Kao Group Mid-term Plan “K20” Q&A Session Summary

Date: Monday, December 12, 2016

Respondent: Michitaka Sawada, President and Chief Executive Officer, Kao Corporation

1. How do you envision Kao’s shareholder returns, investments, depreciation and M&A in the period to 2020?

Our current cash on hand is approximately 300 billion yen. Even in severe business conditions, working capital of 200 billion yen will cover business operations for about two months, so aside from the capital expenditures that are incorporated into our plan, we should have 100 billion yen out of that 300 billion yen that we can use freely.

Our plan for this year called for approximately 100 billion yen in capital expenditures, most of which we invested in sanitary products. I expect that figure to decrease a little from next year onward, but I think we will be able to make around 150 billion yen to 200 billion yen per year in investments for growth, aside from capital investments. For example, even when conducting M&A, there are occasions when it does not proceed smoothly due to timing. In such a case, if we wind up with a little more leeway than planned, we would like to use those extra funds for purposes such as share repurchases.

Although we envision investments for growth of 500 billion yen to 600 billion yen over the next five years, we will continue to provide returns to our shareholders through dividend increases and other means.

[Supplementary explanation]

Because capital investment will not reach the 100-billion-yen level in the peak year of fiscal 2016, Kao will increase cash on hand even as it continues its ongoing dividend increases with a target payout ratio of 40%. Together with the amount for investment left after subtracting the funds needed for business operations from the current 300 billion yen in cash on hand, Kao will be able to make 150 billion yen to 200 billion yen in investments for growth per year, including M&A.

2. Will Kao’s future capital investments be under 100 billion yen per year?

That will depend on what kind of investments we make related to future business development. Investments in Japan up to this year have almost all been earmarked for factories, so large-scale investment, if any, will be outside Japan. We are already investing in Indonesia and China, so the amount will change depending on the scale of investment, including Thailand, Vietnam, the Americas and Europe, but it is unlikely to exceed 100 billion yen.

3. Based on current exchange rates, I assume you envision operating income of around 270 billion yen under “K20.” How much income do you envision from the growth of current businesses, as well as from M&A and new businesses?

We have not included much in the way of income from new businesses in the plan. New businesses may contribute to growth in net sales up to 2020, but I think it will be difficult for them to generate profit. With that in mind, we must promote growth in existing businesses with a high operating margin. For businesses with an operating margin under 10% — for example, cosmetics, Consumer Products in Asia and Consumer Products in the Americas and Europe — we must raise it to 10% or more. At the same time, we will invest in new businesses. New businesses will fully contribute to profits beyond 2020. Thus, we expect to be able to raise a high operating margin of 15% in 2020 one step higher to 17% by 2030.

If we conduct M&A of low-profit businesses, our margin will drop considerably even if we increase sales. We must choose our M&A targets with due consideration of this point.

4. **Conforming with the new IFRS 15 and revising your sales system will have a negative impact of approximately 60 billion yen on Kao's net sales, resulting in net sales of approximately 1,420 billion yen for 2016. Is it then correct to assume that with a CAGR of +5%, net sales for 2020 will be about 1,726 billion yen and operating income will be about 260 billion yen?**

I can't be sure until fiscal 2016 is over and we have finalized our earnings figures, but if net sales do not exceed 1,700 billion yen in 2020, we will not have achieved CAGR of +5%. Operating income fluctuates from year to year, but without consistent annual increases of 0.5 percentage points, we will not be able to raise the 13% operating margin forecast for fiscal 2016 (after the application of IFRS 15 and the impact of the change in the sales system) to 15%.

Since we have been actively making capital investments, depreciation will reach its peak next year and the year after. It may be quite difficult to increase the operating margin in 2017 and 2018, but increases in 2019 and 2020 should compensate, so we envision operating income above 250 billion yen. However, operating income will increase based on growth in net sales, so your figure of 260 billion yen is probably not so wide of the mark.

