FY2022 2Q Financial Results Conference Call Q&A Summary

August 10, 2022

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

Q1	Your operating profit guidance for the 2H of FY2022 is 60.8 bn yen, calculated by subtracting 1H operating profit from the full-year guidance. Am I correct in understanding that your 2H operating profit, excluding one-off items, will be around 65 bn yen after excluding the decrease of 1.7 bn yen resulting from the application of hyperinflation accounting and the provision for potential credit loss in China of 2.0 bn yen? In that case, your operating profit is expected to improve significantly in the 2H over 1H. In which regions you expect a significant improvement in operating profit?
A1	In terms of one-off items in operating profit in 2H, we expect to record a provision for potential credit loss in China of around 2 bn yen on a Tanshin basis, which is significantly smaller than the amount recorded in the 1H. While we are not being too optimistic, we expect a relatively significant improvement in operating profit. The impact of lockdowns in China is likely to gradually diminish, the 3Q includes September, which is a period of very strong demand, and we anticipate demand to rebound after lockdowns are lifted. For your information, the effects of the application of hyperinflation accounting for our Turkish subsidiaries is not a one-off items. We expect exchange rate movements to be one of contributors to improving operating profit. In addition, we expect an improvement in the operating profit margin as a result of the flow-through of selling price increases as raw material prices remain elevated. We expect this situation in all regions rather than in only particular regions. We have been aggressively raising selling prices in every region, including Japan, which we expect to result in a substantial improvement in our operating profit margin. In addition to these factors, the new consolidation of JUB is expected to contribute around 1 billion yen to operating profit in the 2H.

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

Q1	Regarding the credit loss provision in China, you say there is a possibility of an additional provision of around 2 bn yen in 2H, on top of 13.0 bn yen in the 2Q of FY2022. Since the business environment has changed since the beginning of this year, can we assume that there will be no further addition to the credit loss provision? Is there still a risk of an additional provision?
A1	The provision for potential credit loss of 13.0 bn yen in the 2Q was the amount determined with the auditor and covered receivables from customers centered on real estate developers. Although there is no change to our estimate of 10-15 bn yen announced in the 1Q of FY2022, we cannot assure you at this time that we will not record a provision of 15 bn yen or more. Lockdowns may be extended further in China and there are concerns about policy changes in the Chinese government. However, I can say that an additional provision of 10-15 bn yen is unlikely, although the total amount may be slightly above 15 bn yen due to exchange rate movements and other factors. Considering that recording a provision every quarter would undermine investors' confidence in us, we recorded a sufficient potential credit loss provision of 13.0 bn yen in the 2Q.

Q2	DIY revenue increased by 15% YoY and Project revenue decreased 5% YoY in China in the 2Q. According to your assumptions for the FY2022 forecast on page 29 of the presentation, 0-5% growth is expected for Project revenue. Do you expect the Project business to recover in the 2H? Or do you expect this business to continue to slow down in the 2H but exchange rate movements and other factors to cause Project revenue to increase?
A2	The Project market was strongly impacted in the 1H by lockdowns in China. Also, our Project business customers range broadly from government-affiliated real estate developers to paint distributors, and we expect the Project market to recover in the 2H. However, the Project market is currently weak overall. Our plan is to make sure to achieve our full-year earnings forecast while increasing our market share.

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

Q1	Regarding movements of raw material prices and your selling price increases, can we assume that raw material price increases will be more moderate in the 2H than in the 1H, causing the operating profit margin to improve due to the flow-through of selling price increases as described on page 5 of the presentation? Do you expect to see a more significant improvement in the operating profit margin in the 3Q or 4Q after bottoming out in the 2Q?
A1	We adequately implemented selling price increases in the 2Q but operating profit decreased due to the strong impact of raw material price increases and lockdowns in China. However, we anticipate an improvement in our operating profit margin in the 2H due to the flow-through of selling price increases and additional pricing actions with raw material price increases expected to moderate. Regarding whether our operating profit margin will improve dramatically in the 3Q after reaching a bottom in the 2Q, I cannot say for sure because the strength of demand varies from region to region. Nevertheless, we believe we can significantly improve our operating profit margin in the 3Q, as long as there are no unexpected events, because this is the period when demand is normally strong in the Asia region. I realize that our 2Q operating profit margin did not rebound from a year earlier to the level forecast in February 2022. However, we believe we can achieve the revised operating profit target of 105 bn yen for FY2022, which we have set as a Group-wide target.

