Kao

Kao Group Fiscal 2017 Presentation Q&A Session Summary

Date: Thursday, February 1, 2018 17:00-18:40

Respondents:

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Toshiaki Takeuchi, Representative Director, Senior Managing Executive Officer

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1. Capital expenditures are forecast to increase from approximately 80 billion yen in fiscal 2017 to 90 billion yen in fiscal 2018. What do you have planned, and where? What kind of plans do you have for new innovative products?

We will make proactive capital expenditures in China and Indonesia, which are growing significantly, as well as Taiwan and ASEAN countries such as Thailand. We will also invest in proposals of high-value-added products in Japan.

2. In the Cosmetics Business, which has outstanding issues, what will you do during fiscal 2018, and what will you accomplish by fiscal 2020?

Not all cosmetics are struggling. Performance was very good for cosmetics in Asia and *Curél* derma care, which has been reclassified into the Cosmetics Business in fiscal 2018. Major reforms of the cosmetics business centered on skin care are progressing. We are not comparing ourselves with what our competitors are doing. Our outstanding issues are that we are not capturing inbound demand and that we have not been able to develop effective marketing by price segment. We will review our strategy to tailor it to each price segment. In the high-price segment, we will position the global brand *KANEBO* in the price range just below *SENSAI*, our top-class brand in Europe, and enhance counseling. In doing so, we will also capture inbound demand. In the mid-price segment, where we make expenditures for TV commercials and counseling, we are considering ending some counseling even if it causes a brief drop in sales. In the low-price segment, *Curél* and the *free plus* brand for sensitive skin are performing well and growing in sales even without TV commercials or counseling. We will build the image of each brand and execute appropriate strategies. In retrospect, the division into Kanebo Cosmetics and Kao had made it difficult to distinguish individual brands. Rather than taking the approach that Kanebo Cosmetics is emotional and Kao Sofina is science-based, we will effectively utilize the image and features of each brand as assets.

The operating margin for cosmetics in fiscal 2017 was 2.1%, or 4.7% if we calculate it including *Curél* without allocating expenses. We will raise that margin to over 6% in fiscal 2018, to between 8% and 9% in fiscal 2019, and to 10% on sales of 300 billion yen in fiscal 2020. By promoting the growth of our clearly differentiated brands that are performing well and considering reducing expenditures for brands that cannot be differentiated, we will establish a varied approach. Our intention is to determine the direction of the Kao Group's Cosmetics Business by fiscal 2020.

3. In cosmetics, considering that the Kao Group incurred one-time expenses of 3.7 billion yen in fiscal 2016 for *AUBE*, structural reform in Europe and other purposes, why was there a decrease in operating income on a like-for-like basis in fiscal 2017? What were the reasons for the substantial recovery in the fourth quarter of fiscal 2017? Do you expect concrete results in operating margin growth in fiscal 2018 from revising your strategy?

(Note: The one-time expenses of 3.7 billion yen consisted of 1.9 billion yen allocated to cosmetics and 1.8 billion yen for structural reform in Europe allocated to skin care and hair care.)

Operating income in fiscal 2017 was substantially impacted by a decline in inbound demand. The recovery in the fourth quarter was the result of general factors such as different timing of expenses and in promotions in comparison with the same period a year earlier, and growth in sales of cosmetics in Asia. We believe we can achieve an increase in operating income in fiscal 2018 by thoroughly implementing the strategies we explained earlier. In addition, if we can make innovative proposals, we can expect further growth in fiscal 2019 and beyond.

4. **Cosmetics sales and profits are currently concentrated in the fourth quarter. What is the expectation for your reforms of this disproportionate earnings structure in fiscal 2018?**

   Viewed quarter-by-quarter, we post a series of losses from the first quarter, then generate profit in the fourth quarter. We aim to reform this structure, but we must expand the scale of sales to do so. For fiscal 2018, our plan is to reduce quarterly fluctuations.

