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Advancing Well-Integrated Management among MCHC Group that Prioritizes Scale to Compete Globally, Growth and Strengthening Earnings Potential

Seimiya Launched in April 2016, the new medium-term management plan *APTSIS 20* builds on the initiatives MCHC has implemented thus far to enhance corporate value. In this forward-looking plan, I recognize a shift in emphasis from expanding scale to strengthening earnings potential as MCHC evolves into a corporate group able to compete globally. Could you give us the highlights of *APTSIS 20*, in light of the outcomes of the previous medium-term management plan *APTSIS 15*?

Kosakai Over the five-year period of *APTSIS 15*, MCHC concentrated efforts on reforming the business structure to expand scale and compete on a global basis. As a result, MCHC recorded ¥3,823.0 billion in net sales in fiscal 2015, underscoring the scale it has attained. At the same time, we pushed through reforms to stabilize earnings, which had been an issue.

The MCHC Group consists of three business domains, Performance Products, Industrial Materials and Health Care, and each domain has an optimized portfolio of current business lines under MCHC's strategy. Among our initiatives, we worked to stabilize earnings by shifting the weight of the earnings structure toward the Performance Products domain and away from the Industrial Materials domain. The Industrial Materials domain, which encompasses the petrochemicals business, is characterized by high volatility and unmanageable factors, while the Performance Products domain has relatively stable businesses in highly specialized fields. We were determined to reform the business portfolio by focusing our efforts on how to shift as much weight as possible onto the Performance Products domain, and off the Industrial Materials domain.

As a result, the contribution of the Performance Products domain to operating income increased to 27% over the five-year period of *APTSIS 15*, from 17% when the plan was launched in fiscal 2010, while the weighting of the Industrial Materials domain decreased to 36% from 48%.

Seimiya What measures did MCHC implement for the Industrial Materials domain, a major cause of earnings volatility?

Kosakai Operating income in the Industrial Materials domain was just over ¥100 billion in both fiscal 2010 and 2015, but the quality of the profits was quite different.

In fiscal 2010, roughly 80% of this operating income was generated by terephthalic acid, MMA, carbon products and polyolefin. In fiscal 2014, however, the industrial gas business accounted for about half of the profits in the Industrial Materials domain, reflecting the addition of relatively stable earnings from the industrial gas business of TNSC, bringing more stability to the entire business domain. Under the current medium-term management plan *APTSIS 20*, we are focusing on how to deepen our involvement in the three business domains, instead of broadening our reach under the previous plan. In other words, we are keenly focused on boosting growth and asset efficiency in each business. In this context, I think that it is essential that we advance well-integrated management among MCHC Group centered on MCHC.



Seimiya I think it is extremely important that MCHC, as a pure holding company with multiple operating companies, drives efforts to generate synergies among the operating companies. Has MCHC put in place any required common rules or processes in business management to put together the diverse operations of the Group? As a holding company, how does MCHC keep a grip on operations?

Kosakai The MCHC Group has been managing approximately 60 strategic business units (SBUs), setting annual missions for each business unit and evaluating performance using a common set of metrics that apply across operating companies and business units. In addition to financial indicators such as operating income, we have also adopted non-financial indicators of our performance, such as the Management of Sustainability (MOS) Indices, indicators we developed to measure our contributions to sustainability, to assess overall business performance.

Seimiya I understand that the Group uses common metrics to evaluate the performance of each business. Under *APTSIS 20*, the MCHC Group manages its portfolio based on a four-quadrant model comprising the growth businesses, the next-generation businesses, the cash-generating businesses, and the businesses to be restructured. How does MCHC screen for businesses to be restructured?

Kosakai MCHC takes a comprehensive look at each business unit's progress toward their targets, identifies businesses that are struggling, and thoroughly facilitates reconstruction of these businesses. If a business continues to struggle after measures to streamline and improve the business with an eye to its future potential, we have in place an exit rule where we withdraw from the business after three years of losses.

Seimiya Does this mean that each business unit is managed based on its own balance sheet and cash flow?

Kosakai We have managed businesses on this basis to a certain degree in the past. With the MCHC Group applying IFRS in fiscal 2016, we are now able to more accurately compare each business unit, including subsidiaries inside and outside Japan. We believe this will lead to more advanced levels of management.

