FY2018 3Q Online Financial Results Analyst Conference Q&A Summary

Date: February 2, 2018 (Fri.) 16:45 to 17:45

Respondents: Tsuyoshi Hachimura, Chief Financial Officer;
Mamoru Seki, General Manager, General Accounting Control Division

1. Results for the 3rd Quarter of FY2018 and Forecasts for Full-Year Results (P/L related)

Q. Looking at the current full-year forecast for net profit attributable to ITOCHU, we expect the actual result to exceed the forecast by ¥50.0 billion, as the same amount has already been recorded as extraordinary gains during the first nine months of FY2018. This prospect is very likely when we consider the fact that throughout these nine months, ITOCHU has posted net profit attributable to ITOCHU after deducting extraordinary gains and losses of ¥304.0 billion, which attests to ITOCHU's potential to yield base earnings of ¥100 billion each quarter and ¥400 billion in a fiscal year. Do you have any concerns that would undermine ITOCHU's earning power in the fourth quarter?

A. Currently, we don't foresee any such issue. If there were something, it would have been clearly explained in our 3Q financial results announcement.

Q. We think that full-year net profit attributable to ITOCHU may increase, in the best case scenario, by around ¥53.5 billion, based on a ¥20.0 billion risk buffer being set aside under business plans at the beginning of the fiscal year, ¥23.0 billion in adjustments reflecting headquarters assessments on the performance of the Metals & Minerals and Food Companies in line with upward revisions in the profit forecast, and a ¥10.5 billion positive impact due to U.S. tax reforms. Is our projection plausible?

A. At the closing of the third quarter, ITOCHU's performance is quite strong. We haven't spent the buffer and we do recognize possibilities for upward forecast revisions for the performance of those two Companies. Accordingly, we also think that the actual profit result may increase by that amount.

Q. Please tell us about the Textile Company's possibility for achieving its full-year performance forecasts.

A. Because face-to-face marketing industries are confronting extremely harsh conditions, we suspect that the Textile Company may miss its full-year net profit target of ¥32.0 billion. Along with the strong showings of the Converse business, Leilian and Java have enjoyed robust results thanks to the success of cost reduction efforts, but Edwin faces such issues as inventory growth in excess of our projections. We also recognize a need to reconsider our strategies for the Edwin brand, which has been centered on marketing made-in-Japan products.

Q. Please provide us with your latest full-year forecasts for the Machinery and ICT & Financial Business Companies, whose current results fell below 70% of their full year performance targets.

A. Operations of the Machinery Company are in good standing, except that specific allowance recorded in the third quarter for overseas business negatively affected overall nine-month profit results. Moreover, this Company has a tendency to yield a disproportionally large profit in the fourth quarter. We therefore believe that the Machinery Company is likely to achieve its full-year targets. Looking at the ICT & Financial Business Company, the ICT Division has a similar tendency, so we expect it to earn greater profit in the fourth quarter. In addition, the relatively stagnant performance of the Financial & Insurance Business Division served as another negative factor. However, we expect both ICT and Financial & Insurance Business divisions to achieve their full-year net profit targets.

Q. As for the Metals and Minerals Company, full-year forecasts for ITOCHU Minerals & Energy of Australia

(IMEA) include greater year-on-year profit growth compared with estimated profit growth presented in full-year forecasts for the Metals and Minerals Company itself. Do you expect a certain negative factor to emerge in the fourth quarter that undermines the Company's performance?

A. Forecasts for the Metals and Minerals Company's performance in the fourth quarter would have been a bit more robust if the latest resource prices were taken into account. Nevertheless, our current forecast for this Company is based on ¥70.0 billion.

Q. The Food Company recorded a significant quarter-to-quarter increase in gains on equity in earnings of associates and joint ventures. Does this increase include extraordinary gains posted by affiliates?

A. UNY and FamilyMart's contributions to consolidated profit in the third quarter included extraordinary gains resulting from the introduction of consolidated taxation. As announced by UNY and FamilyMart, however, we will spend a commensurate amount on expenses for store restructuring and other measures in the fourth quarter.

Q. METSA FIBRE completed facility expansion based on its plan for increasing production capacity. Please give us your forecasts for pulp production volume.

