CFO Message

As a company, we aim to be resilient to fluctuations in demand and changes in the environment. To this end, we strive to balance strengthening our capacity for growth, improving our financial stability, and returning profits to shareholders.

Keiichiro Shiojima
Executive Officer, Director
CFO, President of Financial Strategy Group
Hitachi Construction Machinery Co., Ltd.

Key Strategies for Capital Allocation

A Balanced Distribution of Capital Among Capacity for Growth, Stability, and Shareholder Returns

For the Hitachi Construction Machinery Group (the Group) to achieve sustainable improvements in corporate value, we aim to create a corporate structure that is resilient to changes in the business environment and fluctuations in demand. In support of this aim, we plan to allocate capital equally among capacity for growth, stability, shareholder return. We began operating our medium-term management plan, *Realizing Tomorrow's Opportunities 2022*, in fiscal 2020. This plan defines indicators (KPIs) and the targets we prioritize.

Our target for adjusted operating margin, an indicator of profitability, is 10% or higher. Our targets for sales revenue and a value chain business sales ratio (an indicator of growth potential) are 1 trillion yen and 50%, respectively. Other targets in our plan include an ROE of 10% or higher (capital efficiency) and a net debt-to-equity ratio of 0.5% or lower (financial stability). Last, we set a target of 30% or higher for dividend payout ratio (shareholder return).

To date, our guideline for R&D investment has been 3% of net sales. Despite a challenging fiscal 2020, we will maintain our commitment to investments, aiming for 4% under the new medium-term management plan. We will focus investments in the key areas of digital and cutting-edge technologies. We believe these areas are essential for securing future product superiority. We categorize the markets for group products generally into advanced countries, accounting for about 40% of total sales, and emerging countries, accounting for about 60% of total sales. We plan to expand our presence in both markets. The trend toward ESG considerations has strengthened over recent years among the developed world. Various countries have declared the urgent need in particular for the development of decarbonization technologies, as well as for the development of labor-savings and autonomous driving technologies based on ICT. We plan to make considerable investments in these areas as they relate to our purpose as the Group. In emerging markets, we plan to accelerate the development of products for specific applications and purposes to achieve functional superiority and price competitiveness. Rather than relying solely on our own resources, we intend to leverage open innovation to hasten this development. The exception will be technologies in operability and control, where we already have strengths. Here, we are investigating a wide range of startup and venture funds to best focus our investments.

Fiscal 2020 Financial Activities and Future Initiatives

Improving Cash Flows for Further Investments in the Next Stage of Growth

The spread of COVID-19 caused production stoppages and the stagnation of group inventory operations in Europe, India and other regions through fiscal 2020. We were forced to delay the announcement of our financial results, and we could not make future projections for a period of time. From a financial perspective, we prioritized cash flow and conducted large-scale production cutbacks in response to the situation. We achieved the significant milestone of 1 trillion yen in sales revenue two years ago, in fiscal 2018. This achievement also increased working capital, while the spread of COVID-19 in the following fiscal year depressed demand and resulted in two consecutive accounting periods of free cash flow deficits. We recognize that stakeholders expect profits on earnings, so we prioritized improving cash flow and implemented production adjustments promptly in fiscal 2020. We saw faster-than-expected recoveries in markets such as China, and cash flow improved significantly as a result of shrinking working capital through production adjustments. By the end of the fiscal year, we reduced our net D/E ratio 10 points to 0.48. Market conditions are expected to recover in many parts of the world in fiscal 2021. We are now in a position to turn cash toward new investments to our expand growth and profitability.

Issues Currently Facing the Group

Stabilize Earnings and Improve Financial Leverage by Strengthening Our Value Chain Business

The construction machinery industry is sensitive to economic change. One of the most important issues for management is how we absorb these fluctuations. Strengthening our value chain business will be an important strategy to resolve this issue in the future. We will stabilize earnings through deeper interactions customers and by taking advantage of our direct sales and service-oriented business structure. When new car sales fluctuate, for example, we want a stable base of sales revenue, developed by a higher sales ratio of our value chain business.

One of the values we provide in the value chain is construction equipment rental. While the impact of the pandemic has seen companies reduce investments, rental demand has been growing. With nearly 300 managed locations in Japan, we work with our customers as partners to build relationships of trust and provide a wide range of equipment that meets the needs of construction sites. We are proud to be one of the few manufacturers that have succeeded in operating a profitable rental business. The rental business is even a more attractive option when considering the perspective of ESG. Over the past few years, there has been a shift from ownership to rental use. This shift has occurred mainly in developed countries, and more customers are using a combination of ownership and rental. The rental business is also a service that society needs in terms of maximizing the value of resources, and we expect this business to grow in the future.

Another challenge is to improve our financial leverage. We recognize that fiscal 2020 ratio of 2.4 was high compared to the industry level. To improve this ratio, we believe we must establish a management structure supporting steady sales revenue of 1 trillion yen, while also monitoring our ratio of total assets to equity based on the scale of our production facilities and other factors. In other words, the approach is to establish a production system offering immediate supply in response to rising demand, ensuring profitability by controlling indirect costs while maintaining the operation of production facilities using rental equipment and parts when demand decreases. The Group goal is to establish a well-balanced financial base by reducing debt, investing in growth, monitoring ROE to ensure efficiency, and returning profits to shareholders.

Shareholder Return and Total Shareholder Return

Become a Highly Valued Company Through Greater Communications with Stakeholders

Due to a significant decrease in profits for fiscal 2020, our annual dividend of 20 yen per share (payout ratio of 41%) did not meet the expectations of our shareholders. Despite the pandemic, we have improved our financial stability and in the future, we plan to offer shareholders stable returns and a dividend payout ratio of 30% or more in the next fiscal year and beyond.

In fiscal 2020, we began disclosing total shareholder return, which was 213.8% for fiscal 2020. We believe that communication with our shareholders and investors is very important. To this end, we held an ESG presentation in December 2020. Going forward, we will continue to communicate our business potential and future prospects to improve the value of the Group.

Competition in the construction equipment market is intensifying. Developed countries are accelerating their search for the next generation of construction equipment, while emerging countries are spurring price competition. During these challenging times, our group will prevail by providing customers with valuable products and services through our diverse value chain businesses and the trust in quality that we have cultivated. We will continue to work to strengthen our financial position and solidify the foundation for new investments. We hope that our shareholders will continue to support us for many years to come.