CFO Message

Based on the recognition that we can increase our corporate value by improving our capital productivity, we will work for the full implementation of our financial and capital strategies in line with the medium-term management plan.

Vice President and Executive Officer, Director and CFO
President of Financial Strategy Group
Keiichiro Shiojima

As CFO of the Hitachi Construction Machinery Group, I regard increase our corporate value as synonymous with improvement of our capital productivity. Our basic financial and capital policies are to: (1) help employees be more aware of the cost of equity; (2) select easy-to-understand KPIs (for both internal and external use); (3) appropriate manage our balance sheet; and (4) increase opportunities to engage in dialogue with shareholders and investors. In order to improve return on invested capital in conjunction with cash flow (CF) management, we must first foster an internal awareness of capital costs and clarify the criteria for investment decisions using ROIC. We are also calculating the net present value (NPV) of our investment based on a weighted average cost of capital (WACC) rate of about 7%, aiming to realize a gain on an investment within three years and recover the investment cost within ten years.

In its “BUILDING THE FUTURE 2025” medium-term management plan, the Hitachi Construction Machinery Group has set four core strategies along with some quantitative key performance indicators (KPIs) related to capital productivity and ESG issues. I regard it as one of my responsibilities to lead the implementation of the Group’s financial and capital policies by appropriately identifying the opportunities and risks posed to the Group, thereby contributing to its medium- to long-term growth.

Highlights of Our Performance for FY2023

For FY2023, which was the first year of the current medium-term management plan (“MTMP”), global demand for hydraulic excavators dropped by 11% year on year to 223,000 units (according to our estimate as of July 2024). However, the Hitachi Construction Machinery Group increased its sales revenue by 11% year on year to 1,405.9 billion yen, mainly driven by its independent business expansion in the Americas. It also boosted its adjusted operating income by 23% to 168 billion yen, thereby hitting a new record for both sales revenue and adjusted operating income. In the Americas, which is now our growth driver market, we posted sales revenue of 217.5 billion yen (up 30% year on year) through independent business expansion. In the value chain (VC) business, we recorded sales revenue of 554.6

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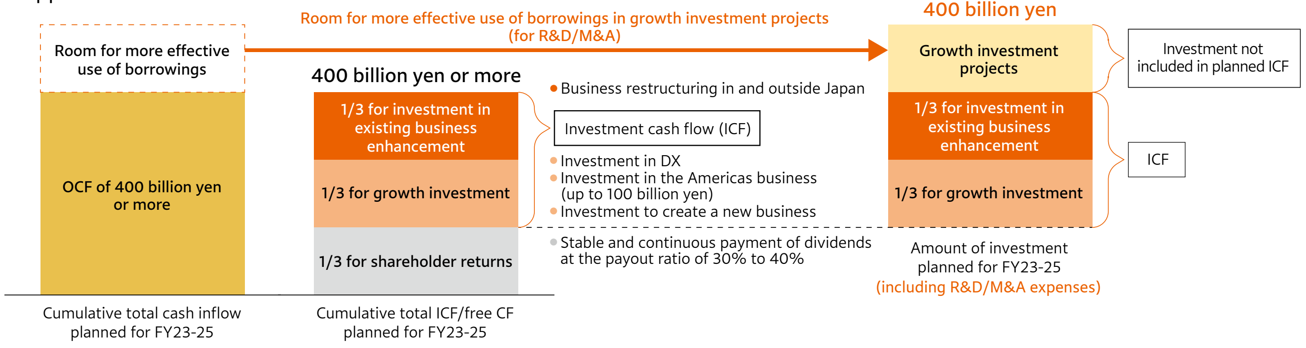
billion yen (up 10% year on year), which accounted for 39.4% of our total sales. Sales revenue in the mining business came to 291.8 billion yen (up 18% year on year). The year-on-year increase in adjusted operating income is attributable to the markup of our sales prices and to the weaker yen, which delivered extra profits of 31.6 billion yen and 31.5 billion yen respectively, far offsetting an increase of 19.4 billion yen in the cost of materials and an increase of 16.3 billion yen in indirect costs including strategic expenses. Moreover, in order to increase our profitability and capital productivity, we reclassified non-core operations in the specialized parts and services business segment into discontinued operations, and as a result posted a net loss of 11.8 billion yen including the amount of impairment loss.

