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# 【Q&A Session Minutes】

## Presentation on 2Q FY2020 Financial Results

Date: August 11, 2020 (Tue), 10:00-11:30

Presenters: Yoshinori Isozaki, President & CEO; Noriya Yokota, Director of the Board, Senior Executive Officer & CFO; General Manager of Corporate Planning Dept., and General Manager of Accounting Dept.

Q. With regard to the Japan Beer and Spirits Businesses, I feel Kirin focused on home use early on. I am wondering, however, whether accelerating growth in the new genre in the next fiscal year and beyond will lead to a future profit pool or not. When you think about management in the beer market, which do you think has more potential, to go for cans for home use or *Tap Marché* to take up the decline in on-premise? Can *Tap Marché* still be advantageous about profitability over traditional on-premise beer even if other craft brewers' beer are sold?

**Isozaki:** With regard to Japan beer business, we will be more focused on expanding cans of *KIRIN ICHIBAN*. Unlike the global beer market, home use is more profitable in Japan. We will also be acceletating *Tap Marché*, to be sure, but when we are asked which to more focus on, we will focus on *KIRIN ICHIBAN* for home use, considering the impacts of the COVID-19. However, there is still some time before the unification of liquor tax on beer products, so we will continue to strengthen the new genre, which is growing at a double-digit rate, taking into account factory utilization rates and other factors.

Q. Now that there have been significant changes in the Japanese alcoholic beverages market, you should move forward with the Health Science business plans, shouldn’t you? Will *Lactococcus lactis strain Plasma* be available only under the Kirin brand? Moreover, will it a catalyst for further evolution in collaboration with FANCL CORPORATION? I'd like to hear your in-depth thoughts on the collaboration with FANCL, including the additional acquisition of shares.

**Isozaki:** By the registeration of *Lactococcus lactis strain Plasma* as Foods with Functional Claims with Japan’s Consumer Affairs Agency, we will be able to labeling it in our products. We will continue to accelerate the pace in this area. Regarding collaboration with FANCL, we do not intend to limit to Kirin brand, but would like to expand the brand to FANCL as well. We will accelerate the collaboration in order to make it a certain mass product. We would like each company to select the most appropriate brand for their respective products. With regard to additional investment in FANCL, our first priority is to create synergies so that investors and our shareholders will be able to better understand the investment.

Q. Can I expect to see an increase in sales in the next fiscal year or later by the registration of *Lactococcus lactis strain Plasma* as Foods with Functional Claims?

**Isozaki:** Due to regurations, we cannot claim immunity in our current products. We have to show that the product is different from the previous one, so we aim to change the package as soon as possible.

Q. I think it's a very good initiative to take a comprehensive review at Kirin in its current state. I would like to know Kirin Holdings' strengths and weaknesses that were found in it. I believe that the answers to these questions will lead to cost reductions and transformations in the future.

**Isozaki:** In the current challenging circumstances, we have conducted a review of our strengths and weaknesses. Here I would like to point out three of our strengths.

First, when compared to other Japanese and global breweries, the decisive difference is that we have not confined our Fermentation and Biotechnology to the alcoholic beverage business. We have our own technological capabilities to pursue, launch Pharmaceuticals and Health Science businesses, and commercialize them. In regards of our research, *Lactococcus lactis strain Plasma* was registered as Foods with Functional Claims for the first time in history in the field of immunology by providing scientific evidence. We believe this is another result of our efforts to pursue our Fermentation and Biotechnology.

On a different note, the former CEO of Amgen, now one of the world's leading biopharmaceutical companies, commented on Kirin's high level of technology: "Kirin has excellent fermentation technology, and they understand the importance of R&D. For most breweries, brewing is an ‘art’, but Kirin is the only company that has taken in the ‘science’. They entried to the market with biopharmaceuticals at a time when small-molecule drugs were the mainstream, and their pharmaceutical business has grown by leaps.” In addition, Charles A. O'Reilly's recent book, "Lead and Disrupt: How to Solve the Innovator's Dilemma," mentions Kirin's pharmaceutical business as an example of the first part of the book.

