Investor Briefing on FYE 2023 Business Results and FYE 2024 Management Plan: Q&A Summary

Date: May 11, 2023 (Thur.) 13:00 to 14:30
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. P/L Related (Including Economic Environment)

Q: Compared with other general trading companies, I get a more optimistic impression regarding the FYE 2024 plan for core profit. Were there any specific assumptions, including those regarding downside risks, when formulating the FYE 2024 plan?

A1: As for assumptions, because ITOCHU is building a portfolio focused on the non-resource sector, the Company is not as affected by falling resource prices as other general trading companies. The Company's resource exposure is mainly energy, iron ore and coal. Regarding energy, although we expect a decrease in dividends from LNG projects, our Russia-related interests (which do have large exposure) did not contribute to profit during FYE 2023, and the decrease in oil prices only had a limited impact on the FYE 2024 plan. In addition, regarding iron ore and coal, although performance is likely to be somewhat impacted by falling prices, we expect profit contributions from Canadian iron ore projects we invested in, Australian projects that will expand or launch, as well as projects we plan to invest in going forward. As a result, any drop in the resource sector's core profit is expected to be limited. Although we have not disclosed our price assumptions for iron ore and coal, we have set the standard at current prices. Regarding the non-resource sector, although there will be a negative recoil from the robustness of energy trade in FYE 2023, we plan an increase in profit due in part to the recovery of Dole and HYLIFE, which suffered big losses in FYE 2023. As for downside risks, despite expecting a certain level of recovery in Japan's economy due to traffic returning to normal and an increase in inbound demand, uncertainty persists in the global economy due to geopolitical risks, including U.S.-China relations and the Russia-Ukraine situation. We are also warning of the emergence of unforeseeable events that could require a fundamental revision of existing economic structures.

A2: I infer that other general trading companies set very conservative assumptions for resource prices because a large ratio of their business is in resources. Although resource sector profits are significantly affected by resource price volatility, we have set conservative exchange rate assumptions. Because of this, we can sufficiently cover a certain level of decline in resource prices.

A3: Regarding resource price assumptions, in line with current prices and futures indices, we have set somewhat conservative figures overall. The impact of lower resource prices in the FYE 2024 plan was set at around a ¥28.0 billion decrease compared with FYE 2023. The impact from Canadian iron ore projects already invested in and expansion in Australia is set at around a ¥13.0 billion increase compared with FYE 2023. We also expect profit contributions from new investments. As a result, although core profit in the resource sector declined only slightly (down ¥6.5 billion compared with FYE 2023), we created the plan based on appropriate predictions.

Q: Although the increase in profit in the FYE 2024 plan for the 8th Company is small, what is your prediction regarding progress in growth strategies for FamilyMart and its profit contributions going forward?

A1: Generally speaking, in the convenience store business, the scope for growth is limited if solely confined to existing business, so the Company aims to evolve the convenience store business model. We will not stop at enhancing the convenience and efficiency of stores using digital technologies. We are reinforcing mechanisms to attract customers and strengthening their infrastructure function by adding services, namely installing EV chargers, incorporating pharmacies and receiving postal deliveries.

A2: ITOCHU is building a revenue structure that can increase profit not just in the convenience store business run by FamilyMart, but throughout the entire value chain of the convenience store business, which centers on FamilyMart. Accordingly, the profit contribution of FamilyMart to the Group should be assessed by not just looking at FamilyMart in isolation, but rather all of the Group companies operating businesses in peripheral fields. Actually, the business results of NIPPON ACCESS and other companies doing business with FamilyMart have grown very favorably, setting new record highs* in profit. We have dissolved the mutual-shareholdings of the 8th Company from the second half of FYE 2023, established the Group CEO office as a body directly supervised by the Chairman & CEO from April 2023, and positioned the 8th Company under the management of that office. We needed to smoothly adjust for conflicts of interest that arose between FamilyMart and Group companies. Under the original organization, the 8th Company held shares in FamilyMart and relevant Group companies. This had resulted in many cases where conflicts of interest could not be resolved well, so we also wanted to eliminate those issues.
*Excluding FYE 2011 result following capital reorganization

