Kao

Fiscal 2018 Presentation Q&A Session Summary

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1. Operating income in fiscal 2018 did not reach the forecast, but since the loss on disposal of property, plant and equipment and expenses incurred for structural reforms in the Americas and Europe that reduced income by 3.6 billion yen compared with the previous fiscal year are one-time expenses, can we assume that the absence of these expenses will be a factor in increasing operating income year on year in fiscal 2019?

Yes. In addition, with an eye to Japan's scheduled consumption tax rate increase in 2019, during fiscal 2018 we also invested in facilities for liquid laundry detergents and large-size refill products in fabric care products, for which production capacity was insufficient, and in pants-type baby diapers, for which sales are increasing.

2. Perhaps due to the impact of the new e-commerce law in China, statistics indicate that department store sales of cosmetics in the high-price range are not good in Japan. Since inbound demand (demand from visitors to Japan) for Kao products was not large, will the Cosmetics Business be able to maintain its steady growth?

Due to the impact of the new e-commerce law in China, which came into effect in January 2019, sales of cosmetics in department stores have clearly slowed since the end of 2018. However, because inbound sales have accounted for a small proportion of the Kao Group's total sales, the impact has been minor. In addition, the *Curél* derma care brand and the *freeplus* skin care brand are sold by local subsidiaries in China, and we will achieve a balance between sales in China and Japan by increasing product supply to China. Aside from inbound demand, the performance of individual brands has been gradually improving due to the brand enhancements we have been conducting, and they have also been selling well in January 2019.

3. You said that sales of *Merries* baby diapers struggled, especially in the fourth quarter. What is the price range for the baby diapers sold by resellers in China, and when do you expect the issue of resellers' inventories to be solved? Also, you said you would change the strategy for *Merries* by rolling out different products in China. When will the effects become apparent?

We expect that the inventories of resellers' with which Kao has no direct transactions should start to run low in the first quarter of 2019. To maintain the value of the *Merries* brand, the Kao Group does not adjust its selling prices, so we expect the first quarter of fiscal 2019 to be rough compared with the same period a year earlier, when sales including cross-border e-commerce were strong. We will cover the shortfall through sales in other categories of the Consumer Products Business. From the second quarter onward, we will significantly transform our current strategy, and we are considering options including products different from any *Merries* products so far. They will be launched in China first, rather than in Japan. When the previously mentioned resellers' inventories run out, we intend to join forces with the e-commerce and baby specialty store channels, which account for 70-80% of the baby diaper market in China. We want to restore baby diapers to their performance levels in fiscal 2017, when they reached record highs for both sales and operating income, and then grow further.

We are not exactly sure of the status of resellers' inventories, but sales in China peak in June and November, so we want to move forward with our new initiatives, targeting those periods.

4. By launching first in China products manufactured in Japan that use the latest technologies, does this mean that you do not intend to expand your value-priced lineup of baby diapers in China? You are not going to change your high-value-added premium strategy of offering products based on Kao's high level of R&D capabilities, are you?

We will not change our premium strategy for either tape-type or pants-type diapers. We believe these products can be made in China, rather than in Japan. We currently produce products for the mass market price range in Hefei, China, and we will use our R&D capabilities there for a shift in direction to offer the number-one diapers for mothers and babies in China. In order to do so, of course brand power will be the key. Local manufacturers have grown and are gradually catching up with technologies for ultra-thin absorbents, overall softness and the like, but the Kao Group intends to offer quality products with an even higher level of technology.

5. The Cosmetics Business is targeting high sales growth in Asia in fiscal 2019. Specifically, in which regions, categories and channels do you anticipate growth? The operating margin improved to 9.9% in fiscal 2018, but will you be able to improve it further in fiscal 2019, when you will need to invest in brand building?

In fiscal 2018, which was the first year of structural reforms in the Cosmetics Business, we increased sales and operating income by concentrating investment in brands with momentum and a high profit margin. We also improved the operating margin by using expenses more efficiently. Fiscal 2019 will be a decisive year, with the full-scale start of reforms. In the prestige and high prestige ranges, where we are facing challenges, we are planning to launch high prestige skin care products in the fourth quarter. By region, of course China, which is currently a growth driver, will remain important, but we want to work on a brand-by-brand basis. One example would be the rollout of *freeplus* in ASEAN countries. By channel, the growth of e-commerce has been substantial, and it accounts for more than 20% of the market according to SLI survey data from INTAGE Inc. The Kao Group lagged behind in this channel, but stepped up its response across the board in 2017. In 2018, our growth significantly surpassed that of the e-commerce market, and we intend to further strengthen our efforts in this channel.

