FYE 2024 Q1 Financial Results Online Analyst Conference: Q&A Summary

Date: August 4, 2023 (Fri.) 15:00 to 16:10
Respondents: Tsuyoshi Hachimura, Chief Financial Officer
Shuichiro Yamaura, General Manager of General Accounting Control Division

1. P/L Related (Including Full-Year Outlook, Shareholder Returns Policy)

Q: The first quarter results for general trading companies were mixed. Based on this, will there be any change in the additional shareholder returns policy wherein the Company, when revising forecasts upward during the fiscal year, will provide additional returns targeting a 40% total payout ratio? In addition, going forward, are there any risks or loss concerns, such as the possibility of using the ¥50.0 billion buffer?

A: As a company that aims to turn words into accomplishments, we promote discussions while carefully assessing economic conditions and business performance going forward, but there is currently no change in our additional shareholder returns policy when revising forecasts upward. In our first quarter results, we were able to demonstrate the Company's stable earning power, and we do not have any major concerns in particular as we aim to achieve our initial plan of consolidated net profit of ¥780.0 billion and the profit stage of ¥800.0 billion for the third consecutive year. To achieve our initial plan, we need to work to steadily take solid measures to turn around the businesses such as ITOCHU FIBRE LIMITED (IFL), which were affected by falling pulp prices, and construction materials business, collectively in the General Products & Realty Company, and the Dole and HYLIFE businesses, in the Food Company. In other Division Companies, especially The 8th Company (including FamilyMart) and the Machinery Company, results progressed firm with no major concerns. Although we believe the possibility is low that implementing monetary policy leads to a serious recession, uncertainty in the economic outlook cannot be eliminated, and we are skeptical that current resource prices, including for iron ore, can hold steady. Also, personal consumption will require careful monitoring. As a result, we cannot take an optimistic view.

Q: As for the first quarter results, we can expect the Machinery and The 8th companies to outperform forecasts, and the Food Company to also perform well. However, the Company seems very prudent in revising the forecast upward. Are there any specific concerns about a future downturn? How about the current full-year forecast?

A: The initial plan was prudently set at ¥780.0 billion, including a ¥50.0 billion buffer, mainly due to the uncertain business environment and resource prices. As we announced targeting the profit stage of ¥800.0 billion, there is no change in internal discussions of our aim to achieve ¥800.0 billion. Although the uncertainty in the business environment has not yet been eliminated, we made steady progress in the first quarter to achieving ¥800.0 billion, and there are no major concerns in particular. In case of upwards revision, we plan to implement additional shareholder returns. We need to earnestly assess the situation. Accordingly, August, just after the first quarter, is too soon to decide on upwards revision. We believe it important to steadily work to achieve our first-half targets and firm up our position. We think the General Products & Realty Company will be the one we need to really work on for this fiscal year. IFL and European Tyre Enterprise Limited (ETEL) both declined year on year, figuring out how to restore them will be the key. Regarding the ICT & Financial Business Company, while some consider including the profit contribution from the privatization of ITOCHU Techno-Solutions Corporation (CTC), a tender offer for this matter was just announced, and we must first complete the tender offer. We will prioritize gaining the understanding of the employees and shareholders of CTC.

Q: In the first quarter of FYE 2024, Dole turned profitable but stopped at just ¥0.1 billion. What is the current situation and the degree of achievement for the full-year forecast of ¥2.5 billion?

A: Regarding the packaged foods business, which struggled in FYE 2023, signs of recovery have emerged due to effective sales promotions in addition to rising sales prices and improvement of logistics costs. However, in the first quarter of FYE 2024, there were effects from higher interest expenses, in line with rising U.S. dollar interest rates, and increasing costs, especially for packaging materials in the Asian fresh fruit business. The first quarter of FYE 2023 preceded the steep drop in business results, which partially accounts for the substantial decline in the year-on-year comparison. However, compared with the large loss situation in the second half of FYE 2023, the turn-around is making steady progress. We currently aim to achieve the full-year forecast. We will steadily take measures for structural reforms, including organizational changes and cost reductions, as well as measures to strengthen our earning power, with continuous and careful monitoring for the situation.