A3: The consolidated net profit of FamilyMart alone was ¥41.0 billion in FYE 2020, but fell to ¥17.0 billion in FYE 2021 due to effects of the COVID-19 pandemic. Still, it has been steadily recovering since then, reaching ¥28.0 billion in FYE 2022, ¥34.4 billion in FYE 2023, and now plans for ¥36.0 billion in FYE 2024. FamilyMart is responsible for 90% of the electric bill for franchisees, and with soaring electric bills in FYE 2023, profit fell significantly. Excluding this effect, profit levels almost returned to pre-pandemic levels in FYE 2023. Going forward, if we can gradually rein in rising costs mainly attributable to soaring electric bills and a depreciating yen, you can expect a further recovery in the profit level. The advertising and media business is also making steady progress due to Data One and Gate One, with a certain level of profit contribution expected in a few years.

Q: ITOCHU aims to achieve record-high core profit in FYE 2024. In this light, could you share your thoughts on the current status of the Food Company, which performed sluggishly in FYE 2023, and specific plans for securing recovery in its operating results?

A1: First of all, in FYE 2023, the Food Company was significantly impacted by deterioration in the external environment reflecting surges in fertilizer and livestock feed prices due to the Russia-Ukraine conflict. Also, its price competitiveness has dropped in the face of the depreciation of the Chinese yuan and the Japanese yen, the currencies for our mainstay market regions. Furthermore, economic recovery from the COVID-19 pandemic led to the disruption of transportation networks and subsequent rises in logistics costs. Presently, however, we have seen the gradual stabilization of fertilizer and livestock feed prices, as well as foreign exchange rates and logistics costs. Accordingly, we can expect substantial improvement in the cost of sales and manufacturing. In addition, although Dole's headquarters functions are based in Singapore, the production of fresh produce takes place in the Philippines, while its packaged foods are sold in the United States. This structure requires remote operational management, making it difficult for us to monitor the status on the frontlines. Furthermore, in the packaged foods business, Dole misjudged the forecasts for sales price trends associated with competitors in the United States. As a result, it executed radical upward price revisions in the high-demand seasons of Thanksgiving and Christmas, which, in turn, resulted in serious sales stagnation. Looking ahead, we will strengthen our determination to thoroughly practice hands-on management based on what is really going on at the frontlines. We have already replaced Dole's management team. To some extent, we are confident about the likelihood of performance recovery in FYE 2024, due in part to the absence of the impairment of goodwill that we recorded in FYE 2023 to resolve future anxieties.

A2: In FYE 2023, Dole recorded an extraordinary loss of ¥22.5 billion due mainly to impairment. At the same time, HYLIFE posted an impairment arising from U.S. operations from which it decided to exit. The absence of these negative factors, including the impairment, in FYE 2024 will result in a recovery of nearly ¥30.0 billion in profit. Moreover, if we consider the elimination of losses of both companies, we expect a total recovery of nearly ¥50.0 billion. We therefore do not consider FYE 2024 profit plans for Dole and HYLIFE to be very hard to achieve.

Q: Please elaborate on your macroeconomic outlook for the U.S. and China, as this provides a basis for ITOCHU's business planning.

A: With regard to the U.S. economy, although inflation is expected to negatively affect consumer activities, personal consumption has thus far remained robust. We also anticipate that although monetary tightening aimed at containing inflation will indeed prevent economic overheating, the magnitude of this policy will not grow excessively given recent bankruptcies of some financial institutions. As the energy-related sectors serve as mainstay industries in the United States, some sectors and regions may benefit from surges in resource prices. Accordingly, we think it is possible that the U.S. economy will once again accelerate. As for the Chinese economy, it will take some time until employment and wages improve as a result of the abrupt lifting of the "zero-COVID" policy since the country itself is extremely large. However, we have seen signs of recovery in such areas as movement associated with the Lunar New Year. As potential demand is strong in the area of personal consumption, we anticipate further recovery in demand from the second half of 2023 onward due to the normalization of consumer activities.

