We believe the upfront investment for boosting the earning power required for achieving 2030 vision has utmost importance in our financial strategy

Director and Vice President and General Manager of Administrative Division
Hiroshi Fujii

Nikko Group's financial and capital policy, and investment in human capital

Financial and capital policy and key points of FY 2022

Nikko Group's financial strategy has been to make active capital investment as well as R&D, human resources, and other investments that will lead to medium- to long-term growth. We have set forth financial targets of 60 billion yen in net sales and 6 billion yen in operating income under the 2030 Vision. The challenge, however, in achieving this is to enhance our earning power, and towards that end we will need support from the financial aspect. In FY 2022, the first year of the current Medium-Term Management Plan, we actively carried out capital investment for enhancing earning power for the future along with investment in R&D, human capital, and M&A.

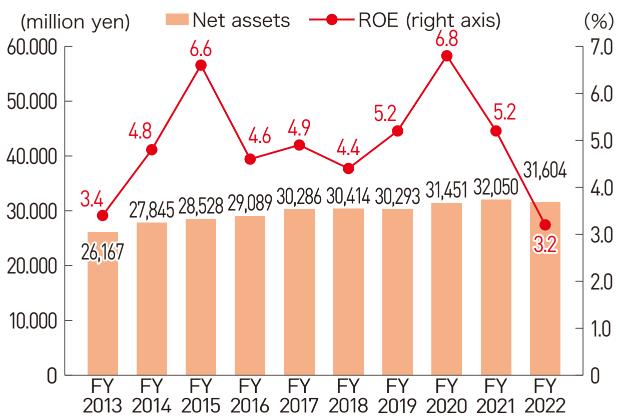
We attach importance to return on equity (ROE) as the KPI for earning power. By focusing on how much we can earn in terms of net income attributable to owners of parent, which is the numerator, without significantly increasing the denominator, i.e., net assets, we will focus on maintaining ROE above the 5% level of cost of shareholders' equity. In reality, net assets were 31.6 billion yen at the end of FY 2022, a modest increase from the 30.4 billion yen four years ago at the end of FY 2018, which was before we strengthened the measure to ensure shareholder returns. However, ROE was 3.2% in FY 2022 due to complex, overlapping factors that worsened the profit in the AP-related business, and went below the capital cost for the first time in two years. While we do not have a KPI for financial soundness, we consider equity ratio above 50% as a benchmark. As the equity ratio at the end of FY 2022 was 60.5%, we believe we have room to increase our net assets.

Upon making proactive investments, assessing where we should be earning future profits is also an important role as the CFO. Basically, I would like to keep away from high risk, high return projects as well as those with low relevance to our current business. While I do understand the importance of new businesses, there are many fields that we thought we should engage in and have not done so yet. I would like to place priority on such fields.

Accelerating investment in human capital

Since FY 2022 we have been boosting investment in human capital, which is the source of growth, and we have set raising wages, increasing personnel, and human resource development as three pillars in the current medium-term plan. In FY2022, the first year, we raised the starting salary of new hires and wages of employees who are union members uniformly by 30,000 yen, while in FY 2023 we raised salary by 5% on average in combination of an increase in the base salary and a regular pay raise. We will strive to maintain the average 5% increase continuously without ending it in just one fiscal year. We are targeting a net increase of 145 employees (at parent Nikko) over the three years of the medium-term plan. In FY 2022, we hired 53 people of which 31 were new hires and 22 were mid-career hires. Net increase was 35. We stipulated the policy for human resource development, which is one of the three pillars, in FY 2022, and will implement the policy from FY 2023. Specifically, we plan to offer position-based training for all employees from FY 2023. While placing importance on acquisition of knowledge, I hope the training will give the personnel an opportunity to gain some insight and voluntarily learn about future career formation.