Q: As the net D/E ratio improved to 0.49 at the end of the first quarter, it is inferred that discussions are underway regarding financial and capital policy for maintaining high ROE in the next medium-term management plan. Could you tell us about those discussions? Also, I imagine that both capital management, such as share buybacks and returns for growth investments will be important to maintaining high ROE. Given this, would you consider, for example, disclosing forecasts of returns on individual projects upon investment?

A: We have previously mentioned that, around this time last year, we were engaged in Companywide discussions aimed at moving to a ¥1 trillion net profit stage with an eye to the period after Brand-New Deal 2023. We have continued those discussions since then and are planning to hold discussions around the same time this year. In particular, we are aware of the need to increase ROE—a strength of ITOCHU—beyond the global standard of 15%, and we are advancing ongoing discussions of how to reflect this in concrete financial and capital policy. We hope to shift our focus from the lower limit of 13% under the current medium-term management plan and aim for higher ROE, but as ROE will be closely linked to profit, we cannot say anything concrete at this time. In FYE 2024, we expect to be able to maintain high ROE, within the 13%–16% range of the initial plan. As for disclosing return forecasts when executing investments, while we are aware of the importance of expanding disclosure, we must disclose information in a well-ordered manner, and return forecasts for individual investments presented by themselves are likely to end up being misleading. To maintain high ROE, in terms of the relationship between share buybacks and growth investments, executing share buybacks just because we have excess capital will not be conducive to corporate growth. Rather, we will basically seek to maintain high ROE by realizing profit growth through growth investments. Investing itself is not our target, and although the privatization of CTC was accomplished through a major investment of ¥387.6 billion, we do not plan to lean toward such large-scale investments going forward. We will steadily build up small investments in fields and regions where we have expertise, building a highly risk-resilient, diversified portfolio to maintain our edge. Remembering the lessons we have learned in the past, as encapsulated in the “Four Lessons” for investment listed in our annual report, we do not engage in a style of management that expands investment just because we have excess capital or concentrate capital only in high-risk, high-growth fields. We are maintaining strict investment discipline and carefully selecting investments for execution. In terms of capital management, the management team feels strongly that the quality of investment is improving and believes we have demonstrated a highly reliable track record. To maintain high ROE, we are also engaged in discussions with Division Companies about the content of assets, the extent of related risks, and portfolio efficiency. The corporate headquarters leads the management of financial leverage, and in the eight years since I was assigned as CFO, we have continuously directed the Division Companies to focus efforts on improving ROA. It's a fact that it's not easy, even for simple things. We will hold similar discussions at the management level in October, based on which we will work out financial and capital strategies and investment returns.

2. The Privatization of CTC

Q: As for new investments, could you provide information regarding the background of the decision to privatize CTC, the growth strategies and approach to synergies that provide the basis for the acquisition price, as well as the progress of growth investments for which returns were factored into the initial plan.

A: The privatization of CTC will represent a large investment following CITIC and FamilyMart, but we were able to obtain CTC's recommendation for the tender offer at an appropriate price that met our investment criteria. Regarding the privatization of CTC, we have held internal discussions for more than five years. During the period, we even officially hired a financial advisor to consider privatization, and, at one time, had abandoned our effort to move forward with negotiations. As new entrants in the IT and digital technology sector strengthen their presence, there are many competitors with higher profit margins and growth rates than CTC. Under such circumstances, we came to this decision due in part to our perception of an urgent risk that CTC could fail to keep up with changes in the industry if it lets up on efforts to grow. Thus far, CTC has provided value-added services that utilize advanced technology and its expertise in the sale of and maintenance of IT equipment, and has built a unique earnings base centered on system integrator (SI) functions. In recent years, however, amid drastic changes in the business environment of the IT and digital technology field, CTC's growth rate and profit margin have been somewhat weaker than its competitors. Over the coming three years, the IT and digital technology field is expected to see even faster growth than the past three years. That growth, however, is expected to be centered on such areas as upstream consulting and downstream data analysis—areas where CTC has not been concentrating investments of management resources. The digital technology utilization needs from CTC's customers continue to grow more diverse and complex. Following our successful takeover bid and after privatization, in addition to the organic growth of existing SI functions, we will explore possibilities for collaboration or M&A with companies inside and outside the Group and expand our scope to include consulting and data analysis as we work to increase CTC's revenue opportunities and further enhance its profitability. By executing these growth strategies, we seek to realize a CAGR commensurate with the amount invested. This investment is in the ICT & Financial Business Company, an area that promises particularly high growth within the consumer sector, which is an area of strength for ITOCHU. As we aim for profit growth in FYE 2025 and beyond, investment in IT and digital technology field, which has a high growth rate, is significant to ITOCHU in terms of capturing and reflecting the high PER and PBR of the market.

