect increases to continue based on conditions in the small mass market and elsewhere?

Manufacturers and retailers are not engaging in price competition. Furthermore, the number of high-value-added products is increasing. *Medicated Pure Oral Foaming Toothpaste*, which was launched in April, can be used about 190 times per bottle, but the price is higher than for conventional products. In addition, *Rerise* hair color for gray hair, a product that will be launched in May with features completely different from conventional hair color, also has a higher price. For the mass market, Kao is also taking the initiative to launch high-value-added products and is promoting value through distinctive products. One example is fully renewed *Merit* shampoo.

What proportion of sales is accounted for by products for the small mass market?

Sales for the mass market are still large, but we have recently offered many products for the small mass market that address diversifying needs.

Since products for the small mass market have high unit prices and involve relatively limited marketing, does that mean they have higher profit margins than mass-market products once they have reached a certain scale?

Since sales volume is not as large as for mass market products, we offer products with higher added value. Small mass market products also require more effort in areas such as production and sales, so it is necessary to raise efficiency to increase the profit margin.

9) The Cosmetics Business has not met its plan in Japan. What went wrong? When will you explain the new strategy for the Cosmetics Business?

We would like to set forth our strategy for the Cosmetics Business at another time.

In the Cosmetics Business, sales in Asia have grown steadily, beyond our expectations. In Japan, the mid-price market is shrinking and sales are sluggish, but we are improving operating income by using expenses more efficiently. We are not so far off the plan. In addition, we are seeing positive signs, with definite growth in sales of brands with distinctive features such as *SUQQU* and *RMK*.

Does that mean that in the Cosmetics Business in Japan, you planned on a decrease in sales in the first quarter, but you expect a slight increase in sales for the full fiscal year with the introduction of new and improved products in the second quarter and thereafter?

Although increasing sales in the Cosmetics Business in Japan will not be a simple task, we believe we will be able to recover, since major factors such as the provision for returns were taken care of in the first quarter.

10) Sales of baby diapers in China decreased by double digits, but how was the sell out to consumers in January through March?

Our market share did not decrease much. Including sales by resellers, which are ultimately reflected in market share data, the *Merries* brand did not decline.

What is the breakdown between Japan and Asia in the 0.4 billion yen increase in operating income from the Human Health Care Business?

Operating income decreased slightly in Japan and increased in Asia. The growth of *Laurier* sanitary napkins in Asia was a significant factor.

(Supplement)

Because the outlook for cash flow for fiscal 2018 has been settled following the completion of the acquisition of Oribe Hair Care, LLC, on April 27, 2018 the Company announced the repurchase of its stock during the period from May 1, 2018 to June 22, 2018, up to a total of 7 million shares and a maximum amount of 50 billion yen.

Kao Group First Three Months of Fiscal 2018 Conference Call Q&A Session Summary

Note

The content presented in these materials is the opinion of the Company. The content is a summary of questions and answers in a conference call. The Company makes no guarantee or promise regarding the accuracy or completeness of this information, which is subject to change without notice.

Forward-looking statements such as earnings forecasts and other projections are based on information available at the time of disclosure and assumptions that management believes to be reasonable, and do not constitute guarantees of future performance. Actual results may differ materially from expectations due to various factors.