Investor Briefing on FYE 2024 Q2 Financial Results: Q&A Summary

Date: November 8, 2023 (Wed.) 10:00 to 11:30
Respondents: Masahiro Okafuji, Chairman & Chief Executive Officer
Keita Ishii, President & Chief Operating Officer
Tsuyoshi Hachimura, Chief Financial Officer
Hiroyuki Naka, Chief Strategy Officer
Shuichiro Yamaura, General Manager, General Accounting Control Division

1. Investments Related

Q : I would like to ask about management's big picture, especially its investment policy going forward. Currently, the ¥800.0 billion profit stage is being established. As a foundation aimed at the next growth stage, will you promote proactive investment moving forward, and can we assume there will be investment that can be expected to provide stable profit? What is your feeling on this? Also, will there be any change in the fields and regions targeted for investment in consideration of such factors as the current yen depreciation, market prices, and rising geopolitical risks?

A1: Investments in recent years have centered on business partners and Group companies with whom ITOCHU has long-standing commercial relationships and personnel exchanges, including ITOCHU Techno-Solutions Corporation (CTC), DAIKEN CORPORATION (DAIKEN), DESCENTE, and Hitachi Construction Machinery. Our stance is to invest in companies that we expect will have synergy with the Company going forward and to provide steady profits, especially in the non-resource sector. While paying attention to the highly uncertain business environment at present, including the rapid rise in geopolitical risks, we select opportunities to invest in companies that steadily generate profit. When deciding to move forward with an investment, we take time to consider such topics as whether we have business insights in the field and if we can demonstrate functions through our hands-on approach, without relaxing our investment discipline based on the Four Lessons for Investments.* There will be no change in this policy moving forward.

*Four Lessons for Investments (to rigorously prevent below):
1) Overpaying for investments, 2) Investments aimed at seizing profit from investees,
3) Overdependence on and overconfidence in partners, and 4) Lack of hands-on management

A2: The business front lines are quite proactive toward investments. Many investment candidates have emerged, but current stock prices still seem rather high considering the present economic conditions. From the following fiscal year forward, we think there is a high possibility that stock prices will start heading toward a decline. Accordingly, determining the timing to execute an investment is important. When considering investments, we conduct more extensive examination than ever before and we have also issued orders across the Company to tighten the reins. Currently, our pipeline is brimming with potential investments. Although it is true that we think the situation makes it easier for high-quality opportunities to emerge, there are actually many investments that we reject after carefully considering them at the Investment Consultative Committee in order to more effectively deploy our funds, which are not unlimited. ITOCHU fundamentally emphasizes investments that aim to expand related businesses afterwards, such as the additional stakes we took in CTC and DAIKEN. Hitachi Construction Machinery will not just play the role of business partner in North America; going forward, we expect it will demonstrate such functions as expanding business in regions outside of North America. Moreover, Tokyo Century Corporation is strengthening its relationship as a partner with Hitachi Construction Machinery more than before by investing in a North American construction machinery financing company alongside ITOCHU. Going forward we think the Machinery Company will be able to expand business centered on both Tokyo Century Corporation and Hitachi Construction Machinery. Even in other Division Companies, we are refining our strategies from the perspective of how to expand business going forward centered on core Group companies. And, while new investments and acquiring additional stakes in existing investments are an extension of that strategy, we will need to very carefully determine the timing of the investments.

Q : Considering the accumulation of core free cash flows after deducting shareholder returns during the period of the current medium-term management plan, I think it is possible that the Company will carry over a surplus which is accumulated after growth investments and shareholder returns into the next fiscal year. Is there anything you can currently tell us about discussions regarding cash allocation, including growth investments and shareholder returns for the next medium-term management plan?

A : Core free cash flows in the first half of FYE 2024 amounted to an outflow of ¥341.0 billion. In the second half, we already expect a total cash outflow of around ¥1 trillion comprising an outflow of around ¥700.0 billion in investments, including for CAPEX and the squeeze-out of CTC and DAIKEN, and ¥332.0 billion already committed to shareholder returns. I think this projection is clear to external parties as well. We have currently accumulated over ¥1 trillion in our investment pipeline and are conducting detailed analyses of such factors as potential synergy for each investment project, the timing of investments, and their profit contribution from the following fiscal year forward. When deliberating investments, the Investment Consultative Committee rejects numerous investments and consistently applies rigorous investment discipline. Prior to discussions of cash allocation going forward, we first carefully assess investments connected to overall profit growth, which is a prerequisite, and hold discussions to judge the accuracy of projected profit contributions from the following fiscal year forward. We assume positive core free cash flows after deducting shareholder returns during the period of the current medium-term management plan, and plan to continue B/S control appropriate for A ratings and highly efficient business generating around 13–16% ROE. Moreover, we have announced cash allocation that balances growth investments, shareholder returns, and control of interest-bearing debt. Regarding cash allocation for the next fiscal year forward, we will continue to consider our options after judging the likelihood of profit growth and investment going forward. Furthermore, the loss buffer of ¥30.0 billion for the revised forecast of FYE 2024 is conservatively set, as we assume it is possible that investments expected to provide profit contributions during FYE 2024 will slide into the following fiscal year and beyond. In addition, the scale of growth investments for the following fiscal year onward can change depending on the progress of investments in the second half of FYE 2024. We are currently deliberating the shareholder return policy and therefore ask you to wait for its announcement in May 2024.

