FY2023 Financial Briefing Q&A

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[Time] 10:00 – 11:00

[Speakers] Hiroyuki Ueshima Representative Director, President and CEO
Masaya Ikemoto Representative Director, Senior Managing Executive Officer
Masatoshi Kamada Director, Managing Executive Officer

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Medium-Term Management Plan **ACE 2.0**

[Q1]: On page 25, regarding the status of QUICK WIN, there is a difference in progress for each item. For example, organizational restructuring is high, but progress in strengthening field capabilities and delegating authority does not seem to be progressing. What is the background to this and how can it be improved in the future?

Ueshima [A]: As you mentioned, the reorganization has taken a step forward in terms of progress. First, the reorganization from 11 divisions to 7 divisions was implemented last November.

In addition, we have reduced the number of division heads from 11 to 7, and in fact, as of this April, five of them are new appointments. We have been reorganizing the entire company, including the general managers and division heads, with the target date of this April. Therefore, we would like to work with the new business managers to strengthen our field capabilities, and we consider it more of an action for the current fiscal year to strengthen our field capabilities.

On the other hand, with regard to the delegation of authority, we are also proceeding with revisions to the request matters for approval, etc., and we are proceeding with the major ones in the last fiscal year. Especially with regard to the delegation of authority to the field, we would like to proceed from this April, just as mentioned earlier. I hope this answers your question.

[Q2]: On page 31, I would like to talk about the progress of the initiatives in the area of improvement. In FY2023, loss on valuation of securities decreased by JPY2 billion, resulting in an overall decrease of JPY3 billion. I have the impression that fixed asset impairments and others have not decreased as much as expected. Please tell us again the reasons for this and the probability of achieving the JPY1 billion loss in FY2025.

Ueshima [A]: Others include some factors. Briefly, the total of the losses of subsidiaries, losses or impairments of equity-method affiliates, and loss-making transactions in business.

Therefore, there is a great deal of offsetting within them, and it does not appear to be decreasing. In terms of the significant decrease, the loss-making transactions in business I mentioned earlier has been improving at an accelerated pace.

On the other hand, regarding the deficit of the subsidiaries, due to the deficit in the color former business in FY2023, which I have mentioned earlier, the others do not appear to be decreasing in total. However, we have made considerable progress in terms of offsetting the contents, and we are working to further reduce this by half in 2024, and we will continue to implement the action plan we are currently working on. I believe it is highly probable that the loss will be less than JPY1 billion in 2025.

However, as we go through various businesses, there will naturally be some that fail. Therefore, there is a possibility that a certain amount of impairment will occur in the course of the challenge, and we cannot promise that this will be reduced to zero. However, we would like to reduce it to less than one-tenth of the 2021 level or to less than JPY1 billion.

[Q3]: You have a policy of 100% total return ratio until FY2025. What are your thoughts on the dividend policy for FY2026 and beyond? I know it would be difficult to continue 100%, but is there a possibility of changing the continued dividend increase?

Ueshima [A]: Thank you. First of all, as I mentioned earlier, we consider the fact that ROE has not reached 8% to be a major issue for management that is conscious of cost of capital and stock price, and we are making this announcement in the form of completing the **ACE 2.0** period in FY2024 and FY2025. Therefore, while we are naturally considering this matter in the next mid-term plan, we have decided to limit the period to two years, in order to take into account the situation and to further examine the issue.

Regarding dividend increases, the current medium-term management plan calls for continued dividend increases, but as for shareholder returns, various indicators are now available, and we will consider including new indicators.

[Q4]: Page 22 on shareholder returns. What is the background behind the 100% total return ratio for FY2024 and FY2025? Excluding foreign exchange effects, ROE will reach 8% if net income reaches about JPY30 billion in FY2025. What is your profit forecast for FY2025?

What kind of discussions are taking place within the Company regarding ROE targets and shareholder returns in the next mid-term plan for FY2026 and beyond?