Q2	Have you implemented pricing actions even if it means to risk a decline in sales volumes? Or have you successfully raised selling prices while increasing sales volumes at the same time?
A2	Although it differs depending on the business models we adopt, we are raising selling prices while increasing sales volumes. For instance, our Chinese DIY business sells premium products and economy products. We are raising selling prices of premium products while increasing their sales volumes. For economy products, we are more focused on increasing sales volumes, which may cause a decrease in the operating profit margin due to a change in price/mix. But we are not sacrificing the operating profit margin of premium products.

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

Q1	DIY revenue in China grew 28% in the 1Q and 15% in the 2Q and the full-year revenue growth forecast is 15-20%. Therefore, can we assume that 2H revenue growth is expected to be 15-20%, which is roughly in line with the full-year forecast? Also, please tell us whether your Project business was impacted by home buyers refusing to pay back mortgage loans in July or thereafter? And could you give us a supplementary explanation on reasons for increasing the full-year forecast for the Chinese DIY business?
A1	To answer your first question about the DIY revenue growth in China, our full-year growth forecast is 15-20% as you can see on page 29 of the presentation. Our revenue growth forecast for the 2H is roughly the same as the growth achieved in the 1Q and 2Q. Revenue in the 1Q was favorably impacted by a smaller-than-expected demand decline due to the Chinese New Year, but revenue in the 2Q did not increase as much as expected due to lockdowns in China. However, we anticipate a demand surge in the 3Q after lockdowns are lifted, and we expect to continue to achieve revenue growth of around 15-20% in the 2H. Regarding your second question about the impact of issues involving mortgage loan repayments, I believe this is a home construction completion problem between real estate developers and home buyers, although this issue has some impact on consumer sentiment in the DIY segment. We assume the Chinese government will urge real estate developers to postpone home buyers' loan repayments if their homes are not delivered but to resume repayments of loans once the delivery of residences is completed. This issue is unlikely to have a big impact on our business. Our interpretation is that the Chinese government is focusing on satisfying the public by ensuring that real estate developers complete the construction of houses. Many of the projects we have newly undertaken are on cash on delivery terms, and therefore we do not expect to needlessly face an increased risk. The Project market is soft as a result, but there are actions we can take to deal with this situation. As for your third question about the sales volume/price analysis for the DIY business, we are raising selling prices of premium products in a suitable manner but sales volumes of economy products, where prices are lower than prices of premium products, are increasing. This is impacting the price/mix. However, increasing revenue through growth in overall sales volumes and prices, including those of economy products, will enable us to apply operating leverage to absorb fixed expenses. An increase in sales volumes of economy products may slightly reduce the operating profit margin, but we are determined to increase an absolute amount of operating profit.

Q2	Am I correct in understanding that demand for DIY and other paints is picking up following the lifting of lockdowns?
A2	When you look at the overall lockdown impact on China, major cities including Shanghai were under severe lockdowns. Major cities are a prime market for premium products, but these cities do not account for more than 50% of total sales in China. Although there may be some bounce back in demand following the lifting of lockdowns, we do not anticipate a big rebound because sales did not decrease much in the 2Q. Economy products were not our focus previously, but we will invest human resources, goods, and money in marketing these products in order to increase our earnings.

