
First Nine Months of Fiscal 2018 Conference Call Q&A Session Summary

Date and time:

Wednesday, October 24, 2018

16:00–16:55

Respondents:

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

Hideo Makino, Vice President, Financial Controllers

Mitsuhiro Watanabe, Vice President, Investor Relations

1. How much did net sales and operating income for the July-September period fall below your expectations?

Net sales were nearly 10 billion yen below expectations. This shortfall was mainly due to sales of *Merries* baby diapers to consumers in China. Operating income was 3-4 billion yen below.

Will this make it difficult for you to achieve your forecast of consolidated results for the fiscal year ending December 31, 2018?

Achieving our net sales forecast will require a substantial increase during October-December, and sales of *Merries* to consumers in China have been recovering since October. In Japan, demand for the purpose of resale in China has dried up, so we expect sales within China to increase.

Would you say that the downturn in sales of baby diapers in China has bottomed out?

That is how we see it.

2. How much have sales of baby diapers through cross-border e-commerce and in China decreased compared with the same period a year earlier? Have there been any changes in market share trends or the competitive environment in China?

The scale of cross-border e-commerce sales was not very large in the previous fiscal year, but we were unable to achieve an increase. Total sales to consumers in China decreased nearly 10 billion yen. As sales of local manufacturers' products grew, *Merries*' market share decreased a little during July-September.

Does the rising rate of usage of pants-type baby diapers mean Kao's sales of pants-type diapers have been growing since October?

Not only are pants-type diaper sales growing, but without resale of products from Japan in China, retailers' and distributors' inventories will gradually run out and Kao's sales will increase.

3. Even though sales momentum did not change much in the Human Health Care Business and the Fabric and Home Care Business from the January-June period to the July-September period, operating income decreased substantially. Was that due to higher raw material costs and marketing expenses? Were there any other factors that negatively impacted the margin mix?

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In the Fabric and Home Care Business, we were unable to achieve the increase we expected in sales corresponding to our investment in marketing in Japan. That was a major factor. Higher raw material costs and loss on disposal of property, plant and equipment also had an impact. For the Human Health Care Business, the main factor was the decrease in sales.

Why couldn't you increase sales in the Fabric and Home Care Business in Japan? Also, raw material costs may rise even further. How will you deal with that?

The competitive environment was severe, with new products from competitors and other factors. We will deal with higher raw material costs by offering new and improved high-value-added products.

Was it because raw material costs were high while product prices were trending downward?

Sales increased slightly in the Fabric and Home Care Business in Japan, but we had to deploy marketing expenses to avoid losing market share as we head toward the consumption tax rate increase in fiscal 2019. We need to increase sales further.

Do you mean that since conditions in the consumer products market in Japan are not bad, you will be able to increase sales further?

Yes.

4. For baby diapers in China, have you been competing in the high-price segment with local manufacturers whose share has been increasing? Has there been downward pressure on prices?

Price competition is intense between Kao and its global competitors' brands, and retailers' profit margins have declined as a consequence. Meanwhile, the quality of local manufacturers' products has improved to a certain extent, and their sales have been increasing because they are following a strategy of giving high profits to retailers. As a result, the market share of global competitors has been gradually dropping, with corresponding growth in the share of local manufacturers.

How will you respond to local manufacturers' products?

We intend to continue responding by aiming to be the world leader in terms of quality, which is *Merries'* strength. We will also enhance pants-type baby diapers.

So, would you say that local manufacturers' sales have been increasing because they are competing in the high-price segment and retailers are actively selling their products because of the profits, while global competitors have been experiencing downward pressure on prices?

Yes.

5. In the Skin Care and Hair Care Business, operating income for January-June decreased compared with the same period a year earlier. What led to the shift to a 1.6 billion yen increase in July-September?

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Strong performance by skin care products in Japan was a major factor. Operating income from *Bioré* grew substantially due to the hot summer and launch of new products. In the Americas, operating income declined substantially in January-June but improved in July-September.

In each of the first three quarters of 2018 (January-March, April-June and July-September), operating income in the Cosmetics Business continued to increase around 4.0 billion yen compared with the same respective periods a year earlier. With sales in Japan on a downward trend, what is the breakdown of operating income between Japan and the rest of Asia?

Structurally, until the previous fiscal year the Cosmetics Business in Japan was unprofitable from January through September, then generated operating income during October-December. In fiscal 2018, it has generated operating income since April-June. Together with strong performance by our eleven global strategy brands (G11), sales in Asia have grown substantially, and the operating margin has also improved significantly. We had said that we were aiming for an operating margin of 6% for the fiscal year ending December 31, 2018, but the operating margin in January-September was 6%, so now we are looking to exceed that figure for the full fiscal year.

You said that operating income for July-September was 3-4 billion yen lower than expected. Am I correct in understanding that the main causes were the Human Health Care Business and the Fabric and Home Care Business?

That is correct. Operating income fell short of our expectations mainly due to the Human Health Care Business and the Fabric and Home Care Business. The Human Health Care Business was significantly affected by a decrease in sales of baby diapers in Japan and China and higher raw material costs, and the Fabric and Home Care Business was significantly affected by higher raw material costs.