Ueshima [A]: As you say, if net income reaches JPY30 billion in FY2025, ROE of 8% will be achieved. Of course, we are proceeding with that intention. Our current shareholders' equity is nearly JPY400 billion. It has increased significantly in the past few years.

On the other hand, the growth rate of R is low in the growth strategy, so we may have to strike a balance, but first we will factor out ROE and take the three approaches of increasing profitability, increasing turnover, and increasing leverage. In order to achieve an ROE of 8%, with respect to E, we are considering maintaining the current situation with a total return ratio of 100%.

8% ROE itself is not our goal. Including WACC, the cost of capital is more than 8% and may continue to increase. To aim for double-digit figures in the future, we are discussing to achieve 8% as a passing point in this medium-term management plan, **ACE 2.0**.

[Q5]: In terms of thorough ROIC management on page 25, which business or segment do you feel is particularly in need of major improvement from President Ueshima's perspective? How do you think this can be improved?

Ueshima [A]: Thank you. ROIC management is something that we have been discussing internally since last year, and I have my own ideas about how to spread ROIC management.

Since each segment has a different ratio of trading company and manufacturing functions, we have been working to improve ROIC by setting WACC for each and improving ROIC in a WACC-conscious manner. As a result, in terms of how to improve ROIC, we have factorized the ROIC tree down to the finest level and picked up several keywords and indexes, such as improvement of gross profit ratio, inventory turnover, and capital turnover ratio, and incorporated them into an action pattern that is more easily understood by people on the field.

As to which segment, as I mentioned earlier in the four quadrants, our strategy is to use leverage and increase R in our manufacturing function, especially in the semiconductor, food, and life science.

In the case of resin sales, which require a large portion of our working capital, it is very difficult to generate a return on invested assets, so we have to create a mechanism to generate cash in a different way than before. We will also place the highest priority on reallocating the assets and resources that we currently have.

I believe that the NAGASE Group still has earning power. I know this may sound very inelegant, but I would like them to be more focused on earning a single yen, and I strongly ask them to do it with the feeling that it is their own money, not the Company's money. In this regard, we would like to eliminate waste and, as I mentioned earlier in the cash allocation section, promote a company-wide approach of accelerating the recovery of invested capital to invest in growth.

[Q6]: In the overseas gross profit on page seven, there is a remarkable growth in Europe. Could you give us more details about the strong performance of the food ingredients business, what kind of sales strategy you are pursuing in Europe, and what your outlook for the future is?

Ikemoto [A]: I am Ikemoto in charge of this business. Thank you for your question. Thank you for taking the time to look at Prinova Group' s strong sales of food ingredients in Europe.

The position of the Prinova Group in the overall market is rising not only in Europe but also in the US. However, in the case of Europe, there were various changes in circumstances due to the war and other factors. We were able to secure existing customers, and at the same time, while our competitors were falling in the turmoil, we were able to secure our own market. There are many factors, but in general, we have secured our share of the market in Europe.

However, as we have explained, market conditions continue to fluctuate, and the low-priced Chinese products are dragging down the profitability considerably, so some may point out that profitability is low relative to sales.

In light of the above, we are currently experiencing a number of difficulties, but we are taking on the challenge of continuing to improve and recovering earnings in the future. That is all from me.

[Q7]: Regarding the dissolution of cross shareholdings, how many acceptances for sale have you received from partner companies since FY2024?

Ikemoto [A]: Thank you for your question. Ikemoto will continue to answer your question.

With regard to the dissolution of cross shareholdings, we are continuing to discuss various issues, as each company is taking a very hard look at its capital policy these days. We have already been selling our policy shareholdings, and at the same time, many of our partners have also sold their shares in the form of cross-shareholding dissolution.

We have already received a number of offers, and we will keep a close eye on the trend of how they release their shares while monitoring what each company has in its portfolio. That is all from me.

[Q8]: You mentioned that the cost of equity is more than 8% based on your dialogue with investors. Did you take a survey, or are the figures obtained from informal dialogue?

Ueshima [A]: Thank you. I have been informed that in discussions with various investors, the number has been 6%, 10%, and various other figures, but I have heard that most of them are of the opinion that it is at least 8%.

