Investor Briefing on FYE 2022 Q2 Financial Results: 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: November 9, 2021 (Tues.) 13:00 to 14:30

Respondents: Keita Ishii, President & Chief Operating Officer
Tsuyoshi Hachimura, Chief Financial Officer
Hiroyuki Naka, Chief Digital & Information Officer, General Manager of the Corporate Planning & Administration Division
Kazuaki Yamaguchi, Deputy CFO, General Manager of the General Accounting Control Division

1. Shareholder Returns and Growth Strategy Related

Q: When deciding on the new dividend policy, what kind of discussions were held regarding share buybacks? The ¥130-per-share dividend in FYE 2024 is based on a projection of ¥650.0 billion in consolidated net profit, which is ¥50.0 billion higher than the earnings base of ¥600.0 billion outlined in the medium-term plan, so what kind of growth is anticipated?

A: After announcing the medium-term management plan in May 2021, in June, we reset the unexecuted share buybacks of nearly ¥57.0 billion which were based on the medium- to long-term shareholder returns policy (announced in October 2018). However, we have not changed the policy of actively and continuously executing share buybacks. Currently, regarding the dividend payout ratio that is inferior to that of other general trading companies, we prioritize dividends (not share buybacks) while being aware that the average dividend payout ratio of the 1st Section of the Tokyo Stock Exchange is 30%. Furthermore, over the three years of the medium-term management plan, the total annual dividends of ¥110, ¥120, and ¥130 per share are roughly the same as a dividend payout ratio of 30% if we were to achieve three consecutive years of ¥600.0 billion in consolidated net profit. Based on the cash status at the end of the fiscal year, we will consider whether to further increase dividends or execute share buybacks.

The ¥650.0 billion, which is inferred from the ¥130-per-share dividends in FYE 2024, also means that we set our own goal by committing to dividends of ¥130. In order to achieve consolidated net profit of ¥650.0 billion, we need an increase of ¥50.0 billion in addition to fixing our foothold of ¥600.0 billion during the medium-term management plan, which some people may take as a significant jump. However, achieving our established targets has been our track record so far and is the Company's mission. We will achieve a dividend payout ratio of 30% with a minimum of ¥130 per share. Although the business environment going forward remains uncertain, we are strengthening our earnings base centered on the stable non-resource sector. We are thus quite confident about accomplishing ¥650.0 billion.

COVID-19 has raised various problems around the world, and ITOCHU has learned many things in the retail sector, the most impacted sector. This phenomenon was the impetus for us to thoroughly implement our "earn, cut, prevent" principles and lean management structure. Being unable to visit customers, we had to think about how we would continue selling products and continue working to reduce costs, such as changing our sales methods and distribution models using e-commerce and other digital technologies. As a result, the resilience of our retail-related business grew stronger and we expect it to further contribute to profit if consumer activities recover towards the second half of the year.

Under the medium-term management plan, we outlined a "market-oriented" perspective as a basic policy with two business sectors as our pillars. The first is FamilyMart. To increase daily sales, we are working to make stores more welcoming by developing attractive products, bringing in people, and offering useful functions. We welcomed Mr. Adachi as Chief Marketing Officer (CMO), revised our marketing, introduced the new private brand "Famimaru," and conducted a 40th anniversary campaign. In addition, FamilyMart is working with the Textile Company focusing on "Convenience wear," and with The 8th Company to make stores as media platforms with digital signage. Also, we have already begun deferred payment services for FamiPay in collaboration with the Shinsei Bank Group and will continue striving to further expand the media and financial businesses going forward. Moreover, we are promoting store manager support with AI; developing automated, unmanned stores and expanding them in collaboration with post offices; and upgrading store networks in a proactive manner. Regarding environmental friendliness, we are taking various measures, such as recycling, green energy, and food loss prevention. To realize attractive and new convenience stores where customers think that if they go to FamilyMart there will be something new, we will further promote collaboration with peripheral businesses centered on The 8th Company.

The other pillar is the ICT & Financial Business Company. The four central fields are the BPO field with BELLSYSTEM24 Holdings (call center), the communications and mobile field with sales agents for mobile phones and maintenance, the financial and insurance field with fintech using experience in the overseas retail finance business, and the digital transformation (DX) and system integration (SI) field focusing on CTC.

In the communications and mobile field, we have operated businesses working with major carriers on the sales, maintenance, and insurance of mobile phones and smartphones. In addition, we aim to diversify and enhance our after-sales services, such as overseas expansion of used mobile phones, cleaning used mobile phone with Belong, and adapting to 5G.

In the finance and insurance field, the HOKEN NO MADOGUCHI GROUP could not make in-person sales due to COVID-19 but offered market-oriented insurance that is customized for each individual.

