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Major questions and answers for the explanatory meeting for business results for the third quarter ended December 31, 2022

Date:	Friday, January 27, 2023, 16:30-17:30	
Participants:	Keiichiro Shiojima	Vice President and Executive Officer & CFO
	Hidehiko Matsui	Executive Officer & CMO
	Eiji Fukunishi	Executive Officer & President of Spare Parts & Service Business Unit
	Toru Sugiyama	Executive Officer & Vice President of Mining Business Unit
	Tatsuya Kubo	President of Corporate Brand & Communications Group

※Some excerpts are included in this report.

1. Business Performance and Financial Condition

Q: What is the reason for the upward revision of the full-year forecasts for revenue and adjusted operating income?

A. Shiojima: In 3Q, we were concerned about procurement and logistics risks, soaring material costs, and shipping and other freight costs, but, as a result, although it has not been smooth sailing, we have managed to keep production on track. The increase in material costs has also been absorbed by selling price increase. Logistics risks continue with the use of (some) charter ships, etc., but these were offset by (overall) increased sales, resulting in a year-on-year increase in both revenue and adjusted operating income in 1Q-3Q.

Revenue increased in all regions except China, and exceeded internal forecasts, especially in North America, Asia, and Australia. In addition to new machinery sales and parts and services of the mining business, the value chain business also exceeded internal forecasts, and we have revised full-year forecast upward in light of the fact that the risks incorporated in the previous forecast are no longer unwarranted.

Q: Regarding the breakdown of sales volume, model mix, and others in "Comparison of consolidated income forecast," how has it changed since the previous forecast?

A. Shiojima: The change in sales volume (previous: ¥0.7 billion→current: ¥17.5 billion) reflected the increase in income resulting from the upward revision of revenue forecast. The value chain composition difference (previous: ¥11.4 billion→current: ¥8.6 billion) was reduced due to an increase in new machinery sales. The other model mix difference (previous: ¥-5.3 billion→ current: ¥-21.6 billion) takes into account increased shipping and other freight costs (previous: ¥-14.0 billion→current: ¥-15.0 billion) and higher unrealized inventory gains due to higher-than-expected intermediate and local inventories caused by delayed shipments and other factors. The other regional product composition (excluding logistics costs and unrealized inventories gains) is a factor in the year-on-year increase in income due to growth in North America and mining, but the increase in the sales composition ratio of compact products due to reduced procurement risks and other factors has reduced the increase from the previous forecast.

Q: Please explain the reasons for the downward revision of the full-year forecasts for income before income taxes and net income attributable to owners of the parent.

A. Shiojima: This is due to the impact of impairment losses resulting from the default of a rental company in North America and foreign exchange losses. In anticipation of the new medium-term management plan, we are completing actions for each of these matters during the current medium-term management plan period. One example is revision of the pension plan. We have been discussing and preparing for this with the labor union for quite some time, but we had to wait for the right moment due to the large amount of losses in accounting. In light of the current strong performance, we decided to revise the pension plan during this fiscal year.

Q: To what extent do you expect the impact of higher material and shipping and other freight costs on your business performance to be mitigated in the next fiscal year?

A. Shiojima: Currently, we are finalizing the outlook for the next fiscal year and the contents of the new medium-term management plan. Regarding shipping and other freight costs, we have the impression that container vessel prices have returned to normal. However, shipping and other freight costs are increasing due to special chartering of shipment to make up for production delays that have occurred to a certain extent. The situation does not warrant optimism going forward.

Material costs are under control compared to the forecast at the beginning of the year, and steel prices are also calming down. On the other hand, fuel costs are on the rise, and we are concerned about the impact on procurement prices. We are not optimistic about material costs. We think it is conservative to assume that shipping and other freight costs for the next fiscal year will be flat compared to the current fiscal year. It is also necessary to estimate the possibility of a further rise in material costs. We are still examining all of these factors and cannot give specific figures.

Q: I understand that a default has occurred at a North American rental company, which is an equity-method affiliate, and I would like to know the details.

A. Shiojima: We are currently in discussions with the company and cannot provide further details. While the joint venture agreement with Deere was in place, there were restrictions on sales activities in North America, but the rental business was outside of the restrictions. Therefore, we took a 33.3% stake in the company in 2018 in order to enter the rental business in North America. Initially, the plan was to increase our stake in the company in stages. However, as we began to develop our own business in the Americas and reviewed our business strategy, we had a difference of opinion with the company’s management regarding its management policy. We decided to cancel the phased investment plan, and, while we were discussing the future direction of the company, a default occurred, and we made a subrogation payment on the company’s debt. We are currently discussing how to respond to this situation. We will continue to make a firm commitment to the rental business in North America.

Q: Is the deterioration in operating cash flow due to the treatment related to equity-method affiliates?

A. Shiojima: That’s right, due to subrogation payments of ¥53.5 billion. In addition, inventories were about ¥30 billion higher than previously estimated, causing working capital to increase.

