May 10, 2019

First Three Months of Fiscal 2019 Conference Call Q&A Session Summary

Date and time:
Wednesday, April 24, 2019
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. What are the sales of *Merries* baby diapers by region? Since you did not respond to price pressure from cross-border online retailers in October-December 2018, how were the conditions in January-March 2019?

During January-March, global sales of *Merries* decreased approximately 20% compared with the same period a year earlier. Sales to consumers in China decreased, including through cross-border e-commerce. Due to the progress of inventory clearance by resellers, we have made progress in negotiating with cross-border online retailers since April. Sales of *Merries* by a subsidiary in China for April look likely to exceed the same period a year earlier.

In 2018, cross-border e-commerce was strong in January-June but slowed during July-December. Consequently, this year the hurdle will be high for January-June, but sales during July-December are likely to increase compared with the same period a year earlier. In addition, we will strengthen *Merries'* brand equity with the launch of a super-premium product line in China.

Merries' share has been growing among Japanese consumers according to purchasing survey data from monitors in Japan (SCI) and the brand has maintained the top share in China, so we believe it can recover in the second half of 2019.

2. What was the impact of China's new e-commerce law in the decline in demand for *Merries* in Japan for resale in China? Was it different from the impact on cosmetics?

The impact of China's new e-commerce law on *Merries* has been distinctly different from that on cosmetics. Resale of *Merries* from Japan to China decreased significantly, and inventory clearance is underway in China. For cosmetics, inbound demand in Japan remains brisk.

Isn't it better for Kao if resale of *Merries* from Japan to China cease completely?

That's true. We are hoping for a desirable situation where sales within China will grow.

If the Chinese yuan becomes stronger against the yen, will resale from Japan to China revive?

We are hoping to curb resale demand with initiatives including the launch of an appropriate super-premium product line for Chinese consumers in China.

3. In the Human Health Care Business during January-March, sales decreased 8.4 billion yen and operating income decreased 8.0 billion yen compared with the same period a year earlier. That was a large decrease in operating income relative to the decrease in sales. What factors other than the decrease in sales led to the decrease in income? What was the impact of raw material price fluctuations in the Human Health Care Business? Also, is the capacity utilization rate falling at manufacturing facilities for *Merries*? Will the rate improve after July, when sales recover?

The 8.0 billion yen decrease in operating income was mainly attributable to *Merries*. About 4.0 billion yen of the decrease in income was due to the decrease in sales. The impact of raw material costs due to higher pulp and petrochemical raw material prices was just under 1.0

billion yen. Also, because *Merries* manufactured in Japan are imported into China, the impact of currency translation due to the depreciation of the yuan was about 1.0 billion yen. The capacity utilization rate for *Merries* tape-type diapers has fallen, but we are aiming for a recovery from July onward. Our investment in pants-type diapers also increased fixed costs.

Was the capacity utilization rate for *Merries* at its lowest point in January-March? How has it been trending since October-December 2018?

Although the capacity utilization rate for tape-type diapers has fallen, we are aiming to recover with the launch of a super-premium product line in China. The capacity utilization rate for pants-type diapers remains high.

4. **What is your view of the momentum of consumption among Chinese consumers? What do you think about changes in business trends and consumer sentiment regarding the purchase of cosmetics or baby diapers?**

Since baby diapers are used by infants, consumers place the utmost priority on safety and peace of mind, so even if China’s economy slows slightly, we expect it will take a considerable amount of time for the effects to show up in baby diaper purchases. As for cosmetics, according to purchasing survey data of Japanese consumers (SCI), the high-price segment decreased from the same period a year earlier while the low-price segment grew. We also see a slight drop in sales per customer in China, including inbound sales in Japan.

How were the competitive conditions for baby diapers in China?

Market conditions, including selling prices for *Merries*, did not change much during January-March.

What were your expectations for growth in China’s baby diaper market in 2019, and how does the current situation differ from your assumptions?

We expected double-digit growth, but we are currently seeing mid-single-digit growth. The decline in the number of births was a concern last year, but the market is shifting to pants-type diapers, and although growth is not what it used to be, it remains an attractive market that will continue to grow moderately.

5. **In the Cosmetics Business, how much have Kanebo Cosmetics, Sofina and the *Curél* derma care brand each grown? Why were the growth rates significantly higher than they were in 2018?**

The Cosmetics Business is strengthening brand management with a new portfolio rather than looking at the businesses of Kanebo Cosmetics and Sofina separately. Among our eleven global strategy brands (G11), compared with the same period a year earlier, *Curél* grew approximately 30%, *freeplus* grew more than 50%, and *SOFINA iP* also performed well. Sales of our eight regional strategy brands (R8), which had decreased in fiscal 2018 compared with the previous year, also grew 9% in January-March 2019 compared with the same period a year earlier, due to substantial growth of *ALLIE* UV care products, among others. Among non-G11 and R8 brands, *DEW*, which we improved in 2017, performed strongly.