[Supplemental explanation]

From fiscal 2017, Kao plans to change its sales system for the Consumer Products Business in Japan and to make an early adoption of IFRS 15, a new revenue recognition standard that will be mandatory from the fiscal year starting in 2018. In accounting, items previously treated as expenses will be deducted from sales, resulting in a decrease in revenues (no impact on income). If this accounting treatment had been adopted from fiscal 2016, the publicly announced net sales forecast of 1,480 billion yen would decrease by 60 billion yen to 1,420 billion yen. Consequently, 1,420 billion yen has been used as the baseline figure for the +5% CAGR in "K20."

5. **I was impressed by your sense of crisis and your message that Kao must do more to break out of its shell. Kao's stability and stable earnings are positive points, but conversely you could also say the Company is conservative and inward-looking. Under K20 and looking forward to 2030, you have a strong expectation that Kao will break out of its shell, but on the other hand, I sense a risk that it could destroy the highly profitable structure Kao has established. What do you think?**

Kao's strong point may be its steady growth from a stable foundation by making full use of the Kao Group's assets. However, to take Kao to the next level, all of us at the Company must at some point break out of our shell. Since I must take the lead, I want to proceed with a truly strong will. That does not necessarily mean that we will destroy the things about the Company that are sound. I believe Kao can manage both aspects of this difficult issue.

6. **Can you explain how you intend to achieve a 15% operating margin by 2020? You expect to raise your operating margin in the Consumer Products Business in Asia which is centered on China and Indonesia, and for cosmetics to 10%. That means other businesses will need an operating margin of, say, 18% or 20%. So, will you be able to achieve your target if fabric care, hair care, skin care and personal health all maintain an operating margin of around 20%? Or will you need something else? Under these conditions, how do you view trends in the operating margin and operating income in the food business, which you plan to re-enter, and the operating margin in the Chemical Business in particular?**

Basically, for businesses with an operating margin below 10%, we will raise the margin to 10%. Other businesses have an operating margin of 20%. Having said that, their operating margins are not just barely over 20%. Many are 24%, 25% or 26%. If we continue to steadily raise these margins, we will be able to achieve an overall operating margin of 15%.

7. **Does that mean you are also aiming for a 10% operating margin for food and beverages?**

I would like to aim for 10% but it is not so simple for food. We will raise the margin further for *Healthya* functional drinks, but I think it will be difficult if we don't do the same for other products. We will try to aim for a high level in 2020 after considering how much we will invest in new businesses. It is a high target, but I think we can achieve it if we make major strides.

8. **Rising market prices for palm oil and other products are a cause for concern. How will this affect the Chemical Business?**

Oleo chemicals still account for a large proportion of the sales of the Chemical Business, so fluctuations in the price of palm oil and coconut oil have a substantial impact on profit levels. We are working to pass on price changes appropriately as far in advance as possible. Among oleo chemicals, derivatives and highly processed products have a comparatively high margin. We intend to create high-value-added oleo chemicals by developing derivatives. Performance chemicals also have a high margin, and the margin for information materials such as printer ink and toner is even higher. We will make full use of our assets to further increase the proportion of such products. That is why we acquired companies that make water-based pigment inkjet ink. It will be difficult to raise the operating margin of the Chemical Business beyond 10%, but our objective is to increase it from its current level of around 10% to 12% or 13%.

9. **It was very encouraging to hear your intention to firmly establish Kao on a global level. I think that if you do not further strengthen the core three brands that you will focus on as a global company, it will be difficult to become number three worldwide. What is your strategy for promoting the further growth of those three brands worldwide?**

We are fully aware that it is not such a simple task. With that in mind, we have not narrowed the brands down to three; rather, we need to have at least three brands with sales exceeding 100 billion yen each. Of course, 100 billion yen is not our final target, and how we go about broadening this core lineup is crucial. For example, *Bioré* has a high position among skin care brands in the Americas. We will establish that position in Europe as well. We have at last developed the potential of bringing in strong brands that can be adapted to each country or region. I think that now is our chance, and if we do not broaden our core lineup by at least one brand, we cannot surpass L'Oréal to become number three. As a first step, we will aim to become number five among global consumer goods companies. Currently, in addition to those three brands, we are aiming to make *Laurier* sanitary napkins a 100-billion-yen brand. Expanding sales only in Japan is not enough, so we are considering various models for how we can broaden *Laurier* globally to further increase sales and surpass 100 billion yen. I am seeing signs that we can achieve this by making full use of our assets, including a horizontal rollout of technology. In addition, *SOFINA* cosmetics sales are still less than 70 billion yen, but by steadily carrying out our current major reform of the brand, I think they can reach the 100-billion-yen level. I would like to broaden our core lineup by aiming for 150 billion yen or 200 billion yen from each of the three brands of *Bioré*, *Attack* laundry detergent and *Merries* baby diapers once *Laurier* and *SOFINA* have become 100-billion-yen brands.

