
Kao Group First Half of Fiscal 2018 Presentation Q&A Session Summary

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- 1. The Cosmetics Business has been making a profit since the first quarter of fiscal 2018 and the operating margin for the first half increased to 5.7%. Was that because the profit margin for *Curél* grew, or was it the result of other initiatives? I suppose the operating margin will continue to improve for a while as a result of controlling expenses, but when do you expect growth in sales?**

Expansion of sales in China and substantial growth in sales, including inbound sales (sales to visitors to Japan), of *SUQQU* from Kanebo Cosmetics Inc.'s subsidiary e'quipe, Ltd., among other factors, contributed to the improvement in operating income, not just *Curél*. In Japan, we are also raising efficiency in the mid-price range, which contributed about 10% of the improvement in operating income. We intend to use the increase in operating income from future growth in brands and regions that are on an upswing to cover our concentrated investment in strategic brands.

Structural reform of the mid-price range requires cooperation with retailers, so it will take time, but we are moving forward. We will also work to cultivate high-value-added brands.

Sales of our G11 global strategy brands grew by double digits, basically as we expected. We are focusing investment on e'quipe brands and China to expand sales and operating income, and we will further substantially increase sales from new products planned for fiscal 2019 and thereafter.

- 2. You said that *Merries* baby diapers have maintained the number-one market share in China, but what is your strategy for the second half of the fiscal year and beyond? Your global competitors appear to be struggling as local manufacturers increase their market share, and if consumer values change, isn't there a risk that ultra-thin diapers made by local manufacturers using superabsorbent polymer (SAP) sheets will become the most prevalent type? How will you respond?**

We have opened flagship stores for the cross-border e-commerce channel and for the e-commerce channel inside China, and transactions have been increasing. However, some major e-commerce retailers (online retailers) adopted a business model of purchasing stock from the market and selling products themselves, so the Kao Group had no direct transactions with those online retailers. From the second half of the current fiscal year, we will make direct transactions with online retailers. In doing so, we will work together with the online retailers to improve brand value and optimize retail profits. Conditions are more severe in brick-and-mortar stores because e-commerce prices are dropping, but we will also work to raise the brand value of *Merries* in that channel.

As for our response to local manufacturers making thin-type baby diapers using SAP sheets, we intend to continue research and development to make *Merries* more absorbent

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as well as thin, and launch improved products. By doing so, we do not think that sales of local manufacturers' products will continue to expand as they have been.

We have been introducing our latest technologies from Japan for *Merries* produced in Hefei, China and in Indonesia. Ultimately, we want to introduce an even higher level of technology to offer high-value-added premium products worldwide through local production.

3. Excluding the impact of initial shipments of baby diapers in the same period a year earlier, sales in China would have increased 14%. How were sales of products other than baby diapers?

The scale of our business in China has grown, and the percentage accounted for by baby diapers has decreased from around 70-80% to about 50%. Sales of cosmetics, skin care, fabric care and sanitary products have increased substantially, and their profit margins have improved. We have to ensure stable growth of baby diapers, but things are progressing in the direction we are aiming for in the sense that sales of products other than baby diapers are also on the rise. In the Consumer Products Business in China, we are aiming to achieve sales of 100 billion yen as soon as possible. Likewise, we want to grow in Indonesia, where baby diapers are selling well.

In the Consumer Products Business in Asia, the operating margin has improved significantly to 15.6% from 9.2% in the same period a year earlier. In addition, we intend to aim for further growth in sales and operating income by fiscal 2020 through improvements in the Americas and Europe.

You mentioned that the market for baby diapers is shifting to pants-type faster than expected. Isn't Kao (Hefei) going to produce pants-type?

Kao (Hefei) currently produces tape-type diapers for the mass segment, but there is ample potential for producing pants-type diapers in the future. At the appropriate time, we want to offer locally produced high-value-added products with a high level of technology.

Are exports of *Merries* from Japan to China predominantly tape-type?

Many are tape-type, but pants-type is increasing. In China, the share of pants-type in the market is rising faster than we expected, so we need to address that.

4. The operating margin of the Consumer Products Business in the Americas and Europe is low. Will you be able to achieve a 10% operating margin, which is one of the targets of the Kao Group Mid-term Plan "K20"? Am I correct in thinking you have a plan to jump-start improvement?

First, we are conducting structural reforms. We need to think about our brand and organizational issues. The results of the structural reforms will be reflected in performance from fiscal 2019 onward, but that by itself will not enable us to achieve an operating margin of 10%. Second, we are preparing for a substantial increase in sales, and we will make a full-scale start in fiscal 2019. With these two measures, we will aim for an operating margin of 10% while expanding sales.

5. Business confidence in China is waning in the stock market and there are

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concerns about the impact on the consumer goods industry. How do you view the current situation and future trends in the baby diaper and cosmetics markets?

In the household and personal care products market, manufacturers in Japan provide high value-added products one after another, and Chinese consumers immediately get information on hit products in Japan, so in fact Japan and Greater China can be viewed as practically a single business region. Therefore, we believe that trends among millennials, who constitute the mass segment, will be similar in Japan and China. However, trends are different in Japan and China among seniors, and their consumption is on the decline in Japan.

