FY2022 1Q Financial Results Conference Call Q&A Summary

(May 13, 2022)

◆ Questions by Takashi Enomoto, BofA Securities Japan Co., Ltd.

Q1	I believe demand in the Chinese decorative paints market has weakened due to lockdowns in Shanghai and other major cities. However, you have a flat 2Q outlook vs. 2Q FY2021 for the Chinese DIY business, according to the heat map on page 6 of the presentation. What is the reason for this outlook?
A1	The situation is changing day by day in China. The lockdowns have impacted housing sales as demonstrated by the default by a Chinese real estate developer announced recently. The heat map shows our outlook based on information available at the time of preparing the presentation. As a result, there is a possibility that the market outlook will weaken from what we projected then. However, as you can see from the 1Q revenue growth of 28% YoY in the Chinese DIY business, we see no significant decline in demand. In addition, the coverage of our distribution networks goes beyond major cities such as Shanghai and Beijing. Moreover, we can tell from our previous experiences that demand is likely to bounce back after lockdowns are lifted. Therefore, our outlook is not that pessimistic. We will pursue a further increase of market share, in particular in the DIY segment. Please be advised that we are providing our best estimates at this time based on constantly changing market trends and conditions.

Q2	You mentioned that there is a possibility of an additional allowance for potential credit loss of around 10 bn – 15 bn yen related to the Chinese business. Your 2Q outlook for the Chinese DIY market is flat versus the 2Q of previous year. Is this outlook based on information before you determined there is a possibility of an additional allowance?
A2	The possibility of an additional allowance for potential credit loss is only based on one estimate from various simulations assuming different scenarios. This additional allowance will be for receivables mainly from some 15 real estate developers and basically have a bigger impact on the Project business than on the DIY business. Although estimates can change, we believe that there is a low probability of an additional allowance. We need to agree with our accounting auditor on this matter, so I will refrain from making a further comment at this time. We disclosed information, to the extent possible, because one estimate will require us to record a significant allowance and our stance is to make a timely and appropriate disclosure to the capital markets.

◆ Questions by Tomotaro Sano, JP Morgan Securities Co., Ltd.

Q1	You mentioned that there is no change in the full-year earnings guidance released in February. Can we assume that there is no change also in the revenue and operating profit margin targets by region provided in the Medium-Term Plan progress briefing in March?
A1	Although we have maintained the full-year consolidated earnings guidance, there are some changes in our regional business outlook. However, I will refrain from going into details in order not to be misleading. For instance, if we record an additional allowance on receivables related to the Chinese business of 10 bn -15 bn yen, it could have various effects, such as an impact on the operating profit margin in the Chinese business. We have set the consolidated operating profit guidance of 115 bn yen as a must-achieve target. At the same time, there are many uncontrollable factors, including exchange rate changes. We do not have enough information to determine if we should revise our forecasts. In addition, even if we decide to provide an additional allowance for potential credit loss, the amount of allowance will not be large enough to require a revision of earnings forecast. Considering this, we have kept our earnings guidance unchanged.

Q2	Please tell us about the progress with the initial plan aimed at improving the operating profit margin. Your initial plan assumed that the operating profit margin will start improving in the 2Q. The 1Q operating profit margin improved slightly over the 4Q FY2021, which leads me to believe that your plans are going as scheduled. Do you expect the operating profit margin to start improving in the 2Q as planned initially? Or, is it difficult for you to predict at this time?
A2	The situation is changing day by day and there are many uncertainties, including whether lockdowns in China are extended for a prolonged period. In the quarterly earnings growth image on page 29 of the presentation for the 4Q FY2021 results, we expected the 1Q FY2022 operating profit to decline YoY. It turned out that the 1Q operating profit was flat versus the 1Q of FY 2021 on a Tanshin basis and exceeded our expectations. In China, the 1Q earnings are usually lower than in other quarters due to the impact of the Chinese New Year. It was a positive surprise that the impact was lower this year than expected. We expect our operating profit to recover to some extent during the 2Q, which is a seasonally high demand period. However, there is a possibility that the pace of improvement of the operating profit margin will be rather slow because of the near-term situation, such as the Ukraine crisis and disruptions in the supply of automotive parts due to lockdowns in China. Despite these uncertainties, we are not in a situation that requires us to revise our earnings guidance. As you can see, various factors are coming into play.

◆ Questions by Atsushi Yoshida, Mizuho Securities Co., Ltd.