2. Outlook for the Construction Machinery Market and Mining Machinery Market

Q: While there are concerns that the U.S. and European housing markets are weakening due to rising interest rates, dealer inventories are still tight. Do you see a slowdown in demand on the sales front?

A. Shiojima: In North America, the start of independent development is strong. Dealer inventory levels are still low, and demand from dealers is strong, including for the next fiscal year. Although there are concerns about inflation and rising interest rates, customers have a large volume of work, and we expect busy conditions to continue into the next fiscal year. The same is true in Europe, where the level of dealers' inventories is not sufficient, and we continue to receive strong requests from dealers. We will make preparations to ensure supply in the next fiscal year.

Q: The North American housing market was soft in 3Q, but, when combined with the non-residential market, will the total demand in North America for the next fiscal year be positive compared to the previous year? In Europe, there is little sign of slowdown at the moment, but what is the outlook for demand in the next fiscal year?

A. Matsui: Regarding North America, housing starts are soft, but commercial and public works are strong. Demand for hydraulic excavators in North America decreased year on year in 3Q, but overall demand has not declined. Sales in North America are expected to remain strong due to strong inquiries from both dealers and end-users because of replenishment of dealers' inventories and other factors.

In Europe, demand did not decline in 3Q, and, although the situation in Russia and Ukraine and interest rate trends are being closely monitored, demand is not expected to decline in the next fiscal year, either. Dealers didn't get enough inventory and inventory levels are low, so we expect to supply a large volume next year as well.

Kubo: In North America, the focus tends to be on the weakening of housing starts, but we expect large public works projects to continue from FY2023 onward as infrastructure investment plans enter the execution phase, and construction machinery demand is expected to remain brisk accordingly.

Q: Compared to three or six months ago, is there a headwind or a tailwind in the direction of business performance? I think the tailwind factors include subdued inflation and U.S. infrastructure investment, while the headwind factors include a deteriorating product mix due to an increase in compact products.

A. Shiojima: Although the outlook for foreign exchange rates is uncertain, expectations for infrastructure investment are returning in the Americas, a key region, and in Europe, which has been affected by rising interest rates. Looking at the inventory situation at dealers and wide-area rental companies, we expect the tailwind to continue for some time. Coal and iron ore prices are firm, and, given the order situation, the mining business is expected to grow.

The value chain business continues to achieve record highs in revenue due to the effect of ConSite sales expansion and other factors.

Naturally, the timing of future peak attainment and subsequents slowdown will be closely monitored, and in some cases adjustments to production lines may be necessary, but, in light of the recent expansion of the dealer network in the Americas and sales performance, the new medium-term management plan should allow for growth in businesses that can grow and increase income margins.

Matsui: Although we are keeping a close eye on interest rate trends, customers have a lot of work to do, and, considering the fact that the overall supply of machinery has been insufficient so far, we believe that demand will remain strong in the next fiscal year.

Kubo: Demand for hydraulic excavators in the current fiscal year is expected to decrease from the previous fiscal year, but has been revised upward from the previous forecast. We would like you to understand that, although demand is decreasing compared to the previous fiscal year, we are receiving a positive response since the second half of the fiscal year, and this is reflected in the figures.

Q: What is the reason for the upward revision of the full-year demand forecast for mining? What is the outlook for the next fiscal year?

A. Sugiyama: In the previous forecast, mining demand was expected to decline -10% to -15% year on year due to the situation in Russia and Ukraine. However, we have revised our forecast upward to 0% to -10% year on year because of continued stronger-than-expected demand in regions other than Russia, supported by high resource prices. We expect firmness to continue in the next fiscal year as well, supported by high resource prices. With regard to our sales, hard rock in the Americas and all types of minerals in Asia and Oceania have been firm.

3. North America Business

Q: Please tell us about the business environment in North America. Also, please tell us about the revenue transition (1Q-3Q and full year) of independently developed business.

A. Shiojima: Of the ¥197.3 billion in 1Q-3Q revenue in North America, approximately ¥110 billion was from independently developed business, excluding OEM sales. Since approximately ¥40 billion in the same period of the previous year was from independently developed business, sales from independently developed business have more than doubled year on year. OEM sales are almost flat, excluding the impact of a one-time price adjustment in the previous fiscal year. In the full-year forecast, of the ¥263.1 billion in North American revenue, approximately ¥150 billion is from independently developed business. Since revenue in the same period last year was approximately ¥70 billion, sales from independently developed business are expected to more than double, as in 1Q-3Q results.

Matsui: Including the newly contracted dealers, the North American business is doing well in both construction and mining. Orders are also coming in from wide-area rental companies. Parts and services are also strong.

Q: Why was demand for hydraulic excavators, mini excavators, and wheel loaders in the North American market for 3Q all negative compared to the previous year?

A. Matsui: The reasons for this can be attributed to the high demand in the same period of the previous year and the fact that, although the proposed infrastructure investment has been decided, the actual start of construction is still to come. We are not too concerned about the future, as we expect the market to remain stronger than in the previous year.