A. Having upgraded its product structure, METSA FIBRE successfully increased its annual production capacity from 2.3 million tons to 3.1 million tons thanks to the completion of a new plant last August. To meet strong demand, we will increase production volume as planned. Although pulp prices are currently surging, we expect an increase in supply volume in the fourth quarter and beyond. Therefore, we believe that it won't take so long until prices settle down.

Q. Give us more details about the nine-month financial results of the ICT & Financial Business Company. Factors contributing to the company's year-on-year profit growth, except for profit from CTC operations, are not sufficiently presented in the presentation materials. Could you elaborate on the current composition of profit? And what successful initiatives are being undertaken by this company?

A. Profit from the ICT Division's operations consists mainly of consolidating listed companies. In addition to the strong showings of CTC and CONEXIO, ITOCHU's mobile phone-related operations have achieved business growth, stably yielding ever greater profits. BELLSYSTEM24 has also enjoyed quite positive results, securing a number of business opportunities thanks to a capital and business alliance with TOPPAN PRINTING as well as collaboration with ITOCHU's operating companies. Moreover, the ICT & Financial Business Company has steadily promoted forward-looking investments in venture companies. While establishing the Fintech Development Section in 2017 to develop new business models, this company invested in a collaborative P2P business with the Sinar Mas Group in Indonesia. Taking a look at the Financial & Insurance Business Division, such consumer finance businesses as UAF and POCKETCARD, enjoyed solid performance. We also increased our equity in POCKETCARD. Currently, discussions are under way to develop highly value-added services by taking advantage of our financial functions to enhance other existing businesses. To secure future growth opportunities, we have also invested in seven Fintech related ventures and six AI related ventures, among others.

2. Cash Flows, Investments and Shareholder Returns

Q. Currently, ITOCHU's core free cash flows have been strong, amounting to ¥185.0 billion as of December 31, 2017. In the fourth quarter, however, outflows will amount to approximately ¥100.0 billion due to such factors as the acquisition of an equity stake in the Taiwan-based Taipei Financial Center Corporation(TFCC) and investment in a fence business in North America. What is your forecast for core free cash flows for the 12-month period ending March 31, 2018?

A. Although we are planning to acquire an interest in an oil field in Iraq, we are not sure about whether outflows related to this project will actually occur in the fourth quarter. Although our initial forecast for core free cash flows at the beginning of the fiscal year was approximately ¥200.0 billion, we believe that we will have to slightly revise this forecast downward. However, we will remain committed to our policy of striking a balance between investment, shareholder returns and debt repayment. We are thus determined to achieve our target for core free cash flows, namely, “over ¥100.0 billion +α.”

Q. ITOCHU increased its equity stake in some existing companies in the first half of the fiscal year while investing in some new projects in the second half. How much return do you expect from these investments in the upcoming fiscal year and beyond?

A. We refrain from providing details quantifying the contribution of individual projects. However, we have maintained our conventional investment criteria. Although the expected timeframe for profit contribution varies by project, we expect returns from these investment projects to exceed our nearly 40 hurdle rates, set according to the business type, as well as other numerical standards determined based on the size of investment.

Q. I think ITOCHU’s current financial position is strong enough to execute massive investment for future growth, to the extent that such investment leads to negative free cash flows for one fiscal year. What is your strategy for investment?

A. In line with the current medium-term management plan, we have striven to maintain disciplined investment, a sufficient level of shareholders’ equity and a tight grip on borrowings. Following our investment in CITIC, these pursuits were ever more important, and we need to show this policy to the market. Thanks to the success of these efforts, we are able to secure a certain amount of funds for investment in the current fiscal year. As CFO, I believe that the balance between investment, shareholder returns and debt repayment will remain a matter of importance going forward. Although we have been formulating the detail of the upcoming medium-term management plan assuming that operating cash flows will be stronger, we still believe that in order for us to execute massive growth investment to the extent that such investment leads to negative free cash flows for one fiscal year, our shareholders’ equity must be slightly greater than the current level. Accordingly, we will refrain from executing disproportionally massive investment in a specific project. We would rather focus on maintaining a balanced approach. For the fiscal year ending March 2018, we estimate core operating cash flows totaling approximately ¥400.0 billion while expecting further growth in the course of implementing the next medium-term management plan. As these cash flows will be robust enough to execute a massive investment even after setting aside shareholder returns, we rather think that we are able to avoid accepting negative free cash flows to do such investment. That’s why we believe that maintaining disciplined operations while practicing our traditional “*sampo yoshi*” merchant philosophy is the optimal management approach. In the course of dialogue with rating agencies, we have communicated our concepts on financial discipline, making it clear that our current policy of focusing on securing positive free cash flows is not based on short-sighted thinking. As these concepts were highly evaluated by rating agencies, we are confident about the significant importance of maintaining tight discipline.