The second is the capability of consumer centric marketing expertise. Taking the example of its Japan Beer and Spirits Businesses, even before the impact of the COVID-19, we have been strengthening our brands earlier along the consumers’ trend toward lower–price products, health-conscious products, and preference diversification. From early on, we have also recognized the importance of the home use market. For lower–price products, we have strengthened new genres such as *Honkirin* and *Nodogoshi*, and for health-conscious consumers, we have strengthened happo-shu, such as *Tanrei Green Label*. Regarding the diversification of preferences, we believe that our ability to build a strong portfolio in the beer category, including cans of *KIRIN ICHIBAN* and craft beer, is evidence of consumer centric marketing expertise.

Third, we have the ability to control costs. Faced with the current crisis, I immediately issued a cost control order, and we expected to cut costs by about 25.0 billion yen at once. This figure did NOT include the automatic decrease in costs caused by the restriction of activities due to the COVID-19. I believe that our employees' organizational strength, culture, and ability to work together as a team and push forward against the crisis are our great strengths.

Q. While you have revised downward full-year forecast for normalized operating profit to 140.0 billion yen, when do you think you will return to the 190.0 billion yen level of normalized operating profit for FY2019?

**Yokota:** While it is difficult to predict at this point when the COVID-19 impact will end, but we expect the impact to continue until around FY2022, and we hope to aim for FY2019 levels in FY2023. One thing to keep in mind, however, is that we believe the market will not return to its original form and that customer preferences and behavior will change significantly. Therefore, in order to return profits to or exceed FY2019 levels, we must improve our performance in areas that strengthen our management resources.

The key to this is our strengths, and we believe that one of those strengths is our technological capabilities. A major example is our Pharmaceuticals Business, which is still growing steadily in overseas sales, although there is a slight delay due to the impact of the COVID-19. There is no change in Kyowa Kirin's goal of achieving its mid-term profit target of ¥100.0 billion in core operating profit by the earliy stage of their MTBP to start from 2021, and we expect to see growth by leveraging its technological capabilities. In marketing and brands, we have strong brands for alcoholic beverages and beverages, especially Kirin Brewery, and FANCL, in which we have invested. In Health Sciences Business, we have competitive advantages in materials that is belonged to Kyowa Hakko Bio and *Lactococcus lactis strain Plasma*, and we intend to expand sales by taking advantage of these strengths.

Although I cannot provide specific quantitative targets, we believe that these will be major growth drivers, and we will utilize our technologies and brands to achieve growth by addressing the issues of consumers and markets in the New Normal and return to FY2019 profit levels as soon as possible.

Q. What is your outlook for the Japanese beer market over the next three to five years? Sales volumes might not returned to the level before the COVID-19, sales prices are uncertain, and there could be significant changes in the competitive environment. I believe that profit margins for the industry as a whole will increase in the short term due partly to cost reductions, but looking ahead, if sales volumes keep declining, will reorganization be irresistible?

**Isozaki:** Sales volumes of beer products have continued to decline since peaking in 1994, and we believe this trend has been spurred by the COVID-19. As a management, when I take a sober look at the future of the market, I believe that the COVID-19 has changed people's lifestyles and this will not return to the old normal, and I expect the market to continue to shrink. It may stop falling at some point, but the fact is that it has been declining for nearly 30 years. I expect so not only due to the impact of the COVID-19, but also to a variety of factors, including the diversification of consumer preferences. We are working on this, but I don't know what the outlook is for the future. Japanese breweries have each strategies, and will continue to implement bold cost-cutting measures and price increases, but there are limits to what they can do by themselves. If sales volume declines significantly, fixed costs will become a major burden, and the break-even point is expected to rise. In those curcumstances, each company will not only restructure by themselves, but will also consider restructuring involving other companies, and we believe that the competitive environment in the industry will be completely different in five years.

