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Morinaga & Co., Ltd.

Q&A Session at Results Briefing for the Fiscal Year Ending March 31, 2024

(held May 14, 2024)

Q. With respect to the ROIC for each business, there were large disparities among businesses; please again explain your thoughts on the optimal business portfolio. Also, the Confectionery & Foodstuffs Business is of particular concern. The target for improving ROIC more than the scope of improvement in the operating income margin is set for the final year of the 2024 Medium-Term Business Plan (MTBP) (fiscal 2026), and I believe you are considering various forms of asset-light management. Please explain your approach and direction concerning this.

A. The graph on page 20 of the briefing materials shows ROIC for the four businesses in our focused domains and the Confectionery & Foodstuffs Business, which is a basic domain. Assets in the Direct Marketing Business in particular are extremely low, and therefore, the ROIC target for fiscal 2026 is an extremely high value while conditions in the Confectionery & Foodstuffs Business are quite challenging. Overall, we will improve both return on capital and growth in an effort to shift businesses towards the upper right of the graph. However, ROIC for some businesses will temporarily decline as a result of investment. We believe that how we structure each of those businesses in the lead up to 2030 and beyond will be a key point.
As you pointed out, ROIC in the Confectionery & Foodstuffs Business is low and the profit margin is also low. We are conducting investigations including phased asset-light management, and we believe that the structure of the chocolate business in particular needs to be changed. In addition to shifting to high-profit products, we are reviewing the lineup including a process of selection and concentration of investment for upgrading manufacturing facilities. We are currently developing measures to achieve a target of ROIC of at least 8% in fiscal 2026.

Q. Is it correct that since you have set a specific ROIC target of at least 8% for the Confectionery & Foodstuffs Business, the direction of what needs to be reduced and what needs to be done has become clear to some degree?

A. Yes, we have formulated measures for each business in order to achieve our targets for fiscal 2026. We believe that there are various factors that will have an impact including whether sales will progress as planned, but these are not excessive stretch targets and are targets that can be achieved in accordance with the plan. The issue now is how we will work towards achieving the targets in each business in a systematic manner.

Q. In the plan for fiscal 2024, the forecast for operating income is 20.5 billion yen, a modest year-on-year increase of 1%, but the operating income target for fiscal 2026 (the final year of the 2024 MTBP) is 24.6 billion yen, and this appears to be a substantial jump. Please describe any opportunities or ideas that you have for substantially increasing income levels in the second and third years of the medium-term plan.

A. We have not disclosed our targets for fiscal 2025, but the 2024 MTBP is a three-year business plan created based on the optimal status of each business in 2030 and was formulated by building up net sales and operating income in each business. The factors that will increase income levels differ in each business. There are various points depending on the business including investment plans, sales growth, and cost reductions, and we purposefully planned the profit levels to be achieved based on these factors. We also plan to increase intangible investment including advertising investment and human resource investment, and consequently, we believe that it will be necessary to take action in order to cover these investments.

At this time, our operating income margin for fiscal 2026 is 10%, and we believe that this target is fully achievable. We will monitor the progress of each plan, and if progress does not proceed as anticipated, we will take further measures including a recovery plan.

Q. Concerning the procurement of interest-bearing debt under the new medium-term business plan (2024 MTBP), the total for investment and shareholder returns is approximately 100 billion yen, and I believe that this is an amount that can be covered with operating cash flows. On the other hand, you explained that you will use interest-bearing debt in an effort to achieve an optimal capital structure. Approximately how much interest-bearing debt did you anticipate procuring?

A. Just as you pointed out, the 2024 MTBP calls for investment of 60.0 billion yen and shareholder returns of 36.0 billion yen for a total of approximately 100 billion yen. In fiscal 2023, EBITDA was approximately 30 billion yen, and consequently, our fundamental thinking is that we will cover this using operating cash as a base. It should be noted, however, that the indicated amounts for investment and shareholder return are our current plan, and as management circumstances change on a daily basis, if an investment project necessary for business development emerges, we will respond in a flexible manner. Also, shareholder returns are set at “36.0 billion yen or more,” and consequently, this figure may increase depending on the balance with the amount of investment.

Furthermore, the procurement of interest-bearing debt is premised on our current estimate for the D/E ratio of approximately 0.11 times based on market value. We do not anticipate that the D/E ratio will change substantially, but the planned investment amount is 60.0 billion yen on a recorded amount basis and we anticipate that the amount will increase on a cash out basis, so we will make adjustments so that we can leverage effectively. We would like you to understand that we will establish a structure such that we can respond flexibly to new investment projects and increases in shareholder returns.