[Supplementary explanation]

Compared with its competitors among global consumer goods companies for fiscal 2015, Kao ranked 7th in net sales and 9th in operating margin.

(Competing global consumer goods companies: Procter & Gamble, Unilever, L'Oréal, Henkel, Kimberly-Clark, Colgate-Palmolive, Reckitt Benckiser, Estée Lauder)

10. Having three or five 100-billion-yen brands will generate considerable synergy with the Kao corporate brand. What degree of synergy do you expect, and when do you expect it?

It will be difficult to generate synergy by 2020. It is not so easy to create a distinctive corporate image or a distinctive brand image, but we have to start somewhere. I think it will differ by country whether we establish our corporate brand or our product brands first.

In China, due in part to the success of *Merries*, Kao products have established a very good reputation for quality, so we will proceed in China by further expanding on the good image of our corporate brand. By doing so, sales and profits from skin care products have been growing substantially.

However, it will be difficult to spread the Kao corporate brand in the Americas and Europe. The best method in these areas will be to establish the various product brands we already have. In this way, we will consider what to do separately in each country or region.

11. What risks can you foresee that would make Kao unable to achieve its targets for existing businesses of an increase of 5% per year in sales and an operating margin of 15%?

The largest risk is the occurrence of a sudden and major negative event. We practice Integrity*, but a small mistake or a loosening of control can lead to a major problem, so our basic stance is to make sure that does not happen in the first place.

Another risk is that the world is changing significantly, and risks arise when our ability to deal with those changes fails.

My greatest concern is the spread of smartphones. When we conducted a market survey in China, we asked our Chinese employees about how they shopped. Almost all the young people said they did all their shopping by smartphone, without going to brick-and-mortar stores. An extreme example would be someone who immediately uses a smartphone to buy a single packet of seasoning. Not everyone is like that, but there are people who don't give much thought to brick-and-mortar stores when they shop. On the other hand, Kao has built a sales system, including in Japan, and has deepened its relationships with brick-and-mortar stores. If this fundamental structure changes, it will have a substantial impact on our existing businesses. I do not think it will completely change over the coming four years, but if we do not deal with physical stores and the unforeseen aspects of e-commerce, we will not be able to strengthen our existing businesses. I intend to tackle this area with such a sense of crisis.

* *Integrity is one of the values in the Kao Way. For further detail, please refer to our webpage of the Kao Way.* http://www.kao.com/group/en/group/kaoway.html

12. I believe Kao will be able to achieve its operating margin target of 15% in 2020. However, the sales target will be a challenge since sales are already large and Kao has never achieved CAGR of +5% in the past. How you will achieve this extremely high target for sales?

I do not foresee that all the four businesses of Fabric and Home Care, Beauty Care including cosmetics, Human Health Care and Chemical will achieve sales growth of more than 5%. I believe Human Health Care will grow the most. We expect substantial growth in Human Health Care, particularly sanitary products including baby diapers and sanitary napkins, and without such growth we will not be able to achieve a 5% CAGR in net sales. Of course, we will also work for as much growth as possible in other areas. In that sense, growth in sales of *Merries* will be crucial. We have made investments for that purpose in Japan, China and Indonesia, and we must promote further investments outside Japan. I believe this will be a major point.

13. I believe that your plans for operating income work out to annual growth of around 9%.

Operating income varies from year to year, but your calculation is correct.

14. I hear that cosmetics will begin to generate synergy for profits in three or four years. On the other hand, since a certain level of investment will be required to increase sales of the Consumer Products Business in Asia, how will you increase the operating margin?

