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Morinaga & Co., Ltd.

Q&A Session at Results Briefing for Fiscal Year Ended March 31, 2023

(held May 16, 2023)

Q. Gross profit and gross profit margin increased in the fourth quarter of the previous fiscal year. Would it be reasonable to assume that this momentum has carried through to this fiscal year?

A. One factor contributing to the above-forecast performance in the fourth quarter was a significant increase in net sales in the Confectionery & Foodstuffs and Frozen Desserts businesses. While it's difficult to generalize as it also depends on product mix and other factors, the impact of rising raw materials prices wasn't as strong as we'd anticipated, and part of the budget to cover operating expenses also wasn't used.

We recognize, therefore, that the figures may have risen slightly excessively. However, as we progressed through each quarter, the gap has narrowed between the impact of rising raw materials prices and the effects of our efforts to counter them. In March 2023 we implemented the second round of price revisions for the previous fiscal year, and expect the boost from this to contribute throughout the current fiscal year. By helping to firmly secure top line performance, we believe it will contribute to profitability.

Q. The "Sustainability Information Update" slide in the presentation mentions the utilization of diverse human resources. Could you please explain how capital will be allocated to secure outstanding personnel? Although increased labor expenses can be viewed negatively by investors, it can increase the value of work output, so I believe allocating capital towards pay increases ought to be given consideration. Also taking into account tax incentives, and other considerations, could you please share your thoughts on striking a balance in the effective utilization of capital?

A. Following this year's spring wage negotiations, we implemented a wage increase averaging ¥10,713 per employee [*a 3.37% increase within the established criteria*], including a base salary increase. We also increased starting salaries. It was a bold management decision and was at a level where tax incentives also apply.

Q. How does it compare to other companies in the industry?

A. It's certainly not a small increase compared to industry standards.

Q. You previously made a strong statement about your intention to quickly return to the operating income level of JPY 20 billion. What specific profit growth expectations do you have in mind for the period covered by the 2024 Medium-Term Business Plan (MTBP)?

A. We're already deliberating on the 2024 MTBP and discussing the framework for bringing operating income back up to record-high levels. We recognize the need for sustained top-line growth as changes to the business environment are expected to continue. We're also working to improve profitability through price revisions. If we can achieve top-line growth, we firmly believe we can get back on the path towards JPY 20 billion. Regarding raw materials prices, we need to pursue a management approach based on the idea that prices may remain high or even continue to rise, while also taking into account the social climate. How we read situations and respond to them, will be a crucially important point. We intend to announce details within the 2024 MTBP.

Q. During the period covered by the current medium-term business plan, there have been profit impacts from upfront investment in advertising and digital transformation. Would it be correct to say that the period covered by the 2024 MTBP will be when you start to see returns on those investments? Or should we expect it be a period of further investment?

A. I think it depends on which specific business we're talking about. For example, our United States business has achieved growth beyond the targets set in our business plan, and we see further significant opportunities in the US market. The operating income margin has recently increased significantly, and it's crucial at this point for us to boost investment in market creation and expansion in the US.

Overall, during the three years covered by our 2021 MTBP, we made a conscious effort to expand a range of intangible investments, despite the truly adverse business environment. For instance, we increased advertising spending by 19% and R&D spending by JPY 2 billion. We've been taking proactive steps to prepare for the future. In the period covered by our 2024 MTBP, we expect to see some of these investments bearing fruit, but we also anticipate the need for additional strategic investment. We also intend to provide more details about this point in our 2024 MTBP.

Q. Can you tell us the background to plans for the United States business with regard to its sales growth and its increasing contribution to profit?

A. The main factor behind the profit expansion in the United States business for the previous fiscal year was the effect of price revisions implemented in November of last year. We increased prices for core products by around 12% to 17%, and sales volume is increasing. We're therefore targeting 27% year-on-year net sales growth for the current fiscal year. Revenue growth from price revisions has a significant impact on profitability and is leading to profit expansion. It's important to note that we're not the only ones implementing price revisions, as our competitors have done so as well. As a result, prices have risen across the US market as a whole.

I visited the United States last year to observe market conditions. Inflation was so high that I became very concerned at times about potential further price increases. However, sales are currently trending steadily, and we have high expectations for the boost from price revisions in the current fiscal year.