Q. Please tell us about your future policies on shareholder returns, including share buybacks.

A. Total spending on shareholder returns will not exceed core free cash flows. In December 2017, we announced the increase of cash dividends for this fiscal year. Although we haven’t revised full-year forecasts, it has become more likely that cash surplus for the fiscal year ending March, 2018 will exceed the amount of cash necessary for paying dividends of ¥64 per share, which has been previously announced. With this in mind, we decided to guarantee that we will pay minimum dividend of ¥70 per share. If surplus at the end of the fiscal year turned out to be even greater than our current estimation, we will discuss whether to further increase the amount of cash dividends or execute share buybacks.

3. Outline of the Upcoming Medium-Term Management Plan

Q. Please give us some details on the upcoming medium-term management plan and what ITOCHU's management structure looks like.

A. The top management team is currently deliberating the draft of the upcoming medium-term management plan. The official announcement is scheduled for May 2018. In the course of these discussions, the President has already presented his thoughts on the renewal of the management structure and future strategies for the Company. Specifically, the CEO will be charged with the formulation of management strategies and plans, while the COO will be responsible for overseeing the execution of initiatives under these strategies and plans. Within this structure, the President asked the incoming COO to take the lead in the creation of new business models. Furthermore, the incoming COO and CSO are both well-versed in the promising field of ICT-related industries. Therefore, the new management structure will position ITOCHU to better pursue business expansion in this field while ensuring faster decision making. On the other hand, the CEO will continue to preside over existing businesses, including CITIC. Thanks to the inclusion of a COO position, which is largely dedicated to the creation of new business models, we will be able to explain the strength of ITOCHU's management structure to the market in a more convincing manner. Although some market stakeholders voiced their concerns about inconsistencies between the current and upcoming medium-term management plans, we are now able to rule out any such possibilities arising from changes in management structure. In addition, all management team members are aware that ITOCHU's conventional approach to shareholder returns and its disciplined financial strategies have garnered solid reputation from the market. As CFO, I have been committed to pursuing these policies in the course of implementing the current medium-term management plan. Building on this approach, efforts are now under way to develop more sophisticated growth strategies through discussions at management meetings. Although we were able to establish a profit base of more than ¥400.0 billion over the course of the current medium-term management plan, we are far from running out of potential for future profit growth. We are therefore engaged in detailed discussions about how to better realize such potential under the upcoming medium-term management plan and achieve record high profit. For example, discussions at core operating companies in each Company are centered on how to accumulate profit and achieve business expansion while becoming more resilient against risks from economic fluctuations. On the other hand, group companies that may need to drastically change their business models in the near future are deliberating how to upgrade their business models by, for example, utilizing AI and IoT. We are also discussing how to provide incentives for employees while updating our investment strategies for these businesses to accumulate assets.

Q. We've previously heard about your vision of establishing the third axis of the distribution industry through an alliance with FamilyMart, UNY and Don Quijote and thus securing significant growth opportunities from promising online businesses. Could you tell us about current progress?

A. We have yet to be able to announce many details about this, but a number of initiatives have been steadily under way to develop FamilyMart business networks in China and elsewhere in Asia. We also began deliberating on revising relevant business models with FamilyMart representatives. Mr. Yoshihisa Suzuki, who has been appointed to take the office of COO in the upcoming fiscal year and is currently serving as president of the ICT & Financial Business Company, is taking the lead in these discussions. We will be able to provide detailed updates on this matter in conjunction with the announcement of the upcoming medium-term management plan.