Q: Given the Xi Jinping administration's policy of placing emphasis on state-run corporations and other local factors, what is your outlook for CITIC? Are you still confident that no major risks lie in this market?

A1: As you have mentioned, the policy of Xi Jinping administration's in favor of state-run corporations has not changed, and CITIC remains positioned as a cornerstone of that policy. CITIC has also responded rapidly to China's real estate problems and, following ITOCHU's investment, CITIC hit record-high profit for eight consecutive fiscal years. Recently, its stock price achieved a turnaround from long-depressed levels. Therefore, there is no specific concern regarding CITIC at present.

A2: Compared to its business results, CITIC's share price is much too low, which is problematic. Although CITIC's share price bottomed out and is now making a turnaround, it is still engaged in serious efforts to improve its share price.

A3: In terms of operating results, CITIC achieved an annual average growth rate of 8.8% and has expanded profit for the eighth consecutive fiscal year. In respect to financial soundness, CITIC has received a long-term A3 rating from Moody's. Furthermore, CITIC Bank, a main subsidiary, boasts a lower bad debt ratio than any of the four major banks in China. With regard to initiatives to contribute to the United Nations Sustainable Development Goals (SDGs), the CITIC Group has announced its policy of achieving carbon peak in 2025 and carbon neutrality in 2050. These timeframes are far faster than the Chinese government's target of achieving carbon peak in 2030 and carbon neutrality in 2060. Because CITIC's top management harbors concerns that its solid profit growth, financial soundness and initiatives aimed at achieving qualitative improvement are not being accurately evaluated, CITIC formed a dedicated team tasked with addressing stock price issues while ramping up its IR activities. In 2022, CITIC hosted around 10 roadshows, in addition to holding financial results briefings in which some 1,000 corporations were invited. In sum, CITIC's top management has a strong sense of crisis about their stock price. Accordingly, we feel that it is strongly committed to making improvements. Thanks to these initiatives, CITIC's stock price rose to 10.58 Hong Kong dollars on May 8, 2023. In contrast, as of that same date, Hong Kong's leading index, the Hang Seng, on which CITIC stock is listed, had dropped around 13% since the beginning of 2022 due to U.S.-China trade tension, fallout from China's zero-COVID policy and real estate problems, the Russia-Ukraine crisis, and other factors. Throughout this same period, CITIC's 37.4% increase in stock price dramatically outperformed its peers. Accordingly, we have seen that CITIC's measures to improve stock prices are gradually gaining traction, reflecting its genuine abilities to achieve stable profit growth even amid an environment with profound uncertainty. That being said, the current PBR is about 0.4 times, while the PER is less than 4 times. These indicators suggest that CITIC has yet to fully win a solid reputation in the stock market. Accordingly, there is quite large room for improvement in its stock price.

2. B/S and C/F Related (Including Cash Allocation and ROE Levels)

Q: What is your policy on cash allocation? What is your current policy in light of ROE levels and the total payout ratio in the future?

A: The basic shareholder return policy in the current medium-term management plan Brand-new Deal 2023 is to achieve a dividend payout ratio of 30% by FYE 2024 and to execute share buybacks actively and continuously. For share buybacks, "actively and continuously" means striving to expand shareholder returns by periodically assessing the status of reserves when dividends alone, based on our progressive dividend policy, appear insufficient and then continuously executing share buybacks. We have executed share buybacks for seven consecutive years. In the release entitled "Upward Revision of FYE 2023 Forecasts and Additional Shareholder Returns," which came out in October 2022, we revised the consolidated net profit forecast up to ¥800.0 billion and set dividends at ¥140 per share (up ¥30) and share buybacks at ¥35.0 billion, lifting the dividend payout ratio to 25.6%. In light of our aim for a dividend payout ratio of 30% by FYE 2024, there was a feeling in the market that this was not quite sufficient. Amid this situation, to meet the market's expectations, we announced additional share buybacks of ¥25.0 billion (for a cumulative ¥60.0 billion) in January 2023 to raise the total payout ratio to 33%. In this way, ITOCHU showed the market that it will keep its commitment of 30% dividend payout ratio in FYE 2024, the last year of the medium-term management plan. Under the FYE 2024 plan, we announced a dividend of ¥160 per share (up ¥20), which would mean a dividend payout ratio of 30% for a consolidated net profit of ¥780.0 billion, and we are considering cash allocations to ensure this does not fall below the total payout ratio of 33% in FYE 2023. Ever since 2015 when I became CFO, ITOCHU has released three medium-term management plans and maintained a policy of balancing growth investments, shareholder returns, and control of interest-bearing debt. Moreover, the Company has pursued positive core free cash flows after deducting shareholder returns, a high ROE, and balanced growth in line with a largely unchanged asset portfolio ratio (90% non-resource sector, 10% resource sector). ITOCHU has also maintained hands-on management over each Group company with consolidated net profit under ¥2.0 billion, which comprise more than 2/3 of all Group companies mainly in the non-resource sector. We have continued these pursuits for nine consecutive years.

