Investor Briefing on FYE 2023 Q2 Financial Results: Q&A Summary

Date: November 8, 2022 (Tue.) 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, Chief Digital & Information Officer
Kazuaki Yamaguchi, General Manager, General Accounting Control Division

1. P/L Related (Including the Probability of FYE 2024 Forecasts)

Q: At the October 4, 2022 announcement of upwardly revised forecasts for FYE 2023 and additional shareholder return measures, ITOCHU announced a consolidated net profit target of ¥800.0 billion for FYE 2024. The stock market, however, seems not to be fully convinced by this target, given the extremely uncertain external environment. We actually find it hard to clearly discern the numerical breakdown of this forecast. Could you please once again explain the strategies ITOCHU is currently envisioning and how they underpin its confidence in achieving that target?

A: As announced on October 4, 2022, our consolidated net profit target was upwardly revised from ¥700.0 billion to ¥800.0 billion. That said, we have yet to draw up a fully detailed breakdown of our profit target for FYE 2024. However, we have seen stable growth in our core profit generation capabilities despite the currently uncertain external environment. Given this, we think that further enhancing these capabilities will be possible. Moreover, we expect to record revenues from our recent investment in Hitachi Construction Machinery, Nishimatsu Construction, Gaitame.Com, and other investees and are taking into account the effect of our future business development measures. Accordingly, we consider ¥800.0 billion to be fully achievable. Also, we will begin formulating a FYE 2024 business plan before long. As part of that process, we intend to determine detailed assumptions, such as those for resource prices and foreign exchange rates, which will considerably affect our operating results, to more clearly establish our roadmap to ¥800.0 billion.

A: In addition, I would like to tell you a story about Mr. Kazuo Inamori, the late founder of KYOCERA Corporation. A certain corporate manager, who had assumed that KYOCERA's strength lies in special technologies, met Inamori and asked him about the technologies his company was employing. Inamori answered that KYOCERA employs no special technologies. The corporate manager then visit KYOCERA's main factories, only to find himself surrounded by quite ordinary technologies similar to those that other manufacturers use. When he asked Inamori why they used such ordinary technologies, the legendary business leader told him, "When better technologies emerge, our dependence on special technologies will put us in a losing position." Inamori continued, saying "Ordinariness is a reason why we are strong. Our strength lies in our capabilities on the frontlines, where we achieve extraordinary results using ordinary technologies."

I heard that story from one of my peers in the business community, who had heard it from a certain professor emeritus. The person who told it to me said that he considered Inamori's ways of thinking to be somewhat akin to ITOCHU's approach. ITOCHU's strength lies in its frontline capabilities developed through the practice of the "Earn, Cut, Prevent" principles as well as the use of a market-oriented approach designed to achieve extraordinary results. These, in turn, position ITOCHU to remain strong despite how few special business assets, like resource-related businesses, ITOCHU hold. Of course, it is not easy for us to be brilliant corporate managers like Inamori. However, it can be stated that dependence on special business assets could cause us to be vulnerable in the face of the loss of such assets. Accordingly, we will work to raise the overall capabilities of our operations. For example, although the Machinery Company is now expected to achieve more than ¥100.0 billion in net profit in FYE 2023, it should be noted that this company has come from a point far behind the other general trading companies to its current position of earnings power. Furthermore, Tokyo Century Corporation has just recorded large impairment losses in connection with aircraft leasing, and we anticipate a considerable year-on-year profit increase arising from the absence of these losses alone in FYE 2024. Of course, we also forecast some negative factors. In any case, however, we believe that depending on revenues from particular businesses is not a good management approach. Therefore, we will strive to fortify our weak points in order to achieve overall improvement in operating results. It is our hope that the stock market will evaluate ITOCHU's future operating results in this light.

Q: Could you share your thoughts on factors affecting ITOCHU's operating results for FYE 2023 and thereafter in light of its pursuit of FYE 2024 consolidated net profit of ¥800.0 billion?