<u>Q. You mentioned that you aim to return to the FY2019 normalized operating profit level in FY2023. What is the breakdown by segment? Will the progress be different depending on segment?</u>

**Yokota:** We have conducted various simulations for each segment and are in dialogue with each operating company. The companies intend to recover to their previous normalized operating profit levels in FY2023. As we have just begun discussions, we have not yet clarified details, such as the difference between the ratio of on-premise and home use. In the Pharmaceuticals domain, we expect the level of profits to continue to rise and to reach 100.0 billion yen in core operating profit in the near future. Therefore, even if there is a delay in recovery in the Food domain, the Pharmaceuticals domain will be able to cover it.

<u>Q. What are your thoughts on the future competitive environment and profit pool? I think it is important that how you consider the competitive environment going forward for securing profits in the Japanese and Australian alcoholic beverage markets. What do you think the competitive environment for Japanese and Australian alcoholic beverages will be over a 3-5 year time horizon?</u>

**General Manager in charge:** Total volume growth is unlikely to be assumed in both Japanese and Australian markets. Therefore, we need to improve the product mix, but it will be difficult to achieve it in the short term and we will take a medium- to long-term view. In Japan, the first revision to the liquor tax will take place in October this year. We will accelerate our efforts so that we can use this as an opportunity for growth. Specifically, we will develop strong brands, focusing on *KIRIN ICHIBAN* and *Honkirin*, and we believe that there are opportunities for craft beers as well. We recognize that improving the profitability of RTD is an issue for management, but we will accelerate our efforts to improve the products mix, such as by launching high value-added RTD that meets changing consumer preferences.

**General Manager in charge:** The Australian alcoholic beverage market was heavily impacted to profits by lower sales in the on-premise channel. The product mix in the home use channel has also deteriorated due to a return to classic category staple brands. Despite the temporary impact of the COVID-19, Lion will continue to pursue its premiumization strategy. We will work to strengthen its brand equity in Australia and New Zealand, including laterally deploying the knowledge of Kirin Brewery's marketing activities, tailoring it to the Australian market.

Q. Do you also need to raise prices to make profits sustainable? Will the situation where price increases are not possible due to the other players' price competition for recovery from COVID-19 impact?

**General Manager in charge:** It would be nice if we could raise prices, but with the number of players remaining the same, we need to strengthen our cost competitiveness and increase profit margins at first.

**Isozaki:** Raising prices is one of our options, but there are things to do first. What is easier to do than raising prices is to control sales promotion expenses. Raising producer prices is not easy, because we're not dealing with our competitors, but our wholesalers, retailers, and so forth. Even if it is achieved, it will take time. On the other hand, when the guidelines were revised, Kirin Brewery took an initiative. I believe there is still potential for restricting sales promotion expenses. The same is true for the on-premise channel, and we believe that there are some solutions to solve this matter for the home use channel in overseas markets as well.

Q. With regard to the Japan Non-alcoholic Beverages Businesses, you explained about structural reform of vending machines channel and SKU reductions, and what are you thinking about in terms of ways to reduce vending machine fixed costs other than withdrawing unprofitable machines? Please tell us if there were any changes in your thinking as a result of the COVID-19, such as reducing the ratio of direct sales and changing operations. Moreover, what is the quantitative benefit of the 20% reduction in SKUs?

**General Manager in charge:** We do not expect vending machine sales to return to the levels before COVID-19 as working-from-home expands. The measures will include reducing fixed costs and withdrawing from unprofitable machines that we have presented to you. The number of vending machines, which was approximately 220,000 at the end of June last year, has been reduced by about 4,000 over the past year. However, sales of vending machines have fallen by about 20% with the impact of COVID-19. Therefore, we will rethink fundamentally the number of vending machines we have installed. We will also implement structural reforms in terms of locations, contracts for new installations, and related fixed costs. We are currently collaborating with Asahi Soft Drinks in the area of machine maintenance, and we are ready to expand the alliance to cover functions that can be shared. In addition, we currently have SKUs dedicated to vending machines, but it will review these SKUs in light of the 20% reduction in SKUs.

Q. In regards of the Oceania Integrated Beverages Business, you once mentioned that selling the Dairy and Drinks Business would not reduce Coporate costs, but with plans to reduce costs at this time, what kinds of initiatives will be taken for the supply chain reform? I would also like to know why the delay in the sale of the Dairy and Drinks Business.