Cash Management on a Global Basis

Kosakai As CFO, I am primarily focused on tightening discipline from a financial perspective, while laying the groundwork for the voluntary adoption of IFRS. First of all, we are rolling out cash management systems (CMS) globally, including in Europe, at an early stage. We have already introduced this system in Japan, and parts of the U.S. and China, and believe that it will lead to higher capital efficiency. However, more importantly, we aim to have an impact on Group governance via cash management. Cash flow tells us

the true condition of the business because it just does not lie. By having MCHC completely ascertain and manage the flow of cash throughout the Group, we will be able to achieve a well-integrated management.

Seimiya When will the global deployment of CMS be completed during *APTSIS 20*?

Kosakai We will center on creating Group synergies in the next five years, being requiring the management of business from an all-encompassing perspective. We aim to finish the global rollout of CMS at an early stage of *APTSIS 20*. Introducing CMS is one measure that we are taking in our shift toward well-integrated management centered on MCHC, instead of management by each operating company.

Seimiya Strengthening capabilities to generate cash is a key factor in increasing corporate value. As CMS improves the MCHC Group's ability to generate cash, there is a greater likelihood that the MCHC Group will be able to meet its targets for financial health and plans for growth investments. From the standpoint of financial strategy, what are MCHC's priorities in allocating cash flow?

Kosakai With regard to shareholder returns, MCHC first aims to maintain a dividend payout ratio at 30% of medium-term profits, linking performance to stable dividends.

Next, MCHC will prioritize its financial health. At the end of fiscal 2015, MCHC's shareholders' equity ratio was 22%, a level that could be better. We are keenly aware of the importance of having a stable financial position in order to sustain long-term growth, and have set a goal to increase the shareholders' equity ratio to 30%. We plan to allocate one-third of net income, an amount equivalent to depreciation and the cash freed up from greater asset efficiency, to investments in growing businesses. We intend to take a balanced and appropriate approach to growth investments from a stable financial position.

Seimiya As the adoption of IFRS sharpens the management of each business unit based on individual balance sheets and cash flow statements, I believe MCHC will be able to create strategies based on more accurate financial statement forecasts. Indeed, this will significantly advance well-integrated management.

Well-integrated Portfolio Management Seeking High Capital Efficiency

Seimiya Putting into practice ROE-based management is another pillar of *APTSIS 20*. I understand that MCHC can achieve its target for ROE of at least 10% through bottom-up initiatives in each business. Can you shed some light on these bottom-up initiatives?

Kosakai MCHC has always managed its operations with an eye to asset efficiency. However, our management of operations based on the statements of income tended to target growth in sales, and did not sufficiently reward efforts on the frontlines to reduce inventories or increase efficiency by other means. Since *APTSIS 20* has set ROE as a key target, MCHC has adopted ROIC as a management target and assessment benchmark. This will clarify the benefits of measures such as inventory reduction. MPI has already implemented management of front-line operations using targets based on ROIC (refer to pages 39-40). We are now preparing a management framework including managing operations based on ROIC for the new-Mitsubishi Chemical Corporation from fiscal 2017.

Seimiya I think that front-line managers/staff will become more adept at screening businesses as their awareness on efficiency improves from the use of common management benchmarks.

Kosakai We will make our investment decisions based on detailed evaluation standards that take into account hurdle rates for each business type, product life cycles and market conditions. With the full-fledged introduction of ROIC as a benchmark, we will take a scalpel to not only unprofitable businesses*¹ but also low-profit businesses.

Seimiya From this standpoint, MCHC is advancing portfolio management based on the four-quadrant model. Will MCHC, as a holding company, screen investment

*¹ In July 2016, MCHC decided on the equity interest transfer of the terephthalic acid business in India and China.

proposals, business management ideas and business withdrawal suggestions that rise up from operating companies, or will management teams at the operating companies make these decisions from a top-down approach?

Kosakai Until now, MCHC has been making the final decision regarding proposals received from the operating companies, reflecting the actual circumstances that management at the operating companies was conducted by MCHC executives. From now on, we will separate supervisory functions and business execution functions. This will let the operating companies be in charge of business execution, and clarify the business supervision role of MCHC. With respect to business portfolios, resource allocation and internal controls, MCHC is responsible for the overall policy, and the operating companies will execute plans based on this policy. MCHC is also responsible for governance, evaluating the business execution performance of the operating companies.

Seimiya I understand that MCHC as a group will create and keep in motion a cycle of business optimization while respecting the independence of the operating companies.