A: In the first half of FYE 2023, we have seen energy and food panics. However, general trading companies, like ourselves, are inherently strong in basic industries and in resource industries involving the acquisition of interest. Leveraging this strength, general trading companies have proactively expanded businesses associated with the heavy chemical industries. Although we have now shifted our focus to downstream businesses, basic industries still constitute an important source of our core profit. Moreover, we now see that basic industries as a whole are being positively affected, albeit gradually, by current rises in energy prices. For example, we have benefitted from a considerable increase in revenues from power trading thanks to surges in oil and gas prices. Energy price surges affect not only electricity rates but also fuel prices, which are related to transportation costs, as well as naphtha prices, which translate into petrochemical raw material costs. These, in turn, significantly impact automobile and other industries. Other general trading companies are similarly experiencing major business growth in heavy chemical industries. Given these circumstances, we can hardly expect a radical downturn in market conditions. Furthermore, many supply chains are being disrupted by semiconductor shortages and labor shortages on the back of the COVID-19 pandemic, issues that are in turn leading to increases in expenditure for high-tech equipment, logistics operations and other endeavors. General trading companies are now benefiting from these phenomena, as well. Moreover, the depreciation of the yen serves a tailwind to general trading companies. Although we cannot completely rule out the possibility of radical changes in external conditions in FYE 2024, we are convinced that we will be able to secure revenues on par with FYE 2023 should current circumstances remain in place for the time being.

A: ITOCHU has stably raised its annual consolidated net profit, which had once been just ¥300.0 billion, growing it over the course of three to four years to ¥400.0 billion, ¥500.0 billion and to ¥800.0 billion. Our policy is to maintain this growth going forward and we are confident in our ability to do so. Although the FYE 2023 operating environment remains harsh for the Textile and Food companies, which operate in the consumer sector, we are quite certain that the environment will improve in FYE 2024. The Machinery Company, meanwhile, is expected to benefit from the absence of aircraft leasing-related impairment losses as well as the full-year profit contribution of Hitachi Construction Machinery. We are thus able, to a certain degree, to forecast the volume of profit from this company. Although the current effect of higher resource prices and favorable foreign exchange rates might taper off in FYE 2024, we nevertheless consider that the absence of these factors could be largely offset by expected recovery in businesses that have been stagnant in FYE 2023. Therefore, we are not at all pessimistic about our operating results going forward.

Q: Please describe the outcomes of additional investment in ITOCHU's existing investees. Have you seen any tangible results in terms of synergies?

A: Thanks to the additional acquisition of shares in some subsidiaries, their balance sheets are now entirely included in the scope of consolidation. This, in turn, enables us to incorporate a portion of profit that had previously been attributable to external interests. As a result, we are now seeing an increase in our asset efficiency, a positive outcome of this move. In addition, ITOCHU now enjoys a stronger position in terms of exercising authority over these subsidiaries' management, making it easier for us to promote business expansion in new fields.

Take FamilyMart, for example. Due to its delisting, a larger proportion of profit earned by this subsidiary is now attributable to ITOCHU, while our increased equity stake helps us to steadily promote such new initiatives as advertising- and media-related businesses involving FamilyMart and the optimization of its logistics operations. With regard to affiliates, we consider the additional acquisition of shares in FUJI OIL HOLDINGS to be a good example. This affiliate possesses superior technological capabilities and is positioned as a Group company of extreme importance. With multiple individuals being dispatched from ITOCHU, the affiliate's North American businesses now involve personnel from our CFO group who support local operations. In terms of assessing returns from additional investment, we review returns from investees on an annual basis. In this regard, we have concluded that the results of our initiatives over the past few years have been positive, considering the low-risk nature of additional investment in comparison with new investment and improvements in asset efficiency reflecting stable growth in profit.

A: DESCENTE is similarly considered a success case of additional investment in an existing investee. Although DESCENTE had been dependent on revenues from its South Korea business, the acquisition of an additional equity stake and the subsequent reform of its management resulted in a well-balanced revenue structure supported by revenues from Japan, South Korea and China.