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

Q1	My question is about the balance between selling price increases and profit margins. Page 18 of the presentation explains that price/mix raised revenue by 9% in the 2Q while the consolidated gross profit margin decreased from the 1Q. Did the gross profit margin decrease, despite gradual decreases in crude oil prices, because the prices of petroleum-based raw materials have continued to increase and there is a time lag between raw material price increases and selling price increases? You assume that USD-based prices of naphtha will settle down considerably in the 2H. On the other hand, do you think an increase in import prices caused by USD appreciation can put a pressure on profit margins? Please explain your views on the impact of raw material prices and exchange rate movements on profit margins and the balance between price increases and profit margins.
A1	In the 2Q, inflation affected raw material prices as well as SG&A expenses and logistics expenses. We were unable to fully offset these higher expenses with selling price increases. The situation with selling price increases is mixed, varying from region to region. For instance, prices in some regions were increased in April and DuluxGroup implemented additional price increases in June. In addition, the degree of flow-through of selling price increases has varied. For instance, price increases in the DIY business become effective immediately in some cases. We expected sales volumes to increase more and passing on price increases will progress more in the 2Q. But in reality, sales did not increase as much as we expected due to stronger-than-expected cost pressure. Nevertheless, the results did not deviate much from our assumptions. The availability of raw materials varies from region to region. For instance, we believe the chance is slim for the prices of naphtha and petroleum-based raw materials to rise further, if not start decreasing, because refining techniques have advanced considerably. Also, the price of TiOx is unlikely to increase further because supply and demand have eased significantly in China. Looking at the overall picture, Turkey is the only region that comes up for discussion as a region affected by the stronger U.S. dollar. Natural currency hedging is occurring in some cases. Only a few of our operating regions are adversely affected by the stronger US dollar, and our earnings are roughly in line with our assumptions announced in February 2022, excluding the impact of exchange rate movements. Therefore, we do not believe that the stronger US dollar will exert pressure on our operating profit margin nor do we expect a large impact from the dollar's strength.

Q2	(Based on the A1) Am I correct to understand that you expect your operating profit margin to recover as the petrochemical market continues to stabilize and your selling price increases catch up with raw material price increases and that you expect a solid performance in the 2H because demand will be strong in some regions?
A2	In FY2021, our operating profit margin continued to decrease year-on-year, but we expect it to improve in the 2H of FY2022. The key point is how much of an improvement we can achieve. We initially assumed that raw material prices would rise through the 2Q and stabilize at an elevated level, if not decline, starting in the 3Q. Based on this assumption, we are executing our plan to raise selling prices whenever and wherever possible from the 1Q to 3Q and possibly in the 4Q as well. In addition to these factors that were within our expectations, there were some unexpected events, such as a potential credit loss in China and the application of hyperinflation accounting for our Turkish subsidiaries.

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

Q1	Please explain your outlook for the decorative paints market in Australia, Europe, and the U.S. The real estate market is softening because real estate prices have started to decline in these regions due to interest rate hikes. Do you see any changes in paint demand? For instance, is demand for repainting, which accounts for 80% of total demand, remaining stable while demand for new construction, which accounts for the remaining 20%, is decreasing?
A1	We are cautious about the outlook for the decorative paints market in the U.S., as are our competitors. Higher interest rates discourage home purchases. In addition, relocations are difficult in the current housing market because rent prices are not declining. Dunn-Edwards, which has many regular customers mainly on the US West Coast, will be impacted in the 2H of FY2022 because repainting demand tends to rise in association with new home purchases and as people relocate to other houses. However, as described on page 29 of the presentation, we expect 5-10% revenue growth in FY2022 in the decorative paints business in the Americas. We assume revenue growth will continue in the 2H of FY2022, although at a slightly slower pace compared to the strong 1H growth, and we do not expect paint demand to decline by 20-30% in the 2H. Looking at our performance in Australia, DuluxGroup's mainstay is decorative paints for repainting, which is a business with high margins. Paint sales for new housing are small. The company has a dominant market share with large retail stores and in the trade distribution network. In Australia, people repaint their houses on a regular basis, not just when they move to a different house. Considering this, we do not anticipate paint demand to decrease in response to increases in interest rates and other factors. There was COVID-enhanced repainting demand in 2020 and 2021 because people were forced to spend more time at home due to the pandemic. We expect sales volumes to decrease slightly this year after the very strong demand during the previous two years. However, we plan to continue to increase revenue by offsetting the decrease in sales volumes with higher selling prices. In Europe, consumer confidence has been cooling due to factors such as the Ukraine crisis. However, Cromology mostly sells its products through its own trade paint stores, where sales did not decrease as much as they did at large retail stores. As a result, unlike at competitors, this company has not been impacted severely by declining consumer confidence. But the outlook is not rosy at all, and the important point is how Cromology can manage to increase its market share in the current market environment. In this manner, the outlook for the degree of impact differs from region to region, ranging from being slightly sluggish in the Americas, stable in Australia, and sluggish in Europe.

