We will increase investment in growth, including in human capital, while maintaining the 60% dividend payout ratio in the Medium-Term Management Plan, to achieve the 2030 Vision.

Senior Managing Director and General Manager of Administrative Division
Hiroshi Fujii

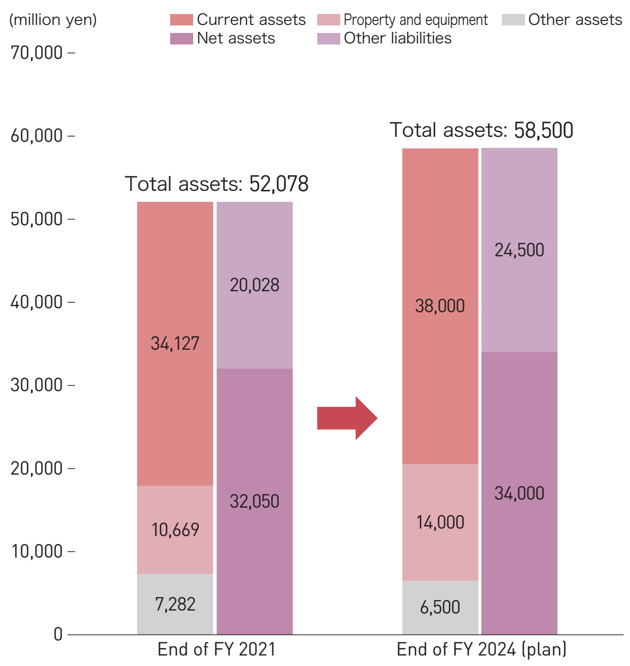
Nikko Group's financial and capital policy and approach as the officer in charge of finance

In recent years, Nikko Group's financial strategy has been mindful of making active capital investment as well as R&D, human resources, and other investments that will lead to growth. In the past the policy was about further reinforcing a stable financial base, but as the officer in charge of finance, I am currently not thinking of putting the brakes on investment for growth. Nevertheless, we are not going to spend that cash wastefully, and will make the equity ratio above 50% as a benchmark for our financial base (61.5% as of the end of FY 2021). If we assume a net asset of 34.0 billion yen (32.0 billion as of the end of FY 2021) in FY 2024, the final year of the current medium-term management plan, we can raise the total assets up to 68.0 billion yen (52.0 billion yen as of the end of FY 2021).
Our capital policy is to keep in check the accumulation of total assets to improve the ROE by maintaining a payout ratio of above 60% also during the current medium-term management plan period, as a measure to ensure shareholder returns. We expect a ROE of 6.2% in FY 2024, which will exceed the average cost of shareholders' equity of 4.4% over the past five years. In the 2030 Vision, we are aiming for an ROE of 10%, and therefore it is necessary to further expand the equity spread of the cost of shareholders' equity.

1 Outlook of balance sheet in the Medium-Term Management Plan taking into account the financial performance in FY 2021

Changes to the FY 2021 balance sheet in the assets side involved a 2.23 billion yen increase in inventories, while on the liabilities side, contract liabilities, which is roughly equal to down payments, was 4.42 billion yen. I do not consider the rise in inventories as excessive as most of the increase was for order-based production. It also includes the 0.45 billion yen prior to AP shipment at the Thailand subsidiary, which constructed a local plant. Another factor is that the shipment in the first quarter of FY 2022 was large. Account title of down payments was changed to contract liabilities, but there was an increase of 1.47 billion yen, which was due to an increase in orders for AP.
We are anticipating total assets of about 58.5 billion yen, excluding M&As, in the balance sheet for FY 2024, the final year of the medium-term management plan (FY 2022–FY 2024), and net assets of around 34.0 billion yen. Based on the capital investment plan of 6.0 billion yen during the medium-term plan period, we are expecting property and equipment to be 14.0 billion yen (10.7 billion yen as of end of FY 2021), current assets (cash and cash equivalents + trade receivables + inventory, etc.) of 38.0 billion yen (34.1 billion as of end of FY 2021), and other assets of about 6.5 billion yen (7.3 billion yen as of end of FY 2021). As a result, equity ratio is expected to decline slightly to a little more than 58% (61.5% as of end of FY 2021).