Q: The Machinery Company and the General Products & Realty Company achieved robust progress in the first half against the revised full-year operating results forecasts. Given this, please describe your rationale for forecasting slow progress at these companies in the second half. In addition, given concerns that housing demand may decline in North America, could you explain the downside risks your North American construction materials business could face due to this decline?

A: We have formulated conservative forecasts for the second half operating results of the Machinery Company and the General Products & Realty Company in light of economic recessions and other factors. As for the Machinery Company, automobile sales currently contribute to its robust performance. However, in the second half, higher U.S. dollar interest rates are expected to cause buying interest to decline, while semiconductor shortages are likely to negatively impact sales at this company. Our forecasts reflect these and other negative factors and are thus conservative. Meanwhile, the General Products & Realty Company is likely to face a decline in housing starts in the United States, stagnation in demand due to seasonal factors and downturns in pulp market prices. We have taken these factors into account to formulate the forecast for its second half operating results. The North American construction materials business, however, may well benefit from the profit contribution of the North American engineered wood products company, in which we have executed additional investment, and thus achieve consistently strong results, despite the decline in housing starts and resulting deterioration in the volume of orders received.

2. B/S (Including Investment Policy)

Q: Please elaborate on your investment policy.

A: ITOCHU has developed a balanced portfolio that is well-diversified. This makes it highly resilient against changes in the economic environment and capable of withstanding market fluctuations and other volatilities. Looking ahead, we will stay keenly conscious of maintaining these aspects of the portfolio in the course of executing investment. We will focus in particular on executing forward-looking investment aimed at better positioning us to expand the breadth and potential of our existing businesses. Also, we intend to employ a medium- to long-term perspective in the execution of environment- and ICT-related investments to strengthen our operations in these fields.

A: Considering that our NET DER at the end of the first half of FYE 2023 came to 0.5 times, we intend to invest more proactively. That being said, given the radical depreciation of the yen, we will have to take an extremely restrictive approach to overseas investment and focus instead on investing in domestic investees for the time being. Although foreign funds are now allocating greater resources to investment in Japan amid the depreciation of the yen, we still have advantages over them in terms of M&A and other domestic investment deals. We will therefore concentrate our investment resources to such opportunities.

Q: ITOCHU's NET DER at the end of the first half of FYE 2023 was indeed historically low. In this light, what do you think is the appropriate level of leverage? Would ITOCHU change its approach to investment or shareholder returns based on the level of leverage?

A: We have seen the stable and natural accumulation of cash from cash flows without resorting to leverage. While staying conscious of external ratings, we currently strive to strike a balance between securing funds for necessary growth investment and delivering robust shareholder returns, aiming for a total shareholder return ratio of more than 30%. In the first half of FYE 2023, core free cash flows, after deducting shareholder returns, turned out to be positive even after executing growth investment. We expect core free cash flows to remain positive in the second half even taking the status of our investment pipelines into account, so we will continue to have capacity for growth investment without using leverage. Furthermore, this may cause our NET DER to naturally decline. As part of the medium-term management plan announced at the beginning of FYE 2022, we set our medium- to long-term target for NET DER at around 0.7 to 0.8 times. However, the business conditions surrounding us have changed radically over the course of the past two years due to steep inflation, the monetary policies of the U.S. Federal Reserve and other factors. Looking ahead, we may be able to raise the level of leverage by securing a constant flow of cash from operating activities and obtaining solid ratings from rating agencies. Regardless, we believe that ITOCHU will not need to use radical leverage in light of the recent interest rate hikes and the composition of its interest-bearing debt, which totals approximately ¥3 trillion, and around 30% of which is U.S. dollar-denominated instruments.

Q: Could you tell us about initiatives and progress in SDG-related businesses, which are designated as a key area under the current medium-term management plan?