The necessary capital expenditure is mostly complete. Since we apply straight-line depreciation, any increase in sales will lead to comparable profits. Because we made a large investment in Indonesia, we had thought it would be difficult to turn a profit quickly, but growth in sales is greater than we expected and Indonesia is moving toward profitability. The market share for *Merries* is now above 8%, and it is growing faster than we had assumed. Laundry detergent is performing very strongly, and body cleansers are also doing well. The primary factor in generating profits is increasing sales. Another factor is the contribution of TCR (total cost reduction) activities to cut everyday costs. Outside Japan, it is difficult to smoothly generate profits in places we have invested without achieving growth in sales beyond our expectations.

Cosmetics are the same. Once they exceed the break-even point they immediately generate profits, but the fact is that sales have not reached that level. Since we cannot have an increase in expenses that would raise the break-even point, we need a method for increasing sales while maintaining a cap on expenses. If the ratio of expenses to net sales increases, the overall operating margin will not rise. We will conduct the business by skillfully using expenses, which will increase little by little. To do so, we will not be able to use the same kind of procedures we have been using, including advertising expenses, so we must drastically change our procedures, approaches and concepts. This does not mean the destruction of the status quo, but it requires an indomitable resolve that we must adopt a new stance.

15. The proportion of consolidated net sales from the Chemical Business (B-to-B) is currently at the 18% level, or just under 20%. What level will it be for your assumed 15% operating margin in 2020? Also, how do you plan to raise the operating margin of 15% in 2020 by two points to 17% in 2030?

We envision Chemical Business sales of close to 400 billion yen in 2020, but sales within the Kao Group will account for about one-fifth of that figure. In real terms, the other four-fifths, or 320 billion yen, will be just under 20% of consolidated net sales. We expect the operating margin to be about 10% to 11%. However, as I mentioned earlier, we have acquired water-based pigment inkjet ink businesses through M&A and are moving forward with higher-value-added products, including the development of derivatives. When these start to contribute to results, the margin is likely to rise slightly.

Increasing the operating margin from 15% to 17% is impossible through business as usual. An increase of two percentage points is extremely large. At some point, we will have to go further to drastically change how we think about generating profit. It will also hinge on our ability to create new businesses with a high profit margin and to quickly and successfully initiate large-scale innovation that transforms the market and instantly raises market share.

16. When a company contains a business like your Chemical Business, which pursues innovation as part of its business structure, it is difficult to raise the operating margin to the level of FMCG (Fast Moving Consumer Goods). A characteristic shared by Japanese companies in particular is to have a business structure that mixes brand businesses that pursue volume with upstream businesses that pursue innovation. In other developed nations, the two are separated, which has promoted specialization within industries. Will you really be able to achieve an operating margin of 17% with a business structure that leaves both types of business mixed together? I have serious doubts, but how will you achieve this target?

In the Chemical Business, there are high-margin products that all of you are not aware of. It seems rash to claim that the target is difficult to achieve because we have a Chemical Business.

We have to review our business at a higher level, but it is not a matter of keeping only high-margin products and getting rid of the rest. That will not bring out the comprehensive strength of the Kao Group. Of course, we are well aware that using our comprehensive strength in an undiscerning way will lower our profit margin. With that awareness, a major point will be whether we can further raise the level of our comprehensive strength to aim for a new level of products never before seen. We very much want to take on that challenge.

17. With the generational shift in Japan, the generation that is said to use their smartphones for all their purchasing is oriented toward natural rather than chemical-based products. It is a well-known fact that Kao has a very large share of the market for cleaning products in Japan. On the other hand, there are all sorts of

products at 100-yen shops, and you can find many cleaning products sold as "natural" on the Internet. I think there is a risk that these small brands will eat into the share of national brands. As the industry shifts to a structure where small brands can easily become big, what is Kao doing to counter this trend, including in e-commerce and digital marketing?

Your question raises a point that is currently being discussed by our management team. It also holds true for cosmetics. E-commerce is flourishing. It is possible to conduct marketing without spending money and achieve a respectable level of sales by skillfully introducing a concept that is slightly different from other products. This growing trend is threatening major manufacturers.

