Kao Group First Half of Fiscal 2020 Presentation Q&A Session Summary

Date and time:
Wednesday, July 29, 2020, 17:00-18:30 (JST)

Respondents:

Michitaka Sawada	Representative Director, President and CEO
Toshiaki Takeuchi	Representative Director, Senior Managing Executive Officer Representative Director, President, Kao Group Customer Marketing Co., Ltd.
Tomoharu Matsuda	Director, Managing Executive Officer President, Consumer Products, Global
Yoshihiro Murakami	Managing Executive Officer Responsible for Consumer Products – Cosmetics Business
Kenichi Yamauchi	Executive Officer Senior Vice President, Accounting & Finance, Global

1. Operating income of the Cosmetics Business decreased compared with the same period a year earlier. Operating income usually increases in December, but what is your outlook for the second half of this fiscal year?

Because the Cosmetics Business has substantial fixed costs, significant sales growth is required to make a profit. In our current outlook, we intend to recover from the net loss in the first half and return to profitability during the fourth quarter. We expect full-year operating income to be about 40% of the previous year's result.

What percentage did e-commerce account for in Cosmetics Business sales in the first half?

In Japan, sales in the e-commerce channel nearly tripled from 4% in the same period of the previous fiscal year to about 10% now. At Kao China, the percentage of Cosmetics Business sales from the e-commerce channel has always been high, and it is now 70%, which is about 1.5 times that of the same period a year earlier. At Molton Brown in Europe, which was one of the first Kao Group brands to conduct its own direct to consumer online sales business (D2C business), sales in the e-commerce channel in April-June accounted for 75% of sales, or about four times that of the same period a year earlier.

At Kao China and in Europe, e-commerce has thus been compensating for the decline in sales at brick-and-mortar stores. The issue for us is the delay in conducting our D2C business in Japan.

2. What is the outlook for hygiene-related products in the second half?

We do not expect sales in the second half to grow as much as they did in the first half. Compared with the same period a year earlier, first-half sales increased 17 billion yen, but the increase is expected to be only 12-13 billion yen in the second half.

Growth in sales of home care products overall in the second half is expected to be limited to several hundred million yen compared with the same period a year earlier, assuming an increase in stock at households. In skin care products, sales of our mass-market brand *Bioré*, including UV-care products and makeup remover, increased 5.6 billion yen in the first half compared with the same period a year earlier, and are expected to increase 7-8 billion yen in the second half. Second-half sales of commercial-use products are expected to grow 2-3 billion yen compared with the same period a year earlier.

The rate of increase in operating income in the second half is expected to be lower than it was in the first half, when we curtailed sales promotion and new product launches.

3. In the Cosmetics Business, how did eleven global strategy brands ("G11") and eight regional brands ("R8") perform in Japan in the first half? Also, what were the percentages of makeup products and skin care products in total sales? Did either of them grow?

According to SLI data of INTAGE Inc., the overall cosmetics market shrank 18% in April-June, compared with the same period a year earlier. That consisted of decreases of 10% for skin care, 39% for base makeup and 34% for point makeup. Breaking down the figure for point makeup, among eye makeup, eyebrow products decreased 16% and mascara decreased 19%, and lipstick decreased 65% because wearing a mask became common practice.

Based on 2019 data, the ratio of skin care to makeup products is 6:4, so skin care accounts for a greater proportion. However, makeup products, which have been impacted by the COVID-19 pandemic, make up a larger proportion of sales in the Kao Group's Cosmetics Business than they do at other competitors. This has had a significant impact on business results.

As for the performance of G11 and R8 brands in the first half, globally, G11 sales decreased 10% compared with the same period a year earlier, and R8 sales decreased 24%. In Japan, G11 sales decreased 18% and R8 sales decreased 26%.

Recovery of the market for makeup products is likely to take some time. The Kao Group's Cosmetics Business is strengthening premium skin care. What is your outlook for that?