Q. Under your plan for fiscal 2024, by calculating backwards from EBITDA and operating income, it appears that you plan to cover the approximately 1.0 billion yen year-on-year increase in depreciation expenses through increased cost efficiency and other measures. Given the external environment including market conditions for raw materials and the declining value of the yen, how certain are the measures for covering this increase in fixed costs? Also, to what extent is the outlook for the external business environment factored into the plan?

A. In the plan for fiscal 2024, one issue is to what extent the impact of raw materials should be factored in. Raw material prices have changed substantially in the past several years, and recently, soaring cacao-related prices have been a problem. As shown in the waterfall chart of factors affecting operating income, our forecast for fiscal 2024 is that raw material-related expenses will have an impact of decreasing operating income by 4.82 billion yen. Foreign exchange is also an issue. The assumed procurement rate for the fiscal year is 146 yen per U.S. dollar, but we expect some variation in this rate in the future. We formulated a plan to cover these expenses through price revisions and an increase in net sales and to pursue higher income. The shared understanding within the company is that the plan for 20.5 billion yen in operating income is fully achievable.

Q. I would like to ask about the positioning of and your thinking on operating income in fiscal 2024, which is the first year of the 2024 MTBP. The year-on-year increase is set at 1%, which I feel is not high. I believe that the recent increase in prices for raw materials is an ongoing issue, so in the Frozen Desserts Business and the Confectionery & Foodstuffs Business in particular, to what extent will you be able to roll back the effects of soaring prices for raw materials in fiscal 2024? What types of countermeasures will you implement, and what is your thinking on this issue?

A. We already implemented product price increases (for some products in the Confectionery & Foodstuffs Business) in April 2024, but raw material prices are increasing to such an extent that further price increases will be necessary, and we will continue to respond with agility in the future. However, price increases in response to rising raw material costs are conducted after the fact and there is a time lag that makes it difficult to cover all of the increases in costs. We expect that the effects of rising raw materials prices will continue to increase through the second half of this fiscal year, and we plan to pass through the increases to higher prices with agility. We feel that this type of momentum is building throughout the industry as a whole. When we raise product prices, we will thoroughly enhance product strengths and take other measures including reviews of product standards so that consumers continue to recognize the value of our products despite the higher prices.

In the previous fiscal year, during the summer, the Frozen Desserts Business achieved strong performance that can be referred to as an unusual value, and in the fourth quarter, net sales grew substantially thanks to the strong performance of *in Jelly Energy Glucose Boost* and the adoption of English letters for the *HI-CHEW* brand logo to generate interest. In light of this, the plan for operating income in fiscal 2024 may seem insufficient in terms of the numbers, but we are putting together initiatives, including price increases, so that we can do even better than the strong performance in the previous fiscal year.

Q. Based on results in the previous fiscal year, is the business environment more agreeable to product price increases compared to several years ago? Is my understanding correct that retailers and consumers are more willing to accept price increases?

A. Yes, that is correct. There are many makers in the confectionery industry, and until a few years ago, circumstances made it difficult for us to increase prices while competitors did not raise their prices. Today, however, the business environment necessitates price increases, and companies across the board have increased their prices. Under these circumstances, we feel that product strength is crucial. This is particularly true for frozen desserts, where sales of our products have steadily grown despite price increases. We believe that it is necessary to refine product value and have customers recognize that value.

Q. Concerning your plans for this fiscal year for the U.S. Business, the plan provides for a growth rate that is sluggish compared to the previous fiscal year. Can you discuss the specific details of future initiatives for *HI-CHEW* and *Chargel*, including development at high-volume stores?

A. Regarding *HI-CHEW*, we believe that we may have given you some cause for concern, as results from October to December of last year fell below both the non-chocolate candy market average and the previous year's results, based on IRI data (store data). In January to March of this year, we tried to expand SKUs by launching new products and taking other measures, and the most recent IRI data for April indicate that *HI-CHEW* is on its way to recovery, with sales growth of 3.8%, despite the non-chocolate candy market struggling and declining by 7% year-on-year.

For fiscal 2024, we are planning on growth of 9%, just short of double-digit growth, on a local currency basis, that is, on a volume basis. Our number of SKUs is still low compared to other companies, and we believe that there is still room for growth in the number of SKUs handled per store. In the second half of the previous fiscal year, we increased SKUs by six, and this fiscal year we currently plan to increase SKUs by about nine, including event products. Products for which we have high expectations in this fiscal year are gummies, first for the *HI-CHEW* brand, and we recently released two new products. We believe that deliveries to stores are expanding, and that this will lead to higher sales revenue starting in autumn of this year. We have heard reports that at the exhibitions currently being held in the U.S. the products are being extremely well received. By taking steady action to increase the number of SKUs handled per store, such as gummy and other brand extension products, we believe that the plan for this fiscal year is entirely achievable.

