FY2022 3Q Financial Results Conference Call Q&A Summary

(November 14, 2022)

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

Q1	Is my understanding correct that the very strong 3Q performance in Nipsea China was driven by seasonality of demand and subsidy income? Please also tell us about the change in sales volumes in the 3Q and reasons for forecasting a significant revenue decrease in the 4Q.
A1	In the 3Q, we managed to achieve DIY revenue growth due to the relatively strong flow through of selling price increases, although the business environment was not easy. Subsidy income was around 3.5 bn yen in the 3Q as you can see in Adjustments in the Reference Data pages of the presentation. Operating profit in China was 19.0 bn yen and the OP margin was 14.6%, but the OP margin excluding subsidy income of 3.5 bn yen from 19.0 bn yen was slightly more than 11%. That means that the OP margin excluding the bad debt provision improved compared with the 1Q and 2Q. The reasons are a decrease in raw material prices and flow through of selling price increases. While our performance in the Chinese business was relatively strong even excluding subsidy income, there were effects of the National People's Congress in Beijing in late September and October, which is a high-demand period. In addition, there were lockdowns in many areas including Hangzhou which were not reported in Japan and globally, on top of the one in Shanghai. Sales are not too bad, but we are unable to deliver products to customers due to severe disruptions in logistics. As a result, there were quite a few orders which did not turn into sales starting in October. This caused our October sales to be significantly below the initial forecast. This is strictly based on preliminary figures. However, our actual performance has been relatively weak and the challenging environment we have been facing has continued in November. Demand is normally very weak in December but we will take action to achieve a sales recovery. In the meantime, sales as of this time in mid-November are below our initial forecast. The FY2022 forecast on page 8 of the presentation reflects current market conditions, which require us to adopt a somewhat conservative outlook. We will tightly control costs in order to improve earnings. Our conservative 4Q guidance for the Chinese business is due largely to disruptions caused by lockdowns, rather than the effects of the soft market. Although the situation is improving overall, we do not expect an improvement at the regional and district levels soon.

Q2	Are you saying that demand will not be weak in the 4Q but sales will be affected by disruptions in logistics, with demand expected to recover if the situation improves?
A2	Demand is not necessarily strong considering the business sentiment in China. However, according to the local management, the problem is that we are unable to deliver products to customers, which has had a significant impact, even though order intake has been relatively stable. The situation is not sufficiently positive to assume that demand would be strong without disruptions in logistics. In fact, the situation does not allow for optimism because the Zero-COVID policy has been gradually impacting our operations.

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

Q1	Based on your presentation at the conference call for 2Q FY2022 in August, provision for potential credit loss in China was 13.0 bn yen in the 1H and is estimated to be 2.0 bn yen in the 2H of FY2022. Is there any plan for recording an additional provision? Please also give us your outlook as to when the logistics bottleneck in the Chinese real estate market will end.
A1	There was no large provision for potential credit loss in the 3Q, and we will determine in the 4Q whether we will make the 2.0 bn yen provision as I mentioned in August. We have estimated that the total amount of provisions in FY2022 will be 15.0 bn yen based on the operating profit forecast of 105.0 bn yen based on our August forecast. At this time, we do not anticipate a big change in our outlook for a 2H 2.0 bn provision, such as by not making a provision at all or doubling this provision. As I have mentioned on prior occasions, we are continuing to do business with customers with some financial problems while avoiding taking on additional risk by doing business based basically on cash on delivery. With our outlook at this time unchanged, we have decided not to record a provision of 2.0 bn yen in the 3Q. As for the status of logistics bottlenecks, we have factories in more than 50 locations all over China and the situation varies from region to region. Disruptions were mainly focused previously in urban areas, such as Shanghai and Beijing, but they are spreading to regional areas, causing logistics disruptions in rural areas to some extent. We expect demand to recover after the Chinese New Year, around February or March next year. In particular, we are hoping that demand will rebound in March, which is a high-demand period. However, the supply chain disruptions in the 4Q are so severe that it is difficult for us to determine an outlook. I will give you updates on this situation in February when we announce our FY2022 results or earlier if we have information available. At this time, however, we are not in a position to predict the timing of the end of logistics bottleneck.

Q2	I had an impression that disruptions in logistics have had a significant impact. Do you have an additional comment on this?
A2	If the Chinese government relaxes the Zero-COVID policy and vaccinations increase, the logistics bottleneck may not be a very significant problem. However, we cannot exclude the slightly pessimistic scenario for how long it will take before various conditions improve throughout China. Nevertheless, demand has not dropped significantly. If you ask me if demand is strong, the situation actually is slightly negative taking into consideration the current business sentiment. What I can tell you now is that there is a complex combination of factors in the Chinese market.