CTC is a prominent system integrator but we are forming capital alliances with multiple function supplement companies in areas where CTC is unable to offer services on its own. We are strengthening alliances with various peripheral companies, such as the data analysis visualization provider BrainPad, WingArc1st, DX consultant SIGMAXYZ, digital design consulting firm AKQA, and security provider SilverSky. When offering SI services, CTC adds in the knowhow from partner companies to be able to provide better offers. In addition, CTC has a lot of experience related to managing renewable energy and is conducting pilot tests with the Energy & Chemicals Company on energy management systems, including for wind, geothermal, and solar power. As mentioned above, the ICT & Financial Business Company has many tools and can provide a wide range of knowhow amid the ongoing digitalization trend among customers. In addition, this Division Company is undertaking a digital transformation to break the walls of ITOCHU's vertical product silo organization and is playing a very important role.

As for decarbonization-related initiatives, we plan for monetization of the use of new types of batteries and recycled batteries as well as VPPs from the next fiscal year forward. In the non-resource sector, there are many businesses where stable revenues are expected, and as long as there are no major economic downturns, we think we will be able to achieve consolidated net profit of ¥650.0 billion.

Q: The forecast for core profit in FYE 2022 was revised upward from the initial plan of ¥530.0 billion to around ¥630.0 billion. Could you tell me about the sustainability of profitability and the details of the upward revisions for the Energy & Chemicals Company, ICT & Financial Business Company, and General Products & Realty Company?

A: In FYE 2022, demand has quickly recovered from the sweeping decline caused by COVID-19, which struck most major countries except China, but production has not caught up yet. The supply and demand balance has been upset, and product prices have risen from their normal levels due to supply shortages and demand surges. In the Energy & Chemicals Company, profit from energy trading and LNG will be concentrated in the second half of the year. In addition, because gasoline and kerosene prices generally increase in winter, this is expected to contribute to the earnings of ITOCHU ENEX. We also expect an increase in the electric market price in winter to support the Power & Environmental Solution Division. Furthermore, we also expect revenue contributions from a recovery in sales of energy storage systems (ESSs) for individuals and companies that could not be sold during the COVID-19 pandemic as well as from the commercialization of SemiSolid batteries. In the ICT & Financial Business Company, we expect a recovery in mobile phone-related business and the HOKEN NO MADOGUCHI Group due to a restart of in-person sales while anticipating CTC's backlog to account for profit.

In the General Products & Realty Company, besides the sale of Japan Brazil Paper & Pulp Resources Development in Q1, there are three large pillars. The first is North American construction materials-related businesses, such as Master Halco and Alta Forest Products. These operations showed strengths as they seized opportunities springing from a rising market and carried out well-timed purchases amid the surging wood prices and COVID-19-induced home shopping demand. The number of housing starts is also steady and we expect this to continue going forward despite a slight dip in the second half. The second is ETEL. It was significantly affected by COVID-19 lockdowns, but those effects have been gradually receding. Both wholesale and retail sales volumes have recovered, and we expect ETEL to continue to contribute to profit for the next fiscal year onward. The third is IFL, where pulp prices remain high. Although pulp prices in the second half of the year will decline in China, they will remain high in Europe, and we expect revenue contributions. The most important point is that the General Products & Realty Company has significantly transformed its own business format. Originally, the Division Company conducted trade of pulp and natural rubber, but it has changed the products it handles, rolled up and refined related businesses, and built a business model that brings in cash by selling some of those businesses. In the residential-related field and real estate field, we expect many business opportunities going forward, including in Japan, and further growth. Looking ahead in fields closely related to the consumer sector, we will promote acquisition and other initiatives.

Q: Regarding the aim of achieving consolidated net profit of ¥650.0 billion counted backward from dividends of ¥130 per share in FYE 2024, what kind of growth investments will ITOCHU implement?

A: As for growth investments, we are largely thinking of three. The first is growth investments that add value to existing businesses and augment missing functions. For example, in the ICT & Financial Business Company, we have promoted investments that supplement new functions missing from existing businesses and enhancing corporate value by integrating them. The second one is to buy up businesses we have already been investing in, the policy we have implemented for the last three to four years. Because we have a hands-on management style for businesses we already invest, we have a detailed grasp on the content of their businesses and can easily envision growth strategies going forward. The third one is investments in new fields, such as the decarbonization field. Investments in new fields are forward-looking investments that need time to recover their investment, and we need to implement these for the future. As there are multiple investment pipelines, we will implement investments going forward and strive to achieve profitability, with an eye to realizing consolidated net profit of ¥650.0 billion in FYE 2024.

