FY2018 1Q Online Financial Results Conference for Analysts: Q&A Summary

Date: August 4, 2017 (Fri.) 17:00 to 18:00
Respondents: Tsuyoshi Hachimura, CFO;
Mamoru Seki, General Manager, General Accounting Control Division

1. Results for the 1st Quarter of FY2018 (P/L related)

Q: The Food Company seems fairly robust. Could you explain what has contributed to its profit growth, including Dole and trading operations? What is your forecast regarding the sustainability of such results in the 2nd quarter onward?

A. As I have explained previously, our strongest earnings pillars are in the Food, General Products & Realty, and ICT & Financial Business Companies, along with a portion of the operations under the purview of the Machinery Company. In particular, the Food Company performed well. Along with the favorable performance of operating companies, non-consolidated earnings from trading recovered from the previous fiscal year's stagnation, which was attributable to the loss posted by the Provisions Division and some transactions with poor profitability. With regard to the Dole business, although this subsidiary delayed capex projects until we invested in it, over the most recent two years we have been pushing forward with the upgrade of its irrigation systems while pursuing cost reduction efforts. These initiatives have yielded stable results.

FamilyMart UNY Holdings, recorded a year-on-year decline in profit on the performance including Uny Group Holdings (UNY GHD) basis. Specifically, although profit from UNY operations grew, the convenience store business recorded a fall in profit due to increased expenses mainly associated with brand conversion. Nevertheless, we expect that despite these one-time expenses, the full-year results of FamilyMart UNY Holdings will meet forecasts made at the beginning of the fiscal year. Their alliance with Don Quijote Holdings is expected to create synergies in both the convenience store and general merchandise store (GMS) businesses, leading to future contributions to profit.

NIPPON ACCESS is likely to meet its annual target of achieving a year-on-year profit increase, as transactions with Circle K Sunkus are growing. We also announced our decision to raise our equity stake in FUJI OIL HOLDINGS to 33.4%. In addition, Prima Meat Packers, HyLife and other key operating companies have recorded solid results. Our U.S. grain handling operations have also recovered from the sluggish results recorded a year earlier, thereby contributing to overall profit improvement.

Q. Please explain the current status of ITOCHU Minerals & Energy of Australia (IMEA) and the impact of cyclones, if any, on operations.

A. IMEA holds iron ore mines with world-leading competitiveness while maintaining stable production output. Jimblebar, in which ITOCHU has interest, expanded its annual production capacity to 50 million tons. If the current trend in iron ore price continues, annual profit will far exceed the annual plan. However, since we now anticipate a weakening in the demand-supply balance, we expect iron ore prices to decline just as they did in the beginning of 2017. Earnings from coal are largely centered on thermal coal, which we expect will make no significant contribution to profit. In addition, the impact of cyclones on our operations was minor.

Q. Drummond is now seen as a contributor to profit. Could you provide us with updates about Drummond? How sustainable can dividend payments be?

A. Colombian coal prices have been strong since the second half of the previous fiscal year. Along with a lower volume of coal production in South Africa, demand from Asia remains as firm as estimates made at the time of investment, strongly boosting Drummond's results. However, despite the currently favorable performance, we don't simply anticipate that the full-year dividends will echo the fourfold increase in dividends paid for the 1st quarter.

Q. Please explain what is driving profit growth in the energy business.

A. The growth in profit is largely attributable to the strong showings of ITOCHU ENEX, whose energy business is making significant contributions. Although non-consolidated earnings of the Energy Division from trading have recovered from the previous fiscal year's sluggish performance, we are facing challenges in overseas trading operations. Accordingly, we will review the overall energy trading operation. Meanwhile, other factors for the year-on-year profit growth included the absence of a hedging-related loss recognized by the ACG project in Azerbaijan and internal tax charged in the same period of the previous fiscal year.

Q. Extraordinary gains totaled ¥7.5 billion in the 1st quarter. Is this amount entirely attributable to factors you anticipated when forecasting full-year extraordinary gains, which amount to ¥35.0 billion, in the Fiscal 2018 Business Plan?

A. In formulating the plan we did not anticipate recording ¥2.0 billion in proceeds from the sale of asset management-related operations. However, we did assume ¥2.0 billion in profit, largely in connection with a ¥3.0 billion decrease in tax expenses associated with pulp-related operations. Further extraordinary gains totaling ¥33.0 billion are likely to be realized in the 2nd quarter onward. Nevertheless, as we see that the primary source of extraordinary gains/losses is the asset replacements, the outcome will, by and large, remain fluid. The full realization of the initial forecast totaling ¥35.0 billion depends on business trends going forward.

2. Cash Flows and Investments

Q. During the 1st quarter, operating cash flows appeared to be fairly strong. What factors contributed to these cash flows?

