Summary of the Q&A session following the May 2020 conference call about Current Priority Management Issues and Business Strategy for institutional investors and analysts

Date: Thursday, May 28, 2020, from 1-2:15 PM
Presented by President Keiichi Iwata

Q. Even after factoring in uncertain downside risks including the Covid-19 pandemic, core operating income is expected to be 80 to 110 billion yen. The drop in income seems modest compared with that of the past crisis. What sort of changes were there? You have many highly volatile businesses, but have you thought about decreasing the ratio of such businesses, for instance, by significantly downsizing the Petrochemicals & Plastics business or selling Petro Rabigh? Could you also brief us about the dividend?

A. To answer your question on the reason for the seemingly smaller impact of the Covid-19 pandemic compared with the past crisis, the main reason is that Pharmaceuticals and Health & Crop Sciences, accounting for 40% of our sales (the largest portion), is not so heavily affected by the pandemic. The rest of our sales make-up is 10% from automobiles, 20% from displays in IT-related Chemicals, and 30% from other general living materials.

For the second question of how to resolve volatility in Petrochemicals & Plastics, which is the segment most affected by changes among all sectors, this is not an issue that can be resolved in the short term. We think that the right way is to continuously and steadily shift our focus to high value-added products.

As for dividends, our earnings forecast this time only covers core operating income, so we cannot make any comment for the moment as the full year outlook for our bottom line is too uncertain. As I have mentioned previously, we have two basic goals with respect to dividends, which are to pay a stable dividend, and to maintain a payout ratio of 30% over the medium to long term. These ideas will remain unchanged this year as well. As to which our main focus is, we are putting more weight on maintaining a stable dividend this year.

Q. The outlook for Pharmaceuticals on slide 45 shows that a considerable recovery is expected in the long term, but currently the stock price of Sumitomo Dainippon Pharma is depressed. In this situation, what do you think about an investment to make it a wholly owned subsidiary?

A. That option always remains as possibility. We still have not reached any concrete plan in view of our current capital balance, investment priorities, and other factors.

Q. With regard to Petro Rabigh, is my understanding correct that providing parent-subsidiary loan of around the same amount as the previously planned capital increase will completely resolve the completion guarantee and eliminate the contingent liability of your company? Since this would also involve credit risk, could you elaborate on that a bit more?

A. As you pointed out, we were originally thinking about a capital increase as one of the conditions for the complete release of the guarantee. In this plan, we were to take our share up to 37.5%, or about 1.1 billion dollars in terms of value. Instead, negotiations are currently under way to issue a parent-subsidiary loan or debt guarantee of about 1.5 billion-dollars.

Q. In terms of financial strategy, should I understand the capital increase of 110 billion yen you previously talked about as falling within the 1.5 billion US dollars, and not in addition to it?

A. Yes, that is correct.

Q. With regard to minimizing performance volatility, I see that your company usually maintains stable performance thanks to your strength in the life sciences. However, your fiscal 2019 results were affected by the concurrent impact of the Latuda patent cliff, a drop in methionine prices, and sluggish sales of crop protection products. It seems to me that the current situation is extremely rare. Do you think that if your company is able to survive these difficult circumstances, you will be able to just return to stable conditions? Or are you thinking that the volatility in Petrochemicals & Plastics really must be dealt with, and are therefore considering actively licensing out and making effective use of your intellectual property? I would like to once again confirm the direction of your company, as well as ask about the scale of your licensing revenue.

A. With regard to how we go about eliminating or minimizing volatility, we were already working to create structures for business, finance, and earnings that would not be significantly affected by market changes in order to diversify our company. This business model would allow us to support sluggish business sectors with other strong business sectors. In that sense, we thought that crop protection products would allow us to maintain extremely stable profits, but 2019 and 2020 were extremely anomalous years, marked by methionine price drops and floods in North America. We must take into account, however, that the recent extreme weather is becoming the new normal. I believe that we must be a bit more careful in assessing whether Health & Crop Sciences is really as stable a business as we have expected it to be.