In addition, when we consider IRR, the 8% or more is very much stuck in my mind, and I have no doubts about that, and we are speaking to you as such.

[Q9]: I would like to confirm the market position, growth potential, and sales size of liquid epoxy encapsulant materials. In addition, is CUF or NCP used for HBM memory? I would appreciate your response to the extent possible.

Ueshima [A]: You have asked a very technical question. I will answer the first half of your question, and Mr. Kamada will explain the second half.

As for our position of encapsulant materials, we are currently targeting encapsulants for cutting-edge semiconductors. In particular, we are making daily efforts to make liquid encapsulants the de facto standard. As I mentioned earlier, we are also pursuing spec in activities for sheet encapsulant materials to ensure that our products will be adopted in the future when the manufacturing process changes.

In this respect, we always target cutting-edge markets, such as the semiconductors used in high-end servers today.

Mr. Kamada will explain the second half.

Kamada [A]: I am Kamada in charge of the business. Let me answer your question.

As the President mentioned, this growth potential is linked to HBM, and we believe that our business will grow along with its growth. The HBM itself is a stacked DRAM, and since it is stacked in many layers, our liquid epoxy has been used in them and work well.

We are unable to provide further details due to confidentiality with our clients.

[Q10]: I have an additional question about liquid and sheet encapsulant materials. According to some reports, for HBM memory stacking, liquid encapsulant is the only way to increase yield. It would be helpful if you could share your views on this report. Also, can we consider it a tailwind for your company?

Kamada [A]: Thank you very much. Regarding the yield rate, only the customer can give a general answer, as it depends on a variety of factors. In general, we believe that liquid epoxy contributes considerably to the yield rate. That is all.

[Q11]: How will sheet encapsulant materials for AI servers contribute to earnings in the future? Also, please indicate to the extent possible what specific areas this will be used for.

Ueshima [A]: Thank you. In the document we explained earlier, there is a roadmap of technologies, and we expect that liquid or sheet materials will be adopted for the 3D type shown in the roadmap.

As for specific numbers of contributions, the wafer bumping business, which we mentioned earlier, the sheet molding compound, the recovering and recycling business of developing solutions, and the food essential oil business, we believe that these four businesses together will generate gross profit of JPY20 billion by 2030, up from zero at present.

You probably want to ask me about what this breakdown is, so I would only like to inform you that the weight of sheet and liquid encapsulant materials, which have been mentioned earlier, is quite high.

[Q12]: Prinova Group' s performance recovery in FY2024 is quite significant. Which of the reasons you indicated on page 21 is the most significant factor? Can we expect similar profit growth in FY2025?

Ikemoto [A]: Thank you for your question. Ikemoto will continue to respond.

In FY2023, especially in H1, market fluctuations were very dramatic. The rapid decline in market conditions damaged our profitability from the year before last, from FY2022 to H1 of FY2023.

In addition, the delay in the start-up of our new plant, including the automated production line, caused labor costs to rise sharply in H1 to H2 of last year.

As I explained earlier, market prices have remained sluggish this fiscal year, but we expect this to bottom out soon. In addition, we expect market conditions to return to normal in H2. At the same time, the automation line has been largely set up for automation. We are also working on measures to reduce labor costs by further reducing manpower and automating existing lines where automation is possible.

We believe that these efforts will contribute to our earnings and improve productivity in FY2024 and FY2025, and we will steadily implement them one by one. That is all from me.

[Q13]: While sales and gross profit in the electronics and energy segment will increase significantly in FY2024, what is the reason for the decrease in operating income? Considering the current boom in semiconductors for generative AI systems, the forecast for FY2024 appears to be quite modest. Please explain including recent trends of Nagase ChemteX' s semiconductor encapsulant materials. Also, what is the competitive situation for packaging materials for generative AI? When will the new concept materials on page 28 be commercially produced and contribute to business performance?

Ueshima [A]: Regarding the gross profit ratio and operating margin of electronics and energy, there may have been some confusion since there are two P&Ls that we have just shown you.