MTMP-Based Financial and Capital Strategies and Cash Allocation

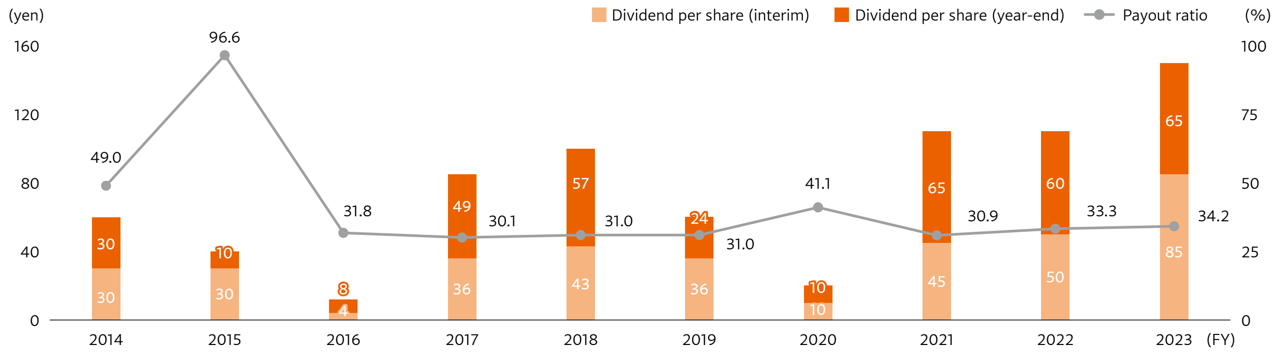
Under our current MTMP, we uphold the following four core management strategies: (1) Delivering innovative solutions for customer needs; (2) Enhancing the value chain business; (3) Expanding business in the Americas; and (4) Strengthening human capital and corporate capabilities. Over the three-year MTMP period, we plan to invest 260 billion to 270 billion yen in total (as compared to 81.8 billion yen over the former MTMP period). In order to create operating cash flow (OCF) that supports this size of investment, we will improve our capital productivity and “cash creation ability” to achieve EBITDA margin of 18% or more for profitability, OCF margin of 10% or more for capital efficiency, and ROIC of 9% or more as our new KPIs under the current MTMP. To this end, I hope to lead the expansion of the Americas business, the mining business and the VC business as growth drivers for the steady expansion of funds from operations (FFO: cash flow from operations before changes in working capital).

As for cash allocation during the three-year period under the current MTMP, we assume that cumulative total OCF will slightly exceed 400 billion yen (as compared to 104.5 billion yen under the former MTMP). For FY2023, we recorded OCF of 73 billion yen, influenced by the extension of the cash conversion cycle (CCC) of net working capital by 10 days to a total of 187 days. This was caused by an increase in inventory assets, which we pursued in order to supply more products to dealers and others to meet the expanding demand in the Americas. On the other hand, we took the relevant trade receivables off-balance sheet through the establishment of a joint venture financing company for construction machinery (in which Hitachi Construction Machinery has a 30% stake) named ZAXIS Financial Services Americas, LLC, and this had a positive effect on our cash flow. In the Americas business we will reach an investment recovery phase in the latter half of FY2024 and expect OCF of at least 300 billion yen for the period from FY2024 to FY2025 along with the posting of robust EBITDA.

Approach to Cash Allocation under the Current MTMP



Dividends and Payout Ratios



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As for cash outflow, the amount of growth investment will be about one-third of the amount of OCF (of which up to 100 billion yen will be invested in the Americas business) and the investment made to enhance the existing businesses will account for another one-third. We are planning to more than triple the investment amount relative to the amount invested under the former MTMP. In particular, we will increase the amount of growth investment by around four times. The amount of capital investment totaled 109 billion yen for FY2023, and for FY2024 we will increase it to 120 billion yen, including the amount to be allocated for investment in Hitachi Construction Truck Manufacturing Ltd. in Canada for the enhancement of the mining business. As for the establishment of a new manufacturing base in the Americas, we will make a final decision after achieving net sales of 300 billion yen in the Americas and before the end of the period of the next MTMP. For shareholder returns, we will continue to pay dividends in a stable manner at the consolidated payout ratio of around 30% to 40%. For dividend per share, our annual payment amount hit a new record of 150 yen per share for FY2023, with the payout ratio reaching 34.2%. For FY2024, we are currently planning to pay 175 yen per share to increase the amount of shareholder returns to around one-third of the amount of OCF during the current MTMP, which is a nearly 80% increase relative to the former MTMP, while investing more for our own growth.

