Kubota Corporation

Result Briefing for the 1st half of FY2019 ending December 31, 2019

Q & A Session　(Tokyo, August 15, 2019)

Q.　With respect to the result of financial services in the first half of this year, revenue increased, but profit decreased from the prior year despite decreased sales promotion expenses due to the decline in interest rates in the United States. What was the reason for that? Wasn't the positive effect from the decrease in sales promotion expenses resulting from the decline in interest rates able to compensate for the negative factor of increased costs, such as SG&A expenses?

A.　The increase in revenue of financial services was due to an increase in the balance of finance receivables along with increased retail sales mainly in the United States. On the other hand, there were 2 main factors behind the decrease in profit. First, the decline in interest rates did not have a significant positive impact on financial results for this fiscal year. In financial services, the difference between lending rates and borrowing rates become a profit. However, the recent interest rate fluctuation does not have an impact on profit directly since the term of the loan is 5-6 years. Second, SG&A expenses increased this year because we implemented various measures to strengthen our financial business, such as changing systems for future business expansion in financial subsidiaries particularly in the United States. These factors led to the decrease in profit despite the increase in revenue. However, the amount of bad debts has not increased, and the method of securing profit margins and the profitability of financial services have not changed significantly. We think that the decrease in profit in this first half is within the range of fluctuations as usual.

Q.　Please tell me whether both revenue and profit in North America increased from the prior year or not even excluding accounting adjustments due to reversal of the allowance for sales promotion expenses. I recognize that the impact of increased sales on profit for Q2 was at a low level. Looking at the business trend in this year, I seem that there was little impact of increased sales in North America on profit.

A.　Unexpected factor from the beginning of this year is a decline in interest rate, and there is no doubt that the profitability of North America is rising including the positive effect from the decline in interest rate. Profit in Q1 included the significant positive impact of accounting adjustments. Profit in North America increased year-on-year in Q2 alone, and profitability in North America has been steadily rising, while profit in Q2 did not include the temporary impact of accounting adjustments so much. In addition, even excluding the positive impact of accounting adjustments due to reversal of the allowance for sales promotion expenses, both revenue and profit in North America increased. However, taking out financial results of Q2 only, profit resulted in an increase by 0.8 billion yen year-on-year despite an increase in revenue by 12.5 billion yen year-on-year because the negative impact of the yen appreciation against the Euro was significant in particular.

Q.　Please explain the background to the delay in shipments in Europe and the United States, which caused the shortfall in revenue in the first half of this year against the forecasts. Is it correct that delayed shipments in the first half of this year can be recovered in Q3 of this year? In addition, toward the second half of this year, please tell us about the regions which are stronger or weaker than the original forecasts and changes in the outlook for the second half compared to the forecasts which were created 3 months ago or 6 months ago.

A.　Part of the reason for the shortfall in the first half was due to some sluggish markets such as Myanmar. But the major reason was the shortfall in revenue in North America and Europe, where shipments were delayed, from the forecasts. There are several reasons for the delay. First, there was a shortage of parts from suppliers. Production volume has been at a very high level because sales have grown at a high rate in recent years. In this situation, we ask so much of suppliers to supply parts, but there are cases where the supply may not keep pace with our plans. Although we conducted production adjustments, there were cases where the product was not able to be shipped according to the order of the dealer and the back order was accumulated. Second, confusion arose during the transfer of reassembly lines in the United States. To reduce logistics costs, we traditionally do not ship finished products from Japan, and re-assemble them, such as putting tires, at a manufacturing company in Georgia. This work was transferred from the manufacturing company to the warehouse of the sales company in May, but some troubles occurred at the start of this work. Due to the high-level flow of products, the impact has prolonged despite occurring such problems even for a few days. In Europe, delays mainly in the procurement of parts also occurred at warehouse in the Netherlands where we assemble construction machinery and respond to orders of various options. For these reasons, shipments in Europe and North America did not proceed as planned. However, we believe that the delay of shipments will be able to be caught up steadily in the second half because we already have orders from dealers and our retail sales are steady. Some of the regions for the first half of this year were better than expected, and some were worse than expected. However, despite negative factors such as inclement weather, we recognize that the overall markets are making progress within the range of our expectations.