Am I also correct in understanding that operating income from the Cosmetics Business, the Skin Care and Hair Care Business and the Chemical Business was as planned, and operating income from the Fabric and Home Care Business and the Human Health Care Business fell short of the plan by about 2 billion yen each?

Yes.

Can the Fabric and Home Care Business recover during October-December with sales momentum from the launch of new and improved products in autumn? Can the Human Health Care Business recover if retailers' and distributors' inventories of baby diapers in China return to normal?

For the Human Health Care Business, we are aiming for an upturn during October-December, but a recovery may be difficult. In the Fabric and Home Care Business, we would like to regain ground one way or another. In either case, it will not be easy.

Since the amount of baby diapers from Japan resold in China was larger than the volume sold by Kao, can we assume that the current negative impact will continue?

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It may be difficult to recover during fiscal 2018, but we are headed toward improvement. In October-December, we are expecting results from dealing directly with major online retailers and strengthening our efforts for Singles' Day.

- 6. You said that sales of baby diapers in China were affected by adjustments to retailers' and distributors' inventory of products resold from Japan. Did sales volume decrease because the prices of products sold through sales channels in which Kao trades were maintained? Are stricter regulations in the future likely to bring an end to the business of reselling from Japan in China? Do you think the end of the resale business will be good for Kao in terms of increasing sales volume while maintaining profitability?**

The shipping price of products from Kao has hardly changed at all. The decline of selling prices in retail stores caused by resold items has had an impact on products sold through sales channels in which Kao trades. The resulting decrease in retailers' profit margins has led to a decrease in our shipments. Over the past year, selling prices in retail stores have dropped by about 5-7%, but they did not fluctuate as much in July-September. If e-commerce regulations become stricter, they may have some effect on products other than baby diapers, but we think such regulations would be a step in the right direction.

It seems to me that so far, the problem of retailers' and distributors' inventory adjustments due to resold products has come up about once every fiscal year. Can we expect this problem to disappear?

That is our hope.

What is the breakdown of the 11.4 billion yen increase in operating income in the Cosmetics Business due to higher sales, cost reductions, and other special factors?

Around 70-80% was due to the increase in sales.

Was the remaining 20-30% mostly the result of cost reductions?

Rather than cost reductions, greater efficiency from a shift to digital marketing and other factors resulted in more efficient use of expenses, which led to profits.

Were the effects of the increase in Cosmetics Business sales considerably larger in the rest of Asia compared with Japan?

The operating margin was high in the rest of Asia, but the scale of sales was large in Japan, so the effect of increased sales was not that different in Japan and the rest of Asia.

Having looked at conditions in the Cosmetics Business during July-September, do you get a sense that things will go as you envision in October-December and in fiscal 2019, or do you think that you will not be able to reach your operating income target of 30 billion yen in fiscal 2020 if new products for fiscal 2019 do not do well?

We are seeing good progress. We plan to launch new *KANEBO* and *est* products in the

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high-price segment in November 2018 and expect steady sales growth. In addition, if our cutbacks in brands other than G11 and eight regional strategy brands (R8) go according to plan for the period to fiscal 2022, we think we can also expect steady growth in fiscal 2019 and thereafter.

How much have G11 and R8 brand sales been growing?

G11 brands grew 17-18%. R8 brands sales were slightly lower than the same period a year earlier.

Which of the R8 brands are performing well? Which are facing issues?

Primavista base makeup, which struggled in the previous fiscal year, has been on an upturn. *COFFRET D'OR* makeup has also been showing signs of a recovery. On the other hand, *EVITA* self-selection skin care, which was renewed in fiscal 2018, has been struggling.

7. How much did sales of the Cosmetics Business in Japan grow during July-September on a like-for-like basis?

Sales growth in the Cosmetics Business in Japan during July-September was 4.3% on a like-for-like basis.

I think cosmetics account for a large proportion of sales to visitors to Japan. Is there any reselling of cosmetics from Japan in China? Will there be any impact if stricter e-commerce regulations bring an end to resale of cosmetics?

Inbound sales for January-September totaled about 20-22 billion yen, 75% of which were for cosmetics, and sales of brands such as *Curél* derma care and *SUQQU* counseling cosmetics in particular have been growing. I think stricter regulations and legislation in China will have a temporary impact on sales, but sales will shift to other channels. We believe that stricter regulations will establish a sound market and maintain a degree of discipline, which will be a positive situation in the long term.

8. How do you envision the competitive environment of the Fabric and Home Care business over the next year?

We are preparing promising new products for next year. Please wait a bit for details.

Are you also thinking about different sales channels and selling methods?

We have no particular changes in mind.

What happened in categories such as laundry detergents and fabric softeners during July-September?

Laundry detergents recovered slightly. Fabric softeners are getting back on track with improved *Flair Fragrance*.

What was the contribution to results from Washing Systems, LLC, which you acquired in the United States?

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We only just acquired Washing Systems. It operates in the commercial-use field, so we are aiming for steady growth, unlike laundry detergents and fabric softeners for consumer use.

What is the outlook for Washing Systems' annual contribution to operating income?

We are currently calculating the intangible assets and other items that need to be depreciated, but we expect the company to have an operating margin of around 10%.

Note

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