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## Kao Group First Quarter of Fiscal 2017 Conference Call Q&A Session Summary

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Date: Wednesday, April 26, 2017, 16:00-16:50

Agenda:

- (1) Summary of Financial Results for the Three Months Ended March 31, 2017 16:00-16:20  
Kenichi Yamauchi, Executive Officer, Senior Vice President, Accounting & Finance  
Hideo Makino, Vice President, Financial Controllers
  - (2) Q&A Session 16:20-16:50  
Kenichi Yamauchi, Executive Officer, Senior Vice President, Accounting & Finance  
Hideo Makino, Vice President, Financial Controllers  
Mitsuhiro Watanabe, Vice President, Investor Relations
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**1. How large was the initial shipment following the distribution channel change due to sales reforms in China? Was it as you expected? Excluding this initial shipment, what was the value of the sell-out of baby diapers in China?**

The initial shipment was approximately 3 billion yen, within the range of our estimates. Assuming that a certain quantity remains as inventory at some retailers, sales growth was around 20-30%.

**2. The sales growth rate for baby diapers in China was in the low 20s in fiscal 2016. Has that momentum changed?**

The momentum has not changed. We will grow by double digits in China.

**3. For fiscal 2017, you have forecasted increases in operating income of 7.8% for the full year and 1.1% for the first half due to a decrease in purchases of baby diapers by resellers in the second half of the previous fiscal year. I realize that you were taking a conservative view of the first half. Did you anticipate a decrease in operating income in your plan for the first quarter?**

We expected operating income for the first and second quarters to be basically the same as in the previous fiscal year. Therefore, we cannot achieve 200 billion yen in operating income unless there is year-on-year growth of 13 billion yen or more in the second half.

**Will there be a rebound in sales of baby diapers in the second half from the decrease in the previous fiscal year?**

Operating income of 200 billion yen is an ambitious target, representing an increase of about 15 billion yen compared with the previous fiscal year, so we want to exceed the previous first half's results as much as possible.

**4. The completion of amortization of intangible assets (trademarks) in the Beauty Care Business should have resulted in a growth factor of approximately 1 billion yen compared with the same period a year earlier, but the increase was only 400 million yen. What were the reasons for this in cosmetics and skin care/hair care, respectively?**

For cosmetics, operating income declined somewhat as we have been making expenditures for major reforms and other reasons since fiscal 2016 and sales did not increase much.

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Skin care and hair care grew overall, but skin care performed strongly while hair care did not increase.

**Does that mean that the decrease in operating income from cosmetics exceeded the growth factor of about 1 billion yen from the completion of amortization of intangible assets?**

That is correct.

**5. What were the reasons behind the decrease in operating income in the Fabric and Home Care Business, despite like-for-like sales growth of 3% and zero net impact of raw material price fluctuations?**

The Consumer Products Business was affected by rising raw material prices. Including selling price adjustments in the Chemical Business, the net impact of raw material price fluctuations was zero. In addition, we have been making expenditures in Asia in response to the entry of Procter and Gamble (P&G) into Thailand's laundry detergent market. We will make up for the decrease in the second half of fiscal 2017, mainly in Japan.

**What was the magnitude of the impact of rising raw material prices on the Fabric and Home Care Business?**

About 300 million yen.

**Why didn't sales grow in Asia? Was it because of P&G's market entry?**

In Thailand, P&G entered the laundry detergent market with the Downy fabric softener brand, intensifying competition with Unilever, for which Thailand has traditionally been a stronghold. Kao's *Attack* also has share to a certain extent, but we have been drawn into competition.

Also, in Indonesia, since *Attack Jaz1* has expanded its market share over the past few years, it has been forced into price competition with local brands. Kao will rally in both cases.

**What was the situation for the Fabric and Home Care Business in China?**

The competitive environment did not change much in China.

**6. What was the breakdown by region of the 4.2 billion yen increase in operating income in the first quarter?**

Operating income in Japan basically did not change because we made expenditures for cosmetics, baby diapers and other purposes, and there was no positive impact on operating income from raw material price fluctuations unlike in the previous fiscal year. The increase in operating income from Asia and the Americas covered the decrease in operating income from Europe.

**Which region accounted for the largest portion of the 3.0 billion yen increase in operating income from the Human Health Care Business?**

Operating income increased in the Human Health Care Business due to strong sales of

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baby diapers in China and cross-border e-commerce.

**Is an operating margin of 15.4% for the Human Health Care Business going to continue?**

We think that the 15.4% operating margin in the first quarter was a bit high from the viewpoint of cost effectiveness. We do not think it will be easy to maintain.

**Is my understanding correct that in the Human Health Care Business, operating income decreased in Japan due to the expenditures you made, but operating income from cross-border e-commerce and baby diapers in China grew by 3 billion yen?**

Operating income from the Human Health Care business also increased in Japan.