Q : I get the impression that many of the investments during the current medium-term management plan would be additional stakes in existing investments and there would only be a limited amount of investment in new fields. Is there an investment strategy that will be become a new fulcrum for the next medium-term management plan and beyond? What is your aim moving forward?

A : It may appear that we are concentrating on acquiring additional stakes in solid existing investments, but we are obviously also considering new major investments. The fact of the matter is that there were some we passed over after careful consideration, but there are also some that we are still deliberating. However, because the investment amounts are large and involve other partners, we need to seriously assess whether to go through with them and the timing. This does not necessarily mean that these kinds of projects will be carried over into FYE 2025 or beyond; we could go through with them in FYE 2024.

Q : I would like to ask about the definition of “growth investment.” Are the acquisitions of additional stakes in listed subsidiaries and affiliates, such as CTC and DAIKEN, positioned as growth investments? And is the higher amount of profit seized from acquiring additional stakes considered profit growth?

A : Although some may think that acquiring additional stakes in listed subsidiaries and affiliates are not growth investments because they simply seize profit that flowed outward, ITOCHU has steered CTC and DAIKEN toward privatization to create and expand synergy and therefore considers acquiring additional stakes one kind of growth investment. ITOCHU acquires additional stakes and sells stakes as needed after continually reviewing the strategic significance of owning the stakes in each listed subsidiary and affiliate. When we discuss growth investments for the next fiscal year onward, we will continue carefully analyzing such factors as the B/S scale, profit contributions of investment and the impact on cash flows; then we will explain our updated investment policy upon its release in May 2024.

Q : As ITOCHU strives to firmly establish a ¥800.0 billion profit stage, the market is paying close attention to the growth rate going forward. For growth investments, what kind of strategies and timelines are you considering to raise the growth rate?

A : We have achieved steady growth in consolidated net profit, which was ¥161.0 billion in FYE 2011. From that time, CAGR has been over 10% and rose to over 15% when we reached the ¥800.0 billion profit stage. We are proud of having achieved a growth rate at such a high level. Although we have not set quantitative targets, we strive to formulate growth strategies, including investments, while always thinking about how we can maintain a growth rate of over 10% going forward.

Q : There are other general trading companies that incorporate a certain level of capital gains in their quantitative plans as a business model, but what is your policy on asset replacement while continuing to disclose the growth rate going forward?

A : Many other general trading companies have recently started to focus on asset replacement, but ITOCHU has conducted strategic asset replacement all along. For example, eyeing the peak of the business, we sold PrimeSource, which realized a cash recovery of around ¥110.0 billion. Or, in consideration of cash efficiency, we made additional investment in the softwood pulp business (METSA FIBRE) using the money from the sale of the hardwood pulp business (CENIBRA). Our policy is to, of course, hold onto prime businesses that expect sustainable profits. There are cases when Division Companies may discuss selling even prime businesses to achieve their budgets, but ITOCHU monitors activity to ensure that businesses with room for growth are not sold off merely to temporarily boost financial results through capital gains. Conversely, there are also cases when Division Companies, to maintain their scale, may be reluctant to sell profitable businesses despite low investment efficiency, but ITOCHU will promote the sale of businesses that have peaked out. Regarding CONEXIO Corporation, some people in the Division Company wanted to hold onto the company because of its relationship with telecommunication carriers, but amid expectations of changes in the industry structure, including lower fees for agencies, we decided to sell the company to a buyer who could achieve better synergy. We will continue to conduct this kind of asset replacement while carefully analyzing the content of each business.