Reviewing the past medium-term management plans since 2015, Brand-new Deal 2017 (FYE 2016 to 2018) saw core operating cash flows reach ¥1,255.0 billion over three years. However, net investment cash flows came to an outflow of ¥970.0 billion, including the investment in CITIC, while shareholder returns constituted an outflow of ¥318.5 billion. Reflecting these factors, core free cash flows after shareholder returns were basically zero. The distribution between investment and shareholder returns over the three years of the plan was 3:1. Then, with Brand-new Deal 2020 (FYE 2019 to 2020, and 2021), core operating cash flows over the three years amounted to an inflow of ¥1,691.0 billion. However, net investment cash flows were an outflow of ¥1,065.0 billion due in part to making FamilyMart a subsidiary, shareholder returns constituted an outflow of ¥528.9 billion, and core free cash flows after shareholder returns were positive at around ¥100.0 billion. The distribution between investment and shareholder returns over the three years of the plan was roughly 2:1, and the ratio of shareholder returns was higher than in Brand-new Deal 2017. Over the six years of these two plans, we conducted large-scale investments that form the current basis of our growth foundation, including the investment in CITIC and making FamilyMart a subsidiary. Still, we have nevertheless been able to maintain positive core free cash flows after deducting shareholder returns. Over these six years, consolidated net profit grew from ¥400.0 billion to ¥800.0 billion, reaching a profit stage twice as high.

Finally, turning to the business results over the last two years (FYE 2022 to 2023) of the current plan Brand-new Deal 2023 (FYE 2022 to 2024), core operating cash flows came to an inflow of ¥1,661.0 billion due in part to the steady accumulation of operating cash flows. However, net investment cash flows were an outflow of ¥346.0 billion due in part to the replacement of assets and early execution of exit plans, shareholder returns resulted in an outflow of ¥487.5 billion, and core free cash flows after shareholder returns for the last two years were positive at ¥827.0 billion. In FYE 2024, in each sector, we have already built up a pipeline of highly accurate investments, and we assume cash allocations to investment will increase. The forecast for core operating cash flows in FYE 2024 has not been disclosed, but if the level remains the same as the last two years, shareholder returns will be around ¥260.0 billion because we already committed to a dividend payout ratio of 30% and a total payout ratio of 33%. After subtracting this amount earmarked for shareholder returns, around ¥500.0 billion to ¥600.0 billion could be used for additional investments and shareholder returns. Similar to the past two plans, if we were to leave virtually zero core free cash flows after shareholder returns over the three years of the plan, the amount that can be invested in FYE 2024 is the sum of core free cash flow of ¥827.0 billion (after deducting shareholder returns) earned over the course of past two years and core free cash flow of ¥500.0 to ¥600.0 billion (after deducting shareholder returns) to be recorded in FYE 2024, excluding any additional shareholder returns.

We also need to carefully select investments based on maintaining our credit rating and reflecting on past experiences. We do not think we will be able to execute the entire investment pipeline, but we are maximizing investment that will lead to profit for all stakeholders as we aim to achieve a profit stage much higher than ¥800.0 billion. Regarding cash allocation that balances growth investment, shareholder returns, and control of interest-bearing debt, we do not set predetermined amounts. We achieved results by finding optimal "*Sampo-yoshi*" solutions based on the status of management and status of cash flows. Although investment inherently includes uncertainty, the past investments of CITIC and FamilyMart support the Company's current growth, and that shows up in our track record.