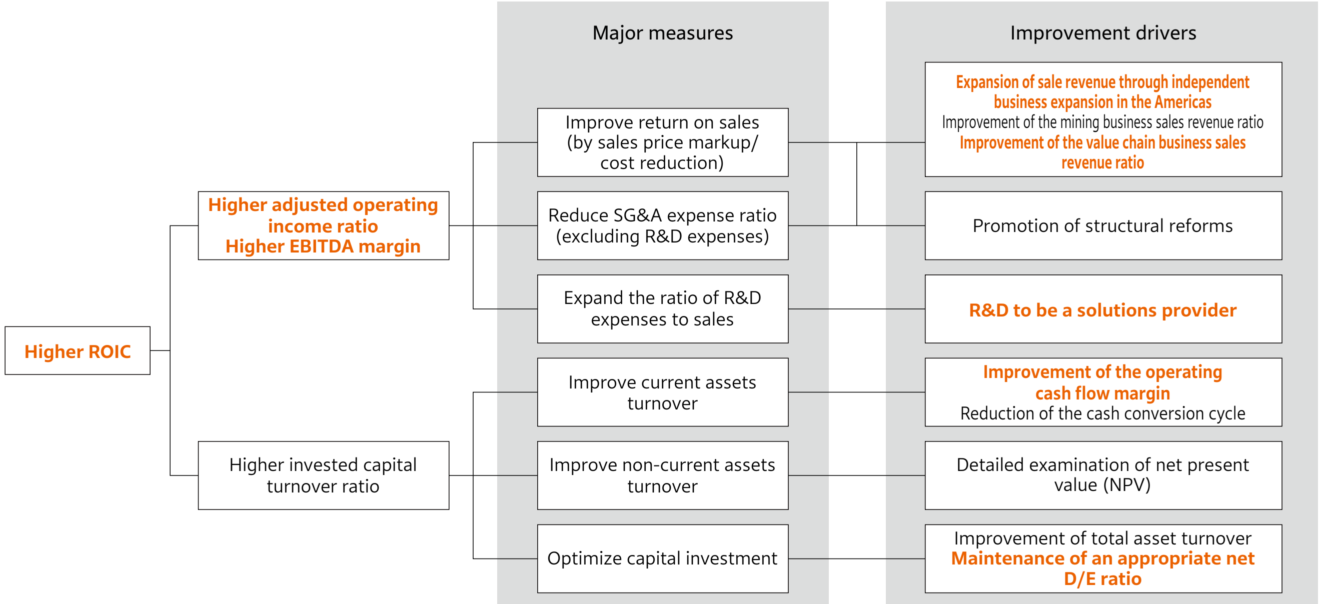
Improving Capital Productivity by Using an ROIC Tree for Business Unit Management

In order to improve ROIC for greater corporate value and capital productivity, we started to create an ROIC tree in FY2024. In reference to the tree, we set some improvement themes for ROIC and monitor progress made on them from the viewpoints of both investors and ourselves. From the viewpoint of investors, we calculate ROIC by using consolidated invested capital as the denominator for the formula. From our internal viewpoint, we manage ROIC-related targets for each of our business units (BUs) based on their respective working capital and fixed assets.

For FY2023, our overall ROIC and ROE came to 9.8% and 13.1% respectively, from 8.4% and 11.0% respectively in FY2022, to be equal to or a bit above the corresponding targets set in the current MTMP. With WACC being kept at around 7%, we have been able to achieve nearly 3% for the equity spread rate. To provide a clearer view from the investor perspective, we will link the major KPIs set in the current MTMP with the major ROIC improvement themes by using the ROIC tree, thereby increasing the effectiveness of our measures for higher ROIC. Specifically, we have set the following, among others, as our major improvement themes: Expand sales revenue through independent business expansion in the Americas; boost the VC business share of our total sales revenue; increase the OCF margin; and stabilize the net D/E ratio. As for the expansion of the ratio of sales in the VC business to total sales, we deem it important to keep a balance between increasing the sales ratio and boosting the sales of our machines themselves, rather than simply focusing on raising the ratio from 50%, which is a target set under the current MTMP, even higher to 60%.

From our internal viewpoint, we started to break down our balance sheet for each BU in a simplified manner in FY2023 with an eye to managing ROIC individually for the products of each BU, for which we also reduced the number of KPIs used as improvement drivers by

■ROIC Tree



Colored letters: Drivers linked to the KPIs set under the MTMP

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each BU to around three. For ROIC, the Mining BU as well as the Spare Parts & Services BU, which is engaging in the VC business, have a high ROIC. In contrast the Construction BU has a low ROIC. We need to foster the consolidation of product models and cost reduction in the Construction BU to improve its capital productivity whereas the idea that the BU does not need to make profit from the sale of machines as profit can be secured from the sale of spare parts and services is widely shared internally. The Rental & Used Equipment BU also has a low ROIC, which sometimes drops to a level below the WACC rate. This is mainly due to the purchase of various rental assets. In this BU, we will extend the lifespan of our products to promote a business geared toward the circular economy, while raising the operating income ratio without focusing too much on short-term ROIC as a requirement that we should meet. Also, for the improvement of ROIC, we may need to make a decision from a management accounting perspective, including discontinuing the sale of a product for which we have recorded an operating loss for two fiscal years in a row. In fact, we sold non-core VC business operations in FY2023.