Under the new growth strategy we announced last year, we have been strengthening brands by going through the plan-do-check-act (PDCA) cycle more quickly and in finer detail, and we have been successful in continuing to draw consumers’ attention online through digital marketing. In Japan in summer we will conduct a campaign in response to the extreme heat, and in autumn we plan to expand our lineup of prestige skin care brands, which we have not been fully addressing. As a result, to the extent it is possible we hope to exceed our fiscal 2019 plan for sales growth of 4.5% and an operating margin of 11% in the Cosmetics Business.

How did the growth rate of the G11 brands change from last year?

In 2018, growth was nearly 20%, driven by *Curél*, *freeplus* and *SUQQU*. In addition to these brands, during January-March 2019 *SENSAI*, which will be launched in Japan this autumn, and *KANEBO* performed well.

Is the lack of growth in the Japanese market due to a slowdown in inbound demand?

In Japan's cosmetics market, there appears to have been a slowdown in inbound demand due to the implementation of the new e-commerce law in China in January, but demand recovered in February-March, and sales of the Kao Group's cosmetics to inbound customers grew about 20% compared with the same period a year earlier. Inbound sales also grew about 20% for the full year in 2018, and *Curél* and *SUQQU* continue to be the brands those customers are buying, so we are not seeing much impact from the new e-commerce law on our strong brands.

Sales of *freeplus* grew about 50% in Japan compared with the same period a year earlier, in addition to continuing strong sales in China.

Is the growth of *freeplus* due to new products?

We have started using a new spokesmodel and launched new products to strengthen brand development in Japan.

Growth became apparent in the Cosmetics Business during January-March due to the absence of R8 brands recording negative growth as well as the continued growth of the G11 brands.

6. **The operating margin of the Cosmetics Business for January-March was 9.2%, and you have said that you expect to be able to maintain that high level throughout the year. What is the basis for that expectation? Do you foresee continued growth of R8 brands? Is it due to more efficient use of marketing expenses from the shift to digital marketing?**

We are planning new and improved products and various measures, and the effectiveness of using digital marketing is becoming apparent, so we expect growth to continue.

Will future growth in operating income be the result of greater cost efficiency? Or will it result from sales growth? Hasn't the operating margin improved because inbound sales exceeded your expectations?

The operating margin improved as a result of growth in sales, although inbound sales were not the main factor. Last year, more efficient use of expenses led to a major improvement, but this year we intend to improve the operating margin by increasing sales.

Which brands sold more strongly than you expected?

Sales of *Curél* and *freeplus* grew significantly, and sales of *ALLIE* were strong in Japan.

Since last year, inbound sales of cosmetics have been growing by 20% quarter-on-quarter. How much of that was accounted for by resellers? How are cosmetics different from *Merries* baby diapers, for which resales have decreased?

For cosmetics, we are unable to grasp the situation at resellers. The difference from *Merries* seems to be the disparity in the operating margin on resales. For *Curél* and *freeplus,* inbound sales remained strong but for products such as *MegRhythm* thermo products, which had been growing until last year, sales slowed in Japan while growing in China. Inbound demand for our strong brands has not fallen even though regulation became stricter under the new e-commerce law.

For *MegRhythm*, I have a very positive impression that borderless marketing is working in Japan and China.

7. In the Fabric & Home Care Business, sales increased 6.6% compared with the same period a year earlier and operating income decreased 3.5% (0.4 billion yen). Excluding the impact of the acquisition of U.S.-based Washing Systems, LLC, the increase in sales would have been 3.2%. How should we view this increase in sales and decrease in income, including the impact of higher raw material prices? In addition, regarding laundry detergents, what is the status of the discontinuation of sales of *Attack Neo* and the initial shipments of *Attack ZERO?**

* *Attack ZERO* is an innovative new product that realizes "Three Zeros": "Zero stubborn stains," "Zero musty odor" and "Zero detergent residue" and revives garments.

Sales increased due partly to initial shipments of *Attack ZERO*, which hit the shelves in April, but operating income decreased because of a slight drop in prices for *Attack Neo* due to the end of sales and the impact of higher raw material costs.

We will carry out various measures to achieve substantial growth in sales of *Attack ZERO* for the full year.

It seems to me that the selling price of *Attack ZERO* is high, partly due to the "one-hand pump dispenser" bottle.

Laundry detergents tend to get drawn into price competition, but we are confident in offering the one-hand pump dispenser feature, so we intend to take time to communicate the value of the product.

Will you also deploy sales promotion expenses in April-June to increase sales?

We will strengthen marketing activities in April-June to prepare for last-minute demand in July-September ahead of the increase in the consumption tax rate in Japan.