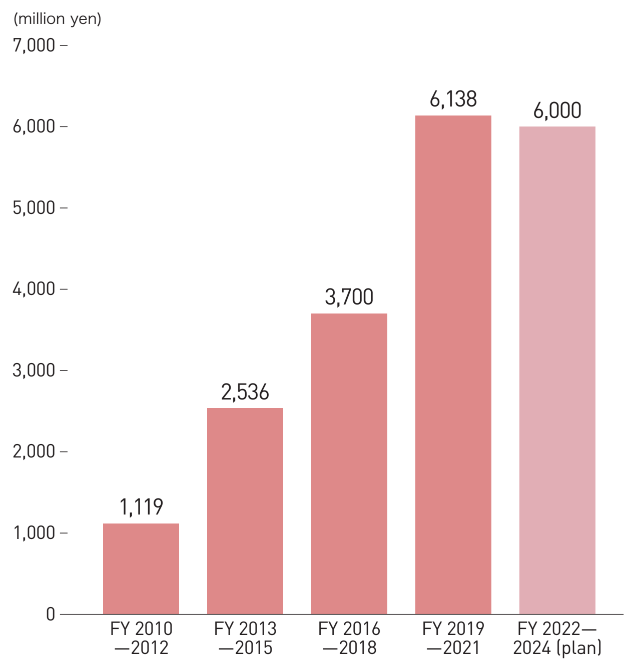
● Balance sheet trends



2 Outlook for growth investment (incl. M&A)

Capital investment for the Medium-Term Management Plan period is expected to continue at a high level of 6.0 billion yen (6.1 billion yen in the previous medium-term plan). Specifically, the breakdown of capital investment is as follows: 1.2 billion yen for the development test center taking into account the decarbonization business expansion, 0.3 billion yen for IT and other system-related investment, 0.4 billion yen for single employees dormitory, and 1.0 billion yen for land and machinery with an eye towards the consolidation of contractors. M&A will be added to this. As there is a possibility of more contractors having difficulties to continue their business in the medium- to long-term, Nikko is thinking of arranging land, construction, and facilities where it can bring together such contractors.
In our M&A policy in the Medium-Term Management Plan, we are considering (1) manufacturers engaged in environmental recycling and engineering, (2) industrial equipment manufacturers (with maintenance service) with an eye towards strengthening the maintenance service business, and (3) service providers that can strengthen our maintenance and service business. At the same time, we are not considering the acquisition of companies with large intangible asset value that require a large amount of goodwill amortization.