Q1	Is my understanding correct that the 1Q earnings of Cromology were in line with the initial plan with no revisions? What is your outlook for the contribution to earnings from JUB, whose acquisition is scheduled for completion at the end of May?
A1	We expect that the operating profit of Cromology in FY2022, the Year 1 following acquisition, will be around 5 billion yen after PPA. The 1Q is traditionally a low-demand period compared to other quarters. What’s critical is how much we can increase earnings in the 2Q and 3Q. In any event, we have no information that requires us to revise our outlook. The Ukraine crisis and other uncertainties have caused consumer confidence to fall in areas of Europe near Ukraine. As a result, Cromology can now only be expected to achieve the initial plan, rather than exceeding the plan by a wide margin. Cromology’s 1Q revenue increased by 3.4% YoY, which is attributable to selling price increases more than to sales volume growth. Market conditions were rather soft in the 1Q and are expected to remain the same in the 2Q. We cannot disclose the earnings of JUB because its acquisition has not closed yet. Six or seven months of JUB’s earnings will be included in our consolidated earnings this year. Therefore, we expect its earnings contribution will be less than one billion yen. JUB is proceeding as planned toward the closing based on a very favorable relationship with DuluxGroup, and these companies are preparing to move on to collaborations for future growth opportunities. JUB’s revenue was around 15 billion yen in FY2021 and is expected to be roughly flat in FY2022. Considering this, we expect its operating profit will remain roughly the same as in FY2021. We will disclose information about JUB as much as possible when we announce our 2Q FY2022 financial results.

Q2	Are there any logistics bottlenecks due to the Ukraine crisis impacting Cromology?
A2	The Ukraine crisis dragged down consumer confidence. In addition, the increases in logistics costs and raw material prices globally have impacted the French economy. As with business in other regions, our focus is on taking actions to offset the impact by raising selling prices and reducing expenses.

◆ Questions by Atsushi Ikeda, Goldman Sachs Japan Co., Ltd.

Q1	Please explain the status of the Chinese decorative paints business. Your Chinese DIY business achieved very strong growth of 28% in revenue in the 1Q of FY2022. Meanwhile, your competitors in the DIY and Project businesses have raised their aggregate average selling prices by 4% to 13%. We believe that raw material prices have increased to levels in the 2Q that significantly exceed your assumptions. Please tell us about the progress with selling price increases both in the DIY and Project businesses based on the current market environment. I think that the sales composition ratio of the DIY business in the overall decorative paints business increased slightly in the 1Q. If this is true, I believe the virtual operating profit margin in the decorative paints business of 7.8% looks somewhat low. Could you give us your outlook for the operating profit margin in the 2Q and afterward?
A1	Revenue growth in the DIY business is mostly attributable to higher sales volumes. We have been able to pass on higher costs, but at the same time we need to take into account the impact of a change in mix of top-selling products. While our sales volumes increased, the percentage of sales volume growth of economy-range products increased slightly. As a result, revenue growth in the 1Q was driven mainly by sales volume growth. In addition, the DIY revenue includes revenue in the adjacency area, which is growing steadily. This is the status of the DIY business. Selling price increases have a positive impact on Project revenue as well, but Project sales volumes declined by more than 5% versus the 1Q FY2021. In the DIY business, we are focusing on strengthening areas that are already strong. In the Project business, we are focusing on projects where we can secure profits, rather than solely pursuing market share gains, by taking selective actions to some extent. With the overall market softening, we don't think we are losing much to competitors. Some competitors may launch an aggressive offensive to take projects away from us. We are monitoring the situation to maintain the proper balance between increasing market share and securing profitability. Our operating profit margin in the overall Chinese decorative business has not yet rebounded after hitting bottom. This is because variable costs have continued to eat into the operating profit margin, although we have tightly controlled SG&A expenses and other expenses as raw material prices and logistics costs rise considerably. The impact of the Chinese New Year in the 1Q this year was lower than expected, but this quarter is not traditionally a high-demand period. What's critical is to deliver strong performance in the 2Q and 3Q.

Q2	Your Chinese competitors are focusing on the DIY business and have very high growth rates. Although there is still a significant gap in revenue between Nippon Paint and competitors, isn't there a risk that you cannot easily raise selling prices and your profitability will decline depending on the competitive environment, such as the competitive climate prevailing in the Project segment?
A2	We believe there is a significant difference in the scale of business between us and competitors. Therefore, the fact that competitors are growing faster than us does not mean that we are losing to them. The DIY business is a brand-based model, and you cannot build a powerful brand overnight. Our brand still gives us a competitive advantage. In the present market environment, our strategy is to solidly increase sales even of economy range products, where competition is slightly more intense than for premium products. In the premium market, we believe we are ahead of our competitors. Considering the product mix, an increase in demand for economy range products does not increase the operating profit margin as much as an increase in demand for premium products does. However, the reason for this difference is not that we cannot raise selling process of economy range products. We will continue to drive growth in the DIY business as a clear focus segment, and we see no major factors that will inhibit growth in this business.