◆ Trend in net assets and ROE



Achievements and issues of the first year of the Medium-Term Management Plan, and future outlook

Income worsened in AP-related business due to overlapping complicated factors

In FY 2022, the first year of the medium-term plan, we carried out capital investment as well as R&D, human resources, and other investments generally in line with the plan, but issues remained as the consolidated business results fell short of the plan at the beginning of the fiscal year, with net sales totaling 39.7 billion yen and operating income of 1.0 billion yen. By business, the gap with the budget target was large at the AP-related business due to overlapping complicated factors. Specifically, earnings at domestic road pavement companies worsened because the rise in asphalt price resulted in a significant fall in the net sales of our high-margin maintenance service, and we were unable to pass on the rise in steel and other raw material prices to the selling price as the delivery time for AP is long. The Thai subsidiary also posted an operating loss of 400 million yen in FY 2022 (operating loss of 250 million yen in FY 2021).

Currently, growth in net sales in the AP maintenance service has turned positive year on year from July 2023 partly due to the recovery in performance of road pavement companies. We are also expecting that maintenance service sales will rebound after the suppressed demand for maintenance investment. The rise in raw material prices is also expected to gradually slow down, and we are entering the phase for recording sales of the projects in which we raised the unit price. Here also, we are expecting improvement in profitability. Further, in the AP-related business, orders for warm mix (foamed) equipment among environmentally friendly products increased significantly since FY 2022, and we expect to sell around 60 units in FY 2023 for net sales of approximately 1.0 billion yen. This is a new environmentally friendly product, and it has quite good profitability compared to regular AP. However, the demand for warm mix (foamed) equipment may disappear once we complete one round of installation, and therefore it is necessary to continuously introduce environmentally friendly products.

Aiming to turn the Thai subsidiary profitable in FY 2025

The biggest challenge we face is to turn the Thai subsidiary established in 2019 profitable early on. The plan for the Thai subsidiary is to manufacture AP with local employees and sell the products in Thailand and the ASEAN region. We needed to develop customers from scratch in Thailand, and we also had to teach everything from monozukuri to procurement of materials from the beginning to local employees, who had no experience with AP. For that reason, we entered into a joint venture with local company NilKhosol, but it took time to get production on track. That was partly because we could not dispatch employees because of COVID-19. From January 2023 we are providing support with a 26-member team on dispatch for the project.

The local sales agent for the Thai subsidiary is TIPCO ASPHALT, a major asphalt supplier, and as of now there is a steady increase in orders with the company having an order backlog worth 700 million yen as of the end of June 2023. We believe that a net sales of 1.5 billion yen would be enough to turn it profitable, but attaining the sales would be difficult in FY 2024 and we expect a 200 million operating loss for the year. Therefore, we are expecting the Thai business to turn profitable in FY 2025 or later. Also, the order backlog of 700 million yen is entirely from within Thailand, and we do not have any orders from Indonesia or Vietnam as we had expected.

Till now, 70% of the products for the market in Thailand have been manufactured in Japan, with the local subsidiary producing the remaining 30%. We have prospects for achieving the production ratio of 70% in Thailand and 30% in Japan in FY 2024, and we expect the manufacturing cost also to go down. In Thailand, we have been selling export models made in Japan, but the customers were not seeking such high specifications. So, we are thinking of paring down the excessively high specifications and lowering the cost by a total of 20% through localization and model change. We will complete this model within the year. Parallel to the cost reduction, we are also hoping to win new orders for a total of about 10 units from Indonesia and Vietnam. Competition is a Chinese company in Thailand and a South Korean company in Vietnam. In Indonesia, we compete with both Chinese and South Korean companies.