As for the purchase price, we began negotiations at ¥3,800 per share, and ultimately agreed on ¥4,325. Whether this is seen as high or low, we did not, of course, ease our investment criteria, and given that it falls within the DCF-method price range that we use, we determined that this was an appropriate price.

Looking at other investments, although we will refrain from naming specific projects, we are advancing considerations of numerous projects across a wide range of fields; there are projects where the decision to execute has been approved, projects where only the investment policy has been approved, and projects that have been rejected. In May of this year, we showed that we would shift our focus toward growth investments in FYE 2024, and that, assuming we will maintain positive core free cash flows after deducting shareholder returns during the period of the current medium-term management plan, we will still have an investment capacity of around ¥1 trillion. As we consider opportunities to use this capacity, we have absolutely no intention of relaxing our financial discipline. In the first quarter, the Investment Consultative Committee, which I chair, screened more than double the number of investment projects than in previous years, and we rejected many. For example, in the IT sector—the same sector as CTC—we rejected two major projects. We are not allowing ourselves to get over-eager, and our policy of strictly and rigidly screening each project is unchanged.

Q: Considering how hard it currently is to secure human resources in the IT and digital field, is there concern that the privatization of CTC could cause an uptick in the attrition rate and negatively affect CTC's ability to secure human resources? What are your assumptions in light of your experience with the privatization of FamilyMart?

A: This goes back to the discussion of CAGR, but in its business plans, CTC took an extremely optimistic view of hiring and expanding the number of systems professionals. This was a point on which CTC and ITOCHU had very different views. Given the shortage of system professionals in the operating environment, we felt that for CTC to expand its business going forward, a top priority would be securing and expanding its human resources, including systems professionals, along with other human resource utilization measures. Gaining the understanding of CTC's employees is essential to making the privatization of CTC a success, and we see this as an issue to approach with the utmost delicacy and care. We also discussed internally and at length the extent to which being a publicly traded company contributed to CTC's employee engagement. As a result of analyses and discussions from a variety of perspectives, we determined that the most important factor in gaining the understanding of employees was not maintaining listed status itself, but providing an environment in which employees can do satisfying work following privatization, as well as carefully and convincingly providing an image of the future in which their compensation will steadily improve and they will have opportunities to pursue new challenges and develop their careers. Also, after privatization, in order to expand CTC's business domains, CTC will need human resources with different skills compared to the past, as well as more, higher-paid human resources. We expect that creating such new employment opportunities will ultimately help increase motivation and reinforce CTC's ability to attract human resources.

Looking at FamilyMart, in the process of growing business performance, front-line vitality has also increased, and we have gained employee understanding of new added value and functions in such areas as retail media. By advancing automation efforts to reduce operational burdens, we have also shown franchise owners and employees our stance of valuing people and their perspectives, which has generated a positive response. Last year marked the peak of franchise agreement rollovers from former Circle K and Sunkus stores, and more owners chose to continue their contracts than we originally expected. Accordingly, we do not see the outflow of human resources as a major management issue at FamilyMart.

Q: Regarding the investment efficiency in acquiring additional shares of Group companies, including the privatization of CTC, the decision might be made not only because of additional profit that can be recognized, but from synergies. How will ITOCHU realize synergies from the additional investments of CTC and other Group companies?

