February 9, 2017

Kao Group Fiscal 2016 Presentation Q&A Session Summary

Date: Thursday, February 2, 2017 17:00-18:30

Respondents:

Michitaka Sawada, President and CEO

Katsuhiko Yoshida, Senior Managing Executive Officer

Toshiaki Takeuchi, Senior Managing Executive Officer

Kenichi Yamauchi, Vice President, Financial Controllers, Global

In the fourth quarter, sales of baby diapers weakened in China. Am I correct in understanding that it was due to inventory adjustments associated with the termination of Kao's distribution agreement with Shanghai Jahwa United Co., Ltd. (Shanghai Jahwa)?

Sawada: Your understanding is correct. It was a one-time factor.

What is your targeted growth rate for sales in China in fiscal 2017?

Sawada: The growth rate of the Consumer Products Business in China was 24% in fiscal 2016. We want the same rate of growth in fiscal 2017. At the very least, we must achieve growth in the double digits, meaning the 10-19% bracket. This will consist mainly of baby diapers, but baby diapers sales have spurred growth in skin care and fabric care products, which now account for around 30% of profits. Conditions in the Chinese economy are challenging, but daily necessities have not been affected so much.

What is your assumed growth rate for baby diapers?

Sawada: Over the past few years, baby diapers have been growing by over 20% annually, and we want that to continue.

What is your plan for sales channels following the termination of your alliance with Shanghai Jahwa?

Sawada: In 2016, we built a sales network and we expect it to function well going forward. There are many companies that want to work with us.

Takeuchi: Compared with 2011, when we started the alliance with Shanghai Jahwa, the market has changed considerably, with a higher ratio of sales from baby specialty shops and e-commerce. Kao will continue to focus on those channels.

In your assumptions for the fiscal 2017 forecast, what is the basis for the estimated negative 1.0 billion yen impact from raw material prices?

Yamauchi: Prices of fats and oils remain high, and we expect them to decrease slightly. This is our assumption if crude oil prices do not fluctuate significantly.

Your forecast for cost reductions in fiscal 2017 is aggressive. Has something changed?

Sawada: Our total cost reduction (TCR) activities in fiscal 2016 yielded 11 billion yen. That was the result of all our employees working hard together. However, by continuing reductions at our usual rate, we will not be able to achieve an operating margin of 15% and operating income of 255 billion yen in 2020. We will push for achievement of these targets throughout the Company, from the top down.

Do the results of cost reductions come evenly from all businesses?

Sawada: TCR activities have centered on Japan so far, but contributions from outside Japan have also increased with our global expansion. This will continue.

You have said that you will generate a profit in Indonesia in fiscal 2020. What size market share do you expect then?

Sawada: Baby diapers will not generate a profit at a 10% share, so our share must exceed 20%. Profits are already beginning to materialize, even while we are making capital investments. The same as it was in Japan, profits will increase suddenly once we pass the break-even point.

In your mid-term plan, you have set a high operating margin target of 10% for the Consumer Products Business in the Americas and Europe. Was the more than 1 billion yen you invested in structural reforms there in fiscal 2016 enough? What kind of structural reforms were they?

Sawada: I cannot give details, but we are implementing the same structural reforms as we previously conducted in the cosmetics business—including raising personnel efficiency, reorganizing brands and changing the way we conduct sales and marketing—starting in Europe, for efforts that were not just a continuation of former methods. Now, our operating margin in Europe is approximately 5%, or approximately 7% excluding the impact of structural reform costs. It will grow another 3 to 4 percentage points by 2020. We are not considering additional investment.

In the Americas, the operating margin is currently 4%. Since the business structure is different from Europe, we will adjust our approach in making our next investments. We will incorporate our results in Europe into the Americas as we aim for an operating margin of 10% in both the Americas and Europe.

In the Beauty Care Business in fiscal 2017, the like-for-like sales growth forecast is high at 5.3%, but how much will cosmetics grow? Are major reforms complete?

Sawada: Sales growth of cosmetics in fiscal 2017 will be about 5-6%, the same as the Beauty Care Business. Skin care and hair care will grow by about 4%.

In cosmetics, we are expecting growth from Kanebo Cosmetics' global brand *KANEBO*, *KATE*, *suisai Beauty Clear Powder* and other products.

In this flat market, I don't think there has been growth of 5 to 6% so far. Do you expect that level of growth because your major reforms are complete?

Sawada: The major reforms are in progress. For Sofina, we launched *SOFINA iP* in department stores in Japan, and then renewed the skin care lineup. We are now also rolling out *iP* at drugstores. We will also expand sales of *ALBLANC*, a non-department store brand. Outside Japan, from spring 2017 we will sell *SOFINA iP* in Taiwan and Hong Kong, and introduce holistic beauty. If possible, we want to create a flagship store like the Beauty Power Station in Ginza. After that, we will expand further into Singapore and elsewhere in Asia by fiscal 2020.

For baby diapers, are the activities of parallel importers resurging a little, due in part to the effect of exchange rates from the end of 2016?

Sawada: I do not think the activities of parallel importers will cease, but Kao is enhancing its rollout of cross-border e-commerce. Since the inventory of parallel importers is being used up, their activities are unlikely to be as much of a problem as before.

