
First Nine Months of Fiscal 2017 Conference Call Q&A Session Summary

Date: Monday, October 30, 2017

Respondents:

Kenichi Yamauchi, Executive Officer, Senior Vice President, Accounting & Finance
Hideo Makino, Vice President, Financial Controllers
Mitsuhiro Watanabe, Vice President, Investor Relations

- 1. Operating income from the Beauty Care Business decreased 3.9 billion yen in the July-September period compared with the same period of the previous year. What were the circumstances in Japan for cosmetics and for mass skin care and hair care? How has the response been to the improved cosmetics skincare products (*est*, *DEW*) launched since September?**

The 3.9 billion yen decrease in operating income can be broken down as roughly 60% from cosmetics and 40% from mass skin care and hair care. We have only just launched *est* and *DEW* so it's still early to evaluate, but they are getting a good reception.

Is my understanding correct that operating income from cosmetics increased in Asia but Japan held back growth significantly? Did sales promotion expenses for cosmetics increase from the previous year?

Your understanding is correct. The increase in sales promotion expenses also included expenses related to products that will contribute to sales in the future, such as *DEW*.

So, expenses for July-September were large because they included upfront expenses?

Yes.

- 2. In the Fabric and Home Care Business in Japan, competition was severe during July-September. Why do you think it will not be as severe during October-December and thereafter?**

From July to September, there were aggressive marketing activities accompanied by new product launches by competitors, but price competition appears to be settling down since they have already shifted back to normal marketing activities.

There has been fierce price competition from competitors in laundry detergents in Thailand and Indonesia, but now your results are on a recovery track. Has something changed in the market environment?

In Asia as well as in Japan, price competition does not continue indefinitely. The situation of our competitors appears to have changed.

In Asia, price competition was severe during January-June. Are you saying it was subsiding during July-September?

That is what we think.

In Japan, competitors engaged in fierce competition by launching new products in September. Would you say that subsided in October?

First Nine Months of Fiscal 2017 Conference Call Q&A Session Summary

That is what we think.

- 3. What is the outlook for sales of Sofina and Kanebo Cosmetics, respectively, and what is the impact of the decline in inbound demand? Previously, President Sawada said that if Kao could not change, Kao would be left behind by the cosmetics industry, but it feels as though they have already been completely left behind. There is no way that the rebuilding of the cosmetics business will enable us to keep up with the competition just by launching improved products during October-December. I think the situation is critical. Do you intend to conduct a review and launch urgent, innovative measures for the future?**

For cosmetics in Japan from January to September, sales of Sofina decreased by mid-single digits from the previous year, while Kanebo Cosmetics sales decreased by low single digits. There was also the factor of a time lag, because the timing of this year's launch of improved products was later than last year's. Inbound sales were around 70-80% of the previous year's level. Absent the time lag in the launch of improved products, sales were nearly on par with the same period of the previous year. As a result, the July-September period appears considerably lower year on year, but we are managing the situation to achieve our plan for the full year. During October-December, we plan on launching improved *DEW* and *Lift Professional*, as well as new products in the high-priced range for *KANEBO*.

In addition, both Sofina and Kanebo Cosmetics have been slow in responding to the e-commerce channel, and we foresee growth in sales in the future from doing so.

We initially expected year-on-year sales growth of 5-6% for cosmetics, but sales have not grown even though we deployed marketing expenses. For the full year, sales growth for both Sofina and Kanebo Cosmetics is expected to be limited to the low single digits. With our cosmetics reforms, we are aiming to increase profits in 2019 and thereafter by increasing sales. We need to proceed with increasing sales and profits per store and with reforming the structure that has caused sales and profits to be concentrated in the fourth quarter. We are currently conducting a fundamental reconsideration of our approach. We will let you know about it at an appropriate time. Although we are proceeding rather slowly compared with your expectations and with our competitors, we will compile the things we need to deal with one by one, fix them and take on new challenges.

- 4. Operating income for July-September 2016 decreased from the previous year due to an increase in marketing expenses, so the bar for year-on-year growth must have been considerably lower for July-September 2017. What was the reason for the small year-on-year increase in operating income?**

The impact of higher raw material prices was about 2 billion yen. Other factors included the difference in the timing of the launch of improved cosmetics products, deployment during July-September of marketing expenses for *Bioré*, which had been low from January to June, and counteracting fierce competition in the Fabric and Home Care Business. Together, these factors decreased operating income by several billions of yen.