A: With all projects, we always execute investments after considering the next steps we will take in light of our portfolio and the investee's industry environment; we never approve investments aimed simply at capturing a greater share of equity earnings. The additional investment in DESCENTE in the first quarter was not exceptional. Related to the privatization of the CTC, we have advanced strategic capital alliances with multiple DX-related companies to build a value chain that enables us to provide wide-ranging functions from upstream areas to downstream. For example, in the data utilization, analysis and consulting domain, we have formed tie-ups with WingArc1st, BrainPad and Sigmaxyz, and established the joint venture AKQA uka with AKQA. In the cloud and app development domain, meanwhile, we have established GI Cloud, and we formed a capital alliance with COMTURE in the first quarter. By taking such steps, we are looking for ways to generate synergies. While strengthening consulting and data analysis functions, going forward, we will expand CTC's domains and the functions it provides to achieve profitability and a growth rate for CTC that are on par with its competitors. As for other additional investments, the ability to incorporate synergies, including trade benefits and the effects of collaboration with Group companies is a distinct characteristic and advantage of investment by a general trading company. We cannot disclose specific figures, but we carefully examine the likelihood of achieving synergies and make sure that it clears internal investment criteria before making investments.

Q: Is the biggest aim of CTC's privatization to improve the growth rate of CTC and to promote DX within the ITOCHU Group, by reinforcing consulting functions?

A: In transitioning from SI operations to a DX focus, upstream areas offer a high profit margin and exhibit strong market expansion, so reinforcing consulting is, indeed, absolutely imperative. However, the DX value chain we envision encompasses the provision and expansion of a broader range of functions from upstream to downstream. We expect to further reinforce our capital alliances and other collaborative efforts with companies that have consulting and data analysis functions. At the same time, the capital alliances of the DX value chain will also help to enhance the provision of functions that have been difficult with just CTC due to the human resource constraints. Also, as the market continues to further expand, the industry landscape will shift and each company's position will be defined. Private companies will be able to more freely implement capital policy. Furthermore, privatization will allow us to flexibly advance overall support for CTC, including in overseas business development, which is currently difficult.

3. <u>Other</u>

Q: How is the status of your collaboration with Hitachi Construction Machinery leveraging the functions of ITOCHU?

A: Performance in the construction machinery business has been strong overall in the North, Central and South American markets, and, reflecting this, Hitachi Construction Machinery's results have also been favorable. In particular, demand for mining-related construction machinery has been strong, and sales of mining excavators, parts and after-sales service have also been favorable. We began the collaboration with Hitachi Construction Machinery by focusing on the North American market, and efforts are progressing smoothly, centered on exports of construction equipment to North America as initially envisioned. In addition, Hitachi Construction Machinery, Tokyo Century Corporation and ITOCHU jointly established a finance company for construction machinery in North America. This company has already commenced operations, and, while paying close attention to credit risk, we expect further growth in the leasing-related business, including the development of new customers by leveraging the existing customer network of ITOCHU. ITOCHU's involvement in the Central and South American business is currently minimal, but we are considering expanding our business area from North America and getting involved through products going forward. Our collaboration with Hitachi Construction Machinery has only just begun, but progress has exceeded expectations.

Q: FamilyMart's performance has been strong, due primarily to recovery in daily sales. Given the expansion of upfront investments to strengthen the foundation of the retail media business and the external environment, including persistently high costs, do you think performance will continue to improve? What is your outlook for future profit margins?

A: FamilyMart's future growth will be based on strengthening its product appeal and measures to attract customers. Building on this, FamilyMart is laying a forward-looking foundation to build up the retail media business, including digital signage and advertising distribution. Right now we are seeing the upfront costs, but we plan to develop this into a ¥10.0 billion profit business in the future. In terms of the profit margin, there is still room to reduce costs through distribution improvements, labor saving and automation, and FamilyMart is steadily working to do so on the ground. We also believe there is potential for further growth through business collaboration and synergies with NIPPON ACCESS and other Group companies. These reinforcements to the business model in Japan will also help enhance competitiveness when horizontally rolled out to business overseas in the future. We do not have major progress to report yet, but in the near future, we believe that these efforts will contribute to profit in business overseas.