Q: The dividend payout ratio in FYE 2022 based on the new dividend policy is below the payout ratio when the medium-term management plan was announced. If the high profit level continue in FYE 2023 and the level of consolidated net profit does not decline, will it be possible to further increase dividends from ¥120 per share?

A: ITOCHU's policy is to stably and steadily increase single fiscal year consolidated net profit and shareholder returns without major deviations. We have held multiple discussions internally on the point that the current payout ratio in FYE 2022 is below the initial plan. We would like you to view shareholder returns as not applying just to a single-year period, FYE 2022, but as the medium- to long-term returns for the three-year period of the medium-term management plan. While it is difficult to accurately forecast earnings for FYE 2023 and beyond, we will steadily carry out our progressive dividend policy and not focus solely on the dividend payout ratio. In other words, we think we should signal that we will make a robust ¥22 increase in dividends from ¥88 per share in FYE 2021. In addition, regarding the possibility of further increasing dividends, there was a case in the past that we did not achieve an increase in dividends as a result of implementing a large-scale investment. With the unclear business environment for the next fiscal year onward, we commit to the dividends of each fiscal year being a minimum. Regarding shareholder returns, we will flexibly consider returns while carefully examining cash allocation at the end of each fiscal year, including FYE 2022.

Q: NET DER fell to its lowest level of 0.61 times, and free cash flows were high at nearly ¥500.0 billion. What do you think would be appropriate leverage? And do you plan on large-scale investments?

A: We are thinking that cash allocation must be planned for the whole three years of the medium-term management plan. As for maintaining our current businesses, we expect CAPEX to be around ¥200.0 billion per year, and if the dividend payout ratio is 30% with consolidated net profit of ¥600.0 billion, we expect shareholder returns of around ¥200.0 billion per year. With the remaining cash, we will conduct growth investments but also carefully analyze and consider the content of the investment pipeline, including large-scale investments. The current NET DER of 0.61 times is the lowest among general trading companies, so it would be good if we use a little more leverage. However, ITOCHU will avoid reducing shareholders' equity to increase its leverage. The Company has a financial and capital policy that is conscious of credit ratings, and its appropriate NET DER is around 0.7 to 0.8 times. We need to enhance shareholders' equity in case of unpredictable situations and will aim for shareholders' equity level of ¥4 trillion. From FYE 2022 to the first half of FYE 2023, we are working to expand shareholders' equity and focus on growth investments from FYE 2023 forward.

Q: Regarding the corporate value calculation formula used in the annual report, the numerator of “created value” is specifically shown in, for example, shareholder return measures, but how do you think about action plans that contribute to the denominators of “cost of capital” and “growth rate”?

A: As for ITOCHU’s cost of capital, if we calculate by CAPM amid this low interest rate environment, it will be around 5%, but we set it at 8% aware of expected returns from shareholders. For ITOCHU to be an attractive company with an ROE exceeding 13% over the medium to long term, we think it would not be good to set a low level of cost of capital for investments. On the other hand, we need to control volatility and reduce cost of capital. ITOCHU is aware of rising demand for environmental friendliness and is enhancing initiatives for the SDGs ahead of other general trading companies, but as we promote environmentally friendly investments, there are issues of the difficulty of acquiring returns on par with existing businesses and the relatively high risks. Overall, we think we need time to continue reducing cost of capital. With a keen awareness of these issues, we are working on further refining existing businesses and increasing core profit, absorbing initial costs of new businesses, and considering replacing investments that were conducted with a low cost of capital.

Q: Environmental businesses often take time to achieve profitability. Accordingly, it seems likely to take a while until these operations begin to contribute to ITOCHU’s growth. Could you describe your action plans for multifaceted expansion?

A: Previously, we had undertaken major investments in untapped fields on several occasions. Most of these investments ended up in failure which, in turn, forced us to withdraw. Drawing on lessons learned from this experience, we are taking a prudent approach to investment in new fields, always assuming that a worst-case scenario could come into play. Accordingly, we will in no way carry out a massive investment in a product-oriented business only to inflate our consolidated net profit. Rather, we aim to enhance the added value of existing businesses through investment even when financial gains from each project are small. We also strive to use our market-oriented perspective in investment so we can secure a foothold to support our future endeavors even if, in the short term, we fail to achieve profitability. We will thus target the types of investees that enable us to flexibly implement measures aimed at creating added value through collaboration with partners. When it comes to decarbonization, what must be done is twofold. We need to decarbonize energy sources upstream while adjusting energy supply and consumer demand downstream. However, corporations are inclined to pay the upstream more attention due to the larger monetary amounts associated with these operations. However, the decarbonization of upstream operations often involves issues requiring national-level coordination and takes a long period of time to achieve profitability. We will of course be involved in upstream decarbonization, but we are also horizontally developing downstream businesses that could be profitable earlier. Starting with marketing ESSs, we are striving to launch relevant businesses, such as the third-party ownership (TPO) model for solar panel installation, the provision of subscription services via collaboration with finance companies, and the development and licensing of SemiSolid batteries. Looking ahead, within one year, we aim to complete a pilot project involving the verification of a micro grid that connects FamilyMart stores, supermarkets, warehouses, gasoline service stations and other facilities. We will then move forward to develop a small grid by connecting micro grids.