5. **In the Human Health Care Business in Japan, growth on a like-for-like basis for the nine months ended September 30, 2017 was about 10% compared with the same period a year earlier, but growth for the full year was 7.4%. That is quite a downturn. What was the reason? Cross-border e-commerce? The impact of pricing? Or was it other factors? What was the situation for baby diapers in China?**

   Structurally, when the price of baby diapers decreases in Japan, they tend to be resold in China by resellers thus lowering the price in China. With the decrease in the activities of resellers, sales slowed in Japan, but sales were strong in China. We manage the baby diaper business on a global level, including Japan and China, to maximize profits. Reliably providing baby diapers to consumers in Japan and consumers in China will lead to profits.

6. **What is the reason for the difference between the yearly target of 5% growth in net sales with a 3% increase in expenses and 8% growth in operating income toward K20 and the forecast for fiscal 2018? Net sales are forecast to grow about 2% excluding the impact of acquisition of Oribe Hair Care, LLC and operating income is forecast to increase 5%. Is that because you are assuming new risks? Are you being conservative? I believe you need to make greater expenditures to expand sales. What are your thoughts on this?**

   The forecast is neither conservative nor does it anticipate any new risks. In fiscal 2018, we foresee conditions that could impede Chemical Business sales and we have planned only small increments of growth in the Fabric and Home Care Business and elsewhere. In the Skin Care and Hair Care Business, we expect growth between 4% and 5%, excluding Oribe Hair Care, LLC. Although we would like to increase sales, competition is intense, and we must consider how to deploy marketing expenses. At the current scale of sales, 5% growth will not be easy, but we want to grow as much as possible.

7. **I can’t envision any of your cosmetics brands in the high-priced segment as growth brands, and I think this will be a major problem in the medium term. What is your opinion? Are you considering M&A?**

We are not considering M&A. We will re-examine the brands we already have, brush them up and focus on them. The *SUQQU* and *RMK* brands for department stores are doing well. In addition, *est the lotion* received various awards at the end of 2017, more than doubling the number of customers visiting stores. Rather than distinguishing Kanebo Cosmetics brands from Kao's cosmetics brands, we are differentiating each of our brands and reviewing the ones that are difficult to differentiate in order to establish a varied approach. Strong-selling brands are slightly different in Japan and elsewhere in Asia, so we will also establish a varied approach for both places, although we have not been able to do that sufficiently yet.

8. In fiscal 2017, operating income rose as sales of the Consumer Products Business increased 4.4% on a like-for-like basis with a 2.2% increase in expenses. How are you working to curtail expenses under the difficult circumstances of intense competition?

In addition to TV commercials, we are engaged in various kinds of digital marketing so that we can communicate effectively even if we reduce marketing expenses to some extent. Overall expenses are increasing, but we will promote a new media mix to communicate our value more effectively to targets through methods such as experience-based events. For example, we have been increasing market share for *Merit Pyuan* and other products without airing TV commercials. We will promote effective methods of communicating value that lead to sales. For methods that do not, we will reconsider our approach.

We will refine our proposals of high-value-added products with higher profit margins and more efficient use of indirect costs.

9. How far along are you in making improvements toward your fiscal 2020 target for more effective utilization of expenses?

I think we are about 80% of the way there. For example, expenses can be reduced just by consolidating multiple surveys into one and looking at it from multiple perspectives. The same is true of how we hold meetings. There are still activities where cost-consciousness is not being leveraged, so we are conducting a review so that we can use expenses more efficiently while achieving the same effects. Even in research and development and sales activities, expenses will increase due to the increase in the number of products and our proposals in response to the small mass market, but we are conducting a review of more effective methods, including sales promotion tools such as in-store displays.

10. In skin care and hair care products, the Human Health Care Business, and the Fabric and Home Care Business, considering that sales of *Bioré* skin care products, *Merries* baby diapers and *Attack* laundry detergents are each over 100 billion yen, there appears to still be potential to further improve their operating margins. What are your thoughts from the perspective of managing the brands and their expenses?

We think there is still a lot of potential for improving operating margins. In the Fabric and Home Care Business, we were able to maintain margins despite an increase in costs for natural fats and oils. In Asia, margins are still subpar and there is room for improvement. In skin care, they have improved because *Bioré* skin care performed well in the United States and *Jergens* skin care also performed steadily, but they are still not comparable with those in Japan. In the Human Health Care Business, there are still things we can do to improve baby diaper sales and profits in each region. There is ample room for improvement in operating margins, including from making more efficient utilization of expenses, coming up with ways to communicate our value, and proposing high-value-added products.