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

Q1	In the Chinese real estate market, there are issues such as consumers' refusal to repay mortgage loans and concerns about the structure of this market. We are concerned about the possibility of events that would severely impact your earnings. Are there any quantitative risks that you are aware of at this time?
A1	One of the items that could have a significant impact on our earnings is the provision for potential credit loss. Since we started the Project segment in China 6 -7 years ago, we have been increasing our market share by providing a broad range of solutions with a focus on the top 30 and top 100 major real estate developers. At that time, extending the collection period of trade receivables from certain real estate developers was an effective way to beat

	competitors, although it involved certain risks. However, the Chinese government has implemented restrictive measures, putting real estate developers including quasi-private companies in a challenging situation. In this environment, we have been diversifying the receivable collection risk since the 2H of FY2021 by increasing transactions with state-owned real estate developers and focusing on projects of distributors such as builders. As a result, the percentage of major real estate developers in the total transactions has been gradually decreasing. Based on our understanding of differences in the current market environment compared with past environment, we are aiming to expand operations by keeping a balance between earnings and risks. When you look at the new housing market in China, sales of ready-to-occupy units with interior finishes are increasing, rather than skeleton units without interior finishes. As a result, some of the DIY demand is flowing into the Project segment. However, we have been focusing more on the DIY segment since FY2021 and we believe that there is still room for revenue growth due to our ability to pass on price increases and our strong brand power in the DIY business. As a result, DIY revenue growth has increased dramatically from the low single-digit YoY growth in 2019-2020 to 35% in FY2021. The DIY business involves very limited risk because the collection period for trade receivables is short and receivable collections are basically completed by the end of the year. If our business is reliant on the Project segment, your concerns would be well founded. However, NIPSEA China's sales are mostly from the DIY business in China, which has remained on strong growth path, so we do not think the risk involved is high. Regarding geopolitical risk, there has been considerable progress with decoupling in China. However, China is not self-sufficient in all raw materials, so the country may be vulnerable to some risks. In addition, if China were to become isolated from the rest of the global economy, it would disrupt the entire Chinese economy. If that happens, there is a risk that disposable income will decrease, which will cause paint demand to decline. Although there may be geopolitical risk involving China, we do not believe there are many major risk factors that could affect our businesses.

Q2	You explained your measures to diversify risk in the Project segment. Are you taking all possible actions to manage receivables? Also, you said you expect that Project market conditions will improve slightly in the 3Q compared to the 2Q. Do you expect the deterioration in market conditions will ease in the 2H of FY2022?
A2	Although we believe that the worst is over in the 2Q of FY2022, including the issue with cash flows of real estate developers caused by the Chinese government's zero-COVID policy, the situation remains unpredictable. However, the Project business is serving not only new construction but also demand for large-scale repairs for houses that have been built in large numbers since the late 1990s. We will focus on capturing orders for these repainting projects for the steady growth of the Project business. For the management of trade receivables, we are reducing the percentage of major real estate developers in total project sales. We do business with developers where there is risk by receiving cash on delivery. On the other hand, we will expand transactions with government-affiliated real estate developers with growth potential in order to grow while properly managing risk.

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