Q: As part of your forecasts for FYE 2022, extraordinary gains are estimated at ¥124.0 billion. What is your projection for FYE 2023 and beyond regarding the level of extraordinary gains?

A: In past years, we have sometimes recorded more than ¥100.0 billion in extraordinary gains on a gross basis. For example, in FYE 2019 we posted over ¥200.0 billion due to such factors as gains on revaluation in connection with FamilyMart, which then became our subsidiary. However, we have never recorded more than ¥100.0 billion profit on a net basis. In this light, net profit for the first half of FYE 2022 represents our record high. Although we are currently not positioned to discuss extraordinary gains and losses for FYE 2023 and beyond, ITOCHU’s policy is to achieve growth driven by an increase in core profit, rather than counting on extraordinary gains.

2. China and CITIC Related

Q: With regard to CITIC, could you explain what real estate risk exposure it potentially faces in connection with businesses like the Evergrande Group? Moreover, please tell us your thoughts on their possible impact on ITOCHU's financial results.

A: Currently, the Chinese government is handling relevant issues in a way that carefully calculates possible repercussions. However, the impact of turmoil involving the Evergrande Group on our operations is limited. China's real estate market accounts for 25% of its GDP. Accordingly, there are a number of industries supporting this market, and they have served as a driving force behind China's economic growth. The Chinese government has implemented a variety of measures aimed at controlling excessive corporate growth, with some IT firms recently subjected to government-led clampdown. Real estate firms, too, have historically been subject to similar government measures. In August 2020, the Chinese government issued guidelines on real estate financing, suggesting that the Evergrande Group has been considered problematic. Although ITOCHU has no direct transactional relationships, CITIC Bank, a subsidiary of CITIC Limited, in which we invest, has engaged in transactions with this firm along with other CITIC group companies. With this in mind, we are regularly sharing information with CITIC's senior managers and exchanging opinions with them about the Evergrande Group. In September 2021, the president of CITIC Bank announced that the balance of its lending to the Evergrande Group has been reduced from 2018 onward, with a sufficient value of collateral being secured. Moreover, CITIC Bank's operating results, announced for the first nine months of FYE 2022, indicate steady performance. Also, we are carefully verifying the ratio and balance of non-performing loans. As a matter of fact, at quite an earlier time, CITIC Bank launched enhanced risk management and potential countermeasures to defend against issues arising from the Evergrande Group. This is why we have concluded that these issues will have only limited impact on ITOCHU's operations.

Q. Please share your views on the level of CITIC Limited's stock price, its future growth potential and the deceleration of China's economic growth. Also, please explain your thoughts on the impact of U.S.-China confrontation on its operations.

A: In line with its five-year plan, CITIC Limited is striving to double its consolidated net profit from the current level, even after having accomplished six consecutive years of growth in both profit and dividends. It is no doubt that CITIC Limited is well-positioned to achieve future growth. With its dividend payout ratio steadily growing, CITIC Limited is also engaged in proactive IR activities. Considering these factors, we are wondering why its stock price has not risen as robustly as it should. We, of course, note that if the scale of Evergrande Group-related issues grows into a major phenomenon affecting the entire real estate market, the spillover may not be confined to China. However, it has been able to manage risks arising from the Evergrande Group as discussed above. There is a sense of anxiety in China regarding such factors as resurgences of COVID-19 along with power shortages and the resulting suspension of production activities, a major issue expected to worsen in winter and affect local supply chains. We believe, however, that the government will tolerate a certain degree of deceleration of economic growth under the banner of "common prosperity" as advocated by Xi Jinping. That being said, with the upcoming Beijing Olympic games expected to stimulate solid consumer activities, we hardly anticipate that China's growth rate, which is currently at around 5%, can decline to a level as stagnant as 2%. If China's economic growth were to decelerate, it is likely to decelerate in a well-controlled manner. We will continue to pay close attention to the impact of this trend. As for U.S.-China relations, we believe that it is possible to avoid unnecessary confrontation between the two economic superpowers, but we also recognize that this problem is not easy to resolve. We are anticipating that the two nations will continue to explore amicable solutions even as they push against each other.