On the cost side, while we anticipate lower marine transport expenses than in the previous fiscal year, we expect raw material prices to continue soaring. We plan to increase spending on advertising and human resources as well. We intend to allocate earnings generated from *HI-CHEW* towards *Chargel* or towards further expansion of the *HI-CHEW* brand. At the same time, we'll conduct a thorough review of expenses to ensure a balanced approach.

Q. What's the current situation with *HI-CHEW* production capacity?

A. We're planning two production line expansions in Taiwan, as well as exports from Japan. In terms of more fundamental expansion initiatives, in April of this year we established a *HI-CHEW* Global Branding Office, which is dedicated to overseeing the brand globally. We're starting out strongly determined to accelerate the global growth of *HI-CHEW*, including production and brand expansion, and we're studying optimal production systems to link up with retail sales.

Q. Can you please provide an update on *Chargel*?

A. With *Chargel*, we've been focusing on the West Coast of the United States and on California in particular, through a range of different initiatives. Japanese grocery stores in the United States are beginning to stock it, but brand recognition among consumers is still extremely low. This is similar to the early stages of *HI-CHEW* in the United States, where it was important for us to first build on successes within specific areas. Since *Chargel* is in a product category that didn't exist in the US market, we're working to boost recognition, such as through product sample giveaways at numerous events. However, creating a new market isn't such an easy task. In Japan, we achieved a rapid increase in *in Jelly* sales to nearly JPY 10 billion within about four years, whereas in Taiwan it took us about 20 years to reach the current state. In both Japan and Taiwan, *in jelly* sales are more than double of sales in *HI-CHEW* sales, so, as we've been saying since the initial launch of *Chargel*, we view the product as a very significant opportunity with success very much dependent on our own efforts.

Q. So you're envisioning a timeline closer to the *in jelly* timeline seen in Taiwan?

A. In Japan, Morinaga & Co., Ltd. has high brand recognition levels and a well-established sales network, and we invested in *in Jelly* marketing very decisively. In the United States, however, our brand recognition levels are still low, so I think it'll take time. Although we'd like to establish a market presence sooner as we head towards 2030, we'll avoid rushing and will stay focused on steadily building on successes on the West Coast, with a focus on California. We've received very favorable feedback from product sample giveaways at triathlons and cycling events, and intend to keep steadily advancing in that direction.

Q. Can you provide us with any hints regarding the "third arrow" in the United States business?

A. *HI-CHEW* has secured a permanent spot in the sugar confectionery sections of mainstream US supermarkets. Other Japanese confectioneries are displayed in Asian food sections, and it's pretty much safe to say that *HI-CHEW* is the only Japanese product that's established a place in regular confectionery sections. This is proof of our sales capabilities and we're considering leveraging this advantage to try introducing made-in-Japan products. It might be a slight exaggeration to call it a "third arrow", but initially we'll be looking to get products imported from Japan onto store shelves.

We're gaining traction with *HI-CHEW* in mainstream US supermarkets, which will in the future enable us to also get *Chargel* and a variety of other products onto store shelves. It may not result in significant short-term results, but we view it as a very significant opportunity in the medium to long term.

Q. Even in the current business plan, the operating income margin target for the Confectionery & Foodstuffs business is only 2%. That's the kind of margin that would make me question the value of continuing a business. Can you tell us about your thoughts on this and any future reforms?

A. The current impact of rising raw materials prices is a significant challenge. In recent years, we improved operating income margin to around 6% before it declined again. In our 2030 Business Plan, we set an operating income margin target of 10%. It's true that we're yet to see tangible results, especially in the Confectionery & Foodstuffs business, despite pursuing fundamental structural reforms. As we approach the period covered by the 2024 MTBP, we're discussing just how far these structural reforms should go. We haven't lowered our income margin target, and we're continuing to work towards achieving it.

Q. Considering the level of cash and deposits at the end of the previous fiscal year and your investment in the new head office building, I estimate that your company's cash and deposits level is roughly JPY 30 billion, which is equivalent to about two months' worth of what you mentioned you consider to be your monthly revenue. In terms of balance sheet management, what further plans do you have in mind?

A. When redefining our capital policy and shareholder return policy, we generally made progress as anticipated with cash and deposits adjustment measures aimed at enhancing capital efficiency. Our basic policy is to pursue aggressive growth investment while maintaining a solid financial foundation. We intend to consistently adhere to our commitment to shareholder returns in order to increase corporate value in a sustained manner.