Going forward, we will continue holding thorough internal discussions regarding long-term financial and capital policies from FYE 2025 onward. In any case, first and foremost, we are fully committed to achieving consolidated net profit of ¥780.0 billion, ¥160 dividend per share, a total payout ratio of 33% or higher in the FYE 2024 plan, which has entered the final year. We will carefully assess the progress of investment and the business environment in FYE 2024 and continue to consider upward revisions to our targets for consolidated net profit or total returns that are appropriate at the ¥800.0 billion stage. Aiming for a profit stage of ¥1 trillion in the near term, ITOCHU is discussing whether ROE, which is the Company's strength, needs to be at least 15% and not between 13% and 16%. Emphasizing ROE, the Company does not raise ROE by reducing shareholders' equity through share buybacks. Rather, the Company is discussing the policy of realizing high ROE by expanding profit, mainly in investments, and will connect this with financial and capital policies from FYE 2025 onward.

Q: If ROE is set at a minimum of 15%, is there no need to change the current financial and capital policies? For example, based on the upgrades from credit rating agencies, is there a possibility of a policy change to decrease the priority of expanding shareholders' equity or perhaps less commitment to positive core free cash flows after deducting shareholder returns?

A: Since the first half of FYE 2023, we have been continuously discussing how to make changes while retaining the good parts of the current financial and capital strategies as we have achieved higher operating results in quantitative indicators that provide a basis for these strategies. While aiming to achieve consolidated net profit of ¥1 trillion in the future, we make estimations using various assumptions regarding the optimal capital structure and the ideal ROE level. ROE is an important global indicator, enabling comparisons between various companies that anyone can understand. I have personally said for a while that we need a minimum ROE of 15%. The ROE during the period of the current plan is set at between 13% and 16%. This figure was calculated on the assumption that we would aim for consolidated net profit of ¥600.0 billion when the plan was originally created. Now, considering the profit stage of ¥800.0 billion, ROE could be at a level exceeding 13% to 16%. Due to soaring resource prices, the consolidated net profit has grown for general trading companies that have a high percentage of resources. As a result, their ROE is improving, but going forward, as resource prices and exchange rates return to normal, we will see the true value of their consolidated net profit and shareholders' equity, and the ROE level the Company should aim for will reveal itself. When I became CFO, the Company's shareholders' equity was less than ¥3 trillion and the shareholders' equity ratio was less than 30%. I therefore outlined expanding shareholders' equity and improving shareholders' equity ratio as utmost priorities. We have steadily worked to enhance these figures by returning core free cash flows after deducting shareholder returns to be positive. At the same time, because this means we exercise robust control over interest-bearing debt, the strategy was also indispensable for our goal of raising our credit rating. In addition, getting core free cash flows positive after deducting shareholder returns uses single fiscal years basically. By changing to a cumulative base for the period of medium-term management plans as necessary, we were able to execute the large-scale investments in such businesses as CITIC and FamilyMart, which make large contributions to consolidated net profit, and the growth in consolidated net profit enables our current shareholder returns. Some people may consider that the current shareholders' equity level is sufficient, but amid a highly uncertain business environment, we have not made a change to our policy of enhancing shareholders' equity, which remains our last resort. Current shareholders' equity stands at ¥4.8 trillion, much higher than ¥3 trillion, but we are carefully considering the appropriate time to apply leverage.

Q: Having entered a new profit stage, ITOCHU now aims for profit at the ¥800.0 billion level, which is far in excess of the previous ¥500.0 billion level. Factors contributing to growth in consolidated net profit are believed to include the outcome of past investments and the positive impact of higher resource prices. Looking ahead, for ITOCHU to enter an even higher profit stage, the Company will need to undertake a certain scale of growth investment. Please explain your investment policy and the sectors you will focus on. Also, other general trading companies have announced their intention to take a more proactive approach to growth investment. Given this, what circumstances do you consider appropriate to invest under the current operating environment?