As shown in the first figures before allocation of corporate cost and others, we also expect an increase in profits in electronics and energy. However, with regard to your question about whether the increase in operating income is small in the midst of such a boom in semiconductors, we have both a trading company function and a manufacturing function in the semiconductor business. In the manufacturing function, we are steadily pursuing spec-in activities of products and expect significant growth in the future.

After all, as I mentioned earlier, the actual figures will be recorded in 2026 or 2027.

On the other hand, in the trading company function, which earns immediate profits, the Chinese market, which is a large market, is accelerating its shift to domestic manufacturing due in part to the decoupling of the US and China. Therefore, I would like to explain that these figures include the fact that Japan’s material exports are in a very difficult situation.

Could you repeat the second question?

The second question. Considering the current boom in semiconductors for generative AI systems, the forecast for the new fiscal year appears to be quite modest. Please explain including recent trends of Nagase ChemteX’s semiconductor encapsulant materials.

Ueshima [A]: DRAM and logic devices for this market are currently growing very strongly. On the other hand, NAND is still in the process of recovery, but we have not yet seen a recovery in semiconductors to the FY2022 level by the end of this fiscal year. We expect the market to grow in FY2025, actually exceeding the FY2022 figure.

On the other hand, we are steadily promoting sales and manufacturing activities for raw materials for this market with a view to their adoption by our customers. Although there is a slight time lag, we hope that you can look forward to 2025 and 2026.

[Q14]: Please explain the details of ROIC management in figures. Please tell us the segments you manage and current ROIC and target ROIC for each segment. Also, do the segment heads fully understand ROIC management?

Ueshima [A]: It is a very sharp point, and I am sobered by that. Regarding ROIC management, in H1 of last year through November, the back office has been making various preparations to pick up ROIC in each segment. As I mentioned earlier, due to organizational restructuring and changes in division heads, management is officially proceeding based on the rate from this fiscal year.

In terms of whether it is working or not, each factorization is quite detailed. For example, they are told to reduce inventories or increase operating profit margins. Why is that? We have explained to the division manager level the factorization that ROIC is like this. In terms of whether it has penetrated down to the level of those in charge, I believe that it has been incorporated into the actual behavioral patterns.

Under such circumstances, we expect the gross profit ratio to improve from 17% in 2022 to 18.3% in 2023 and to 19.1% this fiscal year. The inventory turnover months has also improved from 1.41 months in 2022 to 1.21 months last year.

Dividing sales by total assets, we get 2.41 to 2.24. We are still in the process of making improvements due to various factors, including the lack of leverage, but we intend to make further improvements by breaking down the factors and incorporating them into our operations.

[Q15]: What is the target value of WACC in your company? Also, what is the acceptable range of interest rate increases for debt?

Ikemoto [A]: Thank you for your question. First of all, regarding the WACC target, as announced in our medium-term management plan, we believe that if we can lower the cost of capital as much as possible from the current level and, if possible, operate at a lower level than now, say 5.5%, or at the 5% level, we will first improve the overall capital efficiency.

However, since it is necessary to take various measures to achieve this, we have currently set each target for the mid-term plan.

Regarding debt, what is an acceptable range of interest rate increases? Regarding debt-to-equity ratio, I think there is a debate whether it is good or bad, but we are operating it at a low level. We are doing this by allowing a net D/E ratio of up to 0.5. As for the interest rate that is the premise for this, there is some debate as to whether the current interest rate will rise by 0.25%, but we believe that such a range will be well tolerated in the short term.

Therefore, we do not have any major concerns about the capital structure at present. We will continue our efforts to lower the WACC in order to improve capital efficiency, and we look forward to your further guidance in this area. That is all.

[Q16]: What are some of the risks that you foresee for the Prinova Group in achieving its performance plan for FY2024? Could you tell us to what extent the plan incorporates various risks?

Ikemoto [A]: Regarding Prinova, there are various risks, but the major one is the price slump since last year. Due to the recession in China, products made in China are increasingly being shipped out of the country. Since last year, we have been wondering when these things will settle down.

