

## Date:

Friday, September 1, 2023

## Agenda:

- (1) Answers to Preliminary Questions
- (2) Q&A Session and Dialogue

## Speaker:

Yoshihiro Hasebe, Representative Director, President and Chief Executive Officer

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**(1) Answers to Preliminary Questions**

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**Details of structural reforms**

- The reason why we cannot announce the details at this point is because we have not finished giving explanations to involved parties. For example, regarding the termination of production of the baby diapers at our plant in China, we cannot announce the details until all the negotiations with the stakeholders such as the government, raw material manufacturers, suppliers are complete.
- Negotiations on machinery and raw materials, which account for a little more than half of the entire negotiations, have almost been completed. The remaining negotiations are related to people, and will start from now on.
- In the future, we will disclose the details of completed negotiations that can be disclosed.

**Feasibility and risks of structural reforms**

- The details of the structural reforms have already been agreed upon by the accounting firm. The plan has been formulated based on reasonable grounds.
- The structural reform expenses of 60 billion yen include revenue from the sale of assets such as brands. The total expenses may change depending on the amount of assets sold.
- Note that these expenses include the structural reform expenses related to the Cosmetics Business, which have already been announced.

**Looking back on the two and a half years since being appointed as President and CEO**

- More than 50% of the plan is not making progress as I expected. I am aware that this is reflected in our business results.
- I have mostly recognized the issues that we must tackle going forward, and I am now working on them at a rapid pace.

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**(2) Q&A Session and Dialogue**

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**1. In Kao Corporation, there are no labor unions in effect. What procedures will be necessary to proceed with promoting the structural reform of human capital?**

I understand that the part of the reforms related to employees will require thorough communication. Therefore, it will be important in the future to have communication with them due to the structural reform.

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**I understand that there is a certain number of employees, mainly those in managerial positions, who do not agree with your recent policies. Do you consider that you will need to urge such employees to make a decision as to whether to remain in the company while complying with its policies or to leave the company?**

One guide is related to whether each employee can demonstrate his/her abilities to the fullest in the context of the business portfolio that we are aiming for. I think it is important for the following three elements to be all present: the employee's intention, the company's awareness, and the presence or absence of the employee's abilities to be demonstrated in the context of new business portfolio.

- 2. Regarding the breakdown of the structural reform expenses of 60 billion yen, I would like to know the ratio between the items that involve cash outflow and the items that do not.**

The items that involve cash outflow are approximately less than half of the 60 billion yen.

With respect to the profit improvement effect, we will reform businesses with poor investment efficiency and low growth potential. The number of SKUs has increased too much over the last several years, and so we will reduce SKUs that do not contribute to both sales and profit. As a result, related personnel expenses, marketing expenses, inventory management expenses and other expenses will be reduced. When such reduction effects are combined, a profit improvement effect of approximately 30 billion yen can be expected from 2025 onward.

**Is my understanding correct that not many businesses other than the Cosmetics Business will be subject to structural reforms?**

Businesses other than the Cosmetics Business will also be included. Overstocked raw materials and excessive equipment will be subject to the reforms.

- 3. I think the feasibility of structural reforms is high, because a specific amount has also been announced alongside the reforms. What are the risks, if any?**

The implementation of approximately two thirds (40 billion yen) of the 60-billion-yen structural reform expenses has already been fixed. The balance of around one third (20 billion yen) includes fluctuation factors that require negotiations.

- 4. You stated that the portion of structural reforms that will fluctuate in the future accounts for one third of the entire reforms. I would like to know what this portion contains.**

Out of the three measures, (1) Conduct a drastic strategic review and reorganization of inefficient businesses, (2) Promote structural reform of human capital, and (3) Reform of earning power, we have a rough idea for approximately two thirds of (1) and approximately one third of (2). By adding the marginal income improvement effect of (3) to these, we will generate the profit improvement effect.

We have a clear idea about the portion regarding raw material disposal and equipment. As such, regarding the portion related to employee, we will work to be able to present career plans that each employee can be satisfied with.

**You stated that the structural reforms will be implemented from 2023 to 2024. I feel quite a strong increase in the speed. What is the biggest factor related to this?**

Previously, our management regarding investment efficiency was insufficient. We had been emphasizing profit and loss, and so improvements in investment efficiency were rarely seen even if there was a temporary increase in sales or profit. As such, we introduced return on invested capital (ROIC) and changed our decision-making approach to focus on investment efficiency.

