Event Name: 1H FY2022 Financial Results

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Speaker: Seiji Izumisawa, President and CEO

Hisato Kozawa, Executive Vice President and CFO

Questioner 1

Q: In Q2, business profit was ¥40 bn, but how do you assess the Q2 results versus the plan? Also, in the full-year forecast, exchange rate assumptions were revised toward a weaker yen, while business profit was left unchanged, which appears to be a downward revision in real terms. What were the negative factors behind this? Or was the latest forecast prepared conservatively, taking into account uncertainty?

Kozawa: Our progress during the past three months has not deviated largely from our original projections. While there were negative factors in Q1, we were also able to enjoy the positive aspects of the depreciation of the yen in Q2, and therefore I think that we are making good progress. Regarding the full-year forecast, we could have increased business profit if we only considered the exchange rate assumptions. However, there are some uncertainties, including inflation and economic recession, and it's difficult to assess exactly how these factors will affect us. In particular, our performance shows that materials and logistics cost inflation have been affecting us quite a lot. Moreover, regarding foreign exchange rates, while our projections had included exposure to transactions in foreign currencies, even for yen-denominated transactions, there is actually a certain amount of impact on materials and logistics cost inflation from materials cost increases due to the depreciation of the yen. As a result, we do not believe that the yen's depreciation will have as much of a positive impact as originally thought. Therefore, we determined that it was premature to increase our profit forecast at this time. On the other hand, regarding the figures in each segment, we were confident enough in the performance of the Aircraft, Defense & Space segment to determine that it will do better than the original forecast and thus increased its profit guidance by ¥10 bn. As we could not make the determination that the company-wide business profit forecast merited revision, we slightly lowered the forecast for the relatively riskier Energy Systems segment by the same amount that we had raised the guidance for Aircraft, Defense & Space.

Q: Regarding the impact of materials and logistics cost inflation and semiconductor shortages, your initial forecast included a positive impact of ¥10 bn. How do you view this now? Since the impact of inflation will be greater than expected, will you be able to make even more price increases in order to maintain the +¥10 bn target?

Kozawa: We had initially expected an impact of +¥10 bn, but we now believe that it will be around zero. This is because the impact of materials and logistics cost inflation has been more severe than anticipated. Although it is difficult to analyze the factors behind these cost increases, we believe a significant portion of this is from an increase in procurement costs due to the effect of the depreciation of the yen on yen-denominated transactions.

Q: Is it safe to assume that price increases are proceeding steadily?

Kozawa: I do not have the impression that price revisions are not proceeding as planned. I believe that we will experience the benefits of these price increases during 2H of this fiscal year, in accordance with the initial forecast.

Q: Please provide a breakdown of the -¥17 bn impact on business profit from materials and logistics cost inflation and semiconductor shortages.

Kozawa: The -¥17 bn includes +¥12 bn in price increase impact. This means that the gross negative impact from materials and logistics cost inflation was -¥29 bn, of which -¥19 bn came from materials cost inflation and -¥10 bn came from logistics cost inflation and semiconductor shortages.

Questioner 2

Q: You maintained the company-wide business profit forecast while increasing Aircraft, Defense & Space and decreasing Energy Systems by the same amount. Could you let me know in which Energy Systems sub-segments you expect to see decreased business profit? Please also let me know the causes of this.

Kozawa: At the time of our Q1 FY2022 Financial Results briefing, I explained the one-time expenses related to downsizing of our European coal-fired thermal power operations. We believe that some more organizational optimization costs may be incurred in the Steam Power business, which is one of the factors lowering business profit. Also, there are several large projects underway in Energy Systems with which there are some unexpected risks associated. Compared to the other segments, Energy Systems has the highest risk of earnings volatility, and if we had to choose a segment to revise our forecast downward, we determined that it would be Energy Systems.

Q: Have there been any changes to the actuals or forecast for IGCC-related additional costs? Please let us know the P&L impact included in the 1H results.

Kozawa: In Q2 FY2021, we booked ¥15 bn in IGCC-related additional costs. We have incurred some expenses in 1H of this fiscal year, but they were around half of last year’s amount.

Q: At the Q1 briefing, you explained foreign exchange effects in terms of positive factors and temporary negative factors. In 1H, what was the status of the factors that had negatively impacted profit in Q1?