Group Management Incorporating Non-Financial Benchmarks

Seimiya I have high regards for the MCHC Group's initiatives on the non-financial front, such as its vision of realizing *KAITEKI*, MOS and Management of Technology (MOT), from the perspective of sustained improvement in corporate value. As an outsider, however, it is difficult to get a firm grasp of all these initiatives. Have employees come to understand these initiatives, and to what degree?



Kosakai At each operating company, a Chief Sustainability Officer (CSO) has been appointed to promote sustainability through meetings. Meetings are held at least once a month to promote sustainability, including subcommittees for each MOS-related subject, to tightly coordinate actions. In addition, twice a year, each operating company holds a reporting event about the state and degree of penetration of Group-wide activities.

Our annual survey of employee perceptions monitors the degree of awareness of *KAITEKI* based on questions about whether the employee is on board with our management philosophy. At this stage, more than 70% of our employees have indicated that they sympathize with the concept of *KAITEKI*.

Seimiya I understand that MCHC is keeping tabs on employee awareness. How are the MOS and MOT Indices used in management?

Kosakai When a business investment is considered, the decision is typically based on a financial assessment using metrics like the internal rate of return (IRR). In contrast, MCHC also takes into account the investment target's degree of contribution to sustainability as a basis of its investment decisions.

Thus, we have been putting the MOS Indices into practice by quantifying their contribution to sustainability, and our next challenge is how we link this approach to financial indicators.

We aim to come up with a practical solution to this over the five years of *APTSIS 20*.

We are examining how to clearly link MOT to corporate value, and aim to embed it in our framework for establishing businesses with competitive advantages.

Aiming to Create a Conglomerate Premium

Seimiya Market participants have noted that after excluding the corporate value of listed subsidiaries in terms of their market capitalization, there is little value left over

that is attributable to other businesses. The integration of the three chemical companies is an attempt to dispel this so-called conglomerate discount.

Kosakai The planned integration of the three chemical companies, MCC, MPI and MRC, in April 2017 will bring together operating companies with different corporate cultures, and by combining the best parts of these companies, we aim to rapidly generate synergies and improve product competitiveness. Through their integration, we aim to improve R&D efficiency and share sales channels. We believe the new-Mitsubishi Chemical Corporation will derive value from being able to apply all of the Group's capabilities to meet the needs of end users.

Seimiya From the standpoint of synergies and integrating operations, it seems it would be challenging to manage chemical-related businesses and other types of businesses, that is, the healthcare business, under the same umbrella, due to their significantly different business cycles and investment amounts in R&D. Can you clarify MCHC's intentions on this issue?

Kosakai There is a strong preconception that healthcare equals pharmaceuticals. But in addition to pharmaceuticals, the MCHC Group is involved in a broad range of materials for healthcare businesses. Artificial joints and medical materials are such examples, and we have sales of roughly ¥100 billion annually outside the Health Care domain. Although the current contribution to consolidated net sales is small, we believe this domain has growth potential. In addition to pharmaceuticals, our materials and solutions have the potential to contribute to comprehensive medical service, and this is why MCHC engages in both businesses.

MCHC's first and foremost mission is to increase corporate value in a sustained and reliable manner. To this end, we must decide on the composition of our business portfolios and earnings structures. I believe we must strive to create a "conglomerate premium", in other words, create new businesses that are an organic fit with our three business domains.



Message Looking Forward

Seimiya I think that one way to look at MCHC is from the perspective of its accomplishments in visualizing and indexing initiatives that appear difficult at first glance but bring positive outcomes, as well as the incorporation of these initiatives in its management strategies and the fostering of a corporate culture that supports these initiatives. The Company's vision of realizing *KAITEKI*, criteria for deciding corporate activities, and plan for 2020 excels in terms of non-financial information and ESG, and are likely to lead to superior financial performance, in my opinion, over the medium- to long-term. To realize this vision, I think it is crucial for the CFO and financial departments to have a framework in place for optimally allocating capital. Our dialog today has given me a more detailed understanding of the concepts behind MCHC's initiatives to increase corporate value. As the MCHC Group steadily advances these initiatives, I expect to see not only an improvement in figures on the statements of income, but also a decrease in the cost of capital, and lead to greater trust among investors in management's abilities from a medium- to long-term investment perspective.

I look forward to seeing MCHC realize greater corporate value through its unique initiatives.

Kosakai Our dialog today was a precious opportunity to reassert that our most important mission is to increase corporate value in a sustained and stable manner. The MCHC Group will make concerted efforts to meet the expectations of its investors to the utmost extent.