The Cosmetics Business achieved a 10% business profit margin in fiscal 2018. In fiscal 2019, we want to improve that by at least 1 percentage point or more and get close to 12%. We will work aggressively to further exceed our plan for sales as well. The Kao Group Mid-term Plan "K20" sets targets for the Cosmetics Business of sales of 300 billion yen and an operating margin of 10%. In 2018, the operating margin nearly reached 10%, so in the future we will aim for sales of 400 billion yen and an operating margin of 15%.

6. In the Cosmetics Business, if sales grow more than anticipated, can we expect further improvement in the operating margin?

The operating margin in Asia is high, and the e'quipe brands are also performing well. The issue is the mid-price range in Japan, for which the market is shrinking. We intend to proceed in line with expectations by conducting reforms, including eliminating brands.

7. What are the details of the enhancement of high-prestige cosmetics scheduled for the fourth quarter of fiscal 2019? Magazines have reported that you will enhance *SENSAI* in Europe in May and open a flagship store in Japan, but what is your plan?

SENSAI is sold in 40 countries in Europe and the Middle East. We plan to further enhance the brand in Europe in May to make it more appropriate for introduction in Japan and China, followed by a launch in Japan in November. In the fall, we plan to launch a new product line with even higher added value for Kao's prestige brand *est*, which has especially strong-selling lotions.

8. What will change in the Cosmetics Business as a result of structural reforms such as strengthening initiatives in the travel retail channel and introducing a brand management system?

In the cosmetics market, the travel retail channel accounts for about 20% of prestige cosmetics sales, and sales in this channel have grown considerably (approximately 9%) over the past five years. In this channel, the Kao Group previously conducted negotiations separately for the Kanebo Cosmetics, Sofina and Molton Brown businesses, but we created a structure where one team conducts negotiations for all of them. In brand management, we made a new start by strengthening the authority of brand managers, expediting decision-making by reducing the number of meetings and other measures, and revising our team to speed up brand enhancements.

9. What are your expectations for market growth for baby diapers and cosmetics in China in fiscal 2019? How much did Kao's sales grow in these areas in fiscal 2018 and what is the outlook for fiscal 2019?

In the market for baby diapers in China, there have been years of double-digit growth, but currently growth is estimated to be below that level. In fiscal 2018, the Kao Group's sales growth rate for the Consumer Products Business in China excluding cross-border e-commerce was just short of double digits, close to the market growth rate. In fiscal 2019, we expect market growth of 7-8%, and the Kao Group is aiming to exceed that rate with double-digit growth.

In China, although operating income from baby diapers decreased, operating income increased for the Consumer Products Business overall, with contributions from the Cosmetics Business, skin care products and other products. If we put baby diapers back on a growth track, double-digit or higher growth in sales and operating income is possible.

The cosmetics market in China has grown by 12-13% in recent years, according to Euromonitor. The Kao Group was able to grow by more than 50% in China in fiscal 2018. Naturally, in fiscal 2019 we want to grow by double digits and exceed market growth.

We are taking a close look at how much the Chinese cosmetics market really is picking up, and how much impact the economic downturn is having. Inbound demand in Japan has dropped off, but as for the cosmetics market in China in general, the number of people who use cosmetics is increasing and there have been advances in information dissemination through social media and other methods. As a result of these and other factors, I think that there will not be much of a slowdown, and perhaps even a little growth. There will be an impact from U.S.-China relations and other factors, but unlike automobiles and household electrical appliances, we do not expect much of an effect on cosmetics and household and personal care products.

10. I suppose that Chinese consumers have a history of not placing much faith in domestic products and preferring proven overseas products, but why are you changing your strategy to add a new line of baby diapers? Has there been a change in consumer attitudes?

In the baby diaper market in China, although the overall product quality level is rising, prices are falling. We cannot maintain brand power for *Merries* without fundamentally raising the level of our improvements and speeding up the improvement cycle. Although *Merries* has the top market share at nearly 14%, its selling price has fallen and it is losing its premium status. We will conduct a new strategy to expand sales and operating income by enhancing brand power with our high level of R&D capabilities.

11. Will you roll out a low-price line to raise the brand value of *Merries* in China?

We will not make a low-price line.