Future financial strategy for improving cash flow creation capability

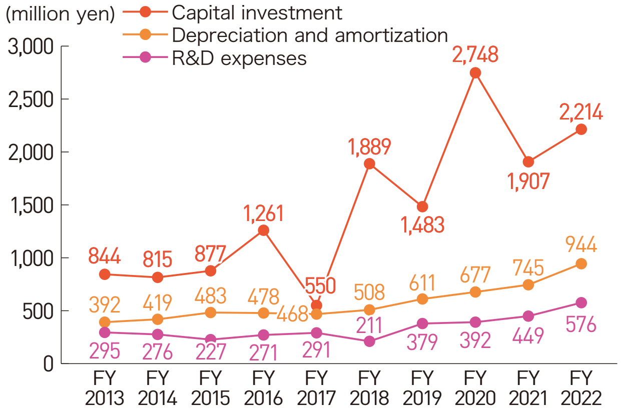
Cash flow creation and allocation policy

Nikko Group plans to invest 6 billion yen in the three years of the medium-term plan and made investments worth 2.2 billion yen in FY 2022. This does not include M&A, but we have spent 1.9 billion yen for the two M&As till now, and we are thinking of one or two more M&As. Operating cash flow creation ability is crucial for funding such growth investments, but our operating cash flow for FY 2022 was -1.6 billion yen. As we maintained a dividend of 30 yen per share for shareholder returns with payout ratio of 112.5%, the net cash at the end of FY 2022 was 4.5 billion yen, a significant decline from 8.6 billion yen as of the end of FY 2021.

Judging from this, it cannot be helped if a shareholder gets the impression that our cash flow creation capability of the main business has deteriorated and we would not be able to afford future investments. Nonetheless, gross profit margin has not declined at around 26 to 27% during this period, but cash flow creation ability has fallen because of the increase in selling, general and administrative expenses. This is in part because proactive measures such as capital investment, R&D, human resources, and other investments as well as the M&A of Ube Kohki have been driving up selling, general and administrative expenses. Selling, general and administrative expenses for FY 2022 were 9.3 billion yen, going up by 1.7 billion yen in the past three years.

The increase in selling, general and administrative expenses is upfront investment for increasing future net sales and improving gross profit margin. As it would take time to bear fruits, we are not going to be pessimistic about short-term results nor modify the financial and capital policy. Nikko Group is expecting the results from the price revision addressing the high raw material prices to take effect from the second half onwards. Also, in order to secure appropriate profits, we will continue to raise prices in projects where the returns are low in assessment of values offered. Raising prices were difficult in the past because of deflation, but now more customers are understanding the values we create. We need to continue implementing initiatives to increase prices to enable us to raise the wages of employees by 5% every year.

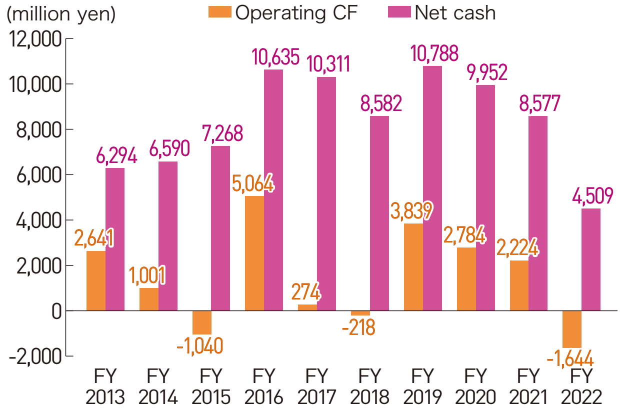
◆ Trends in capital investment, depreciation and amortization, R&D expenses



Cash flow creation from balance sheet

We are also pursuing cash flow creation from balance sheet. In FY 2022, we sold 370 million worth of strategically-held shares, bringing the value of such shares held at the end of the fiscal year to about 2.2 billion yen, and their ratio to shareholders' equity was 9.56%. Going forward, it may not be easy to decrease the strategically-held shares as many of these belong to business partners, but we will continue to reduce them. Behind the worsening of total asset turnover ratio and cash flow creation is the requirement to keep the stock for long because of the continuing prolonged delivery time of motor and electronic parts. Traditionally, we used to place orders for parts once we received an order, but now we are maintaining stock of necessary items to enable prompt delivery and this has led to accumulation of stock on the balance sheet. Taking this perspective also into account, it is necessary to further increase the collection of contract liabilities (down payments). We receive payments equivalent to a third of the contract amount from customers at the time of order as contract liabilities, and they were more than 3.7 billion yen as of the end of FY 2022. However, we have not been able to collect them from about 30% of the customers. There is the need to change business practices and it takes time, but we are negotiating tenaciously and hope to achieve future cash generation.

