FY2019 1Q Online Financial Results Analyst Conference Q&A Summary

This document is an English translation of a statement written originally in Japanese. The Japanese original should be considered as the primary version.

Date and Time: August 3, 2018 (Fri.) 16:00 to 17:00
Respondents: Tsuyoshi Hachimura, Chief Financial Officer;
Mamoru Seki, General Manager, General Accounting Control Division

1. Results for the 1st Quarter of FY2019 and Forecasts for Full-Year Results (P/L related)

Q: Could you elaborate on the comment about the temporary decrease in net profit of the Metal & Minerals Company following a change in the investment structure of some iron ore mining stakes? In addition, despite this being an issue for the quarterly recognition of profit, does that mean there is no effect on the full-year results?

A: I cannot comment on the projects of ITOCHU Minerals & Energy of Australia (IMEA) because we are bound by nondisclosure agreements. However, regarding the change of the structure for investment, this was a result of the expiration of third-party mine leases. Profit from those mining stakes will contribute in the form of annual dividends, instead of being consolidated quarterly, as before. There is no negative impact from this change. Also, IMEA set conservative price assumptions in their fiscal year plan (¥42.7 billion). Actual results are likely to rise a little.

Q: I assume some of the iron ore and coal mines in which ITOCHU has stakes are probably seeing somewhat low production levels. What is the current status of these mines and what is the outlook for them? In addition, can you confirm the impact on production levels of the investment structure change in IMEA's mining stakes?

A: There is currently no big change from the initial production forecast. Production levels at the joint venture that changed its investment structure are not that big. Although it might look like the production volume of the Drummond mine has decreased slightly, production itself is steady and we do not see a slowdown. My understanding is that the background to this question is that as trade friction continues there might be a need to adjust production levels going forward. However, IMEA's exports to China account for only about 60% of its iron ore and 30% of its coal production. At this time, we have not determined that there will be a large impact, but we will keep an eye on the situation going forward.

Q: While the Food Company made steady progress in their first quarter results, the segment recorded a year-on-year decrease in gross trading profit as did some operating companies. The fiscal year plan for the Food Company (¥80.0 billion) seems to have some hurdles. What is the current state of affairs?

A: Although NIPPON ACCESS had a slow start due to such extraordinary expenses as the cost of moving headquarters and introducing new systems, things are not currently at the point where we would change the full-year forecast. Listed companies are also contributing. In addition, the income of ITOCHU FEED MILLS increased year on year due in part to a gain on sale of affiliated company shares. The income of ITOCHU Sugar also rose year on year. Besides these, there were other positive factors from operating companies not listed in the disclosure materials. On the other hand, the income of Canada-based pork producer HyLife decreased due to a temporary drop in production volume following the construction of a new plant. As for Dole, although profit declined in the packaged food business due to lower sales prices for canned pineapple, profit increased from the fresh produce business due to recent gains in efficiency at farms in the Philippines. We therefore decided not to change our outlook for Dole from the fiscal plan (¥10.5 billion). Making FamilyMart UNY Holdings a subsidiary is a priority for the Food Company. We'd like to think about any next steps after considering the progress of making the company a subsidiary.

Q: The Dole packaged food business recorded an impairment loss at the end of the previous fiscal year. In comparison, what is the current situation like?

A: The only major negative impact on profit in the first quarter was the contraction of the profit margin following a drop in prices for canned pineapple. This is within the realm of normal business, and we do not assume additional impairment losses at all. This does not, however, mean we are complacent. The packaged food business has already done what it needs to, such as implementing upgrades through capital investment in the first fiscal year since it was acquired and taking swift action by recognizing the impairment loss at the end of the previous fiscal year. The loss in the first quarter of the current fiscal year was within the scope of normal operations, and we do not perceive it as a serious situation. In the fresh foods business, which is the other pillar, while banana prices sank rapidly, we are improving efficiency in the Philippines to the point of offsetting the impact.

Q: I realize that there is a high probability that a gain on revaluation will be recorded due to making FamilyMart UNY Holdings a subsidiary, but it is difficult to understand the fair value used in the calculations. Can you explain the accounting procedures?

A: All of this talk is for after the takeover bid (TOB) is completed when FamilyMart UNY Holdings becomes a subsidiary, but the theory is that a gain on revaluation will be recorded as you pointed out. However, it is too early to discuss the procedures and the amounts. Our policy is to take the necessary time with an auditing firm to conduct an appropriate valuation of the book value (revaluation) while acquiring a third-party valuation.

Q: Do you think current conditions will persist in the pulp market?

A: Compared to the plan's original assumptions, the strength of the pulp market is expected to continue through the end of the current fiscal year. Although softwood pulp and hardwood pulp have different applications, demand for both is strong. We do not foresee any new operations that would lead to an oversupply, and we think that prices will likely remain high the entire fiscal year.