A: SDG-related business take time to become profitable. In upstream development projects, we are focusing on efforts in hydrogen and ammonia, but most of these projects are still in the feasibility study stage. ITOCHU has made initial indications of its intent to participate in these projects, but we are still working to select partners and customers and examining transportation methods, so we expect these projects to take several years to begin generating revenue. That said, we are taking firm action on upstream development projects related to renewable energy so that we will not lose out on future profit expansion opportunities. In addition, downstream decarbonization efforts, such as electric power consumption control, represent an important area for contributing to energy self-sufficiency, and storing electricity to use it efficiently will be key. We believe that in the future, with the spread of electric vehicles and other technologies, storage batteries will become even more important, and we are therefore advancing Energy storage system-related businesses. Currently, we have made multiple small-scale investments of around ¥500–¥1,000 million, and we aim to achieve profitability through coordination across these individual investments. Many projects in the storage battery business are in the demonstration stage and will not generate major profits in the short term, but they are making steady progress. We also have projects that contribute to the achievement of the SDGs in such areas as direct reduced iron and CO_2 fixation cement. Though small in scale, these too are advancing steadily.

3. Other

Q: Looking at China, with China's increasingly aggressive stance on Taiwan following the election of Xi Jinping to a third term, it is hard to shake the feeling that the level of geopolitical risk is rising. Could you tell us your current thoughts on China, given ITOCHU's significant exposure there?

A: With Xi Jinping further consolidating the power of his administration since his reelection, China is expected to move toward a more a controlled economy under the direction of the Chinese Communist Party. Under the Common Prosperity program, it seems likely that wealthy individuals or regional governments will not be as freely permitted decide where and how to invest. Instead, investment will likely center on state-run companies controlled by the central government, and these companies will drive the Chinese economy. From that perspective, there is relatively little concern about CITIC, which is substantially a state-run company. With the Xi administration growing even stronger, pushback from the United States is expected, but China and the United States are closely connected economically, and they cannot easily disentangle their supply chains. Even if sanctions are levied on the telecommunications, high tech or systems sectors, similar sanctions on general consumer goods or components are unlikely. Similarly, we do not expect rapid, disruptive restrictions on trade or that China will close in the near future. Also, China has seen more closely than any other nation the consequences of Russia's isolation from international society as a result of the invasion of Ukraine, so it is hard to imagine that China will cut itself off from international society to pursue growth alone. Looking at the Taiwan issue, the prospect of the world's two superpowers going to war is not realistic, and I personally hope it will never come to that. China takes a realist approach and carefully considers the consequences of its actions. Perhaps I'm being a bit optimistic, but I think that, even if they bicker somewhat, the United States and China will diligently work to maintain their relationship, continually making adjustments as needed.

A: About a month ago, I had dinner with an executive of a major Chinese company. He said that political tensions were high in the run-up to Xi's election, keeping investment down, but once the Chinese Communist Party's congress ends, they could proceed with business in earnest. It was his opinion that, under the Common Prosperity program, continued overseas expansion by private companies would cause the Chinese economy to slow, and since China cannot allow that, there would be major shift toward prioritizing economic policy after the party congress. Business in China can be hard to understand, and it's not clear how long the current situation will last, but China takes an even more realist approach to economic matters than Japan, so I personally do think that there will probably be a reemphasizing of economic policy.

Q: The change in framework of The 8th Company during the second quarter seemed rather abrupt. What led to the change? Could you tell us about the state of FamilyMart-related businesses and challenges related to coordination with the other Division Companies going forward?

A: Talking with Group company executives, we realized that when conflicts arose between FamilyMart and companies in which The 8th Company held a mutual interest, such as NIPPON ACCESS, it was difficult for The 8th Company to reconcile its interests as a shareholder in both sides. Understanding this, we decided to promptly terminate the mutual holdings. Going forward, The 8th Company will concentrate on expanding FamilyMart's business squarely from FamilyMart's perspective and continue to evolve. In addition, the horizontal expansion of new businesses proven at FamilyMart is steadily progressing, and we will continue to advance these efforts through The 8th Company, as planned when the company was established. The growth of FamilyMart will also lead to the growth of Group companies involved in related businesses, but we aim to avoid the development of cozy relationships between Group companies and advance rationalization while expanding profits.