Kozawa: The effects of foreign exchange rate revisions on provisions for losses on construction contracts continued to negatively impact the P&L during 1H. However, the positive flow-based factors over the six months of 1H exceeded these negative factors, resulting in a net positive impact from foreign exchange effects on our 1H results.

Questioner 3

Q: Please let me know the background behind orders growth by business. Also, President Izumisawa mentioned that he felt that Energy Transition efforts including CO2 capture, utilization, and storage (CCUS) are taking off in real terms. Could you let me know if this is resulting in not only inquiries about also orders? Also, how much of an impact do you see these new initiatives having on future order intake?

Izumisawa: From the perspective of securing realistic sources of energy, renewable energy alone cannot meet energy demand. Therefore, there are growing needs for gas turbines. Moreover, customers have responded positively to our proposals related to future fuel conversions to hydrogen mixed or 100% firing. In Aero Engines, maintenance, repair, and overhaul (MRO) business has expanded as passenger air travel has recovered. We have also seen an increase in inquiries for compressors and other products. Regarding CO2 capture, inquiries for feasibility studies have been increasing since the previous fiscal year. In fact, inquiries in 1H alone have already exceeded the number received in FY2021. Due in part to the passage of the Inflation Reduction Act in the U.S., I think demand has been growing for CO2 capture. However, we are still in the stage of waiting to see when these developments will lead to actual business.

Kozawa: Just to clarify one point, CCUS is included in our Plant & Infrastructure segment, not Energy Systems. As mentioned in a recent press release, there is a hydrogen supply project called the Advanced Clean Energy Storage (ACES) Project in the U.S. for which we received orders for hydrogen production equipment. These orders are included in the Energy Systems segment.

I would also like to briefly introduce a new item that has been added to our order intake disclosures. On page 20 of our 1H FY2022 Financial Results presentation, order intake for large-frame gas turbines through our Chinese licensee has been added for reference. Regarding gas turbines sold to the Chinese market, some turbines are manufactured in and shipped from Japan, while the relatively commoditized models are also manufactured by our partner. These MHI turbine models are licensed to this partner. China has been rapidly converting their power generation fleet to gas turbines.

Whereas our licensee received orders for seven units during FY2021, they have received orders for 19 units in 1H FY2022. Although MHI does not book revenue from the construction of the plants themselves, we do supply parts that eventually contribute to our order intake and revenue.

Q: Regarding the new gas turbine orders you are booking, I know that customers have an eye toward hydrogen mixed or 100% firing. Has this served as a tailwind for gas turbine orders?

Izumisawa: At this stage, customers do not have specific plans for hydrogen mixed or 100% firing. However, I believe that customers appreciate the fact that our gas turbines can achieve mixed hydrogen firing by simply changing the combustors.

Q: Nuclear Power orders have also increased. Is this because plant restart efforts are increasing?

Izumisawa: Yes, that is correct. Rather than this being a new development, there was a slight increase in orders related to continuing plant restart efforts, Specialized Security Facility construction, and the nuclear fuel cycle.

Q: You increased the full-year forecast for business profit in Aircraft, Defense & Space, and I think that progress has been good in this segment. It appears that business profit improved even more from Q1 to Q2, but what factors are increasing business profit despite Commercial Aircraft's struggles on the revenue side?

Kozawa: As for the reason that YoY business profit increases grew from Q1 to Q2, in addition to foreign exchange effects, there was also the contribution of fixed cost reductions in the Aero Structures business. The increase in the full-year forecast mostly comes from foreign exchange effects.

Q: I believe that the absolute value of business profit in Aircraft, Defense & Space increased comparing Q1 and Q2 on their own. Is it correct to understand that this was also due to the effect of exchange rates and fixed cost reductions?

Kozawa: The impact of foreign exchange effects was larger, I believe.

Questioner 4

Q: In July of this year, natural gas and nuclear power were officially determined to be transitionally green energy sources by the EU Taxonomy. As the Taxonomy goes into effect in 2023, specific benefits may not yet be apparent, but normally, I believe that projects will be easier to obtain financing going forward. Is it OK to expect that, due to this, the business environment in gas turbines and nuclear power will improve even more? Or is it more likely that, even though the Taxonomy will come into effect in 2023, things take time, so the effects of this will not materialize in the next fiscal year but rather during the next medium-term business plan period? What kind of changes are you forecasting?