Strengthening our licensing business in Petrochemicals & Plastics is precisely our strategy to make it part of a stable earnings foundation that is resistant to market changes. Having said that, a licensing business is not possible without considerably attractive products. We currently license our propylene oxide process, our hydrochloric acid oxidation process, and some MMA processes. But since MMA is closely related to our business, the first two items fall under general licenses. Our licensing revenue and the accompanying catalyst revenue are central to the Petrochemicals & Plastics sector, but they are not yet sufficient to support the whole sector. The next licensing possibility is caprolactam. In this business, all companies are facing an extremely difficult situation, since margins have dramatically declined. However, we have received a lot of inquiries, as our caprolactam is technically superior to the others. In fact, we believe that it will be our third licensing pillar. Combining all these together, we would like to make them a stable source of revenue that can support the performance of Petrochemicals & Plastics sector.

Q. So does that mean that you do not intend to license out all licensable technologies but intend to license out only those other than the core ones, such as polyolefin and engineering plastic, which you wish to retain inside the company?

A. Yes, that is exactly the case.

Q. Core operating income in the Health & Crop Sciences sector on slide 9 is expected to increase to 33 billion yen in fiscal 2020, from 2.1 billion yen in fiscal 2019. For this profit increase of 29 billion yen, could you give us a breakdown in terms of how methionine market prices, the crop protection business, and the acquisition of Nufarm subsidiaries add up to increase in the core operating income?

A. Improved results in the Health & Crop Sciences sector reflect about 10 billion yen in expected recovery in the methionine business, and increased sales of crop protection products overseas, which accounts for the rest. For methionine, this is not such a dramatic increase, because we factored in the recovery of the market from January to March 2020, and then made the forecast on the premise that a modest rally will continue in the first half of fiscal 2020.Despite this conservative forecast, the results in the previous fiscal year were so severe that we expect to see an improvement of about 10 billion yen this year. As for crop protection, because our North American business experienced such an extreme business environment in 2019, we are assuming that performance will return to normal. Thus, this core operating income does not reflect a dramatic increase.

Q. You explained that a leading South Korean panel manufacturer would withdraw from LCD business. Could you give us your view on the impact it might have on your business, along with your take on the future trend of touch sensor panels and the status of new products on which you are pinning your hopes, such as cover window films and organic EL luminescent materials?

A. This South Korean manufacturer's withdrawal from large-scale LCDs for TVs is indeed a big event. Almost all of that volume will shift to Chinese panel manufacturers. Fortunately, our company has sites in China, and we have a history of working with Chinese panel manufacturers since they launched production. Therefore, even though we have had a great relationship with this South Korean manufacturer that exited the production of large-scale LCDs of TVs, and even though much of the market is shifting to Chinese panel manufacturers, it will not have a big impact on our business. We enjoy the world's top share of nearly 30% in polarizing film for LCDs for TVs. Polarizing film manufacturers started focusing on their strong business areas, and as a result, our position in polarizing film for LCDs for TVs gained more ground, relatively speaking.

In terms of the impact on our business, we have concerns over the impact of the US move to tighten China-related export control regulations. The US controls the use of some of its technology-based semiconductors by certain Chinese smart phone manufacturers. If this prevents us from making high-end smart phones, our touch sensor panel business may be affected.

As for organic EL luminescent materials, JOLED will launch a new line of substrate size 5.5 G in full scale at its Nomi Works. As we reported earlier, since JOLED's luminescent materials use our products, our business is expected to be bolstered by the full operation of their production. However, since the shipment volume of organic EL luminescent materials for 5.5G is limited, unless they are adopted for TV use, it may not lead to major profit. We are working on the development of 5.5G for TV use and expecting to see a move soon toward the adoption of 5.5G.

As to which cover window film becomes a dominant product in the market, our race with competitors continues in each configuration. It still remains to be seen which product becomes the standard in the market.

Q. About Dongwoo Fine-Chem (South Korea), don't you have to factor in impairment risks?

A. We once recorded impairment losses for optical products of Dongwoo Fine-Chem (Dongwoo) in fiscal 2017 that ended in March 2018. However, it does not mean that any specific discussion has been made on this subject since then. Needless to say, since Dongwoo long sensed the move of Korean customers toward business restructuring, Dongwoo has taken various measures in line with such moves. However, Dongwoo's outstanding capacity for technological development was largely due to its geographical position neighboring its customers. The withdrawal of customers of large-scale LCDs for TVs from South Korea, will pose a major challenge in how the capacity for technological development in this area can be maintained. South Korea is experiencing now what we experienced in Japan in the past, with a time lag of a few decades. I presume that what our company experienced in the past will be experienced by Dongwoo. The situation is as you pointed out, and I would like to keep an eye on it.