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

Q1	You mentioned that the outlook for Nipsea China is bleak based on preliminary figures for October and afterward. On the other hand, one of your competitors in China has released an outlook for October that includes an improvement in DIY paint shipments. Please tell us the background for your outlook including your analysis of competitors and regional differences.
A1	We do not have enough information to analyze the background for shipment data of Chinese competitors. Our 4Q outlook is that business is slower than we expected in August due largely to disruptions in logistics. Given the current situation in China, I guess our Chinese competitors are affected by the same factors to some extent. Co-President Wee Siew Kim will give you more details on the situation in China at the upcoming small investor meeting.

Q2	Please tell us about the situation other than logistics disruptions, such as the status of order intake.
A2	Order intake has not declined but its growth has been slower than we initially expected. Although the timing of recording sales will be delayed due to delays in the delivery of products caused by logistics disruptions triggered by lockdowns, I don't think there is any difference in order volumes between us and competitors. But we need to closely monitor the status of orders throughout the 4Q.

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

Q1	You mentioned that the situation in Indonesia is also more difficult than you initially expected. However, I believe demand is robust in Southeast Asia, including Thailand, Singapore, and Indonesia. What are reasons for your grim outlook for the 4Q?
A1	As described on page 21 of the presentation, the Indonesia business delivered very strong growth in the 3Q with revenue increasing by 37.7% and operating profit by 65.2% on a Non-GAAP basis. This strong growth was driven by a surge in demand before selling price increases implemented in the latter half of the 3Q. Taking into consideration the market environment in October, including the business sentiment that was affected by raw material inflation and demand trends after selling price increases, we expect that our 4Q performance will be weaker than we initially forecast. On the other hand, our performance in Singapore, Thailand, and Malaysia will continue to improve in the 4Q as in the 3Q. Although the pace of profit growth will vary from region to region depending on the degree of flow through of price increases, we expect demand to remain solid. The Nipsea Except China segment includes Betek Boya in Türkiye where we have applied hyperinflationary accounting. This resulted in revenue to be higher and operating profit to be slightly lower compared with the levels excluding the effects of hyperinflationary accounting.

Q2	Is the weak 4Q outlook in Indonesia due to a decrease in demand after the surge in the 3Q? Or is it due to the stagnation of the overall economy?
A2	After the very strong 3Q performance in Indonesia, we have assumed a decrease in performance to a certain degree. In addition, there was a deterioration in business sentiment in October. Therefore our outlook on page 8 of the presentation takes into account both factors.

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

Q1	Please tell us about the trends in raw material prices in the 3Q in each region. Do you expect raw material prices to decrease in the 4Q in all regions?
A1	In Asia including China, which accounts for a high percentage of our sales, raw material prices are on a slight downward trend. In particular, prices of TiO2 and other raw materials have dropped from the elevated levels at one time due to easing of the supply-demand balance. In Japan we are negotiating prices with raw material manufacturers, who are increasing prices to reflect yen's depreciation, but prices have not declined as much as we expected. Prices of some raw materials including naphtha have started to decrease, but prices of some raw materials have remained elevated or are expected to increase next year. For DuluxGroup and Dunn-Edwards, which have lower raw material price contribution (RMCC) ratios than at our partner companies in other regions, we expect that the impact of raw material inflation can be basically offset by selling price increases. We have been able to procure TiO2 in the US, for instance, at relatively low prices for a long time. However, there is a possibility that our procurement cost will increase slightly starting next year. Therefore, I cannot tell you that we expect an earnings improvement driven by raw material price decreases in all regions.

Q2	Do you expect raw material prices on a consolidated basis to decrease because raw material prices are declining somewhat in Asia including China, which accounts for a high percentage of your sales?
A2	The gross profit margin in the 3Q improved QoQ. We expect the margin to improve further in the 4Q driven by the flow through of selling price increases and lower in raw material prices, despite uncertain factors such as sales volumes.

Q3	Am I correct that disruptions in logistics have only affected sales of products but not the procurement of raw materials?
A3	We have not experienced opportunity losses from the interruption of raw material procurement. We are stocking up raw materials more than we normally do in order to prevent running out of products.