Q. As for change in sales incentive ratio in factors affecting operating profit, the results for the first half of this year were +8.2 billion yen, compared with the full-year forecast of -6.3 billion yen. Please tell us what is your outlook of the impact for the full year at the current pace?

A. There is a story that there will be 2 times of interest rate cuts from now on, and if interest rates in the United States decline from now on, change in sales incentive ratio will naturally have the positive impact on operating profit. However, the allowance for sales promotion expenses was reversed in the first half of this year on the assumption that interest rates would be flat or decrease. So, reversal loss is expected to occur in the case that interest rates rise at the year-end. At this point in time, I would like to refrain from mentioning the full-year forecast. In addition, although we have remained our full-year forecasts unchanged this time, I think that it was the conservative decision regarding profit in particular. However, our compact tractors and construction machinery business are very sensitive to the economic conditions. Although the current situation is favorable as expected, uncertainty about the business environment is heightening due in part to the effects from trade frictions between the United States and China in recent years. In the case that uncertainty of economic trends from the next year increase, there is a possibility that the uncertainty will affect motivation of restocking by dealers toward the end of this year and investment plans by rental companies of construction machinery for the next year. In light of this situation, we have decided to take into account more risks and keep considering the upward revision for the time being.

Q. Regarding Thailand, it is not raining so much even during the rainy seasons, and the retail sales in July also seem to be worsening. However, you said that you don't need to worry about it so much because the grain price is not falling in the presentation. Amid the deteriorating current figures, may we be really relieved or should we estimate the result in the second half conservatively? Please tell me about the situation in more detail.

A. Retail sales of tractors in the first half of this year increased by 10% in Thailand (domestic sales only) and 11% including Cambodia and Laos from the prior year. Although there are some concerns about drought due to scarce rainfall during the rainy seasons, sales of rice, cassava, and maize continue to be strong, so we expect to achieve full-year forecasts. I heard a report on the sales situation in Thailand in July, and it indicated that progress was expected to be in line with the plan. Currently, we do not expect the draught to be as severe as it has been in the past.

Q. Please tell us about your approach of management from now on. Revenue has grown for the past few years and revenue is about to reach a level of 2 trillion yen. On the other hand, the growth of profit has slowed in the past few years due to an increase in fixed costs such as upfront investment and deterioration in the incentive ratio. Will Kubota aim to achieve sales growth by accumulating upfront investments amid the current turmoil in the global economy and growing uncertainty? Or will you plan to manage with a brake in light of uncertainty? Please tell us about Kubota's management policy going forward.

A. Up to now, we have been aiming for revenue of 2 trillion yen, and if the foreign exchange rate level is a little stronger against the yen, it is thought that we will be able to achieve this target of 2 trillion yen this year. Moreover, the growth over the past few years has created the potential to constantly achieve revenue of 2 trillion yen based on the current business portfolio. However, amid the growing uncertainty about the business environment, we must once again consider the extent to which we will place importance on increasing revenue and expanding the business from now on, and we believe that the increase in revenue is not all of what we aim at. However, we also believe that an increase in revenue is one of the important indicators of our business growth, and we will continue to set target of revenue within the company. On the other hand, I am very seriously aware of the fact that the operating profit margin has declined in the past few years, and we are taking various measures internally to improve operating profit margin this year from 10.2% in the prior year. If the business environment will not change significantly, we expect to be able to secure higher operating profit margin than in the prior year. It is not easy to return to 14% at our peak. However, we would like to take measures to improve the operating profit margin with placing more emphasis on increasing it at the same level as, or more than sales growth. In addition, it is necessary to make R&D investments in order to beat competitors in the market. If we do not conduct the necessary capital investments and IT investments, it will be difficult to secure sustainable profit. With steadily improving operating profit, we would like to conduct the necessary investments while keeping in mind about the pace. Although uncertainty about the economy is increasing, we believe that the basic business environment and market conditions are within the scope of our expectations, and therefore we do not expect any major changes to our management policies at this time. Next year, the next mid-term plan will be considered, so we would like to decide the policy considering the next 3 to 5 years while also considering market trends.