**Isozaki:** We will radically review our supply chain, and as a manufacturer, we will review fixed cost reductions across all divisions. In addition, we will introduce SAP in Australia, following in New Zealand. We believe that productivity will be improved by making our operations more efficient. We have made the agreement with the company to which we are selling our Dairy and Drinks Business. We are in a position to sell the business if the Australian authorities give us permission to do so.

Q. With regard to the Japan Non-alcoholic Beverages Businesses, you state that you will "continue to seek alliance opportunities," and could there be opportunities for more drastic alliances that go beyond traditional alliances such as vending machine column exchanges and operational collaboration? I would also like to hear your thoughts on whether the vending machine alliance could be a catalyst for the effects of the alliance to spread to the Japanese beverage industry, not only in the soft drink industry, but also in a broader sense, including alcoholic beverages.

**Isozaki:** As for the Japan Beer and Spirits Businesses, the answer is the same as for the previous question.

With respect to the Japan Non-alcoholic Beverages Businesses, an alliance in the maintenance area of operations is in place with Asahi Soft Drinks. In the vending machine channel, sales volumes have fallen by 20-30% due to the impact of the COVID-19, which has had a significant impact on the each beverage companies. There is nothing that we can say about an alliance at this time, but if other companies are interested in, we would definitely consider it. Looking at the market as a whole, we believe that it is not good that profits are difficult to be generated in the Japanese market where there are so many players. The industry should be restructured in some way to create an industry structure that can properly generate profits. There are concerns in the beverage industry as a whole, broadly defined, that if the beer industry remains as it is, the break-even point will rise and profit margins will deteriorate in five years. If the industry does not restructure itself, including its fixed costs, either on its own or in partnership with other companies, Japanese breweries will become less attractive to the world.

Q. The Oceania Integrated Beverages Business is in a duopoly market with a market structure that is owned by Japanese companies. Kirin Holdings has the top share in Japan and Asahi Group Holdings has the top share in Australia. Kirin has been successful in adopting a strategy that caters to consumer preferences in Japan, but is there any risk that the way you fight in the Japanese market (e.g., by lower prices) will be carried over to Australia market?

**Isozaki:** We would like to make the Australian market a profitable one as well, but we believe it will not be easy, as the market once enjoyed the benefits of the current low prices. However, we would like to respond with a profit-oriented approach.

Q. Kirin Brewery plans to continue to invest in fixed sales promotion in the second half of the fiscal year, and while many companies are trying to control costs, your strategy of strengthening its brands is excellent. What are your thoughts on this strategy and what is your outlook for the next fiscal year?

**General Manager in charge:** First of all, I would like to reiterate that we are not aiming to grab sales volume by spending variable sales promotion expenses, which are the source of price reductions, but rather to implement sales promotion measures to strengthen our brands as planned at the beginning of the year. With regard to fixed sales promotion expenses, we have been cutting back on the on-premise channel every year. It is difficult to save a big sum immediately even if the COVID-19 impact come out, we will continue our efforts to cut costs and create a new business style for on-premise channel. With regard to the home use channel, we believe that beer products will be affected first by the liquor tax revision in October. Even with impact of the COVID-19, our *KIRIN ICHIBAN* cans are performing well. We have been implementing measures in accordance with our 36-months long-term brand plan, and we will continue to strengthen the brand from a medium- to long-term perspective. In addition, RTD is a growing category that seems less susceptible to the negative impact of the liquor tax revision. We are investing in brands from a medium- to long-term perspective, and we will continue to work on these brands from the next fiscal year onward without changing our strategy. As we explained earlier, we believe it is possible to improve efficiency, particularly in selling expenses, and we will continue to work hard on it.

Q. How big do you think the market size for high value-added RTD is?

**General Manager in charge:** The competitive environment in the RTD category is tough, and it is difficult to improve the product mix with existing brands alone. We believe that there are many ways of launching high value-added products, for example, we could develop flavors that are health-conscious and drink at home. We would like to try it with products that are different from the current trends.