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

Q1	I expect that various discount rates have risen following interest rate hikes on a global scale. Is there a possibility that the higher discount rates will affect your balance sheet and P/L? There are cases in other sectors where companies recognized impairment losses on goodwill due to higher discount rates. Please tell us about the risks involved with higher discount rates at Nippon Paint which has large amounts of borrowings and intangible assets.
A1	Talking about borrowings, which are directly affected by interest rate hikes, almost our entire borrowings are in yen and are mostly long-term loans. As a result, the interest rate hikes have had almost no impact at this time. If there are new M&A deals in the future using borrowings in yen when the yen is weak, our borrowings may become large. However, as long as the Bank of Japan maintains its current monetary policy, we do not expect interest rates to increase rapidly. Even if interest rates increase, our existing borrowings will not be affected because they are on fixed interest rates. As for goodwill, we monitor the risk of impairment losses on a quarterly

	basis. We see no risk of an impairment loss at this time. We cannot say that there is no risk in Türkiye where interest rates are high, but there is no risk in other regions. In M&A deals, we need to constantly take into consideration discount rates and the permanent growth rate. Although our business model includes exposure to risk involving discount rates, we exercise care to select M&A deals where this risk is unlikely to be a problem. There is no risk in our balance sheet. In most cases, the effects of exchange rate changes are absorbed by foreign exchange adjustments. The depreciation of the yen against major currencies is raising the yen-denominated value of our overseas assets. Therefore, we don't see any major risk of negative impact on the balance sheet. Looking at cash flows, our group partner companies in all regions have positive cash flows. Except when DuluxGroup used equity financing for the acquisition of Cromology, there is a low need for NPHD to provide additional funds to our group partner companies. Our Group is characterized by a business model in which each partner company generates cash flows and invests this cash in growth initiatives on its own. As a result, we don't think that the current exchange rate and interest rate environment involves a major risk.

Q2	Are you saying that although the hurdle for borrowing associated with a new M&A deal will increase with the further depreciation of the yen and increase in discount rates, the possibility is low that you would cancel an M&A deal due to the negative impact on the balance sheet?
A2	We will decide whether or not to execute an M&A deal based on comprehensive assessment. For instance, if the valuation multiples of a target company decrease due to the effects of interest rate movements that would be a positive factor for us. We conduct a comprehensive assessment of the relative value and absolute value of a target company within the limits of our balance sheet, or in a case where we use our capital for an M&A deal. We don't think we need to change our M&A strategy at this time. With various uncertainties emerging at this time, we see some risk in relation to whether the acquired company can generate cash flows as we expect. Whether or not we will execute an M&A deal will ultimately be based on comprehensive assessment.

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

Q1	Were the October sales figures in China above or below the 4Q FY2022 forecast?
A1	I would like to refrain from commenting on our monthly performance. At this time, we will not comment on earnings of individual business.

Q2	You expect raw material prices to decrease in China from October to December. Do you expect to offset the revenue decrease with the lower cost of raw materials?
A2	During my explanation of the outlook for earnings, I mentioned that we would take action to maintain operating profit levels despite the possibility that our revenue falls below our forecast. What I meant was that reducing fixed costs is just as important for maintaining earnings as raw material price reductions are. We will tightly control costs to increase profits in pursuit of our sole mission of Maximization of Shareholder Value (MSV).

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

Q1	My question is about the impact of the higher cost of raw materials in China. Your OP margin in the 2Q was 7.6% due to a one-off expense but improved by 4.4 ppts to 12.0% in the 3Q. Can we assume that you did not implement selling price increases many times in the 3Q and the OP margin improvement was primarily attributable to the lower RMCC ratio? There were times when the OP margin in the Nipsea China segment stayed above 15%. Please explain your evaluation of the 3Q OP margin.
A1	The impact of selling price increases is not limited to the quarter in which they are implemented but may extend to the following quarter. The OP margin improvement in the 3Q included the impact of selling price increases in the 2Q. But the lower RMCC ratio contributed more to the OP margin improvement. Under the same conditions, the OP margin in the 3Q was around 11.8% excluding subsidy income of 3.5 bn yen. The OP margin in the 2Q was around 9.2% after reversing the provision for potential credit loss of 13.0 bn yen. We will aim for an OP margin of around 15% in the long term by establishing a dominant market position in China. Our assessment of the Chinese business in the 3Q is that the local management team fared pretty well in terms of the OP margin amid changes in raw material prices. There was also a challenging environment associated with the situation in the real estate market and the government's COVID related policy. Turning to the 4Q, we expect various uncertainties. We will therefore perform an extensive analysis of the status of competition and market environment.

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