In the Kao Group's Cosmetics Business, proportion of sales of the mid-price range and makeup products is high. The mid-price range is an extremely high-cost business because of substantial fixed costs, and makeup products have a low profit margin because of their high manufacturing and promotional costs. Given these factors, strengthening premium skin care brands is one of the major pillars of the growth strategy we announced in 2018. Based on this strategy, we began strengthening premium skin care in autumn 2019. We reinforced the *est* brand in 2019, and in Japan we launched the *SENSAI* brand, which was previously sold mainly in Europe. We also leveraged the global *KANEBO* brand. However, strengthening premium skin care was a strategy premised on inbound demand, so we have diverged from our initial estimates. Therefore, we are currently focusing on two points: (1) strengthening branding that targets Japanese consumers, and (2) expanding sales at Kao China to compensate for the loss of inbound demand.

4. In the second half, will you be more aggressive in cutting fixed costs for beauty advisers in the Cosmetics Business than you were in the first half?

We are not considering drastically cutting costs for beauty advisers. Beauty advisers are important assets of the Kao Group. We will adjust the number of new hires while enabling beauty advisers to conduct web-based digital counseling and optimize staff deployment. At the same time, we are working to deploy marketing expenses more efficiently through measures such as reviewing the timing of new product launches. Launching a new product entails considerable costs for sales promotion, so we are making thorough efforts to reduce costs by reviewing these measures altogether.

5. How do you view the status of the Human Health Care Business and its outlook?

The Human Health Care Business is broadly divided into three categories: sanitary products, consisting of adult diapers and sanitary napkins; *Merries* baby diapers; and personal health products, which include oral care products, bath additives and *MegRhythm* thermo products.

In sanitary products, sales of *Laurier* sanitary napkins were very strong, increasing 6% in the first half compared with the same period a year earlier. That temporary surge in demand in the first half is now facing somewhat tough conditions, but we expect a year-on-year increase in sales for the full year. Sales of *Merries* decreased by more than 5 billion yen in the first half, but operating income rose slightly due to lower manufacturing costs and various measures in areas such as the deployment of expenses. We expect the same trend to continue for *Merries* in the second half. For personal health products, we expect full-year sales and operating income on par with the previous year as a result of strong sales of bath additives. The Human Health Care Business has some ups and downs during the year, but we do not expect significant changes in full-year sales and operating income compared with the previous year.

6. In today's presentation, there was a statement that the possibility of an even more severe impact from COVID-19 has not been taken into consideration. How much of an impact are you assuming at this point?

The revised full-year forecast has not incorporated any assumption of a return to the situation in March and April in Japan. If we do return to such a situation, there is a potential negative impact of 5% to 10% on Cosmetics Business sales, for example. On the other hand, demand for hygiene-related products would be expected to increase. The situation changes depending on the balance between these factors.

7. What are your thoughts on the current situation and outlook for sales of *Merries* baby diapers at Kao China?

Most of the decrease in sales of *Merries* in the first half was in Japan. We expected this amount of decrease, which was equivalent to the amount of sales in Japan for resale outside Japan, which has virtually stopped. On the positive side, sales were strong in Indonesia and manufacturing costs were lower compared with the previous year, among other factors. Taken together, these factors did not have a major impact on operating income. We expect the second half to be the same as the first half. However, we are planning a new product launch in Japan in the autumn, so we expect second-half sales in Japan to increase slightly compared with the same period a year earlier. At Kao China, on the other hand, our online campaign for Singles' Day on November 11 will provide a stimulus to second-half sales, but the outlook is severe, due in part to price competition in the market, so we forecast a decrease in sales in Asia. Based on this outlook, we expect sales of *Merries* in the second half to be basically flat from the same period a year earlier.

8. Lower raw material prices have had a more positive effect than in your plan at the beginning of the year, but the amount of Kao's Total Cost Reductions (TCR) has remained unchanged at 6 billion yen, which was the assumption at that time. Is this because even though you are taking cost-saving measures, their effects are being offset by lower capacity utilization at factories due to decreased production volume?

