Kao

First Three Months of Fiscal 2020 Conference Call Q&A Session Summary

Date and time:
Monday, April 27, 2020, 16:00-16:55 (JST)

Respondents:
Kenichi Yamauchi, Executive Officer, Senior Vice President, Accounting & Finance
Hideo Makino, Vice President, Financial Controllers
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1. **Why is the increase in operating income for the Skin Care and Hair Care Business smaller than the increase in sales on a like-for-like basis? In the Human Health Care Business, on the other hand, operating income increased more than sales. Please explain these differences in the context of factors such as fluctuations in raw material prices and the impact of the production capacity utilization rate.**

   In the Skin Care and Hair Care Business, sales of hand soaps and hand sanitizers, which have relatively low profit margins, have increased due to heightened awareness of hygiene, which resulted in a smaller increase in operating income than in sales. In the Human Health Care Business, in addition to lower raw material prices, an increase in sales of sanitary napkins improved the product mix.

   What was the main cause of the growth in market share for sanitary napkins in Japan?

   New and improved sanitary napkins have been performing strongly for the past two years or so. That trend has continued in 2020, increasing the market share of Kao's sanitary napkins in Japan during the January-March period.

   Didn't the capacity utilization rate at factories have a substantive impact in the first quarter? What is your outlook for the second quarter and thereafter?

   We have ramped up production of hygiene-related products, for which demand has increased. We have added production lines for hand sanitizers and requested employees involved in production to come to work. Although there are differences by product, the capacity utilization rate has not decreased overall. However, sales of cosmetics and hair salon products have decreased and conditions are expected to remain severe in the second quarter and thereafter, so we expect an even greater decline in production volume of those products than we experienced in the first quarter.

2. **How is the Cosmetics Business in Japan doing in each sales channel? You said that the Cosmetics Business in China has been recovering since March, but how was its performance from January to March?**

   In department stores in Japan, the Kao Group quickly imposed limitations on in-store counseling activities, which has had an impact. Sales of makeup products in particular have declined as a result of restrictions on going outside. In Japan and other Asian countries, not just at Kao China, online sales are growing. Kao China's Cosmetics Business conducted an e-commerce channel campaign for International Women's Day in March, and the pickup in sales became apparent around then. We assume that online retailing is likely to continue to grow in presence going forward.

Kao China's sales ratio of e-commerce channel has been high in the past. What was the situation in January-March? How much did Cosmetics Business sales grow?

Online sales increased. As of December 31, 2019, approximately 60% of Kao China's sales in the Cosmetics Business were in the e-commerce channel. During January-March, sales in the Cosmetics Business at Kao China increased approximately 20% compared with the same period a year earlier.

3. **Are the effects of special demand for hygiene-related products in the Skin Care and Hair Care Business and the Fabric and Home Care Business likely to increase in the second quarter and thereafter? If hygiene-related products account for a greater proportion of sales than UV care products from the second quarter onward, how do you think this will impact the operating margin?**

Predicting the operating margin for the second quarter is difficult, but the effect of special demand for hygiene-related products may be equal to or greater than it was in the first quarter. Hand sanitizer is intrinsically a product that does not require significant marketing expenses. Moreover, supply cannot currently keep up with demand. On the other hand, during the first quarter we postponed marketing campaigns and launches of new and improved products. Expenses for these activities are likely to arise in the future.

Is my understanding correct that the substantial increase in the operating margin of the Fabric and Home Care Business was due almost equally to lower prices for raw materials and the effect of special demand?

The increase in sales due to special demand had a greater impact on the increase in the operating margin than did lower prices for raw materials. In particular, sales of home care products increased without significant marketing expenses.

Will marketing expenses in the second quarter and thereafter be higher than they were in the first quarter?

We will use marketing expenses where we need to. Kao is conducting a hygiene-related marketing campaign based on ESG-driven management called "Protect Japan by Kao." Even as we work to streamline marketing expenses, we intend to roll out this campaign aggressively, so expenses in this area are expected to increase.

