

First Half of Fiscal 2017 Earnings Conference Q&A Session Summary

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Respondents:

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1. Have the *KANEBO* and *SOFINA* cosmetics brands been performing well in Japan? If there has been a change in conditions, what caused it?

We are still only partway through our major reforms of skin care, which includes *DEW* for drugstores and the global brand *KANEBO* for specialty and department stores under Kanebo Cosmetics, and *est*, *beauté*, *GRACE*, *ALBLANC* and others under the *SOFINA* brand. Consequently, we are unable to determine how well the reforms are progressing at this time.

Sales of *SOFINA iP* grew, but we need to create a stronger link to three-step skin care. We also want to expand the global brand *KANEBO* lineup into a high-priced segment and to succeed with the improved *est* brand this autumn.

We will deploy expenses to implement measures in 2017 and 2018 with the intention of increasing sales and operating income in 2019 and thereafter.

Operating income for the Consumer Products Business in Japan increased by 4.5 billion yen compared with the same period of the previous year, but the increase would have been greater excluding cosmetics. What was the extent of the impact of cosmetics?

Cosmetics sales and operating income tend to be larger in the second half of the year, but our intention has been to fundamentally change our business model into a structure that generates profit from the first quarter and in which both counseling and self-selection cosmetics are profitable. We are reviewing our procedures, approaches and concepts from the top down with a strong sense of crisis so we do not fall behind competing cosmetics companies.

2. What progress did you make in deploying expenses more effectively in the first half? Your early adoption of IFRS 15 makes it difficult to determine the change in selling, general and administrative (SG&A) expenses, but was there a decrease in the ratio of SG&A to net sales? Was there an effect from changing the way you use SG&A expenses?

Our plan is to increase the expenses we use by 2-3% year on year and to grow sales by 5%, resulting in an 8% increase in operating income. Upfront investment and new product launches vary by business, but on the whole, progress has been as planned and will continue as it has been.

SG&A expenses increased by 11.0 billion yen over the same period of the previous year. Would they have increased more under the previous way to deploy expenses (see presentation materials, page 9)?

Yes. SG&A expenses were 44.4% of net sales in 2016, and improved slightly to 42.8% in 2017, excluding the revision of our sales system and the impact of adoption of IFRS 15 (see

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presentation materials, page 5).

3. Looking at recent foreign trade statistics for baby diapers, exports from Sakata Port have recovered to a near-record-high level. It appears that baby diapers were also a major factor in the 45% growth in the Consumer Products Business in China, and exports to Russia have also grown considerably. What are your thoughts on increasing production capacity in the future? What are your plans for the land you recently acquired in Thailand?

In Japan, we have already increased production capacity, so we are emphasizing its effective utilization. Outside Japan, sales of locally produced *Merries* baby diapers have increased in China. In Indonesia, the market share of our locally produced pants-type baby diapers exceeded 10% in the largest market segment and 8% overall, and we intend to target 20% in the future. We will need to add to our production facilities outside Japan. We are considering various uses for our land in Thailand.

4. Has the Human Health Care Business started operations in the Americas (see presentation materials, page 6)?

The figures in Consolidated Net Sales by Segment/Geographic Area for the Americas include Australia, where we are conducting test sales of *Merries*.

5. How is the market environment for baby diapers in China and Indonesia?

The rate of switching from cloth diapers to disposable diapers is about 50% in China and 40% in Indonesia.

There is considerable room for market growth in China in light of the abolition of the one-child policy and further penetration of baby diapers into inland areas. Also, the shift from tape-type to pants-type diapers and the increasing ratio of premium products leave the market with room to expand further.

In Indonesia, the rate of switching to disposable diapers is still low and the market is expected to grow. The mainstream market is high-margin pants-type, but not tape-type diapers. Growth has been in the largest market segment and low-price segment, making it hard to achieve large increases in sales and operating income, and the premium segment has not been developed yet. A shift to the premium segment is expected in tandem with growth in personal income, and the birthrate is high, so the potential is great. As incomes rise, the factor consumers consider important shifts from absorbency that reduces the number of diaper changes to gentleness to the skin. This makes it more likely that they will accept *Merries*, which are differentiated by their breathability that prevents irritation.

We view China and Indonesia as markets with continuing promise.

6. I suppose that strong nationwide distribution in Japan through Kao's own sales company is a source of earnings, but what will be your approach and timing for rebalancing your operations to deal with the expansion of the e-commerce market and other environmental changes?

Kao's comprehensive, streamlined sales system is a strength. Its direct sales structure is closely aligned with retailers and facilitates reflection of consumer opinions. However, we are strengthening our departments that deal with digital marketing and taking other measures so that the expansion of e-commerce does not turn the strength of the direct

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sales structure into a weakness. We will continue to flexibly adjust our sales system.

With the expansion of e-commerce, the personnel expenses and fixed expenses associated with a direct sales structure will be a large burden. What specific measures are you taking to alleviate that burden?

We have shifted from advertising centered on television commercials to conveying our value through digital marketing as we change our organization and manage expenses to utilize e-commerce. Kao's ratio of e-commerce to total sales in Japan is still low at 5% for household and personal care and 4% for cosmetics. We will reinforce what we have been doing so far.