During the period covered by the 2021 MTBP, we've made shareholder returns of JPY 30.9 billion, exceeding the target. We believe we can provide specific guidelines on financial stability, on which shareholders returns are predicated, in our 2024 MTBP. We'll continue pursuing investment and shareholder returns while maintaining financial security and managing the levels of indicators such as debt-to-equity ratio, leverage utilization, liquidity on hand, and interest-bearing-debt-to-EBITDA ratio.

Regarding the profitability of the Confectionery & Foodstuffs Business, we're taking steps to implement performance control with an eye on ROIC and establish business strategy guidelines.

Q. So you mean concrete figures will be presented in the 2024 MTBP?

A. We'd like to thoroughly prepare and refine our thinking on this so that we can provide clear explanations.

Q. What further growth potential is there for *HI-CHEW* in the US market? I heard previously that you are working to differentiate *HI-CHEW* from local soft candy products based on the products' long-lasting fruity flavors, but does it have any other competitive advantages besides differentiation based on quality? Also, do you perceive Japanese competitors entering the US market as a threat in addition to local competitors?

A. We believe *HI-CHEW* still has significant growth potential.

Firstly, in the non-chocolate candy market, the top brand holds a share of approximately 6%, while *HI-CHEW* currently holds 1.24%. We believe there's ample room to more than double its market share. For example, in terms of product lineup, last year we increased the SKU count by launching *HI-CHEW Reduced Sugar* for health-conscious consumers, and this year we introduced unwrapped *HI-CHEW* products. Our SKU count is still only about one-third of that of the top brands in the market, so we'll continue working to expand our offerings. Additionally, we aim to boost sales by developing products tailored for special events such as Halloween, something we haven't sufficiently pursued as yet.

Furthermore, the brand recognition rate is currently only at 51%, indicating there's still room for growth. Store turnover is good, and customer reviews are much more positive than those for competing products, so we'll keep working on raising brand recognition levels.

As for Japanese competitors entering the US market, we don't see them as a threat. Japanese confectionery products are typically found in the Asian food sections of Japanese grocery stores in the United States, and they've struggled to penetrate mainstream US supermarkets. Similarly, when we first entered the US market, we started by targeting Japanese grocery stores and then gradually built on successes from there, benefiting from publicity generated by Major League Baseball players, which led to increased brand recognition and sales, until we finally managed to get *HI-CHEW* stocked by mainstream supermarkets. According to the president of our US subsidiary, getting products onto mainstream supermarket shelves is very challenging. We'll continue striving for further growth leveraging our local sales capabilities.

Q. I have a question regarding the "in-" Business. With *in Jelly*, you achieved a V-shaped recovery from the sales decline during the early stages of the pandemic. You did this by expanding the purchase rate through promoting new ways to consume *in Jelly* in response to environmental changes. However, I believe that demand from consumers who were impacted by health issues during the pandemic, such as vaccination side effects, also contributed to the recovery. Do you think "in-" Business sales can continue to grow even after such demand disappears? And do think the "in-" Business can help drive your operating income higher as a high-profit business?

A. Firstly, in the current fiscal year we're not expecting the kind of special pandemic and vaccination-related demand we saw in the previous fiscal year. With regard to pandemic-related demand, *in Jelly* products were included in the supplies delivered by the government to COVID-19 patients recuperating at home, and we feel that the products were well received. These products delivered to patients accounted for a few percentage points of the previous fiscal year's net sales. In the short term, demand will fluctuate depending on factors such as increases in influenza cases. We'll therefore focus on promoting consumption settings and expanding target consumers for longer-term growth. For example, we launched *in Jelly Full-o-Fruit* products to capture snacking demand from female consumers. Additionally, with *in Jelly Glucose Boost*, we've acquired demand from consumers in situations requiring enhanced concentration, leading to an expansion of sales. To achieve sustained longer-term growth we're planning to develop a variety of new products, such as complete nutrition products and products for children.

According to SRI data, in April, *in Jelly* recorded 1% year-on-year growth, while the market as a whole was flat year-on-year, indicating that the jelly drink market is starting to level off. *in Jelly* has achieved double-digit growth for two consecutive years, reaching record-high sales, so we don't expect it to continue growing at the current rate. Nevertheless, we believe the strength of the *in Jelly* brand and our gelation technologies hold value that's unmatched by other companies, and we'll therefore remain firmly focused on promoting consumption settings.