The difference in timing was a factor that decreased operating income from the previous year in the Beauty Care Business during January-September, so that will alleviate itself during October-December. Does that mean higher raw material prices and competition in the Fabric and Home Care Business are the factors causing the decrease in operating income?

First Nine Months of Fiscal 2017 Conference Call Q&A Session Summary

That is correct.

Although your competitors have said that higher value-added products are important in Japan, the prices that they actually sell such products for are low, aren't they?

In the small mass market for hair care and other products, many goods are sold through e-commerce and other channels, taking market share away from most major manufacturers. In fabric and home care, our competitors' market approach of lowering prices seems to be aimed at increasing their share.

Is my understanding correct that there is still a gap between the way their top management envisions their sales activities and the way they are handled in actuality?

There are times when competition necessitates measures to lower prices.

5. How was the sales momentum for baby diapers in the major Asian countries of China, Thailand and Indonesia during July-September?

We maintained positive momentum. Looking at the total for Japan and China together, because of factors such as cross-border e-commerce and the activities of resellers, sales in July-September grew 30-40%. In Thailand, the growth rate was high but the scale is still small. In Indonesia, sales grew 30-40% in July-September. Total global sales also grew by nearly 30%.

How much did cross-border e-commerce grow?

Cross-border e-commerce sales during January-September 2016 were small and they have increased substantially since October-December 2016, so sales grew significantly during January-September 2017 compared with the same period of the previous year.

For October-December, considering raw material prices that will exceed your plan, the situation of *Bioré* and the status of competition, would you say that your full-year operating income target of 200 billion yen will be achieved by controlling marketing expenses rather than by sales growth?

It is not a matter of simply reducing marketing expenses to achieve our operating income target. We are committed to reviewing marketing strategies for more efficient deployment and management of expenses through top-down management that includes shifting to digital marketing and eliminating waste in our sales promotion expenses for greater effectiveness.

Achieving the full-year operating income target of 200 billion yen will require a 7.8 billion yen increase in October-December compared with the same period of the previous year. However, in October-December 2016, we recorded additional expenses of 3.7 billion yen, consisting of 1.9 billion yen for a reserve for returns of *AUBE* cosmetics and 1.8 billion yen for structural reform of the Beauty Care Business in Europe. Therefore, in real terms we are targeting an increase of 4.1 billion yen in operating income.

What is the outlook for raw material prices in 2018?

We have not yet decided on a forecast that we can announce.

First Nine Months of Fiscal 2017 Conference Call Q&A Session Summary

- 6. The growth rate of the household and personal care products market in Japan in January-September decreased by 1 percentage point according to SRI, but increased by 3 points according to SCI, which includes e-commerce. At 4 points, the difference between the two is fairly large. What strategies have you adopted to enhance e-commerce?**

Note: SRI: Estimated from point of sales (POS) data from approximately 3,000 retail stores nationwide

SCI: Purchasing data from about 50,000 consumer monitors nationwide

[Panel survey conducted by INTAGE Inc.]

Unfortunately, both household and personal care products and cosmetics have been slower than our competitors in responding to e-commerce. On the other hand, I think that there is still plenty of room for growth in doing so. We need to strengthen fabric care, hair care, cosmetics and other areas. We will also enhance our activities for e-commerce, including advertising.

What progress have you made in dealing with e-commerce?

Our sales to major e-commerce sites are substantial. We would like to further deepen those relationships.

What percentage of household and personal care sales are conducted through e-commerce?

It is still in the low single digits.

With this enhanced response you are planning, what ratio of e-commerce sales are you targeting for next year or the year after?

There are some competitors from the United States who have been fairly proactive in e-commerce. Even where Kao holds the top share in a category at brick-and-mortar stores, there are cases where it is the opposite in e-commerce, so we intend to recover by providing a lineup of products that includes high-volume items and trial products, for example. E-commerce sales have grown in comparison with the previous year, and we want to further enhance them.

