

Investors' Meeting for Corporate Business Plan Q&A Summary

Date and Time: Thursday, March 3, 2022, 15:00-16:30
Presenters: Keiichi Iwata, President
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<Petrochemicals & Plastics Sector>

Q. You've changed the name of the Petrochemicals & Plastics Sector to Essential Chemicals, but your company will be closing your cracker in Japan quite soon, so all that remains now is withdrawing from Keiyo Ethylene, I think. A significant reorganization has been trying to occur recently in petrochemicals, and I think other companies are also on board, but how will your company be involved in the reorganization of the petrochemical industry in Japan? Will you just participate in the industry outside of the country, because it's more or less done in Japan? I would like to ask about Essential Chemicals, including Petro Rabigh, which wasn't touched on much in your presentation.

A. In 2015, when we shut down our ethylene plant as soon as possible, we also shut down our styrene monomer and liquid-phase caprolactam plants as well, so we recognize that we have already undergone some degree of reorganization. At the same time, with regard to polyolefins and similar products at our Chiba Works, while we are proceeding on a high-added-value path, there are still some commodity products. As for what we should do about commodity polyolefin products going forward, because this is a shared issue that the industry is facing, including our company, we think there is a possibility of taking common steps in terms of reorganizing the industry and the like. While I agree with your overall point, however, when it comes to actually extracting something, it becomes a question of how we can arrange a petrochemical complex, with its wide variety of connections, and a question of how much equipment to ultimately bring to a stop. As a result, while we are prepared to enter that discussion, the question of what sort of reorganization will move forward is one where the answer is not yet clear.

Q. Am I correct in understanding that you will not be conducting much in the way of modernization investment or other investment in Petro Rabigh?

A. I think for Petro Rabigh, we would like them to make investments in enhancing competitiveness on their own account, and our unchanged position is that our company will not be conducting any additional capital outlays.

- Q. Your target core operating income for the Essential Chemicals Sector for FY2024 is 54 billion yen, slightly higher than the average for the past five years of around 43 billion yen. In addition, when you showed your forecasts for FY2024-25 at an IR Day about a year and a half ago, your forecast was 40 billion yen, so this is also higher than that. Is the main reason good market conditions? Or is the background that profit margins will also increase in places unrelated to market conditions, such as technology licensing?**
- A. To answer qualitatively, our ongoing efforts up to this point to shift our structure toward greater income is beginning to produce results as the years pass. For example, our catalyst business, which operates as a pair with our license business, is supporting our financial results, and that amount is gradually increasing. Whether you think our target for core operating income in FY2024 is a little high, or you see it as representing a deterioration of market conditions, because it is a drop of about 10 billion yen compared to this fiscal year, that will depend on your point of view, but it is extremely difficult to predict what the market environment will be in FY2024. We have previously explained that we are trying to count the Essential Chemicals Sector as a bonus, securing some degree of earnings capability in the parts of our business outside of Essential Chemicals, where results can be highly affected by market conditions, but even within the Essential Chemicals Sector, the classification of products into commodity products and truly essential products has gradually become clear, so I would like you to take it that we can generate stable earnings with our PO and licensing/catalyst businesses, we can also generate stable earnings with MMA, and we can even generate stable earnings with essential polyolefins, and those earnings guided our current target for FY2024.

Q. Although new entries into the petrochemicals business have decreased due to the global trend toward carbon neutrality, it is not the case that demand itself will suddenly decrease, so am I right in thinking that balancing supply and demand will be an extremely positive factor? Is the reason you have not reduced core operating income for the Essential Chemicals Sector in this Corporate Business Plan because of thinking along these lines, that you think supply and demand will not be that bad? Also, costs are increasing in China, due to factors such as environmental regulations and electricity shortages, so with the current weak yen, has your cost competitiveness caught up to the point where Japanese production will not lose out to China?

A. For the first question, I think views will vary person by person, but for Sumitomo Chemical, we are not taking that sort of optimistic viewpoint. Even in the two years of 2021-22, new ethylene plants are being built one after another around the world, with 12 million tons/year of new production capacity coming online. Of that, about 9 million tons/year is in Asia. Japan's total production capacity amounts to about 6 million tons/year. Newly built plants are on the cutting edge, with better cost competitiveness than Japan's aging equipment, so in that sense I think the era of supply exceeding demand may well continue for some time. As a result, I think there will definitely be pressure to import into Japan. Japan's current ethylene production capacity is about 6 million tons/year, but about 10-15% is exported. Those exports will clearly go away, so even in that sense I think we may not be able to expect any contraction in market conditions.

For your second question about costs in China, while there might be many places where we face similar circumstances in terms of raw materials, my sense is that Japan will lose out just in terms of productivity, just due to the newness of China's equipment. It is true, however, that labor and equipment costs are increasing in China, so for more sophisticated products such as intermediates for agricultural chemicals and precursors for pharmaceuticals, which had previously moved from Japan to China or India, I think it may be the case that actually, Japan is currently ahead in terms of cost competitiveness. The question is now being raised whether there might come a time when more sophisticated products such as intermediates could again be made by Japanese companies.

<Energy & Functional Materials Sector>

Q. In the figure on slide 50, Energy & Functional Materials has not passed the target threshold. For Health & Crop Sciences, I can envision how ROI could pass 7% by FY2026 once your post-flumioxazine products have come out, but could you please share your thoughts on how Energy & Functional Materials could pass this threshold?