Q3	Is demand in the decorative paints market shifting from the Project segment to the DIY segment and is the economy market growing within the decorative paints market as a whole?
A3	The DIY and Project markets look similar but are actually quite different. The main

	source of demand in the DIY market is Do It For Me, which requires painting by professional painters. This market has substantial demand for repainting existing houses. On the other hand, the Project market still is mainly for new construction, and the environment for this market is currently very challenging. What I'm saying is that the DIY and Project markets are two distinct markets with different characteristics, rather than demand shifting from DIY to Project.

◆ Questions by Tomomi Fujita, Morgan Stanley MUFG Securities Co., Ltd.

Q1	I would like to ask about sales volume and price/mix. According to what you explained at the Medium-Term Plan progress briefing in March, there was an 8% sales volume contribution and a 5% price/mix contribution to the consolidated revenue growth in FY2021. Based on the presentation, there was a 7% price/mix contribution to revenue growth in the 1Q FY2022. Does this indicate that selling price increases are progressing as initially planned and are contributing to improving the operating profit margin? The sales volume growth of 1% seems to be slightly weak. Based on your analysis that the Chinese DIY business was robust and Asia Excepting Nipsea China delivered a strong performance, is the reason for weak sales volume growth a sharp decline in the sales volume in the Chinese Project business? Or, did sales volumes in other regions decline? Please give us sales volume figures by region.
A1	Based on the CAGR revenue growth target of 10% in the Medium-Term Plan, I expect that revenue growth is more attributable to sales volume growth than the price/mix contribution, although the breakdown between sales volume growth and price/mix contribution is merely an outcome. Sales volumes of non-paint products increased and sales volumes of automotive coatings declined somewhat in the 1Q. The fact that we were able to achieve sales volume growth of 1% on a consolidated basis demonstrates our solid performance despite the challenging environment. We will continue to analyze our performance using YoY performance comparisons. I feel that comparisons with FY2021 are rather difficult because there were considerable changes in the business climate during the year. As I mentioned earlier, we expect the Chinese business will be weaker in the 2Q than we assumed initially. However, if we are able to overcome current challenges, I believe there is an opportunity for a large company like us to capitalize on our strengths. For example, we demonstrated considerable resilience during the period when demand rebounded in the 1Q FY2020 after lockdowns were lifted. If lockdowns continue until the end of this year, the expected adverse impact on our business will be too large to control all the effects. If that is the case, our sole focus will be to make sure we do our best. With the business environment and raw material market conditions changing day by day, we create certain budgets and targets and take concrete actions to achieve those budgets and targets. These actions include cost savings, selling price increases, and sales promotion measures. As you can see, the management teams are pursuing business growth in a complex environment.

Q2	I am slightly concerned that the sales volume growth was only 1%. I guess some of the reasons behind this weak volume growth are inevitable, such as the Project segment being in structurally challenging market conditions and the impact of auto production curtailments. Did you achieve both sales volume growth and selling price increases, for instance, in the Chinese DIY business? Also, you mentioned earlier that you are somewhat shifting to the economy segment of the Chinese DIY market. I am a little concerned that there are signs of stagflation in China, the Americas, and Australia. Could you give us an update on the situation?
A2	For strategic reasons, I will refrain from commenting on sales volume and price/mix in individual regions.

◆ Questions by Kyoji Chiba, SMBC Nikko Securities Inc.

Q1	I would like to ask about the situation in the Chinese Project business. While your 1Q Project revenue declined by 5% YoY, your competitors reportedly achieved revenue growth of more than 10% during the same period. Is this gap in revenue growth due to differences in focus areas and operating regions? Please give us reasons for this gap, including the analysis of the situation involving competitors.
A1	We have no information about sales breakdowns of our Chinese competitors, so I will refrain from making a simple comparison. With the Project market remaining weak, we have adopted a plan since the 2H of FY2021 to secure sufficient profitability rather than solely pursuing market share increases. The result is the 5% revenue decline in the 1Q of FY2022.

Q2	Your Chinese competitors have been recording losses. Can we assume that you have no risk of going into a big loss based on your plan to achieve growth while maintaining profitability?
A2	I will refrain from disclosing information about the profitability of the DIY and Project businesses. What I can tell you is that Nipsea China is maintaining sufficient profitability in the overall Chinese business,

◆ Questions by Yifan Zhang, CLSA Securities Japan Co., Ltd.