11. In which business segment do you expect the most improvement in operating margins over the next three years?

We need to improve operating margins the most in the Cosmetics Business. The question is how the innovations we introduce will translate into this improvement. In the Human Health Care Business, margins of personal health products are high. The amount of improvement in food and beverage product margins will not be large because the scale of sales is small. For sanitary products, total sales of sanitary napkins and baby diapers exceed 200 billion yen, so it will not be easy to make substantial improvements. In the Fabric and Home Care Business, progress will depend on improving margins in Asia in particular. The scale of sales in Japan is large and operating income is already high. In the Skin Care and Hair Care Business, although sales are expanding globally, operating margins have not yet increased, so we expect to be able to make further improvements.

12. How will you deploy your strategy for high-price cosmetics going forward? How will your mindset and approach differ from before?

We will start with the things we were not able to accomplish with our previous mindset. One such issue is how we can differentiate our brands in light of the major changes that are going on. This is linked to our innovations and cannot be discussed publicly yet, but we believe it will show our direction for the high-value-added and high-priced segment.

I believe the added value required also includes the quality of service in delivering products to customers as well as the products themselves, so how will that delivery differ from the past? What was lacking previously and what will you enhance in the future? Will those changes accelerate the implementation of your strategy?

The aspects of cosmetics include not just the quality of a product but also its image, and of course how you communicate that image and in what channels. As we proceed, we are considering how we must change what we have been doing. We are not yet in a position where we can talk about this in detail. Sometime next year, we intend to talk with a long-term perspective over the next 10 to 20 years about how we can deliver surprise and excitement to consumers with cosmetics as our next growth business.

13. For its shareholder returns, Kao Corporation plans to increase its annual dividend to 120 yen in fiscal 2018, but that feels insufficient in terms of the payout ratio. Has something changed in your policy on increasing capital expenditures and repurchasing stock? What is your policy for the future?

As we have become a company with sales exceeding 1.5 trillion yen and operating income of over 200 billion yen, the Board of Directors is discussing a higher level of capital policy that is not an extension of current policy. In the past, we have used cash flow by prioritizing investments for growth over dividend increases, followed by share repurchases; from now, we intend to consider shareholder returns and investments for growth on the same level.

14. The targets of K20 are net sales CAGR of +5% and operating income CAGR of +8%,

but the fiscal 2018 operating results forecast calls for year-on-year growth of +3.4% in net sales and +5.0% in operating income. Excluding the impact of acquisition of Oribe Hair Care, LLC, these figures would be even lower. Do you plan to make any upfront investments? Or do you have high expectations for growth in fiscal 2019 and fiscal 2020? What is the message of the earnings forecast for fiscal 2018?

The message for fiscal 2018 is that we will restore businesses with outstanding issues—cosmetics, hair care, and food and beverage products. We aim for sales growth of 5%, but it will not be so easy, due in part to competition. We intend to increase sales and profit toward the K20 targets with innovation-based proposals of new and improved products.

It will be necessary to invest in reforms in fiscal 2018, but once they are on track, do you envision stepping up progress toward your targets in fiscal 2019 and fiscal 2020?

We are unable to answer in detail yet. Although we will make investments, there are some aspects and challenging businesses where sales will not start growing immediately.

15. **With the reform of the structure of the Consumer Products Business in fiscal 2018, you will speed up decision-making and place younger people in charge. Will you be appointing employees in their thirties and forties, and if so, how many? What will be the extent of the authority delegated to them and how much will decision-making speed up?**

The number of managers in their forties is increasing. So far, we have reduced management hierarchies by two levels and delegated authority, so we envision much faster decision-making. Before the reform, we managed more than 50 brands in our portfolio with the aim of achieving growth in sales and profit in each business unit. As a result, there were brands that we focused on and invested in, those that we did not, and some for which we could not achieve continuous growth. By allocating this portfolio to an organization where responsibility is more focused, we aim to help brands with outstanding issues recover. By changing about 80% of managers and placing younger people in charge, we intend to overcome outstanding issues with a new approach using digital marketing. We will create a marketing and manufacturing organization that speeds up decision-making by delegating authority to a new organization. The new managers will act with a spirit of challenge, without fear of failure.