FY2023 4Q Financial Results Conference Call Q&A Summary

February 14, 2024

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

Q1	The operating profit margin for NIPSEA China experienced a notable decline from the 3Q to the 4Q. You attributed this decline to the increased expenses in logistics and advertising during the 4Q. How would you evaluate this explanation? Furthermore, the FY2024 guidance anticipates the TUC segment to achieve revenue growth exceeding its 8% in the 4Q of FY2023. In this context, could you please elaborate on the current business environment, including the conditions in Tier 3-6 cities?
A1	The 4Q typically represents a period of lower demand for NIPSEA China, resulting in comparatively reduced sales compared to other quarters. Additionally, the operating profit margin tends to decrease as fixed costs remain constant throughout the year. Although we managed to reduce SG&A expenses in the 3Q, we strategically invested in growth initiatives during the 4Q, particularly focusing on installing CCM machines and increasing advertising expenditures in anticipation of FY2024. Taking these factors into account, we are confident that our performance has been strong across the entire year, rather than just in the 3Q and 4Q. As we look ahead to FY2024, NIPSEA China remains committed to its growth strategy, with a primary focus on the TUC segment, despite the challenging economic landscape in China. Our aim is to pursue market share expansion not only in Tier 3-6 cities but also in Tier 0 and Tier 1-2 cities. In the TUC market, we have observed the withdrawal of several competitors, particularly smaller players, some of whom have transitioned to become OEM partners for our brands. This strategic shift has facilitated efficient growth for us, bolstering our confidence in the effectiveness of our approach. In the TUB segment, we broadened our business scope to encompass non-residential sectors such as schools and public facilities, reducing our dependence on the new build sector. This diversification of our customer base has fortified our operating profit margin. Additionally, we anticipate the activation of operating leverage effects in the near future. That being said, we anticipate maintaining the operating profit margin in FY2024 at a level similar to that of FY2023, even without factoring in the subsidies and other one-off items totaling 8.5 billion yen recorded in FY2023. Given that March, the final month of the 1Q, experiences high demand, our performance during this period will serve as a basis for validating our FY2024 guidance.

Q2	Throughout FY2023, the sales growth rate in the TUC segment exhibited a consistent quarter-on-quarter decline. Looking ahead to FY2024, does the local management possess any concrete indicators suggesting a potential resurgence in the expansion of market share in Tier 3-6 cities?
A2	Examining sales growth in the TUC segment, while sales volume growth is positive, the price/mix is slightly deteriorating due to higher sales growth in Tier 3-6 cities, where sales mostly consist of economy products, compared to sales in Tier 0 and Tier 1-2 cities. Despite these factors, we have positive indications of achieving our sales target for FY2024. However, it's important to note that the Chinese market is highly dynamic, and the situation may change.

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

Q1	Regarding the factors contributing to the operating profit increase outlined in the FY2024 guidance, I anticipate that the impact of new consolidations will approximate around 5 billion yen. Could you provide us with a detailed analysis?
A1	As indicated on page 5 of the presentation, our projection suggests that operating profit will rise by 9% on a Tanshin basis, or by 11% when excluding one-off income/expenses (approximately +8.5 billion yen) and provisions (approximately -6 billion yen). Assuming an operating profit growth of 11%, the contribution from new consolidations is estimated to be approximately 3.5-4% of this growth.

Q2	Am I correct in understanding that the breakdown of operating profit growth will be approximately 70-80% attributed to organic growth and around 30% to new consolidations?
A2	Out of the 11% growth in operating profit, approximately 7.5-8% can be attributed to organic growth, while new consolidation is expected to contribute around 3.5-4%. We believe we can anticipate sufficiently high growth from the existing businesses as well.

Q3	Regarding the TUC segment of NIPSEA China, while one of your competitors foresees steady market conditions in the first half of FY2024 compared to a year ago, your projection indicates sales growth of approximately 15% for the full year. Is the primary reason for this variance in market outlook attributed to the expansion of your market share?
A3	In the TUC segment, our market share in FY2022 stood at 24%, securing our position as the market leader, while the second and third competitors held estimated market shares in the high single digits. We believe we possess a substantial lead over our competitors. The combined market share of the top three players is approximately 40%, leaving the remaining some 60% of the market largely concentrated in Tier 3-6 cities, where we are actively expanding our presence. As we continue to grow our market share in Tier 3-6 cities, some smaller competitors have begun to withdraw from the market. By capturing the market share of these exiting players, we are steadily establishing a track record of high investment efficiency. We have confidence in our ability to achieve significant growth by capitalizing on our brand and other strengths. Despite the challenging economic climate, we are committed to simultaneously pursuing revenue growth and enhancing operating profit margins, all while maintaining a steadfast vigilance.

