Kao

August 4, 2016

First Half of FY2016 Presentation Q&A Session

Date/time: Thursday, July 28, 2016 5:00-6:30 p.m.

Respondents: Michitaka Sawada, President and CEO

Kenichi Yamauchi, Vice President, Financial Controllers, Global

1. **The growth potential of the China business, which is one of Kao's growth drivers, has recently come into question. How are the baby diaper business and market in China? Since the issue of price reductions by Kao's industry competitors has arisen, how do you envision future supply and demand, sales volume and prices? What will your strategy be in response?**

   Sawada: The baby diaper business in China is the most important business for Kao, and we see a market with strong growth potential. The rate of switching to disposable diapers and the number of diapers used are both growing. We have various data, and considering factors such as the baby population, the rate of switching and selling prices, we see a market size of as much as around 900 billion yen on a retail price basis. With the discontinuance of the one-child policy, we can expect a further increase in the baby population. The premium market, which includes *Merries* that were manufactured in Japan, accounts for 30% to 35% of the total baby diaper market, or a size of about 300 billion yen. Moreover, that ratio is increasing slightly. Retail sales were strong in China from January to June 2016, but there has been an ongoing insufficient supply of Japan-made *Merries* because of brisk purchasing activities at stores in Japan for resale in China outside the control of the Kao Group's sales activities. This has inconvenienced retailers and consumers in Japan, and we have expanded our production facilities at an unprecedented speed to fulfill our responsibility as a manufacturer to supply our products. Moreover, as a further response we have started a transformation of our sales structure consisting of a proactive entry into cross-border e-commerce and strengthening exports to a subsidiary in China. With the depreciation of the yuan and appreciation of the yen in addition to this transformation, we have resolved the issue of supply at Japanese stores for the most part.

   We haven't been able to ascertain how much of this resold market inventory remains in the Chinese market and how much has been purchased. However, it currently appears that, in order to move the stock, it is being sold at a lower price than on some electronic commerce sites where we sell our products. We can't expect to achieve our planned level of sales in the Chinese market until that stock is all gone.

   Under these extremely challenging conditions, the fact that combined sales and operating income from the baby diaper market in Japan and China in the first half of FY2016 increased compared with the same period a year earlier shows that we did our best. If these conditions are resolved in the second half, there is likely to be a bit more improvement next year.

   In Japan, we were unable to make product improvements because so far we have had to prioritize expansion of production capacity, but we did make improvements in June. Although sales are currently down in Japan, we will now be investing in the Japanese market.

   In China, aside from the market inventory issue, local manufacturers have been establishing a presence in the premium price range. The quality is quite high, and we can expect competition to intensify.

Skin care is also performing steadily and sanitary products are selling very strongly, with a positive influence from baby diapers.

2. **There is a trend toward lower prices among competitors in the premium price range of the baby diaper market in China. Is your intention not to offer any further discounts in the future below your current prices? If so, what is your reasoning?**

Sawada: In the premium price market, there is a price range that is appropriate. If the ratio of premium product increases and the market grows, there will be a natural tendency for prices to drop somewhat. However, we have no intention whatsoever to adopt a policy of ongoing price reductions. Our responsibility is to increase product quality with improvements and offer good products to Chinese consumers at an appropriate price.

3. **What has the market impact been from the revision of the one-child policy?**

Sawada: In urban areas, parents spend money on one child, so I don't think the discontinuance of the one-child policy will result in an immediate increase in children. If anything, it is likely to have an impact in rural areas.

For baby-related consumption, even those with a low income have a desire to buy something a little bit better for their children when their income increases, so there is room for premium products to spread and grow in rural areas. I believe the rate of shifting to disposable diapers will increase.

4. **As for the market inventory that Kao hasn't been able to ascertain, when do you think the low-price sell-off of the stock will end?**

Sawada: I don't know, but the sooner the better.

5. **Prices are falling on JD.com, the e-commerce site in China. Is there a risk that you won't be able to sell your products without lowering prices even after the market inventory is all sold off?**

Sawada: Price is a major issue in dealing with retailers. We believe they should not deviate from the appropriate price. It is important to set prices appropriately for a win-win-win relationship that includes retailers, consumers and manufacturers. We will continue our efforts to realize adequate pricing with e-commerce, baby specialty stores and others.

6. **How much are total sales of baby diapers in Japan and China? How much have sales grown in China? According to Kimberly-Clark Corporation, retail prices are falling, but what is happening with the retail price of *Merries* in Japan and China?**

Sawada: Combined sales and operating income of baby diapers in Japan and China are rising. We want double-digit or higher growth, the same as or better than the growth rate of the premium market in China. Our market share, including the share outside the Kao Group's sales activities, in increasing little by little. In other words, the value of *Merries* is still on the rise. Together with our products for the volume price range produced in Heifei, China, including product improvements, we will increase total brand value.

7. Why are your non-consolidated capital expenditures high, even though you have reached the end of a cycle of production facility expansion for *Merries*?

Yamauchi: Basically, sanitary product-related investment is increasing. We are still expanding facilities and we have associated materials-related and cost reduction objectives.

8. In the first half of FY2016, operating income increased 17.1 billion yen compared with the same period a year earlier, and there is room to do better than originally expected in the second half, with factors such as raw material prices, total cost reduction activities and a decrease in amortization expenses. What are your reasons for leaving the full-year forecast for operating income unchanged?

