

January 27, 2023
Canon Marketing Japan Inc.

Questions and Answers at Briefing for Analysts on Financial Results for FY2022
and Medium-Term Management Plan 2022 to 2025

Date and Time: January 27, 2023, 16:00-17:30

Format: Zoom webinar

Presenters:

- Masachika Adachi, President
- Hatsumi Hirukawa, Director and Vice President (in charge of group planning and group communications)
- Tsuyoshi Osato, Director and Vice President (in charge of group accounting)

【Q1-1】

Can you provide some additional information about investment in growth in the Medium-Term Management Plan? You mentioned engaging in proactive investment, but looking at the 2022 results, while there were many projects, in monetary terms it seems like not a lot of the allocation has been used. How do you look back on the growth investments made in 2022? And what are thoughts on expanding investments from 2023 and beyond?

【A1-1】

The investments in growth we made in 2022 may not have been sufficient from a monetary perspective, but the business investment projects in which we took part have broadened in scope, and we believe a great deal of progress has been made by putting those plans into action. This year, we hope to allocate large amounts to investments, including M&A. We have also considered investing in the data center business and have been implementing proposal activities, but those plans have not yet borne fruit. Progress on a second building is good, and we hope to accelerate investment in the third and subsequent buildings.

【Q1-2】

My understanding is that in the consumer segment, special circumstances up to 2022 make it easy to generate gross profit from both cameras and inkjet printers. As the situation normalizes in the future, how should we think about the risk of profit margins declining due to expanding SG&A expenses and other factors?

【A1-2】

For both cameras and inkjet printers, we have developed appropriate proposals and ensured profits by improving or maintaining sales prices. As we will also be running in-person exhibitions and other such events in 2023, overall SG&A expenses may increase slightly. Our camera business is performing very strongly, and since we released new products in the latter half of the previous year and have also increased the types of lenses available, we intend to maintain profit margins. Meanwhile, in anticipation of the future, we are making investments in IT and other areas as a product of considering how we will connect with customers going forward. Taking those perspectives into account, it may be difficult to maintain similar profit margins to the previous year in the consumer segment overall.

【Q2-1】

I think rising purchase prices were particularly common during Q4 of 2022. Can you lend some quantitative nuance to what extent was this the case in FY2022, and to what degree you expect purchase prices to rise this year?

【A2-1】

We cannot disclose specific numbers, but last year particularly with consumer products we passed on higher purchase prices to sales prices, and therefore managed to ensure appropriate profits. On the other hand, since we operate under yearly agreements for B-to-B products, we have not been able to adequately pass on the increases to sales prices. For this reason, in 2023 we believe we will be able to achieve a profit turnaround by passing on the higher purchase prices to sales prices. However, since this will involve negotiations with customers, in some cases it can be implemented immediately, and in other it may take time.

【Q2-2】

What is your sense of the direction that the increase in purchase prices itself will take when comparing 2022 with 2023?

【A2-2】

There are goods whose prices rose in 2022, and there are goods whose prices will rise in 2023. We do not expect significant increases in purchase prices in the future, unless there are extreme spikes in raw material costs including cost for semiconductors, energy costs or logistics costs. We do believe there is a risk of price increases, as the prices of devices and software made overseas, including Canon products and products purchased from outside

sources, could rise in complicated ways in the short term. However, in the current fiscal year we do not expect prices to increase as much as they did last year.

【Q2-3】

Regarding information disclosures, we have a deeper understanding thanks to the detailed comments you made about developments in each business, including matrix tables for each segment of sales in the IT solutions business, and Edge SOL. This is appreciated. Regarding the graph on page 23 of the Medium-Term Management Plan, you plan to significantly expand SI services this fiscal year. What is the background to this?

【A2-3】

SI services performed extremely strongly the year before last and last year. These services were originally focused on financial customers, but starting last year, we also managed to secure orders for major projects from manufacturing and distribution customers. We think this segment will also perform solidly this year and have set ambitious targets, but in addition to developing each SI product one at a time and then rolling it out across an organization, we hope to transition to a service-based model. By doing that, we will be able to increase recurring IT revenue from maintenance and operations services. We will increase SI services a little, and the service-type offerings in the middle of the graph will grow. That is the plan we have formulated.

【Q2-4】

Will Edge SOL and the parts of the healthcare business that were transferred help increase SI services?

【A2-4】

Yes.

【Q2-5】

With the business model itself changing into maintenance, operation and recurring revenue, if you are able to grow SI services this much in FY2023, do you think there will be room to grow further up to 2025?

【A2-5】

It will be important whether we can take what we created well with SI services in 2023 and roll it out to other industries. We think we can use applications for major companies as an SI

core and redeploy them in a service format to quasi-major and upper-medium-sized companies. The issue is how to secure SE resources, but we will try our best to meet expectations by engaging in SI development for specific projects and then transitioning those outcomes into service-oriented offerings down the road.