Q4	In India, local competitors are increasing prices. What factors lead you to anticipate that the operating profit margin for NPI and BNPA in FY2024 will remain at the same level as last year?
A4	I will refrain from delving into the details of NPI and BNPA as their acquisitions have not yet been finalized. Nevertheless, as I outlined during the investor briefing concerning the “Buyback of India Businesses from Wuthelam Group” in August 2023, NPI has attained the second-largest market share and profitability through aggressive promotional activities in the southern states of Karnataka and Tamil Nadu. This trend has remained consistent since then. Despite the challenging market conditions in the Indian market during the second half of FY2023, we persisted in pursuing growth that exceeded the market, emphasizing both revenue growth and profitability improvement. Given that our growth continued to outpace market growth in FY2023, we are confident that our strategy of concentrating on the two southern states is yielding success.

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

Q1	The operating profit margin in the Japan segment increased from the 3Q to the 4Q of FY2023. Are there any specific factors that account for this margin growth? Your projected operating profit margin for FY2024 remains unchanged from last year's. Do you consider it unlikely that the margin level in the 4Q will be sustained?
A1	Certainly, we are hopeful that the margin level in the 4Q will be sustained. Nonetheless, our performance in the 4Q exceeded expectations, and we anticipate that the favorable business environment may not persist throughout the year. Our projections are based on the assessment that we can at least replicate the same level of performance as last year. Regarding the impact of one-off factors, some items, such as the reclassification related to transfer pricing, contributed slightly, but not greatly, to the improvement of the operating profit margin. In the automotive coatings business, there was a significant increase in sales volume, and operating leverage worked effectively. Additionally, we raised prices in the marine coatings business, where demand has remained very strong since 2022. When considering Japan Group as a whole, we don't necessarily view the operating profit margin of 12.5% as a standard level. However, we have established a groundwork to maintain a margin level just below 10%. Internally, our target for the operating profit margin is slightly below 10%, and we will consistently endeavor to surpass this benchmark.

Q2	Could you elaborate on the factors that underpin your forecast of 5-10% revenue growth in decorative paints within the Japan segment for FY2024?
A2	In the decorative paints business in Japan in FY2023, we primarily offset the decline in sales volume through price increases. However, in FY2024, as the momentum of price increases diminishes, we anticipate a slight improvement in the market environment, paving the way for growth in sales volume. We believe that achieving revenue growth of 5-10% is well within our reach through various sales promotion activities. Based on the overall market conditions in FY2024 being better than in FY2023, we will aim to generate synergies through the expansion of market share.

◆ Questions from Tomomi Fujita, Millennium Capital Management Asia Limited

Q1	Operating cash flows exhibited a consistent decline from the 1Q to the 3Q of FY2023. It appeared that trade receivables had a negative effect on operating cash flows during this period, leading to lower operating cash flows relative to operating profit. However, in the 4Q, trade receivables had a positive impact on operating cash flows. Can we interpret this as a signal that the collection of overdue receivables is improving? Or is it merely a result of seasonal factors?
A1	As I mentioned previously, NIPSEA China typically collects all trade receivables in the TUC segment during the 4Q, following our annual practice. As expected, cash collected was recorded during this quarter. In the TUB segment, we transitioned to cash on delivery transactions around the second half of FY2022. As a result, we do not anticipate trade receivables collection to pose significant challenges at this time. While it's evident that the trade receivables collection environment is improving, the main factor contributing to the positive impact of trade receivables is seasonality.

Q2	Can we conclude that, at the very least, the trade receivables collection environment is not deteriorating and the risk of trade receivables becoming irrecoverable is decreasing?
A2	In the TUC segment, our transactions primarily operate on a cash-on-delivery basis. Conversely, in the TUB segment, trade receivables stem from real estate developers, typically involving a longer collection period. Nevertheless, we have consistently made provisions for trade receivables where necessary over the past two years. While certain developers continue to be significant clients, we are diversifying our revenue streams within the repainting and exterior paints segments, emphasizing a thorough assessment of debt collection security. Hence, we do not anticipate a substantial provision amount in FY2024, and the percentage of trade receivables necessitating provisions has significantly decreased.