Q. You mentioned that you would pursue more selective investments, reducing total investments by 100 billion yen to improve your financial structure. What kind of criteria will be used for that? For example, in the face of the pandemic, are you going to gravitate toward more stable life science business, or the semiconductor business, where there is further growth potential? Could you elaborate more on how you will be more selective in your investments?

A. It is difficult to explain about this selective investment to reduce total investments by 100 billion yen, since the original Corporate Business Plan of 700 billion yen in investments is not the result of simply adding up each investment. The selective investment is planned on the decision-making basis for those investment targets that are deemed necessary in undertaking various businesses for the next three years. The result of adding M&A to this plan totaled 950 billion yen. How do we go about reducing this to 850 billion yen? The reduction in investments of 100 billion yen this time will be determined by the relative merits of specific investments, and not by targeting specific areas. We will not cut back on those investments that are necessary for business growth and that can lead to profits. Instead, we will reduce investments by postponing the timing of upgrades to obsolete facilities by three or six months, when possible.

Q. With the 100 billion-yen reduction in investments, is the reduction from 950 billion yen to 850 billion yen in sight right now to some extent, or is it largely dependent on what you will be deciding from now on?

A. We perceive that we can achieve about 60% of the target and need to work on the rest a bit more.

Q. On the second item of "Focus areas of FY2020" on slide 55, you mention "Carry through post-merger integration (PMI) for the large-scale M&A." Are you planning to take a new approach or devise and incorporate ways that are different from those in the past? You also said that you were worried about the strategic alliance with Roivant. Were there any points that were different from your alliances with other companies? Is it correct to understand that such concerns are being resolved as you go along?

A. We executed both the strategic alliance with Roivant and the acquisition of South American subsidiaries of Nufarm. We were less concerned about Nufarm, since we already had existing businesses. Meanwhile, we were more concerned about Roivant. Although the alliance with Roivant was decided after very careful assessment of the potential of Roivant's pipelines based on the opinions of various experts, new drug development always involves unexpected risks that we must embrace until the last minute. Besides, Roivant was a venture business with no sales record. We made a decision to tie up with them by valuing their future potential, but we were equally concerned about whether our evaluation of their future potential was right or not.

As to what specifically we are going to change with PMI, the main player of the strategic alliance with Roivant is Sumitomo Dainippon Pharma. As such, we intend to work on how to provide support for PMI from the standpoint of its parent company. Staking the fate of the company, Sumitomo Dainippon Pharma is taking various measures to proceed with PMI. About whether to provide personnel support or financial support as its parent company, we continue to consult and work with Sumitomo Dainippon Pharma.

Nufarm's South American business itself is sound. However, geographical expansion of business, as we express it as "footprint expansion," always involves new operational risks. Our challenge is how we go about making the business solid in the South American countries, which have cultures, commercial practices, and legal systems that are different from our own. We intend to galvanize the power of our Group and go forward with the help of various related organizations and consulting firms as needed.

Tanaka Chemical Corporation, which we acquired, is small in scale, but we would like to work as a team, using an approach to elicit their strengths.

Q. Is it correct to understand that you will build a system in a few months for the acquired Nufarm South American business to further accelerate the realization of synergies, in such areas as product development?

A. Yes.

Q. Your company owns other listed subsidiaries and listed equity method affiliates, aside from Sumitomo Dainippon Pharma. What is your take on the efforts to unwind parent-subsidiary relations with these companies? Since you mentioned cash balance in your answer to the question about Sumitomo Dainippon Pharma, are you saying that it is difficult to do so currently as your financial strength has been weakened a bit?

A. There has always been a debate in the management team about whether we should maintain our equity positions in the listed subsidiaries or listed equity method affiliates as they are. Our first priority is to think about if there are any synergies, and then to what extent a reorganization is high in priority. However, since there are many urgent tasks that we must embark on, I would say that reviewing our stakes in these listed subsidiaries is not so high in priority under the current circumstances.

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