Izumisawa: As our Nuclear Power business operations in Europe are limited to the export of components, I believe that the benefits of the Taxonomy will not appear until a little further into the future. Regarding gas turbines, the Taxonomy itself will be a positive factor, but, as gas supply is a variable factor, investors are waiting to see whether they should actually commit investment to projects or not. However, based on the current electricity demand, I believe that there will need to be some turning back to gas turbines, so overall the situation is neutral.

Q: Currently, the order backlog is increasing, and due to such factors as the time lag between cost inflation and cost passthroughs and one-time expenses in IGCC, you are forecasting a business profit margin of 4.9% this fiscal year. How should we understand the current situation as regards the move toward a business profit margin of 7% in FY2023, which is the target for the 2021 Medium-Term Business Plan? Also, you mentioned that inquiries related to the Energy Transition are strong, so is the probability of achieving the revenue target (¥100 bn) for new businesses in FY2023 increasing?

Kozawa: I believe that we are progressing steadily toward a business profit margin of 7%. We are working hard to control margins quite strictly at the time of order booking, so we are anticipating that, in the next fiscal year and thereafter, projects with margins superior to those seen previously will contribute to our financial results. Of course, there are also risks, but I believe that we are taking appropriate measures toward achieving a 7% business profit margin. Regarding order intake related to the Energy Transition and new businesses, as these will be projects of a certain scale, there may be variability in the timing of booking. That said, the equipment supply business for the Advanced Clean Energy Supply (ACES) Project – a hydrogen supply project – for which we booked orders this fiscal year was recorded in the new businesses area. My understanding is that we have the potential to achieve the ¥100 bn target.

Izumisawa: I would like to make the achievement of a 7% business profit target a sure thing by increasing services a little more and reducing SG&A, and I am motivating each of our business headquarters to do this. There definitely are tailwinds in the Energy Transition and new businesses areas, and I believe that there absolutely will be growth here. That said, regarding whether or not we will be able to achieve the ¥100 bn target, I would like to wait and see a little more.

Q: Regarding margins at the time of order booking, could you let us know which products or businesses in particular are seeing improvements?

Kozawa: Rather than any business in particular, overall, we are working hard to improve margins.

Izumisawa: In the case of large-scale projects, we also perform a follow-up review at the time of order booking. By properly managing this process, we are working to increase margins at the time of order booking, and the results of this are gradually becoming apparent.

Questioner 5

Q: Please let us know your thinking as regards the 2H forecast in Aircraft, Defense & Space. The business profit forecast for 2H is ¥12.4 bn (full-year forecast ¥30.0 bn – 1H actual ¥17.6 bn), but considering that ¥11.1 bn in profit was achieved in Q2 alone, the full-year forecast appears a little low. Based on the production situation going forward in Aero Structures and fixed cost reductions accompanying production increases, wouldn't ¥40.0 bn be within reach for the full year? Please let us know if there are any factors weighing down business profit.

Kozawa: There are no such factors in particular.

Q: Is it safe to say that the profit situation will be better in 2H than in Q2?

Kozawa: The numbers are as disclosed in our official forecast, and that is the underlying premise, but I do not see any contradiction if you were to take such a view.

Q: Please let us know if there are any bottlenecks in your initiatives related to SG&A, which is considered to be a challenge to your achievement of a 7% business profit margin. Also, on the topic of revisions to the business portfolio, as the business environment is evolving at a dizzying pace, I believe that the timeframe in which you asses your businesses must have changed as well. Have there been any changes in the way with which you perform these assessments?

Izumisawa: There is no silver bullet for reducing SG&A, but we are gradually making headway in increasing process efficiency mainly through shared technologies. Once we start to see the effects of these efforts during this fiscal year and the next, I believe that we will achieve a certain amount of SG&A reductions. Also, regarding the business portfolio, as the business environment is undergoing extremely large changes, it is difficult to decide whether it is a good thing to rush to conclusions here. At this phase, I think that it may be better to increase order intake and revenue in businesses that span several business headquarters and aim for synergies. We have already taken care of problem businesses, and I would like to increase efficiencies including through postmerger integration (PMI). I am considering investments in growth areas, and although the speed of these investments has been slightly slower than previously forecasted due to the pandemic, I would like to make up for this going forward.