Q3	Assuming trade receivables remain stable, operating cash flows are projected to be around 180 billion yen. Further, with capex estimated at 50 billion yen, free cash flows are expected to range between 130 billion and 150 billion yen. With this substantial free cash flow base, do you intend to prioritize reducing liabilities on the balance sheet in the future? Alternatively, considering the current debt-to-equity ratio, are you inclined to allocate funds towards M&A endeavors proactively?
A3	While I will refrain from commenting on specific numbers, we have confidence in the strength of our balance sheet. As you mentioned, we intend to primarily allocate the generated cash to M&A activities to enhance EPS, which we believe will contribute to Maximization of Shareholder Value (MSV). While M&A activities are not our sole objective, we continuously evaluate acquisition opportunities, seeking those with low risk and reasonable valuations. Therefore, it is entirely possible that the generated cash will be utilized for M&A activities. While building up cash reserves is beneficial, our objective does not involve repaying debts. Our management philosophy emphasizes refraining from deploying cash towards unnecessary expenses to bolster our cash reserves.

◆ Questions from Ryokichi Kondo, CoatingMedia Co., Ltd.

Q1	Could you provide insights into your market share for automotive coatings, decorative paints, and industrial coatings within the Japan segment, along with the key strategies for each of these businesses?
A1	According to our estimates, we hold the second position in the automotive coatings market in Japan, with the majority of the market share being held by the top two players, including ourselves. In decorative paints, we are ranked first, although we estimate that one competitor is closely positioned. In the industrial coatings market, we command a substantial share in coil coatings, while our presence varies across segments such as construction machinery, agricultural machinery, and powder coatings. Nonetheless, we maintain our leading position in the industrial coatings segment overall. There have been no significant changes in our market position recently; instead, we are observing a slight increase in our market share.

Q2	Do you prioritize specific segments within the industrial coatings business in Japan over others?
A2	We are actively and eagerly dedicating efforts to each segment to achieve consistent growth in market share, particularly in profitable segments. With customer value as our foundation, we aim to enhance our technical capabilities further to deliver high-quality products to our customers.

Q3	You are projecting a 5% revenue decrease in the automotive coatings business in FY2024. What are reasons for this projection?
A3	Although automobile production rebounded significantly in FY2023, our market outlook for FY2024 appears flat, as indicated by the light green color in the heatmap (reflecting growth ranging from -5% to +5%). The primary reason for anticipating a decrease in automotive revenue in FY2024 is our forecast of a slight decline in automobile production.

◆ Questions from Takashi Enomoto, BofA Securities Co., Ltd.

Q1	In the market outlook for FY2024 outlined on page 9 of the presentation, you project flat market conditions across all regions. However, in the assumptions for the FY2024 forecast detailed on pages 6 and 7, revenue growth is assumed in every region. Are you anticipating an expansion of market share in each region? Or are you factoring in market recovery that may not be reflected in the market color on the heatmap? Could you please provide detailed explanations for each region?
A1	While the market color for FY2024 is light green across all regions, indicating growth of -5% to +5%, the outlook varies from region to region. Based on this market outlook, we project +5-10% revenue growth for NIPSEA China and approximately +10% revenue growth for DuluxGroup. The primary driver of this revenue growth is essentially an expansion in market share. In regions where our brands have a strong foothold, such as Australia and China, we view these market conditions as an opportunity to further expand our market share. However, we are committed to expanding our market share in all regions as a fundamental aspect of our strategy, including pursuing market share growth in Japan where we anticipate slight market expansion.

Q2	You are anticipating an increase in raw material prices while projecting a steady operating profit margin. Can we infer that you typically do not pursue market share expansion through price reductions?
A2	The Raw Material Cost Contribution (RMCC) ratio declined in FY2023, but we do not anticipate a significant decrease in the RMCC ratio in FY2024. However, in regions where the RMCC ratio experiences a slight decline, we view it as an opportunity. The funds freed up could be allocated towards promotional activities or potentially used to reduce selling prices in certain regions. In the ever-changing Chinese market, our focus is to uphold the prices of premium products whenever feasible, while considering reductions in prices for select economy products. As we aim to broaden our market share in Tier 3-6 cities, there is a likelihood that the proportion of economy products in our product mix will rise. With the anticipation of a slight decrease in the RMCC ratio, our strategy involves maintaining our operating profit margin by reallocating the saved funds towards promotional and other activities. The situation varies across regions, making it difficult to provide a universal trend. However, our overarching objective is to sustain the current level of operating profit margin.