2. <u>P/L Related (Including Economic Environment)</u>

Q : In the non-resource sector, the Textile Company, Food Company, and other businesses that had been struggling to date have appeared to bottom out, but other businesses now appear to be struggling, such as the pulp-related and pork-related businesses. Could you tell me whether the overall earning power in the non-resource sector is on an upward or downward trajectory? And what is the possibility that consolidated net profit in FYE 2025 will be higher than in FYE 2024?

A1: While it is true that businesses are exposed to market prices even in the stable non-resource sector, the Division Companies expecting growth going forward include the Machinery Company, ICT & Financial Business Company, and Food Company. In the Machinery Company, the performance of Hitachi Construction Machinery remained firm, and North American electric power-related businesses are currently performing well. In addition to businesses related to the planning, development, construction, and sale of power plants, we are building a business model that spans the long-term in connection with plant maintenance and servicing after sale. The United States is supporting renewable energy investment, such as with the Inflation Reduction Act, and is also strengthening measures for solar power and onshore wind power. In addition, based on current conditions, the shift to EVs is unlikely to make rapid progress, and we think that for the time being automobile-related business and transactions will remain firm. We think that in the ICT & Financial Business Company, CTC will maintain firm performance on the back on strong demand for digitalization. In addition, we think the flexibility of offerings and services using existing our group of digital businesses will further improve due to privatization, and we can expect an increase in orders for DX projects. Moreover, there is a lot of room for expanding services using data from the medical business consolidated into the ICT & Financial Business Company after an organizational restructuring in FYE 2024, along with many Group companies that have customer contact points, including HOKEN NO MADOGUCHI GROUP and Gaitame.Com Co., Ltd. Working in tandem with CTC, we will proactively promote the businesses. In the Food Company, performance of domestic Group companies remained firm, including for NIPPON ACCESS, INC. We held discussions the other day with the presidents of around 50 Group companies, and it was shown in the discussions that the strong performance of each Group company in the Food Company. Although HYLIFE and Dole are currently struggling, HYLIFE completed its withdrawal from U.S. businesses in FYE 2024 and expects to recover from FYE 2025 forward. In addition, regarding Dole, managers of the North American packaged foods business were dispatched from ITOCHU, and the head office was moved from Singapore to the Philippines, which is closer to the front lines. In this way, by taking a more hands-on approach to management than before, Dole is entering a recovery trajectory.

A2: There are many strongly performing Group companies in other Division Companies, not just in the Food Company, and many companies achieved record-high profits. Profit for Marubeni-Itochu steel was down because the absence of last fiscal year's outsized performance, but it maintained strong performance in the first half of this year and achieved significant profit growth compared with its competitors. It significantly improved and expanded profit margins by going beyond trade and actively promoting investment, including the North American metal processing business. In addition, the performance of FamilyMart remained very strong. Its performance was led by sales of high profit margin beverages and other products against the backdrop of a warm winter, and we can expect the strong performance to continue into the second half of FYE 2024. The Group has built a value chain, originating from FamilyMart, and FamilyMart's strong results form a structure with a ripple effect on other Group companies along the value chain, including NIPPON ACCESS, INC. and ITOCHU Retail Link Corporation. ITOCHU SHOKUHIN Co., Ltd. achieved record high profit for its first-half results. DESCENTE also achieved strong performance for its domestic businesses, not just its Chinese businesses, and we can expect growth going forward.

Each company's individual initiatives to improve profit margins are a major factor behind the strong performance of Group companies. I will use ROYNE CO., LTD. of the Textile Company to illustrate this. ROYNE was in a precarious position, with Uniqlo gaining a dominant market position and securing around half of the sales for innerwear. To disrupt this situation, they developed high-performance products with a pharmaceutical company using material processed with deodorizing agents in FYE 2019. These were launched for sale as private-label products at major clothing chains and became hit products. As a result, ROYNE significantly expanded profits even in FYE 2021 during the COVID-19 related pandemic. However, these products became unprofitable due to the subsequent emergence of such factors as major yen depreciation and soaring distribution costs, as well as difficulty in reflecting the higher costs to product prices. The new president, who took up the role in FYE 2023, took another look at these products. The existing product names, which were biased toward demand from men, were done away with, and new products were offered under names that men and women would readily buy. Launched at a new price point to reflect higher costs, the products were a success. As a result, they expect to achieve record-high profit in FYE 2024. We have told top management in the Company to strive to conduct business with reference to the case of ROYNE, which took action after wringing out knowledge from everyone. From FYE 2025 onward, by building up this kind of management effort, I think the results of Group companies in the non-resource sector can further expand. On the other hand, the effects of declining product market conditions are thought to be significant. Although we can expect some products, such as pulp, will recover going forward, we think resource prices are currently at high levels and assume prices will fall considerably going forward. The general trading company industry as a whole, especially other general trading companies with a high ratio of resource business, will face relative difficulty in steering business from FYE 2025 and beyond. Even for ITOCHU, which has the lowest ratio of resource business among general trading companies, it will not be easy to compensate for the significant negative impact of a market decline on the resource sector. As can be seen from our past track record, ITOCHU is highly resilient to economic volatility and has achieved steady growth to date. In FYE 2025, we intend to steer business and take measures to ensure profit does not decline.