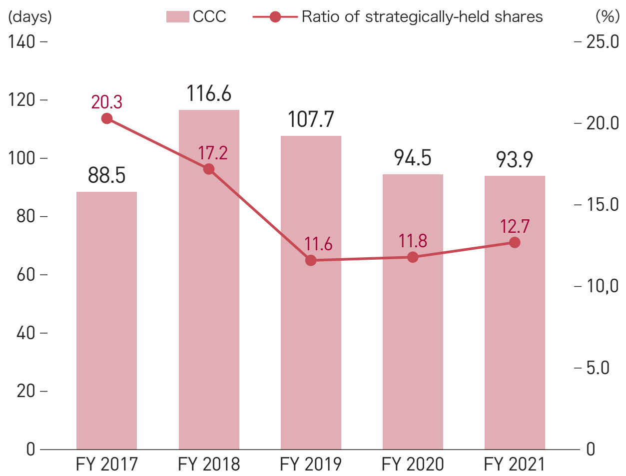
● Trends in capital investment



3 Improve CCC for cash flow creation and reduction of strategically-held shares

In terms of cash flow creation by streamlining the balance sheet, we were able to improve the cash conversion cycle (CCC) during the previous medium-term plan, which was 116.6 days at the end of FY 2018, to 93.9 days at the end of FY 2021. The effect of receiving down payments equivalent to a third of the contract amount at the time of order from AP customers was significant, and contract liabilities (account title changed from FY 2021), which are similar to down payments, increased from 1.63 billion yen at the end of FY 2018 to 4.4 billion yen as of the end of FY 2021, contributing to the shortening of CCC. We cannot, however, expect the same effect for this medium-term plan, and it is also difficult to shorten the deadline for notes receivable. Consequently, the key will be improvement through inventory reduction. Specifically, in AP's case, it takes more than a year from the time of the contract signing to delivery. We are pursuing the standardization of AP in order to shorten this.
With respect to the reduction of strategically-held shares, we hold such shares in 22 listed companies as of the end of FY 2021 with a total market capitalization of 3.1 billion yen with a shareholders' equity ratio of 12.7%. Its ratio to shareholders' equity has decreased from the 20.3% at the end of FY 2018 in the previous medium-term plan. But in the current plan, we are also planning a reduction in excess of 0.8 billion yen based on sales that have been finalized as of now. We are anticipating some difficulties in reducing strategically-held shares in the future as many of them are business partners, but we are aiming for a shareholders' equity ratio of 9%. We may have to take measures that involve changing the company-wide policy.

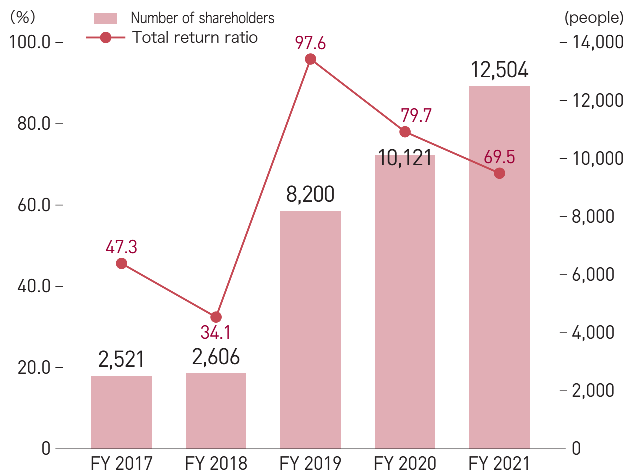
● CCC and ratio of strategically-held shares in shareholders' equity



4 Policy regarding shareholder returns

We will continue to maintain the payout ratio of 60% in the current medium-term plan. We may have to consider reviewing the payout ratio in the medium-term if we are to significantly increase the investment for growth from the current level. However, we are currently not feeling its necessity. While we are maintaining our policy of flexibly acquiring treasury stock, we prefer directing the funds to growth investment for the foreseeable future. Cash and cash equivalents came to 12.4 billion yen as of the end of FY 2021, maintaining a high level, but interest-bearing debts rose to 3.7 billion yen and net cash came to 8.7 billion yen (8.62 billion yen as of the end of FY 2018). The increase in interest-bearing debts include the 1.2 billion yen for the launch of the subsidiary in Thailand.
We were able to significantly increase the number of shareholders from 2,606 at the end of FY 2018 to 12,504 as of the end of FY 2021. This could be attributed to the lowering of the minimum purchase price through a stock split making it easier to become a shareholder, as well as the improvement in dividend yield from raised payout ratio and enhanced information disclosure. We also published the result of the questionnaire survey of shareholders that was enclosed with the convocation notice for the Ordinary General Shareholders' Meeting on our website. The survey had a high response rate of 36%. Moreover, we are planning to invite shareholders to the NIKKO MESSE 2022 held from November 1. The event, which is held at the head office once in every three to four years, is expected to provide opportunities for their interaction.