Questioner 6

Q: Although you have kept the total business profit forecast at ¥200 bn for the full year, I believe there should be a ¥30 bn improvement due to the change in exchange rate assumptions. What factors canceled out this improvement?

Kozawa: Although there will be improvement of around ¥30 bn from foreign exchange effects on the flow side, as I mentioned during the Q1 results briefing, due to negative factors affecting profit including provisions for losses on construction contracts, the impact on the full-year forecast from the revisions to exchange rate assumptions made this time was around ¥20 bn. As for negative factors, cost inflation is one example. Also, although we booked some downsizing expenses in Q1, there is a possibility that we will book some more in 2H. Regarding individual projects, upon assessing the risks that may occur in 2H including IGCC and other existing risks, we determined that we could not avoid being a little conservative with the forecast.

Q: I believe that power companies are in an extremely difficult situation due to soaring energy costs. Do you think that Energy Systems project pricing will become more difficult considering this situation? Also, I believe there is a possibility that in the gas turbines business, rather than combined cycle (power generation using gas turbines combined with steam turbines), it will be simple cycle (power generation using only gas turbines) projects which will increase. Is it OK to be optimistic about the future of Energy Systems?

Izumizawa: I believe that especially Japanese domestic power companies are in a difficult situation with their P&Ls, and we cannot be optimistic including on the pricing front. However, even during this time of tight gas supplies, there are needs for not only renewable energy but also for gas turbines. Although it is difficult to foresee what kind of balance there will be between the two, I believe that there will be a certain amount of demand for gas turbines. It is true that it is difficult to predict whether that demand will be for high-efficiency combined cycle systems or for simple cycle plants. In any event, while there is a limit to renewable energy as coal-fired thermal is phased out and although there may not be a steady growth trend as in the past, there will still be a certain amount of demand for gas turbines. In our approach to this demand, what will be important is how we are able to book projects including long-term service agreements (LTSAs), and I think that increasing cost competitiveness including productivity improvements will be key. We manufacture hot parts – the very core of a gas turbine system – in-house, and there is still room to further improve competitiveness, so I firmly believe that we will be able to secure adequate profitability.

Q: In the 2021 Medium-Term Business Plan, you were targeting ¥4.5 tr in total assets, but currently total assets are ¥1 tr over the target. I think that this is partially due to an increase in assets due to the depreciation of the yen, but are there other causes behind the increase? Also, when looking at the profitability of the flow side, the pace of recovery in Logistics, Thermal & Drive Systems profitability has been slow compared to pure play machinery manufacturers, and I feel that there is large room for improvement here. How do you view this situation?

Kozawa: I am starting to think that it may be difficult to achieve the target of ¥4.5 tr in total assets. The impact of translation effects of foreign currency-denominated assets has been large, and if current exchange rate levels are maintained, there will be around ¥400 bn in impact. Other than this, although we are proceeding with reductions in our strategic shareholdings, because the market price of our shareholdings has increased due to the overall increase in stock prices in the market, the reductions that we have made do not appear to have had much of an effect overall. I think that we could have reduced assets by a little more through asset optimization. Moreover, due to the acquisition of a waste-to-energy special purpose company (SPC) in Singapore in Q2 as a new consolidated subsidiary, assets increased by around ¥50 bn. This was a strategic undertaking, and ideally, we would have made strategic divestments of the same amount, but at the moment we have not been able to achieve this yet. If we are able to achieve this during the next fiscal year, then I think we could get close to the target when excluding foreign exchange effects.

Izumizawa: As a way to increase margins in Logistics, Thermal & Drive Systems, we are currently implementing a variety of measures, including SG&A reductions and decreasing inventories. Some may say that the speed of these efforts has not been fast enough, but we are gradually seeing results. Also, we are starting to work to raise prices in Turbochargers and Car Air Conditioners – where we had previously not done so considering our relationship with automotive OEMs – and we are starting to see benefits from this.

Q: Had you always included the comment about SpaceJet in your earnings reports?

Kozawa: We have always included the same comment.

Questioner 7

Q: You have increased your full-year revenue forecast for Aircraft, Defense & Space by ¥50 bn, but is this due to a revision in Commercial Aviation?

Kozawa: As we have made our revisions in units of ¥50 bn, the actual amount may be slightly smaller than that. The impact of revising the exchange rate assumptions was around ¥20 bn, and other than this, we also revised the evaluation of progress on some Defense & Space projects.

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