Kubota Corporation

Result Briefing on FY2017 Ended Dec. 31, 2017

Q & A Session　(Tokyo, Feb. 21, 2018)

Q. As the impact of adoption of International Financial Reporting Standards (IFRS), foreign exchange gain (loss), which has not been included in the calculation of operating profit before this adoption, will be included in the calculation of operating profit, in addition to some impacts on operating profit caused by foreign exchange rate fluctuations in relation to exports from Japan and translation of operating profit of overseas subsidiaries into Japanese yen. By taking them into consideration, how much do you expect to see the operating profit will be affected if Japanese yen will get stronger against US dollar to 105 yen, while Kubota Corporation (hereinafter, "Kubota") anticipates the exchange rate of 110 yen to the US dollar?

A. With respect to the exports from Japan, the impact of fluctuation is adjusted based on the differences between timing of exporting and that of realization of sales by our overseas subsidiaries through elimination of unrealized intercompany profits. So the impact of foreign exchange rate fluctuation varies depending on the adjustments. In addition, the calculation of operating profit will include the foreign exchange gain (loss), mainly related to revaluation of assets and liabilities denominated in foreign currencies based on the foreign exchange rate at the balance sheet date, as the result of adoption of IFRS. Most of the impacts depend on the foreign exchange rate at the balance sheet date, while we use forward exchange contracts for some of them. So it's difficult to expect these impacts specifically. However, we expect to maintain operating profit growth, if the exchange rate will be 105 yen to the US dollar.

Q. Please explain about the progress toward the financial target in FY2019. (revenues: 2,000 billion yen / operating margin: 14%)

A. We forecast revenues in FY2018 of 1,820 billion yen, and the level of growth rate is not too high compared to that in FY2017. So, we basically consider that we have been making progress in revenue growth steadily. With respect to operating margin, our goal of 14% in FY2019 was set to achieve higher operating margin compared to 13% level in 2015. It is essential for us to launch new products or to enter the new markets with the aim of increasing revenues. However, the operating margin related to new products or new markets should be lower than that of existing businesses for a certain time. We expected these lower margins caused by our initiatives, but it was unexpected that the margin of our existing businesses, which should compensate for lower margin of new products or that in new markets, decreased due to intensifying competition in the United States, unusual weathers in Thailand, and so on. Our basic policy about the marginal profit ratio, which indicates the competitiveness of products, is to improve it without exception when a model change takes place compared to existing model. However, we have introduced some entirely new products in our strategic fields, such as large-sized tractors, large-sized wheel drive combine harvesters in China, and multi-purpose tractors in India, in recent years to create new opportunities for our growth, and our basic policy about marginal profit ratio was not applicable to these entirely new products. In addition, we couldn't charge our customers all of the additional costs caused by stronger emission regulations. Under these circumstances, we couldn't sufficiently undertake activities to reduce costs and increase marginal profit ratio. We will be able to allocate more resources on activities to improve marginal profit ratio in the near future due to completion of the first stage of these initiatives. We understand that the goal of operating margin of 14% is difficult to achieve, but also consider that it's valuable to strive to achieve it. We will make more efforts to improve the product competitiveness and operating margins continuously toward achieving the goal.

Q. Depreciation and amortization expenses and R&D expenses in FY2018 will increase by 11.6 billion yen in total compared to that in FY 2017 according to Kubota's forecast. Is the forecast accurate?

A. Both of these expenses are expected to increase compared to the previous year. It's essential for us to strengthen R&D to satisfy requirements of new technologies in order to develop new businesses, so the increase in R&D expenses will be inevitable especially. By the way, an increase in depreciation and amortization expenses is affected by a temporary factor caused by the change of depreciation method since FY2017, from the declining-balance method to the straight-line method. The amount of depreciation in assets acquired before the end of 2016 has been relatively high and the same amount for initial 2 fiscal years (FY2017 and FY2018) after the changes of depreciation method. Therefore, the amount of depreciation in assets acquired before the end of 2016 will not decrease at all in FY2018. On the other hand, the amount of depreciation in assets acquired last year will increase due to start of depreciation and amortization on a full year basis in 2018, and the amount of depreciation in assets acquired in 2018 will be newly added. So the depreciation and amortization expenses in FY2018 will significantly increase compared to that in FY2017.

Q. You have said that Kubota will strive to achieve 10% of market share in the large-sized tractor market in the United States in FY2018. What kind of strategies will Kubota implement to achieve that share?

A. We will strive to achieve double-digit market share in the large-sized tractor market in FY2018 because our worldwide retail sales units of M7 series, which is our large-sized tractor model, became roughly 1.6 times larger than that in FY2016, when we started full-scale sales of that series, and our market share in the Unites Stets has increased. Specifically, we will implement the reinforcement of dealer network, and the establishment of distribution center in Kansas which will start operations in 2019. As the reinforcement of dealer network, we will establish a sales branch in Midwestern area, which is the core market of large-sized tractors, and strengthen the dealer network and operational activities including dealer supports with the new branch. As the establishment of distribution center, we will promote reduction of distribution costs and continuous business expansion by developing the optimal and efficient supply chain of products and service parts near the core market.