Regarding *Chargel*, we mentioned at a briefing six months ago that successful examples were emerging at overseas Japanese supermarkets and other establishments, and that heavy users were developing on online sales channels. It has been six months since then, and the circumstances have not changed substantially, but we are currently conducting a detailed analysis of what type of customers are drinking the products in what situations. In the 2024 MTBP, the scale of sales is not at a level that can be disclosed, and the current situation is similar to when *HI-CHEW* was first released in the U.S. market, but we believe that just as we created a market in Japan, there will come a time when we accelerate business. Our target for the U.S. business for 2030 is net sales of 48.3 billion yen, and we are currently looking into measures to expand sales of *Chargel* in a way that will lead to expanding sales of jelly drinks, which is our second strategy for overseas business. Accordingly, we ask for your understanding.

Q. I would like to ask about the net sales target for the U.S. Business under the 2024 MTBP. The plan provides for net sales CAGR in fiscal 2026 (the final year of the 2024 MTBP) of 116% compared to fiscal 2023, and the plan for this fiscal year is an increase of 9%. I believe that in order to achieve this, growth of 20% in each of the next two fiscal years will be necessary. How do you anticipate achieving the target in the MTBP?

A. We believe that there is still substantial room for growth of net sales, and the priority will be increasing the number of SKUs handled in stores. This fiscal year, we will also launch event products, and gummies will be linked to sales starting in the autumn. Under the 2024 MTBP, we will increase marketing investment including advertising expenditures, and we set targets based on the determination that we will achieve our fiscal 2026 net sales target of 29.7 billion yen.

Q. My question concerns the target for the operating income margin for the U.S. Business under the 2024 MTBP. The plan provides for an operating income margin declining to 13% in fiscal 2026 (the final year of the 2024 MTBP). I believe that investment is in the background to this figure. What are the specific details of the investment? Also, you discussed expanding the scale of the U.S. Business and developing *HI-CHEW* in Europe. What is the background to this decline in the operating income margin even as sales are growing? Will the margin improve under the next medium-term plan? Also, what is your ultimate target level for operating income margin in the U.S. Business?

A. As we explained during the discussion of ROIC (page 20 of the briefing materials) and investment (page 33), we need to reinforce and rebuild production structures so that we can achieve further growth in the U.S. Business, and we plan to invest 15.0 billion to 18.0 billion yen. We revised the U.S. Business net sales target for 2030 upward from 30.0 billion yen to 48.3 billion yen, and we will start building structures during the 2024 MTBP to achieve this. We anticipate making investment towards the end of the 2024 MTBP, and as a result, the burden of depreciation expenses will arise starting in the subsequent medium-term plan. We expect income to temporarily decline, but this is also related to how much we can increase sales by expanding manufacturing capacity. We have not yet announced the details concerning investment in production structures for the U.S. Business, and accordingly, we will disclose this information including the scale of investment when a formal decision is made. In any case, we will take steady measures to achieve the 48.3 billion yen net sales target for the U.S. Business in 2030 and to achieve the target for the overseas sales ratio, which we revised upward to 25% at this time.

Q. My question concerns investment for reinforcing production structures in the U.S. Business. Is it correct that the planned 15.0 billion to 18.0 billion yen investment is the total relating to the reinforcement of production structures, or is this the initial investment amount with additional investments to be made later?

A. We have not yet made a formal decision, but we anticipate total investment of 15.0 billion to 18.0 billion yen for reinforcing production structures. Of course, this amount is subject to change in the future. Developing production structures involves the construction of plants, and we would like you to understand this to be investment in an entire plant, not just a portion of a plant.

Q. I would like to ask about ROIC in the Confectionery & Foodstuffs Business. I believe that structural reforms in the chocolate business is a key point, but can you discuss a little more specifically the measures for improving capital efficiency?

A. The chocolate business is currently facing a challenging business environment including soaring prices for cacao beans. First, it will be important to develop high-profit products and shift our product mix, but we believe that this alone will not be enough to cover the higher costs. We are currently looking into a variety of measures including raising product prices and reviewing the product lineup as well as increasing or streamlining the operation of our multiple manufacturing lines. We have set an operating income margin for the Confectionery & Foodstuffs Business of 10% in 2030, and the ROIC target for fiscal 2026 is at least 8%. These targets were set based on the measures that we are currently investigating, and although we are unable to disclose the specific measures at this time, we are working steadily towards achieving our targets.

Q. Rather than improving profitability by discontinuing some brands, do you anticipate reducing SKUs?

A. We have numerous brands and products, and we also have manufacturing lines, and for this reason, we believe that we have a variety of options other than reducing SKUs. In any case, we plan to implement measures to raise ROIC and increase profitability.