When do you expect a significant change in sales momentum from these future measures?

We expect double-digit or higher growth each year from further deepening our measures.

- 7. Which category in which region was the main factor in the decrease in operating income from mass skin care and hair care during July-September compared with the same period of the previous year?**

Operating income from mass skin care in the Americas decreased.

Is that because you used marketing expenses for *Bioré* due to the fierce competition?

During January-June, we curtailed marketing expenses slightly in preparation for the

First Nine Months of Fiscal 2017 Conference Call Q&A Session Summary

second half. Since sales of *Bioré* slowed due to the fierce competition in July-September, we deployed those marketing expenses. We also used marketing expenses for products such as lotions, which have their peak sales season during October-December.

Does that mean the operating margin will recover in October-December, since it includes those upfront costs?

It will not reach the January-June level, but we expect a reasonable outcome for the full year.

Globally, operating income from mass skin care and hair care decreased 1.5-1.6 billion yen in January-September compared with the same period of the previous year. Is it correct to say that the main factor was the decrease in income from the Americas and Europe, and that there was no decrease in income in Japan?

That is correct.

- 8. The weather has been poor lately, with a long spell of rain in August and typhoons on weekends in Japan. How do you envision the laundry detergent market in the second half, in terms of both unit price and volume?**

The poor weather is having an impact. We have not disclosed a market forecast with a breakdown into volume and unit price.

For your target of increasing operating income by 4.1 billion yen in real terms during October-December compared with the same period of the previous year, how do you expect to increase income in the Fabric and Home Care Business and the Beauty Care Business?

In the cosmetics business, we expect sales growth for the full year to be in the low single digits. Operating income decreased substantially in January-September, but one way or another, including through more efficient deployment of expenses, we intend to recover to full-year results on par with the previous year. We expect most of the 4.1 billion yen increase in operating income to come from the Beauty Care Business.

So, you do not expect an increase in operating income from the Fabric and Home Care Business?

The Fabric and Home Care Business is aiming for an increase in operating income over the full year, so we expect it to recover the amount that it decreased in January-September. In the Human Health Care Business, we expect operating income to increase during October-December, just as it did in July-September.

- 9. Which businesses were affected by the poor weather in Japan? Was there a large impact on laundry detergents, as might be expected?**

From July to September, it was a cool summer in Japan with little sunshine due to the poor weather, which had a broad impact, including on UV and other skin care products and on laundry detergents because people did not sweat as much.

To deal with the fierce competition from new laundry detergent products launched by competitors, did Kao also use expenses to lower selling prices somewhat?

First Nine Months of Fiscal 2017 Conference Call Q&A Session Summary

A portion was used to lower selling prices.

Did Kao's market share for laundry detergents decrease as the competing new products increased their share?

Our share did not change so much, but we deployed expenses.

Was the decrease in operating income in laundry detergents from the previous year due to advertising expenses?

It was not so much advertising expenses as sales promotion expenses.

Haven't retail prices for laundry detergents decreased?

They have gone down. Differences in selling prices have arisen. Our competitors lowered prices for their new product launches, but there already seems to be a shift back to normal marketing activities, and price competition has subsided somewhat.

10. In July-September, operating income in the Beauty Care Business decreased by 3.9 billion yen compared with the same period of the previous year, and cosmetics accounted for about 60% of that, or approximately 2.5 billion yen. How much of that was attributable to the difference in timing of the launches of improved products? Cosmetics sales in Japan were nearly flat in January-March and April-June, then fell 7.7% in July-September compared with the same period of the previous year. Was a change of that magnitude due to a difference in the timing of improved product launches? How do you view sales conditions excluding that impact?

For cosmetics in Japan, the negative impact on sales from the difference in the timing of the launches of improved products was just under 5% compared with the same period of the previous year. Excluding that factor, sales were nearly flat. As a result of the decrease in sales, operating income decreased by about 2 billion yen. We intend to regain as much of that as we can during October-December.

Are you saying that because of the time lag in the launch of improved products compared with the previous year, only the expenses were incurred ahead of time during July-September, and so the corresponding operating income will be concentrated in October-December?

Exactly. We expect the concentration of operating income in October-December to be greater than it was last year.

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.