Regarding the introduction of ROIC, we owe a great deal to Independent Outside Director Takaaki Nishii's influence. We have received various kinds of advice on structural reforms from him. I believe this is one of the factors that has enhanced our decision-making ability.

**5. I would like to know your prospects on tangible fixed assets for FY2024, including disposal methods for equipment that is subject to structural reform.**

Regarding equipment to be sold, we have finished making a list of candidate buyers, and are in the stage of choosing companies from among these candidates. Once the buyers have become clear, we will disclose the details.

**6. Regarding the feasibility of the operating income target in the Kao Group Mid-term Plan "K27", what is the most distinctive difference in the way figure has been established, compared to past practice? In addition, I would like to know the message expressed in the target.**

Previously, we compiled numbers submitted by business departments in a build-up approach. This time, we changed the approach, in which we decided target figures from a management perspective and then applied them to each business department. The announced numbers were set as the targets that we are committed to meet, and so they may appear slightly conservative. However, within the company, we are working on a business plan to achieve higher targets than the announced ones.

**I would like to know how to view the flexibility of targets in the event of a change in the external environment.**

We created the plan while providing various options and incorporating numbers that are feasible at the very least, even if geopolitical risk or raw material risk arises. I believe the situation in China will change significantly, but we have a general understanding of what we need to do and what we should pay attention to through our business to date, and we will proceed with our business in China based on this experience.

**If ROIC falls below expectations amid changes in the business environment, is there a possibility of implementing additional structural reforms?**

If ROIC falls significantly, new structural reforms must be implemented. However, since we set the figure of 60 billion yen after having identified all the reforms that we should make, we are not considering additional structural reforms at the moment.

**7. You have recorded an impairment loss of tangible fixed assets related to the baby diapers business in China. One of Kao's competitors also recorded a similar impairment loss four years ago. What caused this delay of four years compared to the competitor?**

We need to look back to around 2010 to explain the baby diapers business. First, when sales of *Merries* baby diapers started to take off, support started in China for local manufacturers to develop the baby diapers business. This gave a significant advantage to local manufacturers, mainly in the aspect of cost. Then, from around 2015 onward, thinner diapers began to grow in popularity. From a manufacturer's standpoint, it is indispensable for diapers to have a certain degree of thickness to ensure good breathability after urination. However, progress in the shift to the thin type was an adverse wind for *Merries*, which continued to be thick. We presume the competitor made a decision to shift to the premium segment at that point. However, our decision was delayed, partly due to our data suggesting that *Merries* is by far the gentlest to the skin when used for many hours. The trend remained unchanged thereafter and the business environment continued to be severe for us to continue local production. It was at that time when we decided to record an impairment loss.

Please note that the impairment loss in the baby diapers business in China involves uncertain estimates of profit on sales and other details, and therefore additional expenses may be incurred in the future.

**8. If the structural reforms are successful, I hope the culture will undergo change in a good direction. On the other hand, a culture cannot so easily be changed, and I presume there may arise pressure to return to the original state. What mechanisms do you have in mind to prevent that from happening?**

The conventional matrix management system has a drawback of slow decision-making. As such, we gathered top-tier talent from each department, established small units for each business and newly adopted an organization management system in which decisions are made under their respective responsibilities. Each member takes proactive ownership as representatives of their departments, and so their motivation will naturally increase. I expect these employees will grow and act as leaders for the next generation when they return to their original organizations. If this cycle is established as a steady practice, I do not think that we will go back to the state before the structural reforms.

**9. When did you begin to become aware of the necessity of structural reforms? I believe there may be some challenges, such as changes in the business environment. Do you think it is feasible to bring operating income back to a level of at least 150 billion yen with a high degree of certainty if**

**you can change the business structure through these structural reforms?**

We began to become aware of the necessity of structural reforms in the second half of 2021. Then, in 2022, there were hikes in raw material prices. At first, we did not anticipate that the high raw material prices would have this much of a negative impact, but this revealed the weak points of Kao's businesses. At the same time, it became clear that our strength would decline gradually unless we implemented structural reforms, even if the previous raw material prices were restored, and so we decided to do the reforms.