Raw material prices have generated a gain of 4 billion yen in profit in the first half compared with the same period a year earlier, so 5 billion yen for the full year forecast may seem low. However, while prices of petrochemical raw materials are decreasing, prices of natural fats and oils are expected to rise this year compared with the second half of 2019. Nevertheless, we expect the impact to be somewhat positive on the Consumer Products Business overall, but negative in the Chemical Business, when selling prices are taken into account. Therefore, we forecast a net amount of 5 billion yen for the year. As for TCR, we do not necessarily expect to exceed the amount we decided on at the start of the year, but if some good new ideas arise, we will increase it. We expect to achieve a minimum of 6 billion yen toward cost reductions.

9. There has been unforeseen impact from the COVID-19 pandemic this year, but looking at the situation to date, the Kao Group has fallen short of the guidance it provided at the beginning of the period for the third consecutive fiscal year. So far, you have been steadily achieving profitable growth, but what are your thoughts on not being able to secure profits in line with your announcements?

Because of the severe business environment in 2018 and 2019, we aimed to exceed our guidance in 2020, but we were confronted with various challenges. Management must assume such unforeseen situations and takes its responsibility seriously when it cannot meet expectations. We believe the reason we have been falling short is that we have been slow in responding to changes. For example, when *Merries* baby diapers were performing strongly, we were preparing to strengthen the Cosmetics Business at the same time, but we were unable to link *Merries'* strong performance to investment in the Cosmetics Business in a timely fashion. If we do not continue to cultivate other businesses when a certain business is performing well, we will not be able to compensate when that business performs poorly. In 2018 and 2019, there was a time lag in our response to the difference in performance of *Merries* and the Cosmetics Business. We think our sense of urgency in dealing with the change was insufficient.

This year, employees are giving their all to meet demand for hygiene-related products, but we need to work on what will come next to add to sales, looking one step ahead while going through a process of trial and error. For the past two or three years, we have been inadequate in our efforts to steadily establish and create the next step ourselves rather than making unconnected product launches with random success.

Next year, we plan to launch K25, our new mid-term plan, and will proceed as quickly as possible to ensure our various research assets are deployed so you can expect profitable growth from the Kao Group. We are currently discussing how to expedite these efforts in a way that is more than simply a continuation of what we have been doing.

10. It appears likely that there will be a delay in achieving a 15% operating margin target in the Cosmetics Business. What are your thoughts?

We have been reflecting on our delay in responding to unforeseen situations. We achieved our 2020 target of a 10% operating margin one year ahead of schedule in 2019, but fixed costs and marginal profits are high in the Cosmetics Business. As a result, profits materialize all at once when the top line rises, and fall all at once when it falls.

The global growth of the cosmetics market has been due to the growth of travel retail and inbound demand as people travel around the world. However, we expect that it will take two or three years for COVID-19 to be brought under control and people's movement to return to where it was in 2019. In the meantime, we intend to steadfastly conduct structural reforms. In addition to the measures to reduce fixed costs that we have been carrying out, we strongly feel the need to take the next step in streamlining and consolidating our range of makeup brands. These measures are already under consideration and we will implement them with resolve.

11. With the increase in people staying home due to the COVID-19 pandemic, haven't sales been boosted by factors such as people doing their laundry more often? How is the business doing in areas such as sales of *Attack ZERO* liquid laundry detergent following its renewal?

While the Cosmetics Business is struggling, we believe we must maintain operating income and the operating margin in the Fabric and Home Care Business to achieve our announced operating income figure. The market for home care products grew substantially in the first half. However, although the market for fabric care products expanded temporarily in

January-March due to factors such as bulk purchasing, it shrank compared with the same period a year earlier in April-June, due in part to people doing laundry less frequently because they voluntarily refrained from sports and other events, and due to cutbacks in sales promotion flyers at stores.

We launched an improved version of *Attack ZERO* liquid laundry detergent in May. The product's market share, which was around 11% the same time last year, has recently risen to around 14%, and we expect it to continue rising.

In addition, we generally held back on new product launches for fabric and home care products in the second half of 2019, when there was last-minute demand ahead of an increase in the consumption tax rate in October in Japan. However, this year we are planning many new product launches and intend to add significantly to sales by stimulating the market with measures such as offerings for hygienic cleaning and laundry, including for existing products.