【Q3-1】

I would like to ask about the positioning of industrial equipment in the professional segment. In Q4, the professional segment earned an operating income of 100 million yen on net sales of 8.4 billion yen. Last year this figure was 500 million yen, so profitability has deteriorated significantly. In the full-year forecast for this year, you expect to generate 44.9 billion yen in net sales with operating income of 3.4 billion yen. When predicting financial results for this year, the quarterly results are not stable, depending on what happens with industrial equipment. Operating income in Q1 last year was 2.2 billion yen. In Q2 it was 1.9 billion yen, then 1.0 billion yen in Q3 and 100 million yen in Q4. Going off the current semiconductor environment, no profit will be generated in Q1 and Q2 of this year, with the possibility of a 20% reduction in operating income, and the expectation of a recovery in the second half of the year. You mentioned that the current slowdown may be temporary, but it seems that Q1 and Q2 of 2023 will be quite tough. What are your thoughts on this?

【A3-1】

For industrial equipment, last year we dealt with major projects, and those drying up will have a significantly negative impact on profits overall. When looking at our sales activities, we can see that the projects recorded in our results for the first half of the year were those whose orders were completed in the previous year. Even recently, we are receiving orders for the second half of this year and even next year. The state of the semiconductor market is good for power semiconductor systems but difficult for memory-type semiconductors. Overall, therefore, the situation is mixed. We are pursuing activities to win new orders while selecting projects. As we purchase goods from overseas, delayed deliveries are somewhat of a concern, but we hope to eliminate those issues by conducting activities to secure orders well ahead of time.

【Q3-2】

Do you have any sense of operating income in the first and second halves of the year?

【A3-2】

As President Adachi noted, as there are quite a lot of projects in the industrial equipment

business where we have already made deliveries to customers, we do not see operating income dropping sharply in the first half of the year. While we don't expect to produce numbers on par with last year, our basic expectation is that the first half of the year will perform stronger. As we have plans to import, install and deliver overseas products going forward, we are worried that if those products are delayed, it could have an impact on the second half of this year or the first half of next year. For that reason, as President Adachi explained earlier, we will conduct activities to speed up the process for receiving orders.

【Q3-3】

What are your thoughts on where the 100 million yen operating income achieved in Q4 last year fits into the big picture? This is quite a low figure. Is this simply because too much business was recorded in Q1 and Q2?

【A3-3】

In monetary terms, our performance in Q4 last year was not at a sufficient level to maintain profit. We think it is important to increase this amount. This is not to suggest that we won projects with low gross profits in the industrial equipment business. If anything, we did win major projects in the healthcare field and that impact has become apparent. As sales from industrial equipment are slanted towards the first half of the year, we would like you to understand that Q4 profits look weak.

【Q3-4】

The third data center building was mentioned. The launch of the first building went badly, but the second building has gone very smoothly. What is your approach to investing in the third building in terms of ROI, ROE and the sense of scale?

【A3-4】

Compared with the first building, we were able to sign agreements for the second building at a good tempo. The fact that we had agreements in place before it was constructed was a positive. For the third building, we hope to find a property as soon as possible and begin sales activities at an early stage. We will obtain contracts that we can add as much value as possible. Unfortunately we cannot share details, but that is the basic direction in which we are headed.

【Q3-5】

What is your policy on shareholder returns? The dividend payout ratio is approximately 30%

and Canon MJ is flush with cash. Are you able to consider a dividend payout ratio of 50%?

【A3-5】

We decide dividends based on comprehensive determinations that include profit and medium-term plans, working within a policy of maintaining a dividend payout ratio of at least 30%. We will continue to hold to this policy of at least 30% while gradually increasing the monetary amounts in absolute terms. As a result, please think of the dividend payout ratio as something that will increase.

【Q4-1】

Personnel expenses declined sharply in FY2022 as a percentage of SG&A expenses. Why did personnel expenses decline in comparison to the previous fiscal year?

【A4-1】

There are two factors behind this decrease. The first is a decrease due to natural attrition of personnel. The other is a significant decline in expenses from retirement benefits. With retirement benefit expenses, the differences in actuarial calculations have upward or downward effects, and last year they worked to affect a decrease.

【Q4-2】

I assume the natural attrition part will continue this fiscal year, but should we think of the retirement benefit expenses as a one-off factor?

【A4-2】

The difference in actuarial calculations went in the negative direction last year, and as these figures fluctuate from time to time, there is also a possibility of movement in the positive direction. Under current conditions, we do not expect a decrease on the level of last year in 2023.

【Q4-3】

Regarding industrial equipment in the professional segment, the number of new semiconductor plants coming online around the world has increased, and I assume you are fielding consultations in relation to them. Is the ratio of contracts involving resident or maintenance services not that high? Since we heard last year that there were severe business swings in this segment, I get the sense that this has not translated into recurring business.

【A4-3】

In our Medium-Term Management Plan, and as VP Hirukawa mentioned, for industrial equipment we have developed a recurring-based business of multi-vendor maintenance. However, in the healthcare segment we are pursuing electronic health record projects as prime contractor. If these projects expand they will result in stable earnings. Production printing is another segment that features very stable earnings. In commercial printing, digitalization has gradually made progress in Japan, and we want to properly expand this area without being left behind.

