Kao

September 16, 2016

“Our Vision for Kao Group’s Cosmetics Business” Q&A Session Summary

Date/time: Monday, September 12, 2016 9:30-11:00 a.m.

Respondent: Masumi Natsusaka, Managing Executive Officer, Kao Corporation,

President and CEO, Kanebo Cosmetics Inc.

1. My understanding is that now that you have cleared up the issue of fixed expenses and other costs, you will be conducting brand reforms. I think that a global standard for marketing expenses (advertising expenses plus sales promotion expenses) of around 25% of net sales will be too low for the Kao Group to succeed in competition in the cosmetics business in the future. Estée Lauder and L’Oréal invest around 30%. I believe the Kao Group will need to invest around 30% of net sales for marketing expenses. Considering your targeted operating income margin of 10%, how much are you planning to invest in these expenses over the next three years?

First, there is the issue of fixed expenses. Our largest fixed expense is personnel expenses. With regard to personnel expenses, we are increasing productivity per employee, but we have not reached the point of a drastic change. Over the next two or three years, we need to make significant revisions in dispatching beauty counselors to stores to increase sales per employee and sales per store. Through that increase in productivity, we hope to reduce the ratio of personnel expenses to net sales by at least 3 percentage points. We will incorporate that in our next mid-term plan.

Another issue is manufacturing costs. With our capital expenditures, including quality assurance at our Odawara Factory near Tokyo, Japan, fixed expenses are rising. Now is the time to invest, so we want to reduce the ratio of manufacturing costs to sales by about 1% through an increase in sales. We also intend to incorporate that in our next mid-term plan.

I cannot disclose the details, but we invest about 25% of our net sales for marketing expenses. The problem is that there are many inefficiencies from having many brands and many stock keeping units (SKUs), so we intend to increase efficiency by focusing on a smaller number of brands and SKUs.

Yet another issue is that we want to integrate the marketing activities we have been conducting for each sub-brand into a single activity to raise effectiveness and efficiency. As we see it, the problem is not that our ratio of marketing expenses is so low compared with our global competitors, but rather how we use those expenses.

2. What is your current sales channel composition in Japan, and how do you envision it as of the end of your next mid-term plan?

SOFINA is hardly sold in beauty specialty stores at all. Drugstores have come to account for more than 50% of sales out of its various sales channels, which include general merchandise stores (GMS), department stores and drugstores. Falling productivity per store at drugstores is a major problem. Efficiency is low at small stores, so we want to substantially change our way of doing business. For SOFINA, we will improve business efficiency with a shift in focus to basic skin care with our new *SOFINA iP* products. We will continue as we have been for *Primavista* base makeup, which is strong and efficient. The issue of store restructuring has arisen with regard to GMS and department stores, so we will execute initiatives steadily while keeping pace with their restructuring.

As for Kanebo Cosmetics, there are differences among brands, but we are number two in GMS and drugstores and, unfortunately, number three in department stores and beauty specialty stores. The issue is that, with our history of releasing various brands for each sales channel and each price range, we have not nurtured strong brands. Now, we will grow by focusing on the global brand *KANEBO*, with a global rollout centered on specialty stores with high sales and department stores. Since specialty stores account for a large proportion of sales, for the time being we plan to maintain and strengthen sales with a lineup that accommodates them. At GMS and drugstores, Kanebo Cosmetics has the same problem as SOFINA, and we will conduct revisions to deal with the slight drop in store efficiency.

3. In “Market Trends by Channel and Area in Japan” (slide 7), are customers drifting away from department stores to specialty stores? Or is unit price rising at specialty stores due to the aging of society? Can you explain from the standpoint of customer trends and unit prices of purchases?

There is a shift to self-selection cosmetics and counseling cosmetics from cosmetics in the mid-price range, and makeup brands have become strong and are increasing in department stores. Our *RMK* and *LUNASOL* brands are also growing.

On the other hand, there are few makeup brands in specialty stores. Skin care brands drive sales in specialty stores. I think there is an opportunity for further growth in sales by adding a little more makeup.

4. Would you say that growth in makeup at department stores is supported by the younger generation, while growth at specialty stores is supported by demand from older customers for skin care products with a high unit price, such as high-performance anti-aging products?

Yes. I think it is an issue, and conversely an opportunity, for specialty stores to capture young customers.

5. How will your marketing and sales methods change from previously?

Kanebo Cosmetics has previously been promoting *Yoki-Monozukuri**, production for the five senses. We will be doing that with a sharper focus. For skin care products, previously we only advertised during the initial year when a product was launched. We will continue marketing of focal products, although our methods may not be new. In addition, we will emphasize offering samples and activities at stores so that consumers can use, feel and understand our products. Thoroughly carrying out what we should be doing as a matter of course is fundamental.

** The Kao Group defines Yoki-Monozukuri as a strong commitment by all members to provide products and brands of excellent value for consumer satisfaction. In Japanese, Yoki literally means “good/excellent,” and Monozukuri means “development/manufacturing of products.”*

For SOFINA, our method is to link *SOFINA iP*, which is sold across channels, and skin care, where we sell different sub-brands for each channel. Other manufacturers do not conduct cross-channel sales of the same product. I think the key will be how *SOFINA iP* can transcend the world of cosmetics to reach different populations.

In department stores, *SOFINA iP* has been on sale since January 2016, and is recording the highest repeat rate ever in the history of SOFINA products. We are hopeful about the forthcoming rollout at drugstores.

6. If possible, can you explain the proportion of marketing expenses you will devote to e-commerce in the future? Also, what is your strategy for digital marketing?