12. What are your thoughts on the outlook for the Cosmetics Business from the second half into fiscal 2021? How did the Cosmetics Business perform in Asia in the first half?

Based on various data such as the number of tourists, it is likely to take two to three years before the number of people visiting Japan exceeds the 2019 level. First-half sales in Asia have come to depend on Kao China, where sales increased 24% compared with the same period a year earlier, but the situation is challenging in other countries and regions.

Travel retail is not a very large part of sales in Kao Group's Cosmetics Business, so I do not expect much impact from changes in tourist numbers. What is the outlook for sales in the second half and fiscal 2021?

For the second half, we have no choice over the short term but to compete by achieving stable sales for cosmetics, which we consider to be a business of Kao China. Our outlook for our Cosmetics Business in the second half is an 18% decrease in the third quarter and a 2% increase in the fourth quarter, each compared with the same period a year earlier. Sales in Japan are expected to decrease 23% in the third quarter and to decrease 4% in the fourth quarter. That averages out to a decrease of about 14% in the second half. We are assuming a 40% to 50% increase in sales at Kao China in the second half compared with the same period a year earlier, so Kao China will support net sales and operating income in the Cosmetics Business.

13. You said that the Kao Group will launch a new product for *Merries* baby diapers in Japan this autumn. Will this product be the first step toward aggressive activities in 2021?

Our last major improvement to *Merries* was 16 years ago in 2004, and product performance has been steady since then. In my opinion, any baby diaper product has a lifecycle of about 10-15 years. I think that is one reason *Merries* has been struggling for the past few years. We are therefore trying to bring together the best technologies for a new product to be launched in Japan this autumn, and a super-premium product to be produced locally by Kao China next year. We must be resolute in generating profit and increasing our brand power even if sales dip temporarily. Our first step will be in Japan.

14. In the Skin Care and Hair Care Business, the outlook at the end of the first quarter was for a substantial decrease in sales of products for hair salons in the Americas and Europe in the second quarter, but both sales and operating income improved. Why?

As of the end of the first quarter, we expected severe conditions for products for hair salons in the Americas and Europe in the second quarter because most hair salons were temporarily closed. However, U.S.-based *Oribe* has outperformed expectations by stepping up sales, mainly through e-commerce. In addition, hair salons reopened in June, mainly in Europe, and orders exceeded expectations in June and July.

15. When can we evaluate the performance of hygiene-related products outside Japan?

We currently sell hygiene-related products primarily in Japan, but would like to expand sales to Asia, Europe and the Americas. To show results that investors can evaluate, we must have local production and full-scale sales outside Japan. That will require time for us to address local laws and regulations, so full-scale operations are likely to take a little longer.

16. The presentation for this quarter has been mostly gloomy. Can you tell us about something uplifting, such as your dreams for Kao's future? What would you like to accomplish in your next mid-term plan?

The basis for K25, our next mid-term plan which is now being prepared, can be summed up as caring for and safeguarding people's lives. We consider helping people live with peace of mind, which in turn leads to their happiness, to be an important mission for us. I believe our current hygiene-related products are making a contribution in that regard, but as I have mentioned previously, the Kao Group also conducts extensive research and development (R&D) to save lives in a broader sense. I believe that playing an active role on a global level with the aim of being useful to society is in line with the Kao Group's corporate philosophy.

I think the Kao Group's distribution capability is weak in comparison with global companies. If the current COVID-19 pandemic situation continues, I am afraid the gap between Kao and companies with strong global brands and strong distribution will widen. I think a dream of safeguarding lives makes a wonderful story, but how do you intend to close the gap?

We intend to proceed with the Kao Group's strengths firmly in mind. One major strength of the Kao Group is its R&D. However, we have not fully deployed our R&D assets throughout the world. In addition to safeguarding lives, as I just mentioned, we need to transition to a business operations system that allows us to introduce more of our R&D assets to the world. In 2021 and beyond, we will definitively deal with the aspects of the Kao Group's businesses where we have not been able to utilize these assets. This will allow us to establish a major business outside Japan as well as in Japan, which will differentiate us from our global competitors. We intend to carry out this initiative in a variety of ways that will be clear to all.