By the way, our market share in 0-40hp tractor market in the United States decreased slightly in FY2017, but our market share taking into consideration the horse-power of products sold (based on the calculation as follows: horse-power of the products sold times retail sales unit) increased due to our efforts to enhance the sales operation of mid-sized tractors used by dairy farmers and hay farmers in addition to strengthening the sales of large-sized tractors, such as M7 series.

Q. Please explain about the progress of your efforts to reduce inventories and promote activities of Kubota Production System (KPS).

A. We have been making efforts to establish the structures, which enable to realize the shorter lead time. In fact, we changed deadline for orders from overseas subsidiaries from 3 months before shipping to 2 months before shipping. At the end of FY2017, we achieved the reduction of inventory turnover by 0.2 months to 2.5 months on a consolidated basis compared to that at the end of FY2016, while the turnover tended to increase in the past. We will strive to carry out activities to reduce inventory turnover close to 2.0 months at each business site from now on. Some domestic production sites have already achieved 0.2-0.3 months of inventory turnover, so we consider that it's possible to achieve 2.0 months of inventory turnover on a consolidated basis soon by deploying these know-hows to other sites including overseas subsidiaries.

Q. How will free cash flow trend from FY2018 as the result of measures for inventory reduction?

A. We recognize net cash provided by operating activities as the total of net income and depreciation and amortization expenses ultimately. As for the recent trend of our cash flow, an increase in inventories worked negatively for net cash provided by operating activities. Therefore, we have been making efforts to reduce inventories, which we can control by ourselves. In FY2017, the changes in inventories contributed to an increase in net cash provided by operating activities a little due partly to our efforts. We have been striving to establish the structures to reduce inventories systematically across our group through a global KPS project. So we consider it's possible to increase net cash provided by operating activities more by reducing inventories if these activities will work properly. On the other hand, the inventories may increase temporally when an increase in inventory is needed in connection with the emission regulations. The inventory level in FY2017 was actually affected by the increase in inventories in connection with the emission regulations in Japan.

Q. Please explain about the forecast of financial services result in 2018 in the light of a rise in interest rates.

A. With respect to sales incentive programs such as 0% financing, sales subsidiaries compensate for the differences between the offering interest rates of finance program such as 0% and the appropriate financing interest rates based on the market interest rates. Therefore, our operating result of finance services is not affected by a rise in interest rates so much.

Q. Will the adoption of IFRS eliminate fluctuation in incentive costs caused by allowance for incentive costs related to inventories held by dealers?

A. The adoption of IFRS will have little impact on incentive costs including the allowance on a yearly basis. The allowance at the end of each quarter was fluctuated a lot depending on the changes of incentive programs, so the total incentive costs (including allowance) was fluctuated a lot as well. It's because that the allowance at the end of each quarter was calculated based on the latest incentive programs at the moment previously. However, the adoption of IFRS will level the base of calculation for the allowance throughout the year, so it will reduce the excessive fluctuation in incentive costs.

Q. How much sales were generated from the large-sized tractors? How about the contribution of large-sized tractors to operating profit?

A. The retail sales price of large-sized tractors (M7 series) varies with its horse-power (130hp, 150hp, and 170hp) and accessories so much, but the average retail price is around 150 thousand Euros. The retail sales units in FY2017 was about 1,200. With respect to the contribution of them to operating profit, a manufacturing plant in France where M7 series are produced, has 3,000 units of production capacity which is larger than our annual sales units at present, and the profitability will be improved if the sales unit of them will increase.

Q. Why does Kubota's forecast indicate that revenues in North America will result in a minor increase despite the view that Kubota will introduce new RTV, tax reform in the United States will have favorable impact, and sales of construction machinery and engines will remain strong?

A. We recognize that our forecast for revenues in North America is modest. Naturally, revenues will be affected by fluctuation in foreign exchange rates. In addition to that, some unexpected issues occurred over recent years, such as intensifying competition of sales incentives in the United States, unusual weathers in Thailand, and so on. Therefore, we created a modest forecast in the light of these risks.

Q. Cash and cash equivalent increased in FY2017. Are there any changes in the policy about a dividend or shareholders return?

A. We are going to utilize these cash and cash equivalent to reduce interest-bearing debt first because not only cash and cash equivalent but also interest-bearing debt increased. We will reconsider the policy of shareholders return in situation where interest-bearing debt will decrease, cash and cash equivalent will increase, we will achieve 30% of payout ratio constantly, and we will have a room to increase shareholders return.