A. Just like other general trading companies that have benefited from rising resource prices, the Metals & Minerals Company has seen a significant improvement in operating cash flows. Operating cash flows also expanded in the Forest Products & General Merchandise Division and the Machinery Company. Over the last four years, we have been accumulating approximately ¥400.0 billion in operating cash flows each year. In particular, operating companies have increased their capabilities to secure robust cash flows.

Q. What's your stance on future investment based on the investment results for the 1st quarter.

A. For the full fiscal year, we are assuming core operating cash flows of approximately ¥400.0 billion and core free cash flows of approximately ¥200 billion, which is "over ¥100.0 billion +α." As we have maintained a policy of undertaking investment only within core free cash flows, we are envisioning a net maximum investment amount of ¥200 billion. Although cash flows used in investing activities during the 1st quarter were slightly higher than expected, we will maintain our policy to achieve core free cash flows of at "over ¥100.0 billion +α" while taking a prudent approach to investing in existing businesses and selecting new investment outlets. Core free cash flows in FY2016 and 2017 helped us create cash surpluses totaling ¥410.0 billion and ¥300.0 billion, respectively. However, management believes that it could have allocated more of these surpluses to investment. Taking our future growth potential into account, the allocation of a net ¥200.0 billion to investment is tolerable to us.

Q. Could you give us any examples of outflows attributable to working capital growing and undermining operating cash flows?

A. In certain fields, we are engaged in transactions involving the considerable accumulation of inventory and longer payment cycles. These transactions may occasionally require a major influx of working capital. To avoid the excessive accumulation of working capital, we closely monitor the status of operating cash flows and cash conversion cycles at each Company. In these ways, we are maintaining a firm grip on cash flows, with the aim of achieving core operating cash flows totaling ¥400.0 billion as planned.

3. Individual Projects

Q. Please tell us the progress in expenses associated with brand conversion by FamilyMart vis-à-vis your initial projection. What is the current status of your initiatives to create synergies centered on FamilyMart operations from the beginning of the 3rd quarter onward?

A. As of June 30, 2017, there were approximately 4,300 Circle K Sunkus stores. Plans call for this number to be down to around 1,800 by the end of February 2018. And, the completion of the brand conversion is scheduled for March 31, 2019. Thus, there are expenses prior to the brand conversion. However, the rebranding of these stores has progressed faster than expected. Some stores that completed rebranding to FamilyMart have seen growth in daily storefront sales. We expect further improvement in these operations. In addition to initiatives undertaken by the Food Company, brand conversion is now under way for operations under the purview of the Chemicals, Metals & Minerals and Machinery Companies, and we expect the creation of greater synergies. With FamilyMart UNY Holdings pushing forward with cost reduction initiatives to improve profitability, we will strive to increase profit by expanding FamilyMart-related business.

Q. Is there any revision in the schedules for businesses undertaken with CITIC Medical, or any progress on other CITIC-related synergy businesses?

A. No significant revisions have been made since the end of FY2017. We aim to expand into the administration/management of hospitals and the medical supply business via collaboration with

CITIC Medical rather than engaging in operations directly related to clinical trials. In line with this aim, ITOCHU's top management is engaged with its counterpart at CITIC Medical. Based on the premise that we would not directly provide medical interventions, we are pursuing discussions with their leaders on the scope of collaboration in peripheral businesses while performing due diligence checks. Other ongoing business collaboration projects aimed at creating synergies include those related to e-commerce, FinTech and off-shore wind power generation as well as those undertaken in tandem with Bosideng. However, synergy projects have seen only slow progress overall.

Q. What is your view on the operating environment surrounding C.P. Pokphand Co. Ltd.(CPP)?

A. We recognize that CPP is facing a somewhat harsh environment. First quarter results were negative due mainly to the steep plunge in pork prices. Although pork supply has been excessive in Vietnam due to the pork import limits imposed in China, we nevertheless believe that market conditions will gradually recover from the 3rd quarter onward. Moreover, operating results remain firm in their feed-related business overall. Therefore, we are maintaining our current performance forecasts, which assume a recovery in pork prices. We have no anxiety with regard to the future outlook of CPP, as it boasts significant advantages with regard to businesses targeting the Chinese market.

Q. Please tell us your strategies for POCKETCARD, Orico and other credit card-related businesses undertaken by ITOCHU.

A. Each business is targeting different customer segments. POCKETCARD is aimed at acquiring customers mainly through FamilyMart stores. Orico, on the other hand, engages in a broad range of retail financing businesses, including those related to installment sales. We will utilize POCKETCARD's robust membership totaling 2.7 million. In addition to POCKETCARD and Orico operations, ITOCHU has strengths in the consumer finance business. We are utilizing it as a tool for developing a multi-faceted financial business.