Q1	Do you expect raw material price increases will moderate or stabilize to some extent going forward? Please give us your outlook for the raw material market conditions in the 2Q and 3Q.
A1	As described on page 5 of the presentation, our Japan naphtha price assumption was in the 60,000-yen range at the beginning of the year but has risen to and stayed at the 80,000-yen range. We expect that raw material prices will stay at elevated levels and we will continue to pass on higher prices based on agreements with customers. Furthermore, we believe we need to assume a further increase in raw material prices and consider actions to cope with this situation.

Q2	Can we assume that you expect raw material prices to decline in the 2H?
A2	We expect an improvement in the operating profit margin driven by selling price increases in every region. As I have mentioned at other occasions, we assume raw material prices will stay elevated in the 2H rather than starting to decline.

Q3	In your initial assumptions, did you assume that raw material prices will level out through the 2H?
A3	As is explained on page 12 of the presentation for the Medium-Term Plan progress briefing in March, our initial assumptions for raw material prices were that raw material prices will continue to increase in the 1H and stay at elevated levels in the 2H. Based on the assumption that raw material prices will continue to increase in the 1H, we will implement selling price increases to catch up with raw material price increases.

◆ Questions by Shigeki Okazaki, Nomura Securities Co., Ltd.

Q1	Based on the heat map on page 6 of the presentation, you expect that the momentum of the Chinese DIY market will slow from the 1Q to the 2Q. Can we assume that this is due to the pandemic?
A1	In the Chinese DIY business, the impact of the Chinese New Year in the 1Q was lower than expected and market conditions remained robust. We successfully increased market share and achieved 28% revenue growth. As we enter the 2Q, we see the impact of

	lockdowns increase day by day and there is a possibility that market conditions will become worse than the market outlook at the time the presentation was prepared. Based on our previous experiences, there is a possibility that a rebound in demand will occur after the lockdowns are lifted. Overall, we expect the market to be softer in the 2Q than in the 1Q, but our outlook is not that pessimistic.

Q2	Is my understanding correct that the Chinese Project market conditions in the 2Q will remain the same as in the 1Q?
A2	We expect the market conditions to remain flat.

Q3	Do you expect raw material prices and logistics costs in China to increase in the 2Q from the 1Q levels due to the Ukraine crisis and other reasons? Is my understanding correct that you will implement selling price increases both in the DIY and Project businesses in the 2Q in order to catch up with these higher expenses?
A3	I will refrain from disclosing information about profitability in the DIY and Project businesses. What I can tell you is that we expect an improvement of the operating profit margin in the overall Chinese decorative paints business in the 2Q even if costs increase further. However, our current outlook is that the pace of our margin improvement will be slower compared to what we assumed when we released our full-year earnings forecast in February.

◆ Questions by Yoshihiro Azuma, Jefferies (Japan) Limited

Q1	Does the bearish stock market like the one we are experiencing currently affect your M&A plans in some way? Please explain, along with the impact on risk tolerance and the status of competition with buyout funds?
A1	It depends on the reasons that stock prices are falling. Stock price declines due to higher interest rates would be a plus for our M&A plans because there are no changes in the business conditions of our M&A targets. On the other hand, stock price declines due to heightened uncertainties, as is the case now, would increase risks associated with acquisitions and therefore affect the scale of M&A transactions, multiples, and risk appetite. We seldom compete with buyout funds for our M&A targets because of a difference in appropriate levels of multiples between us and buyout funds. Rather, we typically compete with our competitors, and there is not much difference in risk appetite and other criteria for M&A between us and our competitors.

Q2	I believe you have expanded your distribution networks in China for the DIY business from Tier 0 and 1 cities to Tier 2 and 3 cities over many years. Were your measures for expanding the distribution networks limited by China's restrictions on movements of people during the past two years since the pandemic broke out? Or, were you able to expand the distribution networks without significant difficulties by using DX and other technologies?
A2	In China, the pandemic has not impeded the expansion of distribution networks because there were no significant movement restrictions related to the pandemic until recently. Project revenue was slightly weak in FY2021, but DIY revenue was up significantly due to strong repainting demand, including in Tier 0 and 1 cities. Although lockdowns are one of the events that would impact our earnings, I don't think lockdowns have been a major obstacle to our policy for expanding distribution networks. We are and will continue to take actions including the use of DX to improve user experiences.

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