【Q4-4】

In the industrial equipment field at the moment, what is the ratio of recurring business?

【A4-4】

We do not disclose information on specific ratios, but the ratio has steadily grown.

【Q4-5】

Should we think of it as having gradually stabilized?

【A4-5】

Internally I've given instructions to grow it even more, but since this is something that involves customers, so instead of a rapid increase, please understand that it is something we want to solidly build upon.

【Q5-1】

With electricity and gas rates on the rise, things could get difficult in terms of consumers' disposable income. Particularly in relation to cameras, what impact do you think rising energy prices due to inflation will have on demand?

【A5-1】

We have pursued a number of initiatives at our offices and elsewhere, and have managed to absorb the higher energy costs. I think the biggest impact is at our data centers. As we cannot absorb all of the higher costs there, we want to think about passing on some of the increase to sales prices.

【Q5-2】

Regarding cameras, what is your take on the risk that consumers may be less willing to spend?

【A5-2】

We don't see it as that big a risk, but it will probably be tougher in the inkjet printer segment. For cameras, there are still some customers on the waiting list for the EOS R6 Mark II, so at this stage we do not see signs of an extreme drop in consumer appetite. As you pointed out, if the energy risks increase further, customer willingness to purchase a camera should take a lower priority, and the risk of that is not zero.

【Q5-3】

Maintenance services fell 1% in this period. Is this 1% decline because you are doing things different from the past, such as increasing maintenance services for specific industries? Previously, the reason was cited as large print volume for specific industries. Is there any change to the situation now?

【A5-3】

As we experienced supply constraints for office MFPs, customers had to wait to make replacements. We plan to recover from those supply constraints from March onward. We will actively increase the number of color MFPs in operation and address the decline in the print volume per unit. For LBPs, we have narrowed our targets to specific industries with high print volume, and our moves are aimed at increasing the number of units in operation and controlling the decline in cartridges. We will continue to operate as we have been doing. In commercial printing, since we see an increasing trend of companies wanting to do their printing in-house, we will appropriately launch suitable new products. As the ratio of color will increase when we make proposals for optimal allocation based on in-house commercial printing, our strategy is to increase maintenance unit prices and link it to profits, and we will also increase the number of units themselves. Through these activities, we hope to keep the decline in maintenance services and LBP cartridges to only a slight decrease.

【Q5-4】

Regarding the ITS business, what is behind the continued strong performance in the security segment? Is it demand, or market share? Why is it continuing to perform strongly? Other companies have rolled out these services to businesses that have installed their office MFPs, and they disclose the development rates. Please share how much progress Canon

MJ has made developing these customers.

【A5-4】

The security market is strong. While we do engage in cross-selling with small and medium-sized businesses in the Area segment, in many cases we first gain customers from security, IT infrastructure or PCs and then deliver MFPs to those customers. This is particularly common at Canon System & Support Inc. Even within the Area segment, among partner businesses IT products are often introduced to customers who have installed our MFPs.

【Q5-5】

Would it be correct to assume that there is still room for further development?

【A5-5】

Yes.

【Q6-1】

As an investor I would like to express my gratitude to Canon MJ for further enhancing its disclosures this time, and for making it easier to understand what is happening at the company.

Regarding investment in data centers, with construction costs and electricity prices increasing, the running costs for building data centers have gone up. I understand that it has been more stable with the second building than the first, but the ROI of the second building is uncertain. I also think the construction costs for the third building will go up, and I would like to know what its ROI will be compared with the second building. Will it be around the same level, or should it be seen more optimistically as something that could improve? Please share as much as possible about the ROI for the third building.

【A6-1】

We are not able to go into specifics, but as you pointed out, we understand that various costs including materials, personnel and energy are on the rise. On top of that, we believe it comes down to raising profitability so that we can firmly provide added value, and we are constantly researching how to raise efficiency at our data centers. At the same time, we are also looking at the demographics of customers at data centers. We want to achieve more profitable data center operation.

【Q6-2】

Regarding capital efficiency, you have declared ROE targets but they have become a formality. Proactive capital investment is one of the main avenues of cashflow, but little progress has been made with capital investment, and you have fallen behind on your plans. Looking at the balance sheet, you have accumulated cash. Despite the business going in an extremely good direction, ROE has not improved as much as expected. To further improve capital efficiency and ROE in the process of enhancing corporate value, don't you think it would be better if management decisions were made with a little more awareness of ROE and ROIC during phases when capital investment has not gone well enough?

【A6-2】

As you noted, ROE is recognized as an important KPI for Canon MJ. We are keenly aware that the accumulation of cash in the balance sheet is not leading to investment. As we are strongly aware of our plans to implement investments on the order of 200 billion yen, behind the scenes we are making preparations to truly accelerate investment. In addition, to increase ROE, it is important to improve the net margin on sales that is a component of it, and the entire top management team is pursuing activities with an awareness of the need to raise net profit.

*The content reflects some additions and modifications to enable it to be better understood.

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