The bottom has generally been reached, the low level is settling down, and some items are starting to rise. Therefore, in terms of risk, I think it will continue in H1, but we expect that the level will be different from H2 onward.

We are also keeping a close eye on what form the US tariffs will take, although this may still be a long way off. The US has already announced various plans to raise tariffs on shipbuilding, automobiles, EVs, etc. We do not know whether the tariffs will be applied to products from China, or to our materials for this year or next year, but we will keep a close watch on this.

Logistics is also taking a long time, and there are inventory risks, but largely, I think these two points are the major ones we are paying close attention to. That is all.

Ueshima [A]: If I may make an additional point, as Mr. Ikemoto mentioned, not only the Prinova Group but Chinese products are now being sold in overseas markets to maintain the capacity utilization rate due to the extremely low demand in China.

This has been a sacrifice sale not only in the food industry but also in chemicals, steel, and other materials, and all kinds of materials have been affected. It is difficult to say how long this will continue, but to some extent, we can make good use of it as a trading company function. On the other hand, as a manufacturing base, we have to fight for our own manufacturing capabilities as a competitor, and we are in a very difficult situation.

As a side note, Japanese manufacturers have announced the discontinuation of many of their products as a result of the Chinese sacrifice sale, and this is a big blow to us at NAGASE, which has the products, but it is also an opportunity to acquire new commercial products. We are proceeding with both wheels in mind.

In addition, as far as the Prinova Group is concerned, sports nutrition and energy drinks are a large market in the US, and because this market is targeted at young people, there are many new entrants into the market.

In the face of our best customers suddenly losing market share, we are always on the lookout for new suppliers. We hope to report to you again. Thank you very much.

[Q17]: On page 26, in setting the position of each business group in the four quadrants, if we assume that the criteria for positioning as improvement in the lower left-hand corner is not whether the business is in the red or in the black, but rather ROIC is below WACC, what percentage of sales would fall under this category? Also, do you plan to disclose the business below that, and how to improve it to WACC or above?

Ueshima [A]: As I explained on page 32 titled "Indicators," our ROIC is below WACC, which was negative 1.3% in FY2022 and negative 1.9% in FY2023, which means that the red in EVA is getting bigger.

We are embarrassed by the situation before we can say what percentage of the businesses are in this area, so we are considering the possibility of making this difference positive overall. We do not disclose specific businesses, etc. We would like to take a closer look again in the future in light of such a suggestion. Thank you very much for your advice.

[Q18]: Am I correct in understanding that your liquid encapsulant materials for HBM is already in mass production and available in the market?

Kamada [A]: Regarding whether liquid epoxy for HBM is used in mass production, I would like to say that we have a track record.

[Q19]: Recently, HBM has been growing rapidly in the semiconductor memory market. Liquid encapsulant materials are often used there. Do you see this as a business opportunity for your company? Also, can we expect this to contribute to the future performance of the Company?

Kamada [A]: With the growth of HBM, we believe that our liquid epoxy will continue to make a significant contribution along with the growth of this market.

In addition to liquid epoxy, we are also proposing sheet epoxy, which is our proprietary technology, and taking on the challenge of going even further beyond liquid epoxy. We hope to contribute to the semiconductor industry by seizing this great growth opportunity.

[Q20]: What is the extent to which the business risks associated with the Prinova Group are incorporated in this fiscal year' s plan? It does not have to be a quantitative answer.

Ikemoto [A]: Excuse me, Mr. Okawa. I was not able to explain this earlier. We have factored in market trends to some extent, but we do not yet have a clear picture of what the market will be like in the future. At this stage of the plan, the trend from the previous year to the current fiscal year remains to some extent. It could be said that the plan is based on a view of safety, and we are factoring in a little looser.

In addition, as for the replacement of customers, as President Ueshima mentioned, we have many customers with whom we have a very close relationship, so we have been talking with them and incorporating such matters into our plan in a firm manner.

Tariffs have not been incorporated in this plan because it is a matter of what direction society will move in. That is all from me.

[END]