Sawada: Excluding the effect of currency translation, net sales grew 28.7 billion yen in the first half (presentation materials, page 10) and are forecast to grow 65.9 billion yen for the full year (presentation materials, page 25), which means we need sales growth of 37.2 billion yen in the second half. We will absolutely pursue this ambitious target, even as we make investments amid challenging conditions.

There are five challenging factors. (1) Market downturn in Japan: As a leading manufacturer of household and personal care products, we must provide support for the market, including strengthening our mainstay products and launching new and improved products. In July, conditions were quite severe in the markets for both household and personal care and cosmetics. The weather may be a factor, but it is possible that consumer confidence is not improving. (2) Competition in Japan: Competition with other companies is forecast to intensify, and it may become necessary to make more marketing and other expenditures than we have planned to respond at an early stage. (3) Sales structure transformation for baby diapers and response to inbound demand: We are making expenditures to enhance our marketing activities for Japanese consumers. We will also conduct marketing activities directed at inbound demand. (4) Investment in businesses that will drive future growth: We are preparing for major reforms of cosmetics and rebuilding *Healthya* functional drinks, to be followed by the food business. (5) A greater-than-expected surge in prices of natural oils and fats.

Of course, we will work to surpass our announced income forecast, but since we still cannot foresee whether or not we will be able to do so, we left the income forecast unchanged.

9. Will you increase research and development expenses and marketing expenses?

Sawada: We are expanding our facilities and increasing staff. We are making estimates that include these fixed expenses, research and development expenses and marketing expenses.

10. What amount of expenses will be shifted to another fiscal period, and which segment will account for the majority?

Yamauchi: Basically, it will be marketing expenses recorded across the Consumer Products business.

11. Can you give a breakdown of the 9.8 billion yen increase in income in the Beauty Care business compared with the same period a year earlier?

Yamauchi: The effect of the completion of amortization of trademark was 3.7 billion yen, so excluding that impact the increase was approximately 6.0 billion yen.

12. Has there been a change in Japanese consumers' preference for premium products?

Sawada: Excluding baby diapers, the whole industry is promoting high-value-added products, so if there has been no change in consumer sentiment toward premium products, the trend in consumer purchase prices (presentation materials, page 8) should be upward, but lately there has been no growth. However, Kao must provide support as a leading manufacturer. I think Kao must take the role of ushering in a shift to higher added value for the industry as a whole.

13. In the analysis of changes in operating income (presentation materials, page 15), the product mix and the impact of currency translation accounted for a decrease of 3.9 billion yen. Has the increase in the proportion of sales of cosmetics and other products with high gross profit improved the product mix?

Yamauchi: The product mix is improving, but the currency translation loss when converting income from subsidiaries outside Japan was large due to the appreciation of the yen.

14. With the severe industry environment, aren't you concerned about reduced returns on your investments in growth over the medium-to-long term? In that case, will there be a change in Kao's strategic "post-deflation growth model" policy?

Sawada: In 2012, the year before we formulated the Kao Group Mid-term Plan (K15) that set forth out post-deflation growth model, our capital expenditures were 40 billion yen, but in 2016 they more than doubled to 100 billion yen. We will continue to invest as we see the returns from this investment, but at this time we are not thinking of increasing capital investment to 150 or 200 billion yen to expand our existing businesses. We will invest for overall growth, including M&A. In total, we will grow by making greater expenditures than in the previous year, but since we believe there are some situations where returns are difficult, we will keep an eye on them and proceed appropriately.

15. Regarding your major reforms of cosmetics, how will you deal with the speed of your competitors? What are Kao's unique strengths in the cosmetics business that its competitors do not have?

Sawada: If we do the same thing as our competitors, I don't believe we can succeed in the cosmetics business. We will proceed with firm convictions. For Kao Sofina, we intend to establish a new holistic beauty concept that combines healthcare with our essential research into skin science, which is a field we have been investigating. For Kanebo Cosmetics, we have incorporated an emotional aspect into our skin science.

In Odawara, near Tokyo, Japan, we are building a factory and research center that will begin operations in September as the base for providing cosmetics from the Kao Group to the world.

Our problem is that we have not generated brand value in skin care. With both Kao Sofina and Kanebo Cosmetics, we will base our efforts to innovate skin care on technology, as Kao always does.

16. In the cosmetics business, do you prioritize market share or the operating income margin?

Sawada: We prioritize the operating income margin. It's better not to even be involved in a low-margin business. We intend to steadfastly increase income in the cosmetics business. That will be necessary to compete globally.

17. Isn't a multi-brand strategy necessary in the cosmetics business? Isn't brand M&A also necessary?

Sawada: We are not currently considering brand M&A. Only if we maximize the use of the brands we have acquired so far can we move to the next step. Now, we intend to change the world with chemical and technology M&A.

18. The operating income margin in the Human Health Care Business decreased compared with the same period a year earlier. Will it continue to decrease? Are you happy as long as sales and income both increase?

Sawada: Once sanitary products get past the current severe conditions, the operating income margin will improve. Personal health products have a very high operating income margin, and we will maintain it. In foods and beverages, we must restore beverages and improve the operating income margin. We are also preparing a new food business. We must increase the operating income margin for the entire Human Health Care Business.

Note

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