I believe we will certainly be able to advance in a positive direction if we eliminate all the unfavorable elements first and then implement the growth strategy.

**What are the risks of carrying out the structural reforms?**

One vital aspect is whether employees will agree with and work on the reforms while increasing their motivation in accordance with the direction determined by the company. As such, we place an extremely high level of emphasis on employee engagement. To enhance this, we have been increasing opportunities for dialogue between management and employees, as well as fostering mutual understanding by aligning our thoughts. Once these activities have become established, I expect that employee engagement will certainly improve.

**10. I would like to know your forecast regarding the businesses that will contribute, and the degree to which they will do so in the context of K27.**

We are confident in the skin care business. I think the technology called Outer Skin for applying a coating of film on the skin is particularly exceptional. Previously, people largely relied on their sensory perception as to whether they have applied products well or not. However, thanks to the advancement of digital technology, it is possible to use an ordinary smartphone camera to represent the difference between skin on which sunscreen has been applied and skin on which such a product has not been applied. This has enabled users to find cosmetics and skin care products that suit them, and has enabled us to approach them by showing quantitative accuracy in areas where we tended to apply a strategy based on conceptual images.

In the hair care business, only Kao has a coloring technology that has high chromogenic properties and that does not cause an allergic reaction. Competitors have even asked us for permission to use this technology under a license.

I expect that by globally rolling out such one-of-a-kind technologies, we will gain more consumers who choose Kao and we will create high added value.

**11. Regarding investment management, do you have a mechanism for making investment decisions quickly by establishing an investment committee, for example? I think that management based on ROIC is appropriate for Kao at present, but what are Kao's views on this? Also, I would like to know the significance of using two metrics, EVA and ROIC, in combination.**

We introduced ROIC management because it lets us conduct analysis easily and quickly identify where issues are. On the other hand, Kao has continually placed focus on EVA management. We intend to utilize EVA for managing overall performance and ROIC in its ideal function for partial management, while cross-linking the two.

We deal with investment management by strengthening the role of the Accounting and Finance Department as an organization to cover financial strategies in addition to its conventional role in financial reporting. The Accounting and Finance Department reports the extent to which investment has been recouped, and this department is now able to utilize data for investment management as a result of advances in digitization. In Board of Directors meetings, we have also been reviewing past investment projects.

- 12. I think ROIC should be managed after thoroughly making upfront investment. I would like you to show that the company aims to be constantly on a growth trajectory within disclosure materials as well.**

We understand that ROIC has both advantages and disadvantages. We do not intend to manage investments solely based on ROIC. We will make efforts to be able to present whether the structural reforms have been achieved properly and whether the growth strategy is on track.

- 13. Raw materials costs are one type of fixed expenses among the structural reform expenses. Are these costs for raw materials related to the Chemical Business?**

In the case of baby diapers, for example, the raw materials are pulp and fibers. Long-held inventory is also included in such raw materials.

The breakdown of the fixed costs includes equipment, building and land management expenses, disposal of deferred tax assets, raw material inventory and other elements.

**Is my understanding correct that sales will not decrease even after the implementation of structural reforms? If so, what are the reasons for this?**

Although we will reduce some unprofitable portions of each business, we will not withdraw from the businesses as a whole. Therefore, we expect there will be almost no impact of structural reforms on sales.

**The cost of sales ratio has been rising over the last 10 years. I would like to know future measures, reduction targets and other targets, if any.**

Although there are external factors including the impact of currency fluctuation and hikes in raw material prices, SKUs and inventory almost doubled as a result of prioritizing the securing of retail floor space at stores in the last 10 years. However, the profit margin for each item fell. Going forward,

we aim to improve profit by integrating SKUs and raising the turnover rate per store.

- 14. Regarding baby diapers, is my understanding correct that production bases for export items will remain in Japan? In that case, I imagine that you will bear the risk of currency exchange and of fluctuations in demand outside Japan. Will you be able to respond to these risks by only reducing fixed costs? I also would like to hear your comments on the operation rate of plants in Japan and future plans.**

We will take measures that are the most efficient for the entire sanitary business including adult incontinence products and sanitary napkins in addition to baby diapers.

I believe local production is most desirable in principle, but there are difficult markets like the case of China. From a global perspective including companies both inside and outside Japan, we will proceed with the business while considering the markets in which we can develop our businesses with technological superiority.