In Japan's cosmetics market, I feel that high-priced products at department stores and other outlets are performing well, but low-priced products at drug stores are performing poorly. How do you view the market?

Sawada: In the cosmetics market, companies other than major cosmetics manufacturers are growing in number, and they are moving energetically to expand their market share. We are paying close attention to the fact that sales of major companies are not growing. Also, sales have been shrinking in the cosmetics specialty store sector, but are growing at large-scale cosmetics specialty shops that are unlike conventional stores. Furthermore, the spread of the Internet and social networking services is gaining momentum. It is becoming very difficult to judge.

Fabric and home care sales appear to have slowed in the fourth quarter. What is the context for this?

Sawada: It is due to the timing of new and improved products and marketing activities, so there is no special context. You should look at sales for the full year.

The income structure of consumers is changing and consumption is becoming polarized. Won't the downturn in consumer confidence in the macro environment affect the middle-income segment, making it difficult for you to achieve your mid-term plan?

Sawada: The baby boom generation, which has been driving consumption of daily necessities in Japan, has been losing its power. Instead, the baby boomers' children, particularly women, are driving consumption. However, purchasing behavior has been weak among the millennial generation, who reached the age of 20 in 2000 and thereafter, and the market will shrink if we do not stimulate consumption. We will accurately grasp the needs of each generation and offer proposals a step ahead.

You appear to have invested heavily in marketing in the second half of fiscal 2016. Will this accelerate further in fiscal 2017?

Yoshida: In fiscal 2016, our expenses were aimed at addressing the decline in inbound demand. In addition, we have invested in marketing in preparation for the Kao Group Mid-term Plan "K20." We used those expenses for improving the level of our research, including analytical methods and analysis, for building a global mobile platform, and for digital marketing. There will be no similar increase in fiscal 2017.

Sawada: Looking at K20figures, if we aim for an operating margin of 15% on a CAGR of +5% for net sales, then CAGR for operating income must be +8.3%. To increase profit at a higher rate than sales, it will be important to use expenses efficiently.

With the coming changes in the structure of sales channels for household and personal care products in Japan, how do you plan to allocate marketing expenses?

Takeuchi: Undoubtedly, the e-commerce share of sales will rise. There are many brick-and-mortar stores in Japan's retail industry, and the market environment is significantly different from the United States and China. In China, about half of the sales in the baby diaper market are through e-commerce. E-commerce may not grow as rapidly in Japan as it has in China, but it is certainly growing. We are aiming for an optimal form for e-commerce that responds to consumer trends in cooperation with retailers in areas such as linking brick-and-mortar stores and the Internet.

Sawada: The retail industry will change with reorganization, and Kao will change the way it markets while conducting marketing corresponding respectively to the mass market and “small mass” markets. However, we will raise efficiency so expenses do not increase.

Why did the operating margin in Japan rise in fiscal 2016? What is the outlook for the operating margin and costs in Japan in fiscal 2017?

Sawada: The reason the operating margin in Japan improved was the increase in the ratio of new and improved high-value-added products. The ratio of new and improved products, which was previously 18-19%, is now about 25%. It is the result of launching high-value-added products for various generations, but because the products target “small mass” markets, they also incur costs. For future growth, in fiscal 2017 we will change our methods of communicating value to make them more efficient.

I think production and marketing will become more efficient as the ratio of sales from core brands increases. How do you intend to generate synergy in the coming years?

Sawada: Until now, we have focused on enhancing individual brands, but from now on it will be important to link our corporate image and our products. Generating synergy between the Kao corporate brand and product brands, such as *Merries*, *Bioré* and *Attack*, has always been desirable, but we have been unable to do so. Each individual product brand should at least act as a standard-bearer when developing a new market.

Although it struggled considerably in China, the *Merries* brand has been accepted there, leading to the penetration of the Kao corporate brand and increased trust. This in turn is leading to growth in the share of *Laurier* sanitary products. *Bioré* skin care and *Attack* laundry detergent share have also grown. In Indonesia, as well, the assets of skin care and hair care product brands built up over many years have led to the current strong performance of *Merries*. In the countries we enter in the future, we will start with 100-billion-yen brands such as *Merries*, *Attack* and *Bioré*. Furthermore, linking these brands to our corporate image, for example "Kirei" and social contribution activities, will also generate significant synergies with the corporate brand. For the same purpose, we will cultivate more brands that exceed 100 billion yen in sales.

You assume a fiscal 2017 growth rate of 1% for the consumer products market in Japan, excluding cosmetics, but the market grew by 2% in fiscal 2016 and unit prices did not decline, except for disposable diapers. The number of households also appears to be increasing. What is your basis for assuming a 1% market growth rate?

Sawada: Fabric care is expanding by 4-5% and oral care is also growing significantly. However, looking at the entire household and personal care products market, in which Kao sells in 79 categories, growth is expected to be low, due to past continuous growth. We estimate year-on-year growth of 1%.

In the Kao Group Mid-term Plan "K20," how closely is growth in operating income linked to sales? How will it impact profits if you cannot achieve sales?

Sawada: It differs by business segment and region. Since sales are the source of profits, we have to increase sales. Under K20, we must increase net sales by 300 billion yen and operating income by 70 billion yen. Operating income CAGR must be +8.3%. We cannot achieve our operating income target solely by increasing sales, so we must improve efficiency, including expenses.