Q3	In regions where your brand is well established and competition is not intense, does the business environment allow you to sell your products without reducing prices?
A3	For instance, in Australia, where we have a 50% market share, we are pushing for price increases rather than price reductions. Since our products offered in this market are premium brands, we will pursue market share expansion on a value basis through selling price increases. On the other hand, in regions such as Malaysia and Indonesia, where the demand for economy products is strong, we will also take proper actions to increase market share through economy products, while working on establishing premium brands. In this way, the situation varies from region to region, and each of our partner companies is taking different actions according to their market in their effort to improve operating profit margin.

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

Q1	Over the past few years, your focus has predominantly been on M&A activities within the decorative paints segment. Do you plan to sustain this focus, particularly targeting medium-sized companies within the decorative paints segment? Additionally, could you elaborate on your approach to M&A within the industrial coatings, marine coatings, and automotive coatings segments?
A1	Unfortunately, I'm unable to divulge extensive details regarding our M&A activities. Nevertheless, our M&A endeavors since FY2019 have primarily centered around the decorative paints and adjacencies segments. Our acquisition criteria primarily revolved around reasonable valuations and their potential contribution to EPS growth. While there's a chance of us acquiring a company in the industrial coatings segment, it would only be pursued if the potential target is expected to make stable contributions to our earnings and offers a reasonable valuation. In terms of M&A activities that contribute to MSV, we are committed to enhancing EPS by acquiring excellent companies with balanced risk and returns at a reasonable price. We conduct comprehensive evaluations of their profiles, considering factors such as the stability of their business and customer base. We approach potential targets with an open mind, without setting restrictions based on scale or business areas.

Q2	In terms of financing, is it correct to understand debt financing from banks will be the primary means of financing with little possibility of equity financing through new share issuance?
A2	While prioritizing debt financing, we are not completely dismissing the possibility of equity financing. However, we will only consider equity financing if it is guaranteed to enhance EPS and strengthen our balance sheet. Equity financing will be avoided if deemed unnecessary. Given the current favorable debt financing environment, including interest rate levels, debt financing remains our primary focus.

Q3	Do we need to be concerned about the risk of asset impairment on companies acquired thus far, considering their strong cash flows and performance?
A3	The risk of impairment is inherent whenever goodwill is created. Situations like a rise in interest rates or the progression of stagflation, which could result in our performance falling below expectations, may elevate the risk of impairment. Hence, we consistently conduct impairment tests. The audit for the fiscal year ended December 31, 2023, has not yet been fully completed. However, we have not identified any situations or cases necessitating impairment recognition.

◆ Question from Atsushi Ikeda, Goldman Sachs Securities Co., Ltd.

Q1	For NIPSEA China, the operating profit margin for the 4Q of FY2022, excluding one-off items, was 9.1%, while the operating profit margin was slightly lower at around 8% for the 4Q of FY2023 based on our analysis. According to some information sources, your competitors have reduced prices in the TUC segment. What was the impact on your performance in the 4Q of FY2023? Please also give us your anticipated growth rates for the TUC and TUB segments in FY2024. Can we assume operating profit margin in the low-teens as a guideline assuming that the margin level bottomed out in the 4Q of FY2023?
A1	In FY2024, we are projecting growth rates of around 15% for the TUC segment and 0-5% for the TUB segment. The overall operating profit margin in the entire NIPSEA China will remain largely unchanged from 12.5% in FY2023. Revenue growth in the TUC segment in the 4Q of FY2023 stood at 8%, slightly below our expectations, as we had anticipated a slightly higher growth rate. On the other hand, revenue in the TUB segment decreased by 1%, attributed to an uptick in repaint sales for public buildings, shifting focus away from residential applications for real estate developers as part of our revenue source diversification efforts. We believe we did very well considering that we had anticipated a much larger decrease. Although our operating profit margin experienced a slight dip in the 4Q due to some price/mix deterioration, we believe it is more accurate to assess our performance by considering the combined results of the 3Q and the 4Q. Our performance in the 3Q was very strong even before provisions, so we reduced advertising and promotion expenses to some extent. When the 3Q and the 4Q are combined, operating profit effectively increased compared with last year. In the 4Q, we increased investments such as the installation of Computerized Color Matching machines and advertising expenses. We expect these investments will bear fruit in FY2024 by adhering to our growth strategy centered on the TUC segment. Indeed, our overall results for the 4Q exceeded the targets we had set. While we slightly missed our revenue target, our primary focus remains on achieving our operating profit target. We do not believe that the trend has changed significantly in just one quarter.

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