◆ Trend in operating cash flow and net cash

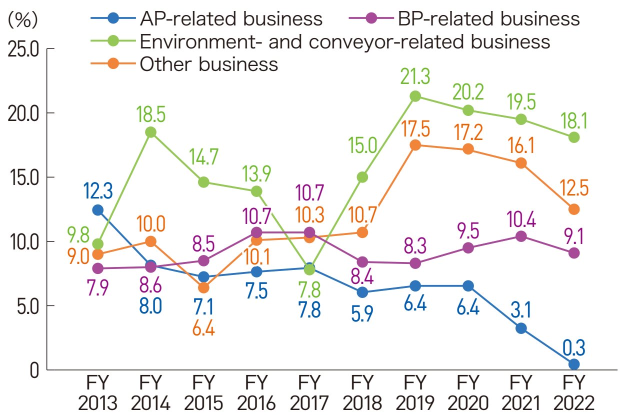


Business portfolio management and future direction

As for business portfolio management, we have been failing to meet the initial forecast in operating profit in the AP-related business in the past few years. Remedying this is the issue with the utmost priority. The reason for the worsening profitability in AP-related business has been the strategic pricing for domestic orders. However, the reason now is the delay in passing on costs caused by the price increase of steel plates and other raw materials (up 200 to 300 million yen) because of the post-COVID prolongation of delivery after the receipt of orders. Further, in FY 2022, the business performance of domestic road pavement companies deteriorated due to the soaring asphalt prices, so the highly profitable maintenance service also declined by 11%. In addition to this, there has been overlapping negative factors such as worsening profitability of the earlier mentioned Thai subsidiary to 400 million yen in loss in FY 2022.

Nevertheless, we have to grow the maintenance service business if we are to expand net sales in the medium to long term, as we cannot expect AP demand to increase in Japan. Therefore, although Nikko Group has been making various related up-front investments, it takes a few years for them to bear fruits. Specifically, AP customers are moving towards outsourcing the repair work, which they were doing themselves till now, because of labor shortage, but we are also lacking in service personnel to respond to this latent demand. We are, therefore, changing our structure so that service personnel can work efficiently by introducing a flat-rate subscription system. The gross profit margin of maintenance service is high at about 30%, but we believe there is still room for improvement through business transformation. In FY 2024, we expect operating income of AP-related business to improve by 600 to 700 million yen compared to FY 2022 as the raw material price increases and losses at the Thai subsidiary would have completed a full circle, and here we expect sales increase in maintenance service.

◆ Trends in operating margin by business



Ube Kohki and Matsuda Kiko, which we acquired in 2022–2023, have technical prowess in contract manufacturing. In the future, we would like to grow contract-based manufacturing as one of Nikko Group's business as its profitability is also high. There is also the issue of lack of successors, and weeding out is expected in the medium to long term among companies carrying out contract-based manufacturing and installation. We also cannot imagine major companies newly entering the contract-based manufacturing field. The two companies have a combined net sales of approx. 2.5 billion yen, with operating margin of around 10%, and they more or less do not have any goodwill amortization. On of the reasons for the acquisition of the two companies also was to outsource manufacturing of Nikko Group's environmentally friendly products and recycling equipment (net sales of about 1.0 billion yen) to group companies, and we expect contract-based manufacturing of recycling equipment to continue increasing in the future. Ube Kohki has seen an improvement in hiring of human resources by forming a part of the Nikko Group, and Matsuda Kiko is also expecting similar improvement in the future.