Q: While the fundamental indicators of CITIC appear solid, I'm worried about recent stock price stagnation and monetary tightening in China. Although I know that stock price alone will not cause an impairment loss, I am still worried about the recent buildup in investment book value and fundamental indicators. What is your take on these risks?

A: After checking whether there were any signs that we should execute an impairment test at the end of the previous fiscal year and at the end of the first quarter of fiscal 2019 and after getting an appropriate opinion from an auditing firm, we have determined that there is no indication of such a need. Although the performance of CITIC has been stable, ITOCHU has not been satisfied with its share price, which fell below 11 Hong Kong dollars. In addition, although the dividend payout ratio is gradually rising, it is still around 24%, and we realize that the company is slow to promote non-financial businesses, which was its target. We will continue to carefully monitor the situation. As you understand, recognition of an impairment loss is based on a comprehensive determination in light of all factors, including the share price and future cash flow recoverability.

2. Cash Flows, Investments and Shareholder Returns

Q: Given ITOCHU's cash flows in the first quarter, could you tell us about shareholder returns and other uses for cash going forward?

A: I take it that you're asking about dividends for the fiscal year. Our policy for the fiscal year is to pay performance-linked dividends, with a minimum guarantee of ¥74 per share, and we are currently reviewing the policy. We are on track toward our fiscal year target of ¥450 billion in net profit, which would be a record high. So, given our performance-linked dividend scheme, an increase in dividends is possible. We are discussing the matter based on the first quarter results.

Q: Please tell us about your forecast for the fiscal year in light of ITOCHU's first quarter investments and plan for the fiscal year. Are there any investments or exits you see coming up in the second quarter or later?

A: There are multiple investments we expect to make in the second quarter and beyond, including continuing existing capital expenditure and cash outflows for certain items that have already been approved internally. However, the annual total is not our foremost concern in managing investment; we carefully select investments based on their ability to generate core operating cash flows to determine how much core free cash flows will increase. At present, we are controlling investments and making progress as planned. While the timing of investments and exits may be somewhat uneven across individual quarters, on an annual basis, our policy of maintaining positive core free cash flows after shareholder returns is unchanged.

Q: The share of Group companies reporting profits is already high. Might raising it further have negative effects? Is there still room for improvement?

A: Yes, there is still room for improvement. We periodically review our operating companies as well as set and rigorously enforce exit criteria for operating companies. Companies that do not meet our management efficiency standards are subject to exit, and we are strictly managing them at the subsidiary level. The subsidiaries of subsidiaries are also subject to such management. We have some companies where the timing of our exit has not gone as planned or where exit procedures are taking longer than expected, so there is still room for improvement. We believe that building solid, profitable companies will help to support ITOCHU's performance, creating downside protection, so we will continue working to raise the share of Group companies reporting profits. In this way, the efficacy of our management policy of carefully monitoring operating companies is felt most when the economy takes a negative turn. We have also built in considerations to prevent negative effects from raising the share of profitable Group companies. We understand that newly established businesses require lead time, and some businesses will only become profitable in the medium to long term. In such cases, we accept the new company's losses as long as the expected scale and duration of losses are considered in their plans from the start, when they apply for investment, and are approved after strict reviews. All of this is factored into our efforts to control the share of Group companies that are profitable. As such, I think that there is no need for concern about raising the share of Group companies reporting profits.

3. Other Topics, Including Future Risks

Q: The first quarter went well, but what risks do you see in the second quarter and onward?

A: Across our segments, there are not really any major risks unique to ITOCHU that we are worried about from the second quarter. However, we are concerned about geopolitical risk and the external environment, including the possibility that growing trade friction could negatively impact the global economy. The direct effects of trade friction would not prevent us from achieving our targets for the fiscal year, but if the tit-for-tat volleys in the trade war between the world's number one and number two economies (in terms of GDP) continue, there could be secondary effects on the macro economy and corporate activity. In particular, how the United States addresses issues related to cutting-edge technologies and intellectual property rights and what happens following the country's mid-term elections will require careful attention. ITOCHU's businesses related to China are independent and locally operated, so I don't think they will be heavily affected. However, looking at the Chinese economy, financial deleveraging in China would normally tighten up capital, but there is simultaneously trade friction. In light of this, monetary easing could result in looser capital and infrastructure investment, though it would take time, and a cheaper yuan could push up exports. Given these and other factors, it will be important to watch how things change in the second quarter and beyond.

Q: Please tell us how the trade friction between the United States and China will impact ITOCHU's businesses in China.

A: China's government has been pushing for financial deleveraging, and we are now starting to see its effects. Currently, a few of the companies we sell to in our trading businesses have asked for extensions on making payments, which is cause for concern. We will need to maintain more rigorous capital management. That said, actual first-quarter performance in China-related businesses, particularly consumer-related trading, was firm. The United States' restrictions on China have affected certain businesses, such as those related to soy (namely, animal feed) a little, but the impact has been extremely minor. We will need to allow for the possibility that the U.S.-China trade frictions will continue over the long term as we consider our businesses.

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