Q : What is your forecast for the Chinese economy based on information from the operational front lines, as well as your take on the medium- to long-term performance of CITIC, and its effect on the entire Company's performance?

A : On a recent business trip to China, local customers told me of their frontline-level feeling that it would probably take some time for the Chinese economy to recover. The stagnation of the real estate industry, which accounts for around one-fourth China's GDP, is also connected to funds for local governments and regional banks. It seems like some time will be needed for financial systems to recover and solve structural problems. While we think the Chinese government will take various economic measures, such as public investments and reductions in interest rates, we do not foresee huge financial moves similar in scale to existing ones. As exports struggle in line with economic deceleration in Europe and the United States, a rapid recovery in the Chinese economy seems unlikely in the short term, and we anticipate a gradual recovery that takes time. Regarding personal consumption, although it appeared that people were relatively reluctant to spend, personal consumption was firm on China's National Day, so the pattern is a bit spotty. We will continue to keep a close eye on trends in personal consumption, including the use of e-commerce on Singles Day. Banks and securities under CITIC progressed as planned, and no significant concerns emerged. As financial easing continues, we expect CITIC to continue playing an important role as a funding provider of the Chinese government.

3. <u>Other (Including Status of Individual Businesses)</u>

Q : The performance of FamilyMart has remained strong. What do you think are the underlying factors and is there room for profit expansion going forward?

A1: FamilyMart and its peripheral businesses significantly impact Group companies, and further growth going forward will be needed. The convenience store business will have to continue increasing the number of visitors to each store. From that point of view, it will be important to develop attractive products and create attractive store environments. Regarding product development, developing and renewing private-label products and connecting them with marketing measures, such as various sales campaigns, will lead to higher numbers of visitors. Regarding creating attractive store environments, we will more rapidly make stores into media by installing more digital signage, and we plan to expand the number of stores with such signage installed to 10,000 stores within FYE 2024. In addition to already conducting targeted advertising using Japan's largest advertisement ID, we plan to conduct optimal advertisement distribution for customers using digital signage in the near future. Moreover, we are taking new measures in retail media strategy, such as digital marketing measures aligned with different data, namely Nagoya Railroad's traveler data and FamilyMart's purchase data, in addition to advertisement ID alliance with PPIH. Aiming for new convenience stores using digital technologies, we will continue enhancing our ability to attract customers by providing customer experiences distinct from our competitors.

A2: FamilyMart's stand-alone consolidated net profit in the first half of FYE 2024 was ¥33.1 billion, nearly achieving the initial full-year forecast of ¥36.0 billion. We believe the company will be able to achieve strong results for the full year. In retail industry, it is important to not just achieve profit through sales but to also create hot selling private-label products and enhance profit margins. FamilyMart products appear to be improving recently, including such bakery products as the much-talked-about "fresh coupé bread." Although specialty bakeries sell bread for around ¥400 to ¥500, delicious convenience store bread is now sold for ¥100 range and it does not disappoint in comparison with bakery bread. We will continue striving to enhance revenues in this industry by expanding sales through effective marketing of good-quality products. I will not expand on this now, but we have many other projects, not yet publicly announced, with strong potential for new business utilizing the customer contact points of FamilyMart. You can look forward to these new efforts going forward.

Q : What is the current state and future outlook of the North American construction materials-related business, which has declined in profit?

A : Regarding the North American construction materials-related business, profit declined from ¥15.7 billion in the same period of the previous year to ¥12.9 billion in the first half of FYE 2024. The major factors were effects from rising interest rates in North America and falling numbers of housing construction projects as well as the decrease in profit of CIPA Lumber and Pacific Woodtech, which handle residential-use structural materials. On the other hand, the performance of the fence manufacturing and wholesale business, especially MASTER-HALCO, remained firm. As detailed in the Annual Report, this business has achieved growth because of ITOCHU's roll-up strategy on acquisitions, and we will continue to focus on the business going forward. While thoroughly practicing lean management, we are considering action aimed at achieving further growth in the following fiscal year and onward.