Kao is not going to immediately shift direction to natural, organic or botanical products. We will offer value that is one step beyond our original target. We intend to precisely target people who are not easily swayed by marketing buzzwords. We will draw a sharp distinction between this trend and how we convey our distinctive corporate image and our passion.

18. **So far, Kao has been growing through a model in which marketing investment drives sales. You have said that you will change the way you use funds from the top down. What will change between now and 2020?**

We cannot raise the margin if a 5% increase in sales entails a 5% increase in expenses. We will not reach an operating margin of 15% unless we increase sales by 8% or 9%. Of course, in monetary terms, overall growth will increase the amount of profit even if the margin decreases. Until now, we added to expenses at about the same rate as or higher than that of the increase in sales. From now on, that way of thinking will be untenable and must be changed. We must adopt an approach in which even a small increase in expenses results in a commensurate or greater effect. There is ordinarily quite a bit of inefficiency, including in our current advertising expenses and marketing. Within the Company, we are promoting a clear awareness that this is no longer a time for investing a large amount in television commercials, as it was in the past. Specific measures are currently under consideration.

19. **So if I understand you correctly, you don't know for sure if sales will grow by 5% — it may be 3%, it may be 4% — but the increase in marketing expenses will not exceed that rate.**

I mean to say that we will promote greater efficiency while keeping increases in expenses below the rate of growth in sales. That will require ingenuity. Outside-the-box ideas will be indispensable.

20. **According to your presentation materials, the market for baby diapers in China is approximately 560 billion yen in 2016 and the market share of Kao's *Merries* is above 16%. Simply multiplying those figures results in around 80 billion yen or 90 billion yen in store sales of *Merries*. However, current sales are not even half that amount. I assume the difference is accounted for by sales through the e-commerce (C-to-C) channel of Internet retailers. If Kao incorporates that amount in its sales, I suppose *Merries* is in a growth stage. In 2020, the market is forecast to be 750 billion yen. Multiplied by a 17% share, total sales of *Merries* would be over 100 billion yen. How much of that will be Kao's own sales of its baby diapers?**

I think it will depend on how active parallel importers are. The trend is toward a considerable decrease, but activity will not stop completely. Basically, we will work to shift C-to-C sales to B-to-C in the e-commerce channel, so our sales may end up accounting for 90% or 80% of store sales. I'm not sure.

21. Does that mean Kao wants to account for about 80% of *Merries* e-commerce sales, if it can?

I do not know whether our share of *Merries* sales will be 80% or not, but we intend to establish our ability to provide Kao products through our own channels to as many consumers as possible in China. For that reason, I want Kao to do all it can.

22. In your strategy for baby diapers in Asia, how do you view Kao's current supply capabilities in Asia, and how much are you thinking of investing over the next five years? Also, what is your strategy for Vietnam and Thailand?

We have considerably expanded production capacity for *Merries* that are manufactured in Japan, so current conditions do not require further capacity expansion. For countries such as Indonesia, where production and sale of diapers is local, if sales growth continues as it has been, a little more investment will be required or our supply capacity will become insufficient, so we will make that investment. We will also invest in capacity at Hefei in China. We have both tape-type and pants-type diapers, and we will change the proportion of the two in line with the market needs of each country.

If we raise our presence a bit in the ASEAN region, we may need production bases other than those in Indonesia. We will give this more thought in the future, but I think the likelihood that we will manufacture in Vietnam is small. If we do manufacture in Vietnam, I think it would probably be to enter markets in western and southern China. Our management team has not discussed this yet.

23. Considering currency depreciation in emerging countries, I suppose the ratio of overseas sales will increase. What is your viewpoint on the impact of exchange rate fluctuations, and how do you hedge and mitigate the risks of that impact?

Basically, when converting sales and operating income outside Japan into Japanese yen, the impact of currency depreciation in emerging countries is small at present. A more serious matter is that currency depreciation in these countries stifles their economic growth. Faced with capital outflow from emerging countries with the strengthening trend toward protectionism, we need to consider skillfully making use of local companies, ways to use currencies that are not mediated by the U.S. dollar, and what currency is the most appropriate. These moves will hedge risk somewhat. We must think seriously about the currencies of emerging countries as well as the U.S. dollar and the euro.

Note

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