There are three conditions for viable e-commerce. The first is the scarcity of the product being sold. The second is the number of SKUs. Fewer SKUs would be better. Mail-order manufacturers have few SKUs. When buying something on the Internet, it's a bother to scroll down the page, so sales are difficult when there are numerous items. Third is price. Pricing policy is difficult because anyone can compare prices in an instant. With these factors in mind, we have given e-commerce a secondary position in our business in Japan. Instead, we are thinking of proactively using e-commerce in China, because we have reduced the number of stores where we sell our products there. We will consider using e-commerce in light of the maturity of markets, the number of Kao Group products and brands, and our infrastructure.

We have to make greater use of the Internet, social networking services and other platforms in our marketing. We cannot do business looking only at Japan.

7. You aim to be the leading cosmetics company in Asia. What are your sales and income targets?

Becoming number one in Asia will require sales of about 400 billion yen. Our target for the operating income ratio for the time being is to return to 10%, which both Kanebo Cosmetics and SOFINA had previously reached. In general, the basic operating income ratio in the global cosmetics industry is most likely 15%. Going above 30% is a little too high, because it means not investing in marketing for sustainable growth. A ratio of 15% to 25% is a condition for a strong brand, so ultimately we will aim for 15% or higher.

8. In your three priority brands and five brands for nurturing, *KANEBO* and *SENSAI* are prestige and high-prestige skin care brands, respectively. Prestige skin care is the largest and most profitable category in Asia, but the Kao Group is a little weak in this area. What are your strategies for these two brands?

The price range for *SENSAI* is 10,000 yen and higher. Because it is not a major component of our department store business, we will steadily create customers rather than expecting large sales. We are preparing to introduce the brand in Asia.

Our global brand *KANEBO* is a major component in the prestige range between 5,000 yen and 10,000 yen, so growth in sales will come from *KANEBO*. In terms of prestige and high prestige, we will roll out *SENSAI* and *KANEBO* in a mutually complementary relationship.

9. You have consolidated production and research in Odawara, but my impression is that your research facility is far from Tokyo. Other companies have their research facilities closer to the center of the city. I think research and marketing should be close to each other. What is your opinion?

I think there is a connection between the distance of research from the market and the distance of research from production. As for distance from the market, it does not take much time to get there from Odawara on the Shinkansen bullet train, and I don't think there is a problem, considering that Kanebo Cosmetics' research has been conducted in Odawara and there have been no concerns about communication.

We view it as an overall positive move to concentrate in Odawara all the people who conduct so-called fundamental research at places including the Biological Science Research Laboratories and the

Fragrance Research Laboratories, which used to be dispersed. Nevertheless, as you point out, we will manage so that research does not become separated from the market.

10. What proportion of sales currently comes from e-commerce in China and what is the growth rate of e-commerce sales? What will your target be in the next mid-term plan?

In China, e-commerce only accounts for about 30% of Kanebo Cosmetics sales. That is because *KATE TOKYO* makeup and *freeplus* skin care were originally sold mainly in brick-and-mortar stores. E-commerce accounts for about 70% of SOFINA sales. If there are no physical retail points where we can deal with customers, we cannot deepen our bonds with customers, so we are currently looking for a balance between physical stores and e-commerce.

E-commerce sales are growing by double digits. On the other hand, because we are slightly narrowing down our physical stores, sales there are growing but not as much as e-commerce.

11. To go from your current sales of approximately 250 billion yen to over 300 billion yen in 2020 works out to annual growth of 5%, but how much do you intend to grow in Japan and Asia? Also, what are your thoughts on the travel retail business?

In Japan, the market is mature, so the growth rate is 2-3% per annum. In Asia, we must grow by at least double digits. We have grown by double digits or more in the past, so it is achievable.

In the travel retail business, the Kao Group is lagging behind. This year, Kanebo Cosmetics established a management structure for travel retail. It is growing tremendously. We intend to accelerate that growth going forward.

12. Since the Japanese cosmetics market is flat, growth of 2-3% is rather high. Will the drivers be your new global brand *KANEBO* and mass-market sales that will start in the next fiscal year?

Yes. The target is high, but skin care is growing steadily. We intend to grow with a focus on global brand *KANEBO*, *SOFINA*, and mass-market Kanebo Cosmetics skin care.

Makeup represents an opportunity. The growing sectors are high prestige and the mass market, and the Kao Group has strong brands in both: *LUNASOL* and *RMK* in high prestige, and *KATE* TOKYO and *media* in mass. What to do for structural reform in the mid-price range is still an issue, but we will grow in both the high prestige and the mass sectors. Makeup has continued to grow, both before and after the voluntary recall of brightening products that we announced in 2013, which was a difficult year.

Since last year, we have also been nurturing *media* into a second brand to follow *KATE TOKYO*. We will begin convenience store sales this autumn. We have to achieve sales growth of at least 2-3% by expanding sales of skin care, which have been challenging, in addition to growth in makeup.

13. What is your time frame for achieving a 10% operating income ratio in the cosmetics business?

This year and next year, we will invest aggressively in marketing, so I think substantial profit growth will occur in 2019 and 2020. Until then, we will prioritize sales growth while strengthening our foundation for the future, rather than substantial growth in profits.

14. Is the integration of Kao and Kanebo Cosmetics complete?

The integration is almost complete. In our sales company, which was integrated in January this year, fully generating synergy is an issue. There are cost synergies, and there are also sales synergies. We have progressed from simply conducting transactions with retailers to holding meetings between the top management of the companies to align our visions for the mid-term plan. The conventional business model in the cosmetics industry is to conduct negotiations with individual stores, not company to company. I foresee forthcoming results.

15. How well has *SOFINA iP* base essence been accepted and established?

In department stores, more than 40% of *est* moisturizing lotion users also use *SOFINA iP* base essence. The repeat rate has risen to about 60% in the first four months since the launch. This is the highest repeat rate ever for a SOFINA product. I think we can expect it to continue.