The market for baby diapers in China is still growing by double digits, and despite a decline in average sales prices due to competition, it is moving toward high-value-added products. In addition, we believe that the abolition of the one-child policy, the rate of switching to disposable diapers in inland areas, and the increase in the number of diapers used per day will also boost market growth. On the other hand, the baby diaper market in Japan is severe, so we need to think about how to grow our business throughout Asia. Popularizing Japanese brands in China, Taiwan, Hong Kong, Indonesia, Vietnam and elsewhere will lead to future growth. As incomes increase in Indonesia and Vietnam, people tend to demand high-value-added products, so *Merries* is very popular there, but we have been unable to supply enough products. Looking at Asia overall, we consider the household and personal care products market to be firm.

In the baby diaper market in China, we have seen faster-than-expected growth for pants-type because of consumer demand to use quality products for their children. In addition, local manufacturers' market share is over 40%, and how we deal with that will be important.

As for cosmetics, Japan and China appear to form a single market. For Chinese shoppers, the first sales channel tends to be travel retail, followed by a shift to cross-border e-commerce and domestic e-commerce in China. Sales in China have been growing by nearly double digits, driven by the high-price high prestige category. We expect the market to continue to grow, driven by the high prestige category. Because the Kao Group's strongly performing products *Curél*, *KATE* and *freeplus* are in the low-price range, we have an opportunity for growth in the high-price range.

However, as demand in China has shifted from home appliances to high-value-added cosmetics, there is also the possibility that it will shift again in the future, so we will need to respond to that eventuality.

6. With the establishment of the Strategic Innovative Technology organization and the drastic revision of your existing model by fiscal 2030, how will your income statement and balance sheet change, and what do you envision for Kao?

Although Kao will not change so much financially, we will drastically change the Company's model, systems, procedures and approaches. We will make investments, and using knowledge from outside the Company, substantially rebuild our numerous systems, which have complex interfaces and have not been integrated, completely remodeling the Company's core systems, including those for sales, supply chain management, research and development, personnel and financial affairs. We expect our members with mathematics or physics backgrounds, who have previously been involved in the

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information technology business, to play an active part.

7. The cosmetics business has grown substantially in Asia. Can any aspect of that performance be utilized for reforms and future growth in Japan?

In Asia, sales in China are growing, and low-price range *freeplus* is doing well. Since there are many proactive consumers in China who like to try new things, we intend to make preparations to establish capabilities to rapidly roll out high-value-added products with innovation-based offerings using advanced technologies. For *SENSAI*, which we are planning to launch in Asia, we want a rollout with extra special intangible value that conveys its quality.

Isn't there any way to accelerate reforms in Japan by introducing the methods you have been using in China?

Since we are taking a unified approach to Japan and other Asian countries, there are cases where we introduce methods starting in Japan, as well as cases where we introduce methods starting in China or ASEAN. We will roll out methods immediately, starting in high-potential places where information spreads quickly.

8. Are you on track to meet your targets for projected investment and return from your structural reform of marketing to achieve K20? Have you seen any results?

Over the past year or two, we have made a major shift in marketing investment from mass media to digital media, and we have been studying the latest digital marketing processes. Particularly in the first half of the current fiscal year, we conducted trials in many businesses and now we have an image of the categories in which we will focus on digital marketing, what kind of digital marketing is effective, and how much mass marketing is still required. As a result, we will strengthen marketing with a combination of mass media and digital media from the second half. In the first half, since we reduced mass marketing to focus on digital marketing, our marketing expenses were lower than planned.

We are investing in marketing with a strong focus on ROI to be aware of returns, so marketing expenses will not increase significantly. During the second half of the current fiscal year and the first half of fiscal 2019, we expect to have an image of what level of investment gets the necessary returns. Rather than controlling marketing expenses, we are able to use them more efficiently as a result of our research into digital marketing.

9. Gross profit for January to June decreased by 1.7 billion yen from the same period a year earlier. I understand that it was because sales volume was flat, but what are your thoughts on this situation as you aim for *Yoki-Monozukuri and higher added value?**

We can improve gross profit by increasing sales volume, but there are many other factors currently under discussion. We will conduct a review to improve gross profit.

* The Kao Group defines *Yoki-Monozukuri* as a strong commitment by all members to provide products and brands of excellent value for consumer satisfaction. In Japanese, *Yoki* literally means "good/excellent," and *Monozukuri* means "development/manufacturing of products."

10. Are you saying that you were carefully studying the competitive environment in the first half of the fiscal year and will respond proactively in the second half, so sales volume will increase and gross profit will improve?

We conducted various trials in the first half, including confirming how we would be impacted by factors such as changes in sales volume and fluctuations in raw material prices, as well as our approach to inventory and our marketing procedures. In the second half, we will verify our findings and once we have the optimal solutions we intend to address various issues including the consumption tax rate increase in fiscal 2019.

11. In the Cosmetics Business, you said that sales of G11 brands have grown by double digits. What is the breakdown between purchases by Japanese consumers and inbound sales to Chinese consumers? Will such growth continue in the second half and thereafter? Have you been generating synergy by enhancing Kao's brand power in China to increase inbound demand?

The value and growth of inbound sales of *SUQQU* and *Curél* have been substantial. Sales outside Japan account for about 20% of *RMK* sales and about 30% of *SUQQU*, *Curél* and *KATE* sales. Most *freeplus* and *Molton Brown* sales are outside Japan, and *SENSAI* is only sold outside Japan. On the other hand, inbound sales of *KANEBO*, *SOFINA iP* and *est* have not increased. We intend to grow these brands globally as high-value-added brands.

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