7. In Asia, operating income from the Consumer Products Business decreased 0.7 billion yen despite the strong performance of cosmetics and the Human Health Care Business. Were the expenses for dealing with competitors and the impact of higher raw material prices really that large in the Fabric and Home Care Business? Is the impact of raw material prices on operating income in Asia linked to market price fluctuations so closely? Prices declined for natural oils and fats and rose for petrochemicals, but what about the price of pulp?

The impact of raw material prices on operating income in the Fabric and Home Care Business in Asia was not so large. Fierce competition in Thailand and Indonesia required us to deploy expenses to maintain our share for laundry detergent. Those deployments have not yet led to results, which was a major factor in the decrease in operating income.

The impact of higher raw material prices has been held off for a while. We deployed expenses to generate profit by increasing sales.

Pulp prices are expected to rise slightly.

8. In e-commerce, sales of small-scale and lesser-known products are growing. Is there a competitive advantage for Kao's national brands that are widely distributed throughout the country? How are you conducting sales to expand e-commerce, and in what categories?

At brick-and-mortar stores, Kao has always made proposals for in-store shelf display and sales methods. E-commerce is the same. We study various ways to attract more attention for a product, such as using different product layouts for the different screen formats of personal computers and smartphones, to propose ways for retailers to conduct sales using e-commerce.

Also, with the increase in "small mass" products, there are aspects where we can take advantage of the expertise we have cultivated in brick-and-mortar stores to cooperate in customized communication with consumers. Together with new initiatives, there are still many things we can do.

For larger size items such as diapers and laundry detergents, we can take advantage of the convenience of e-commerce to increase sales. Also, in the beauty care and health care markets, brands without a strong presence in brick-and-mortar stores are growing by making good use of the e-commerce channel. In addition, this is an area where Kao can capitalize on its strengths in R&D and marketing. In hair care, our rollout of improved *Merit PYUAN* used no TV commercials, centering instead on digital media such as social networking services, and market share has increased to 2-3%. We will diversify into smaller

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segments as we roll out other products tailored to various lifestyles, which was not previously possible on a mass scale.

How do you view e-commerce for premium cosmetics, where there is relatively little conflict with the retail store channel?

We would like to conduct e-commerce for premium cosmetics in areas that are not in conflict with retail stores.

9. Operating income in the Fabric and Home Care Business decreased by 2.6 billion yen. Was competition severe in both Japan and Asia? The competitive environment of e-commerce has made it easy to build small mass sales, for example, by enabling small manufacturers to sell fabric softeners by providing copious information. How is Kao responding?

The 2.6 billion yen decrease in operating income in the Fabric and Home Care Business can be split about evenly between Asia and Japan. In Japan, it was largely due to higher raw material prices whereas in Asia, expenses for dealing with competitors were a major factor.

In the small mass e-commerce market, the top-selling manufacturer is constantly changing. We are going to conduct our own approach to e-commerce with premium products, and to continue providing those products in a stable manner.

10. The sales pitch for the new skin care products to be launched under the Kanebo Cosmetics *DEW* brand is that they improve the elasticity of skin, but isn't there demand for new anti-wrinkle products?

We are also doing research on wrinkles. Good skin elasticity means the entire face looks better, including the complexion as well as the wrinkles. *SOFINA* brand products also take a holistic view of beauty for the whole body, not just individual parts of it.

11. The presentation in September 2016 for the cosmetics business mentioned a "One *SOFINA*" strategy. How is that progressing? What lies ahead?

We are expanding the entire *SOFINA* brand while strengthening skin care with a holistic approach that is beneficial for the whole body. We intend to consolidate the value of *SOFINA* from various perspectives for growth, utilizing skin care as the foundation of the brand. This is currently in progress.

12. What is the background of skin care brand *Bioré's* strong performance in the Americas? Is it sustainable? Can we expect a similar success in Europe?

In the Americas, an approach based on a strong association between *Bioré* and facial cleansers, which exists in Japan, did not go well. Our local associates started with *Bioré Charcoal* cleansers, which are easy to understand because they focus on pores, and now *Bioré* is the number-two facial cleanser brand in the United States after *Neutrogena*. In the Consumer Products Business in the Americas, sales increased 2.9 billion yen and operating income increased 3.4 billion yen.

We introduced these *Bioré* products in drug stores in Europe using the same concept as in the Americas, and they have made a start beyond our expectations. In Japan, it has been 20 years since the launch of deep cleansing pore strips, and we are wondering if we can apply our success in the Americas to our home market.

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13. Baby diapers have become a growth driver over the past few years. Please give us an update on the market growth rate, Kao's growth rate and price trends in the first half of 2017 in Japan, China and Indonesia.

Sales in Japan have not increased significantly due to the declining birthrate, but in China and Indonesia, Kao has exceeded the market growth rate. We want to continue doing so. In China, as we make product improvements and raise performance, we intend to do business at an appropriate price in the premium segment. In Indonesia, we are aiming for growth exceeding the market and increases in sales and operating income at an appropriate price based on the product's gentleness to the skin.

Inbound demand declined in Japan last year, and there seems to have been a change in market share. How is Kao's share recovering?

Our sales reforms have solved the product shortages in stores in Japan caused by purchases for resale, and our share has recovered. Despite the severe market environment due to the declining birthrate, we intend to work to ensure that many people use *Merries*.

Note

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