**How were sales of baby diapers in Japan? How much of an impact has cross-border e-commerce had?**

For baby diapers, we made marketing expenditures in areas such as increased distribution of samples in the Japanese market, and our share has risen from around the second half of the previous fiscal year, recovering to nearly 30%. The scale of cross-border e-commerce is several billion yen.

**Does that mean that the impact of the initial shipment through the new distributor in China was to boost the operating margin?**

It had that effect.

**7. Are there any signs that retail prices of baby diapers in China are bottoming out or improving? Which competitors is Kao taking share from?**

Retail prices for baby diapers were on a moderate downtrend, but we have been sensing a slight pickup since around the fourth quarter of 2016. Prices in e-commerce channel are a little lower than in other channels.

For over a year, Kimberly-Clark, P&G and Kao have been competing head-to-head, with market shares of 15-16% each, but there are many local manufacturers who are increasing their market share little by little.

**Did China make a major contribution to the 4.2 billion yen increase in operating income in the first quarter? Also, what will you do with this increase?**

China played a major role. We are thinking of allocating the increase in operating income to investments in the second half.

**8. What were the gross and net impacts of raw material price fluctuations on the Consumer Products Business and the Chemical Business, respectively?**

The gross impact of raw material price fluctuations was just under negative 7.0 billion yen, consisting of slightly less than negative 7.0 billion yen for the Chemical Business and negative 0.3 billion yen for the Consumer Products Business. The net impact on the

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Chemical Business was zero because it was able to adjust prices in response to rising prices of natural fats and oils. Petrochemical raw material prices have had no impact until now, but we expect a small effect to materialize in the future.

### **Was the Consumer Products Business left with negative 0.3 billion yen due to the impact of high raw material prices in the Fabric and Home Care Business?**

That is correct.

### **What is the breakdown by region of the 1.5 billion yen increase in operating income in the Chemical Business?**

Asia accounted for a large proportion, and each of the other regions also increased income slightly.

### **9. Which businesses particularly increased or decreased expenses as a result of cost controls from your top-down management?**

As our factories have been ramping up production, personnel and other expenses increased. Research and development expenses also rose along with the increase in personnel expenses. The question is where to make up for the increase in these expenses. Among selling, general and administrative (SG&A) expenses, we are trying to make more efficient use of sales promotion expenses.

### **Were there any businesses that did not particularly incur expenses in the first quarter? For example, a focused reduction in Fabric and Home Care or the like?**

Except for cosmetics, where major reforms are under way, we are slowly moving forward with small reductions in overall expenses.

### **Were expenditures the same as in the previous fiscal year?**

Yes. From here on, we will make expenditures while looking at sales trends.

### **What about the 5.0 billion yen increase on a like-for-like\* basis in first-quarter SG&A expenses?**

Among SG&A expenses, personnel and R&D-related expenses and sales promotion expenses increased. Although we have been working in various ways to make more effective use of sales promotion expenses in Japan, sales promotion expenses are increasing in Asia because sales are expanding there.

SG&A expenses are no longer comparable with the previous fiscal year due to the adoptions of IFRS 15 and the revision of our sales system, but the adjusted figures are 44.9% of net sales for the first quarter of 2016 and 42.9% for 2017. We are putting these expenses to use while keeping an eye on the situation.

\* Excluding the impact of IFRS 15, the revision of the sales system for the Consumer Products Business in Japan and the effect of currency translation.

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**10. As of the announcement of the fiscal 2017 forecast, Kao projected a net impact of negative 1.0 billion yen from raw material price fluctuations due to a decline in market prices. In fact, the price of palm kernel oil has been falling sharply. Will you benefit from this drop in prices in the fourth quarter, or fiscal 2018?**

Although that price has fallen, prices for natural fats and oils are roughly the same as they were in the previous fiscal year. A price that was too high has settled down. In the Chemical Business, if raw material prices drop suddenly, there is a risk of a drop in the selling price of high-priced inventory. The Chemical Business can be affected by volatility in raw material prices, so we need to pay careful attention.

**11. The household and personal care products market was flat and volume decreased because the consumer purchase price rose by one point. Am I correct in understanding that this volume decrease refers to baby diapers? Are there other categories where volume decreased? With the added factor of lower prices at 7-Eleven and AEON, hasn't domestic consumer sentiment become worse?**

Categories including baby diapers, laundry detergents, sanitary napkins, shampoos and conditioners were negative. Since it has only been three months, we prefer to keep in mind the state of inbound demand in the previous fiscal year when looking at the situation.

**So, consumer sentiment in Japan is not so bad?**

We do not have the impression that it is bad at this time.

**12. How do you envision competition intensifying in the second half? Will it be different from usual?**

For cosmetics, the question will be whether we can proceed as expected, due in part to trends in competition, such as other companies' launches of new products for wrinkles. Trends in retail prices are also a concern. In the Chemical Business, we expect a decline in selling prices in the second half. Political and geopolitical unrest is also a risk.

**Note**

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