12. Will you add super-premium baby diapers, like your competitors have?

While we make fundamental improvements to the current *Merries* baby diaper line-up, we will also raise the brand's value in another product line that incorporates the best technologies. In many cases, having too many lines does not go over well. We have been producing products for the mass market price range in Hefei. This proves that we can use high-level technology for production in China. Therefore, we intend to proceed in that direction in the future.

13. Both sales and operating margin levels in the Chemical Business are stable and at a high level for a chemical company, but business conditions for household electrical appliance and automobile manufacturers are expected to worsen. In this situation, can we expect the Chemical Business to maintain its levels for sales and operating margin?

Yes, you can. In particular, in the field of inkjet ink for industrial printing, we will roll out our new technologies with various potential applications at our three bases in Japan, Kao Chimigraf, S.L. in Europe, and Kao Collins Inc. in the United States, respectively, and proactively expand them into high-margin businesses. In infrastructure-related businesses, we have unique strengths in areas including concrete admixtures used in tunnel construction, and in shore protection works and other locations around water, chemicals for road construction and amine-based materials for shale oil drilling, as well as electronic materials. We intend to increase the sales and operating margin of the Chemical Business by promoting the growth of these high-value-added products.

14. For the five technology innovations you announced in November 2018, including Fine Fiber, when do you expect to bring them to market, and under what kind of business model? What are your assumptions for your investment and for their contributions to results?

Among the five technology innovations, the only contribution we have included in our forecast for fiscal 2019 that will introduce one of these technologies is *Attack ZERO*, which applies Bio IOS. We do not expect the contribution from the other technology innovations to be large, since the timing of any such launch will be well into the second half of fiscal 2019. Instead, what is important is the size of investment that will be needed to cultivate these technology innovations. We want to skillfully spread these distinctive technologies and expand them as we gain the support of those around us. Then, we intend to take a look at the situation and consider the business model, scale of business and plan for fiscal 2020.

For Fine Fiber technology, while maintaining a balance between the perspectives of business and ESG, we want to comprehensively consider solutions to a variety of issues in the fields of makeup, where there are numerous opinions on social media, and medicine, as well as personal care, where the technology is extremely effective for skin care. We plan to do the same for RNA Monitoring.

To promote the growth of new technologies without substantial cost, we would like to cover investment expenses by successfully revitalizing baby diapers and launching new and improved products including the UV care products to be launched in February and *Attack ZERO*, which will be launched in April.

15. What is the status of your Air-in-Film Bottles?

Rather than move forward all at once, we are thinking of offering them to society on a small scale, and then we can commercialize them once they have gained recognition from the perspective of ESG. Depending on how we move forward, and with which brands, there is a potential for commercialization at a fairly early stage, so we are considering those points. It is also highly likely that we will introduce the bottles outside Japan first.

16. You forecast high growth in sales in fiscal 2019, with year-on-year increases of 6.8% in the Skin Care and Hair Care Business in Japan and 6.4% in the Fabric and Home Care Business in Japan. I suppose you expect a contribution from *Attack ZERO* in the Fabric and Home Care Business, but do you have any plans for new products in the Skin Care and Hair Care Business? Also, what risks could materialize to stop you from achieving these forecasts?

In the Skin Care and Hair Care Business, we are launching *Bioré UV Athlizm* and improving *Bioré UV Aqua Rich* for launch in Japan in February, with the aim of double-digit growth or higher in skin care products. For shampoos and conditioners, which struggled in fiscal 2018, we are planning new product offerings for the small mass market. This plan also encompasses a recovery for *Bioré* skin care in the United States and *John Frieda* hair care.

In the Fabric and Home Care Business, *Attack ZERO* will be of foremost importance, but we are also preparing new and improved fabric softeners and home care products.

17. Will domestic demand in Japan support growth? How much growth do you expect in inbound demand?

Inbound demand is difficult to predict. *Curél* experienced a temporary downturn at the end of 2018, but sales increased significantly in January 2019. We would like overall growth, but trends are different for each product, making it impossible to come up with an average for inbound demand as a category. There are also differences in profit margin, so it is difficult to project how inbound demand will contribute to sales and operating income.

18. How much did inbound sales grow in fiscal 2018?

Growth was in the double digits.

It is better not to view inbound demand as a whole, but to look at individual brands. In cosmetics, there are brands where inbound demand is growing and others are facing tough conditions. Also, brands that are subject to inbound demand will change. Unfortunately, the Kao Group has not been sufficiently capturing inbound demand. Developing appealing brands will be important for future growth, so we intend to focus on that.