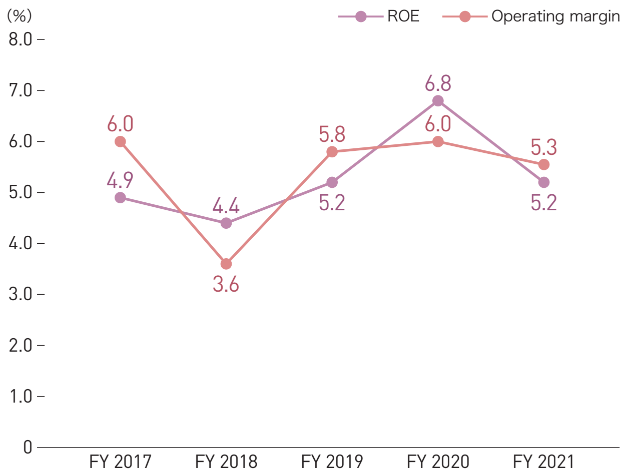
● Trends in total return ratio and number of shareholders



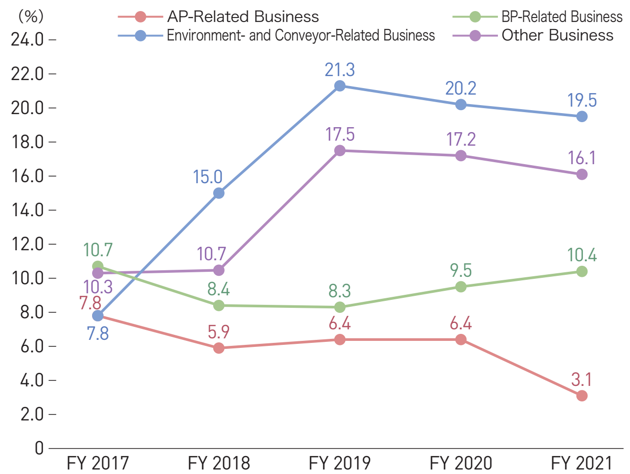
5 Capital efficiency and business portfolio management

We have set ROE as the KPI for capital efficiency. ROE was 5.2% in FY 2021, the final year of the previous medium-term management plan, which slightly exceeded the 5% cost of equity. We had raised the dividend payout ratio during the previous medium-term plan period, and we also managed to keep in check the accumulation of net assets as of the end of FY 2021, but ROE underperformed the forecast as we did not achieve the operating income target.
We are expecting a ROE of 6.2% (operating margin of 6.0%) in FY 2024, the final year of the current medium-term management plan, and ROE of 10.0% (operating margin of 10.0%) in FY 2030. We are assuming the shareholders' equity cost to be between 4 and 5% for the medium-term plan period, based on the average for the past five years. As we have been able to reduce the cost of shareholders' equity in the past few years, the increase in ROE is expected to lead to further expansion in equity spread. This is important for raising the corporate value and we are conscious of that.
As for business portfolio management, the mainstay AP-related business failed to achieve the operating income target by a large margin in the previous medium-term management plan. The reason behind this is the fact that although we have a 70% share in the domestic AP market, instead of an aggressive strategy, we took a defensive strategy that invited a price war with our competitors and affected profitability. There was also the impact from the lockdown in China caused by the COVID-19 pandemic and the rise in raw material prices.
On the other hand, the BP-related business and the other business, which include waterproof boards, mobile crushers, screens, and other mobile products, delivered better than expected profits. So, we feel there are some issues in business portfolio management. In the current Medium-Term Management Plan, we are anticipating an improvement in profitability through a business model reform of the maintenance service business. By focusing on this management, we hope to improve company-wide profitability and lead to the achievement of a net sales target of 60.0 billion yen and an operating income target of 6.0 billion yen under the 2030 Vision.

● Trends in ROE and operating margin



● Trends in operating margin by business



We will make an effort so that the improvement in ROE will lead to the expansion of equity spread and raise the corporate value.