Q. Please tell us about the competitive environment in the construction machinery business in North America. I heard that manufacturers in the construction machinery industry have competed aggressively with Kubota recently. Please tell us about the background to their actions from the perspective of Kubota. Please also tell us how you decide whether to enhance incentives in the sale of construction machinery.

A. We believe that competitors in North America have been aggressive against us due to our introduction of SSL (skid steer loaders), our increase in market share oconstruction machineryf CTL (compact truck loaders), and our increase in the number of dealers who were the strong dealers handling other manufacturers' products and started handling Kubota's products. These factors may cause competitors to feel a sense of danger and to be aware of Kubota in sales competition. As for incentives, the competitive environment differs between tractors and construction machinery. Tractors, particularly compact and medium-sized ones, are in a position to fight the top of the competitors. Total sales volume of top of competitor's and us accounts for considerable part of the market. So, we're thinking about how we should do while looking at what incentives the top of competitors might take. In construction machinery market, on the other hand, we compete with various manufacturers, not only a specific manufacturer, so we do not make any decision by looking at action of specific manufacturer only. We have a considerable lineup of MB (mini-excavator), but we have just a small lineup of CTL and SSL. Therefore, the decision is made based on the trend of the competing manufacturers for each product.

Q. I have recently heard that the level of dealer inventory in North America is insufficient. Please tell us about the way of thinking the appropriate level of dealer inventory.

A. As the way of thinking the level of dealer inventory, when we have variety of products, it is necessary to prepare a considerable number of inventories by placing each dealer with each product. So, we categorize our best-selling and not-selling products and suggest an appropriate level of inventory to our dealers. Regarding tractors, inventory level may range from 6 to 9 months, depending on the season. In spring, the dealers should have more than 8 months of inventories to avoid the shortage of inventory. In September, when the demand is normally low, we reduce the dealer inventories to about 6 months, and we increase dealer inventories in October toward the high sales seasons in the end of the year. So appropriate level of inventories varies with the seasons and it is necessary to have the way of thinking the appropriate level of dealer inventories for each month. We consider 6 months of inventories as the lowest level and from 8 to 9 months as the highest level. On the other hand, construction machinery has little seasonality. We consider from 7 to 8 months of inventories is the appropriate level intuitively because we need to place products that meet customer needs at dealers.

Q. Please tell us about the sales result of M7.

A. Looking at the sales situation of M7 by region, the sales in Europe, which is the main market accounting for half of the total sales of M7, were strong due to the introduction of M7 plus (improved model of M7). Retail sales in Europe reached about 420 units in the first half of this year, compared to about 250 units in the first half of the prior year. We plan to sell about 1,000 units this year, compared to about 650 units in the prior year. Retail sales in the United States were about 120 units in the first half of this year, compared to about 120 units in the first half of the prior year. And retail sales in North America were about 230 units in the first half of this year, compared to about 210 units in the first half of the prior year due to higher sales in Canada compared to our plan. We plan to sell about 600 units in North America this year, compared to about 530 units in the prior year. Retail sales were about 760 units in the first half of this year on a global basis (including Japan), compared to about 570 units in the first half of the prior year. We plan to sell about 2,000 units on a global basis this year, compared to about 1,400 units in the prior year. In addition, we plan to produce roughly the same number of units. Although there is a seasonality of sales and it is not an easy target, we will make efforts to achieve the target.

Q. Please tell us about the sales results of the Indian business you are focusing on in the first half of this year.

A. Our retail sales of tractors in the first half was about 5,600 units, 25% increase from the prior year, despite weak tractor market this year. Driver of this increase was multi-purpose tractor, and sales of that were about 3,100 units, 61% increase from the prior year.

Cautionary Statements with Respect to Forward-Looking Statements