A: In FYE 2023, ITOCHU placed the utmost priority on winning a higher rating from Moody's while taking preparatory steps to counter the uncertain business environment. In FYE 2024, we now intend to execute multiple investment projects that have been considered to date. In this way, we will secure profits for FYE 2025 and beyond. Thus far, ITOCHU's investment policy has been to focus on domestic investees. However, other general trading companies began to follow suit and are now shifting their focus from overseas to domestic investees. In fact, risks associated with overseas investment are currently higher than domestic investment due to geopolitical risks, the depreciation of the yen, interest rate hikes and other factors. Risks in Japan are low, but there are still many high-quality investees, as can been seen by Berkshire Hathaway Inc. considering investment in Japan. Each general trading company has its areas of strength and weakness, but general trading companies that have strengths in resources forecast that many resource interests could become stranded assets in the near term. Thus, they are now conducting proactive large-scale investments in renewable energy, hydrogen, ammonia, etc. I doubt that these businesses achieve profitability on par with current resource businesses, but they are important as social infrastructure, and should be sectors that general trading companies are engaged in. Traditionally, ITOCHU has carefully selected and diligently undertaken investments in high-quality investees, including small investments, mainly in the non-resource sector. This is how we have steadily accumulated profit. Going forward, there is no change in this policy. We have already identified several high-quality investees for FYE 2024 based on the expertise we have cultivated to date. As high interest rates persist, we are beginning to see cases of investments owned by funds being sold in a discounted manner. Currently, although the economy is slightly overheating, it is expected to begin cooling down in the second half of FYE 2024. As we have been executing investment, we will carefully assess inexpensive and high-quality investments while continuing to consider and implement increasing stakes in existing investments with a robust possibility of success. When the ratio of resource businesses is high, performance is easily swayed by resource prices, and business results become highly volatile. As demonstrated by ITOCHU's track record of stable profit growth, if we conduct steady hands-on management centered on the non-resource sector going forward, we can continue to aim for consolidated net profit of ¥1 trillion in the future.

3. Other (Including SDGs-Related Businesses)
Q: Regarding new investments, are you expecting to invest in SDGs-related businesses that will lead to carbon neutrality? Also, projects announced thus far include the initiatives of ferrous raw material initiatives in the UAE and the acquisition of Canadian iron ore interests, so could you explain the situation of SDGs-related businesses that contribute to decarbonization?

A: Upstream projects in hydrogen, ammonia and offshore wind power generation will reach a commercial and profitable track around 2030, so we still need some time. Because it is too late to newly enter these markets after they have become practical, we have already taken up various investments from a medium- to long-term perspective and continue to promote the initiatives related to ferrous raw materials, hydrogen and ammonia. However, regarding hydrogen and ammonia projects, it is not only manufacturing but also developing demand that is important. The need to engage in joint pilot tests with users requires more time, which means we need to confirm economic viability. Therefore, we have not conducted bold large-scale investments and are proceeding cautiously. On the other hand, there are some other projects that are expected to become profitable over a relatively short term. These medium-scale initiatives that can be launched immediately include storage-battery-related businesses, CO_2 reduction through recycling, sustainable aviation fuel (SAF) derived from waste, and waste treatment power generation. We are also steadily working on recycled polyester (RENU) and onsite/offsite solar power business with prominent partners. Through these endeavors, we will first build networks in downstream sectors before achieving substantial results in upstream sectors that need time. Over the near term, we will strive to connect these networks with upstream projects and lead to profitability.

Q: I would like to hear about the conversation with Mr. Buffett.

A: Mr. Buffett's trip to Japan seemed to be mainly for general observation purposes, rather than focused on serious negotiations, in light of the gradual containment of the COVID-19 outbreak. In addition, we received wonderful gifts during our meeting. These were thoughtfully selected. We are impressed and will try to learn his kind approach. I was impressed by the instant change in his facial expression and posture when the discussion touched on business. I could really feel his strong passion for business.