**What are the reasons why you set a 60-billion-yen cap for the structural reform expenses? Is there a possibility for additional expenses?**

We set the amount at 60 billion yen as a result of carefully examining what we will be able to do. If any event occurs that requires consideration and causes this amount to fluctuate significantly, we will make a new announcement.

**Considering geopolitical and technology leakage risks, do you think you will need to change the production system in the future?**

That depends on the nature of the business. For example, at least 90% of the profitability of baby diapers is determined by the facility utilization rate. Technology leakage in cosmetics and chemical products can be reduced through key technologies and know-how on how to make them. In other words, it is important not to transfer the key essence to production bases. We are developing the production system with this point in mind.

- 15. Considering the situation in which the birth rate in China is declining and consumers are becoming fond of locally produced products, I do not believe you can be optimistic even if you will review the production system for baby diapers. What do you expect sales in 2024 to be?**

Instead of setting an increase in sales as the target, we will focus on streamlining and improving the profit rate. Although the birth rate is declining, it is still a big market for the baby diapers business. I also consider the demand to still be strong for diapers that are made in Japan.

- 16. Please let us know the future prospects of the business in Asia within the context of the baby diapers business as a whole.**

Local manufacturers in China are beginning to focus more on export rather than consumption within the country. Therefore, I think it is possible that less expensive disposable diapers made by Chinese manufacturers will have an impact on our businesses in Asia in the future. However, consumers in China prefer thin type disposable diapers, and so it is a special market from a global point of view. As such, I do not expect the disposable diapers favored by the Chinese market to spread in other Asian countries. In addition, there are many small-scale local manufacturing companies in China. Excluding e-commerce, I do not think it will be so easy to secure local distribution channels, as they require a certain degree of investment.

**Demand for sanitary napkins is growing in Asia. Do you think the favorable conditions for Japanese companies will continue for a while?**

Unlike baby diapers or adult incontinence products for elderly people in institutions, sanitary napkins are used by consumers who choose the products themselves. Therefore, I believe it is important that products fit the needs of consumers who choose them. In this sense, I think quality rather than low price matters, and I do not think there will immediately be a situation in which Chinese manufacturers will gain power.

**17. I believe Kao's strength has been its ability to collect information directly from retailers and quickly create products based on this information. However, I think this strength is weakening as more consumers shift to e-commerce. Is it possible to regain this strength through structural reforms and digital transformation?**

By combining consumer insight obtained from a wide range of Kao product users together with data from retailers, and creating a database from this information, we are improving our internal intelligence about consumer needs and how to make proposals for such needs. At Kao, we call this precision marketing.

**I would like to know the advice and discussions on the structural reforms given to you from Mr. Nishii, who has newly been appointed as Independent Outside Director.**

We received all kinds of advice on requirements for achieving the ROIC target and for not taking ROIC management at face value.

**18. Regarding Another Kao, is it progressing as expected when compared to the plan two and a half years ago? Also, I would like to know how you will advance it in the future.**

It has progressed about halfway through the initial plan. Although the number of companies with which we have established partnerships is smaller than we expected, we have been able to collaborate with more leading companies than we anticipated. I intend to announce some cases of partnerships by 2024, but we will first work on structural reforms on a priority basis.



**How do you plan to expand the Life Care Business in the future?**

We will grow the parts of the business that are related to health care.

- 19. In my understanding, the profitability of the Cosmetics Business in Japan will not change significantly by reducing unprofitable brands alone, and will not improve unless personnel expenses are reduced. Is my understanding correct? In addition, I would like to know your prospects for the profitability of the Cosmetics Business and baby diapers business in Japan in 2025.**

The operating margin of the Cosmetics Business will not improve by only eliminating unprofitable brands. By taking the resources allocated to unprofitable brands and allocating these resources to the focus categories G11 and R8, we will increase sales of high added value products and thereby improve profit margins.

For the baby diapers business, we will transition to a business model in which we secure profit while maintaining sales.

- 20. In the case that unprofitable brands in the Cosmetics Business are reduced to integrate resources, which of the following has a greater effect: the reduction and efficiency enhancement of marketing expenses, or the reduction of personnel expenses?**

When the slow-moving inventory is eliminated from stores as a result of reducing brands, the cost related to the relevant inventory management will be reduced. This reduction effect is the largest.

**Note**

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