You said that you expect a gross positive effect of 8 billion yen from fluctuations in raw material prices for the year. Isn't that a conservative estimate?

Lower raw material prices had a positive effect of 2 billion yen in the Consumer Products Business in the first quarter, so we currently estimate that a positive effect of approximately 8 billion yen for the full year is likely, simply by multiplying the first-quarter impact by four. In the Chemical Business, predicting prices of natural fats and oils and product selling prices is difficult.

Did *Curél* perform strongly in Kao China's Cosmetics Business?

Both *Curél,* a derma care brand, and *freeplus,* which is hypoallergenic and contains Japanese and Chinese botanical extracts, performed strongly.

4. **The second quarter is forecast to be even more severe, with a high hurdle in the third quarter as well. You said that you aim to achieve the figures announced in the full-year forecast, but what are your reasons for leaving the forecast of consolidated results unchanged? Do you expect decreases in sales and operating income in the Cosmetics Business?**

Predicting the future is difficult, but at this point we would like to reach operating income of 220 billion yen, the lower end of our forecast range. We expect decreases in sales and operating income in the Cosmetics Business.

If special demand subsides, you can't expect *Laurier* sanitary napkins to achieve the same level of growth as in the first quarter, can you? Why were sales of *Merries* baby diapers strong at Kao China in April?

Market share for *Laurier* has continued to grow, so we expect sales to remain strong, though not as strong as in the first quarter. Sales of *Merries* have started to increase mainly due to the impact of the recovery trend in distribution and online retail in the Chinese market.

5. **How much did the decrease in inbound demand affect the Cosmetics Business? What is your outlook for April-June?**

Inbound sales of both household and personal care products and cosmetics decreased by more than 40% in January-March compared with the same period a year earlier. Sales of *SUQQU*, which is a high-priced brand with a high inbound sales ratio sold at department stores, have dropped substantially. We expect a further decrease in inbound sales in the Cosmetics Business from April onward.

6. **In the Cosmetics Business in Japan, Kao has strong mass-market brands, so I would expect sales to be higher at drugstores than at department stores. Drugstores were still operating in March in Japan, so why did cosmetics sales drop substantially? Were conditions at Kao worse than for the cosmetics market as a whole?**

On a sell-out basis, we did the same as the market. Our sales were no worse than the market. The decrease in sales of the Cosmetics Business in Japan was approximately 15% in January-March and 20-25% for March alone. According to SRI data, the market contracted about 10% in total in January-March and about 20% in March alone. Because the Kao Group quickly imposed limitations on counselling activities at department stores, sales of *SUQQU* and other products sold at department stores fell substantially in March. However, sales of *Curél* remained unchanged from the same period a year earlier.

7. You said that consumer awareness of hygiene has changed significantly, but what kinds of changes have occurred? For sustainable growth going forward, what kind of measures will you take that will lead to sales and corporate growth from Kao's Kirei* Actions?

Consumers have always had a strong awareness of the need for deodorizing and disinfecting, but now they demand more specific information, such as what products are effective for what applications, and whether there is evidence to support claims of effectiveness. Kao has consistently focused on evidence-based research and development and marketing, and going forward we will implement marketing initiatives unique to Kao in which we reinforce these approaches even more strongly.

* Kao's ESG activities. *Kirei* is a Japanese word that refers not only beauty and cleanliness but also to people's well-being and a healthy global environment. Kirei Actions represents Kao's efforts to create products wholeheartedly and engage in activities that contribute to a better future for people and the planet.

Consumer awareness has changed drastically over the past month or two, but what is your view on whether it will last?

We are currently reworking our strategy on the assumption that these changes will endure for a decade or two. We believe that they will become the foundation of our future business and the basis of our future mid-term plans. We expect this change in awareness to have a high level of staying power because we see its impact extending beyond the consumer level to policies on the national level.