Quantification of the Financial Impacts of Climate Change and Future Strategies

The Hitachi Construction Machinery Group is upholding “Product and technology development contributing to climate change mitigation and adaptation” as one of its issues of materiality. To this end, we are working to reduce CO_2 emissions from our product development and manufacturing processes to achieve carbon neutrality (CN) by 2050. As for product development, we are facing various risks in the ongoing transition to a decarbonized society, including those posed by stricter regulations, behavioral changes, external pressure and reputational issues, and changes in demand for mineral resources. Amid these trends, however, we can also gain a competitive advantage and grasp new business opportunities by developing new products for CN ahead of others. As for the manufacture of products, we are not exempt from calls to both save energy and shift to the use of renewable energy, and any delay to meet this requirement will pose a risk to us.

We have been evaluating climate change-related risks and opportunities since FY2020 and are aiming to quantify the financial impacts of climate change going forward. Our Financial Investment Committee has set aside a budget for investment in CN and prioritizes this investment in its screening process for capital/R&D investment projects.

Following on from the conclusion of our first agreement regarding a Positive Impact Finance loan (type without limits on usage) in December 2022, we issued our first green bond in March 2024 to raise funds of 10 billion yen. The funds will be used to develop products expected to contribute to solving environmental issues, such as a fully electric truck without engine. Based on the recognition that climate change is a serious global issue that must be addressed urgently, we will work even harder to contribute to the creation of a safe and sustainable society through the enhancement of our measures for a circular economy and CN. We will also make the environmental value creation activities that we conduct through our business operations more widely known to our stakeholders in order to speed up fundraising while focusing on our own capital productivity and return on investment.

Dialogue and Engagement with Shareholders and Investors, Information Disclosure and TSR

In FY2023, which was the first year of the current MTMP, the management team and the IR division proactively conducted activities to enhance our dialogue with shareholders and investors and highlight our growth strategies more broadly to them. We had individual dialogues with around 250 institutional investors in total, including dialogues between the management team and roughly 70 companies. Our shareholders and investors showed strong interest in a range of issues, including our progress in the Americas business and the mining business, our growth and profit stabilization in the VC business, the details of our earnings guidance, and our approach to the disclosure of information about our dividend forecasts. Results of the dialogues with our shareholders and investors are shared at Executive Committee and Board of Directors meetings as inputs for the announcement of financial results and the discussion of measures for the next fiscal year.

In FY2023, we held ordinary briefing sessions on our financial results, small meetings and domestic and overseas road shows for our shareholders and investors. We also invited them to take a tour of the Tsukuba Parts Center, which is our core base for parts to be used in our after-sale service. Moreover, we held an explanatory meeting on our parts and services business strategies as well as the fourth round of our briefing session on ESG issues. The explanatory meeting on the parts and service business provided participants with an opportunity to deepen their understanding of the business, which is one of the core components of our VC business. At the briefing session on ESG issues, in which we focused on our DX strategies, we explained the medium- to long-term measures that we will implement to increase our corporate value. Moreover, at the Q&A session held at each of the events, we proactively exchanged views with participants. By continuing to hold events such as briefing sessions and study tours of our manufacturing facilities we hope to help both institutional and individuals investors gain a full understanding of our businesses and thereby encourage them to invest in our company.

As a result of the initiatives described above, we started to disclose historical data about the improvement of our capital efficiency on our website, publicly forecast, at the very beginning of the fiscal year, the dividend amount to be paid to our shareholders for the year, and explain our priority measures at a briefing session on our business. We will continue working to enhance dialogue and engagement with our shareholders and investors and expand the scope of our information disclosure in consideration of their needs.

Our total shareholder return (TSR) was 51.8% during the FY2023, outperforming the average TSR of TOPIX constituents (41.3%) and that of TOPIX Machinery constituents (46.2%). However, in terms of forecasted PER and PBR, our relative rating in the capital market is still below a level satisfactory to us. In view of this fact, we will strive to raise our capital productivity (ROIC) while reducing the cost of equity and WACC and boosting our equity spread in an effort to make our growth story a reality, thereby increasing our corporate value on a medium- to long-term basis.