Financial and capital policies for improving corporate value and engagement with shareholders

Taking into consideration a recent request for the Action to Implement Management that is Conscious of Cost of Capital and Stock Price from the Tokyo Stock Exchange, we will strive to achieve the target of 60 billion yen in net sales and 6 billion yen in operating income (10% in operating margin) under 2030 Vision towards improving our corporate value. The current fiscal year is the second year of the medium-term management plan and we are expecting the investment we are currently making to bear fruits in the next medium-term management plan. In particular, during the next medium-term plan from FY 2025 to FY 2027, we will ensure at least 8% in operating margin, if 10% is difficult, in the final fiscal year, and achieve 50 billion yen in net sales, 4 billion yen in operating income, nearly 3 billion yen in profit attributable to owners of parent, and about 8% in ROE, a level at which equity spread expands. That is because operating income will increase by 0.6 to 0.7 billion yen if the current losses and high raw material prices at the Thai subsidiary come a full circle, the impact of upfront investment in human resources, facilities, and R&D will add 0.5 to 1 billion yen, and on top of these will be the increase in gross profit from sales increase. We are expecting that if these take place, we can increase the dividends significantly as shareholder returns. If the payout ratio does not change from the current 60%, the dividend amount will be 1.8 billion yen, which is a 50% increase from the current 1.2 billion yen.

At the moment, Nikko Group is actively investing overseas and in facilities and human resources, and this is because we have the financial strength to withstand this scale of investment. I basically do not think that the Group's capability to generate cash has deteriorated. While our operating cash flow may appear to be weak because we are spending upfront, it is not that the Company's profitability has worsened fundamentally.

Dialogue with shareholders and investors, engagement-related initiatives

In engagement activities, shareholders and investors have consistently pointed out the low profitability of the AP-related business. They ask us if we intend to raise the price because we are the price leader with a 70% share of the domestic AP market, which is an oligopoly. We have reported this at the Executive Committee meeting and our management team is also aware of it. With respect to this, we have been driving forward measures such as standardization of models but we basically feel there is sufficient room for making efforts to sell products at prices that match the value they offer. Another point is the seasonality of net sales, which is high across the Company, with delivery concentrated at the end of a fiscal year, and this is a factor contributing to inefficient management. We do have an idea to implement unprecedented initiatives to level quarterly sales, provided that it would be accepted by the customers.

The number of shareholders totaled 14,541 as of the end of FY 2022, a major increase compared with 8,200 in FY 2019 and 12,504 in FY 2021. Many of the new shareholders are individuals and the rate of replying to the shareholder questionnaire survey enclosed in the notice of the results of the Ordinary General Shareholders' Meeting has been high at about 36%. As a commitment to attach importance to shareholders' opinions, we not only disclose the results of the shareholder survey on our website but also post individual opinions there. This is an act of engagement that visualizes whether or not shareholders' opinions are reaching the management team, and enables us to think from the shareholders' viewpoint. According to the shareholder questionnaire survey result in FY 2022, shareholders who have been holding Nikko shares for one to three years was 51.1% (45.2% in FY 2021) and those who plan to hold Nikko shares for a long period of time (five years or longer) accounted for 63.2% (57.5% in FY 2021). Dividends and shareholder return policy were cited as the attractiveness of Nikko shares and top reasons for choosing the period of holding them, and the management team is keeping this in mind upon managing the Company. We have also been disclosing the materials used for the financial results briefing for institutional investors and securities analysts, but 36% of the respondents of the shareholder questionnaire survey did not know about this. So, we have been strengthening information disclosure through measures including video streaming the meeting on our website.

To commemorate the 100th anniversary of the Company's foundation, we, in September 2019, distributed 100 shares in the Company to all employees of Nikko Group (equivalent to 500 shares currently following subsequent share split) and in 2021 we introduced a system to allot treasury stock with restriction on transfer with the aim of improving engagement and raising awareness among employees to participate in management. These moves made almost all employees into Nikko shareholders, and we are hoping that having the same perspective as our shareholders would lead them to actively make contributions to the business performance.