A. For Energy & Functional Materials, we think that ROI will naturally increase as we steadily collect on the returns from the investments we have made through FY2021, and we feel that expansion along the horizontal axis (the scale of the business) is more of a problem. We would like to invest in the sector further, and turn it into a sector that produces greater income, but until we establish some amount of proprietary technology, we cannot make drastic investments. Because we will see the fruits of past investments going forward, however, with respect to an ROI of around 7%, we think we will achieve that target, if not in FY2024 then in FY2025, so at that point we think that a lack of growth in business scale would be the real issue.

Q. I think that this sector has produced any number of losses in the past, in areas such as separators and high purity alumina. I am concerned that the next time you make a major push for growth, you will again produce losses, but what are your thoughts?

A. After we posted a loss in high purity alumina, we were able to reverse the impairment through a recovery in the business' profitability, so in the end it was not a loss. For separators, because capital expenses were extremely high in the development phase, that portion was a loss. We have not had a loss on capital since the business was commercialized. The Energy & Functional Materials Sector, however, includes a variety of businesses, such as aluminum, dyes, and synthetic rubber. While we have growing product categories, we also have product categories where we need to withdraw or reorganize, so it is true that it is a sector with difficulties. Our unchanging policy, however, is to invest more capital into growth areas, so we would like to continue to strengthen this sector.

Q. For the graph on slide 55 about battery materials in the Energy & Functional Materials Sector, it looks like separators are growing by about 40% from FY2021 to FY2024, but with the electric vehicle market growing at an annual rate of 20-30%, I get the impression this growth is a little subdued. I think your original strategy was to grow by expanding sales routes to a variety of customers beyond your current clients, so is there room for an upward departure? This also shows cathode materials satisfactorily, reaching about double its current level, but is this because you already have customers in view, or is this something for the future? In terms of timing, will we see growth more toward the beginning of the next Corporate Business Plan, or will it grow linearly, or will it grow significantly in the final year?

A. For cathode materials, we are currently building a demonstration plant in Ehime, but this is not just for demonstration purposes, we have business arrangements in place such that if the demonstration can produce good products, customers will use them as-is. This graph shows growth because we are assuming that the validation will go well and sales will be recorded, and there will be some degree of revenue by FY2024. For separators, we have said that we would grow our sales channels to other customers, rather than relying on just a few customers as previously, but while our product has been adopted by a few companies, we have not been able to connect that to expanded sales in significant unit numbers. Our forecast for FY2024 does not assume that our product will suddenly be adopted by a major player. Circumstances in the world of separators are changing, however, and while I think you are aware of talk about a 2170 size and a 4680 size, because capacity increases by a factor of five once you get that big, even with cylinders, and because danger increases exponentially, there will be demand for safer separator functionality. If we can keep up with these sorts of changes in demand, that would become a picture with a broad new world for us. If it does not go well, it will become a risk, but I think this is an opportunity.

<IT-related Chemicals Sector>

Q. On slides 56 and 57, for displays and semiconductor-related materials over the next three years, I would like to ask about how much growth you expect for each in sales income and core operating income. Of the 110 billion yen increase in sales income, should we see that as a little over 50 billion yen each?

A. In terms of an overall vision, display related materials makes up about one half, and everything else (including semiconductor-related materials) makes up the other half.

Q. I would like to ask about the breakdown of the increase in core operating income. Am I right in understanding that the increase in products like photoresists forms the core of the increase, and the increase in compound semiconductor-related materials is supplementing that?

A. The increase in core operating income relies primarily on the contribution from semiconductor-related materials. That includes the contribution from compound semiconductor-related materials, but we expect that the full contribution of those materials to financial results will come later than FY2024.

Q. Does that mean that core operating income in display-related materials is not growing much? Please tell us about the direction for the relevant materials businesses.

A. For display-related materials, a number of factors converged in FY2021, such that it was too good to be true, in a sense. To be honest, we feel that we will face a rather high level of difficulty in maintaining similar levels of profit in FY2024. We would like to brush up on areas such as the technical capabilities of products that currently have been able to secure a high market share, and continue to push toward even higher added value.

Q. Looking at the factors behind increases and decreases in core operating income in FY2021 vs FY2024 for the IT-related Chemical Sector, conditions of trade form a negative factor of about 45 billion yen, while volume differences form a positive factor of about 35 billion yen. I had the impression that in recent years, the drop in sales prices for businesses in this sector was not as bad as it had been, but in this Corporate Business Plan you are incorporating a rather significant level of deterioration in trade conditions, so should we take it that the display-related materials business is fundamentally difficult, and that you are compensating with increased volume in semiconductor-related materials?

A. In the first half of FY2021, supply and demand for display-related materials tightened, so while there was no major change in price levels for materials, as was reported in the media, there was a major adjustment in prices for LCD panels, with a peak between July and September of 2021, and it is thought the impact of that may carry over into the materials side with a slight delay. Those sorts of changes in price levels are extremely hard to predict, so the deterioration in trade conditions in the medium-term forecast was calculated assuming a certain market environment. In any event, compensating for deteriorations in trade conditions through rationalization and increased volume has been a longstanding policy for this sector, so rather than thinking of it as semiconductor-related materials compensating for display-related materials, I would like you to have the sense that display-related materials will compensate for deteriorating conditions of trade within itself through rationalizations, volume increases, and changes in composition (moving toward higher added value), while the increased volume in semiconductors is added on top of that.

<Health & Crop Sciences Sector>

Q. On slide 59, you say that sales of agricultural chemicals will increase by about 90 billion yen over three years, and while I think you have promising products such as indiflin, I would like to ask what products will be central to that, within the limits of what you can say.

A. I cannot speak to the sales of individual products, the major contributor to the increase will be indiflin, which is entering full-scale use, particularly in South America, so please understand that its proportion will be relatively high.

Q. On the order of 40-50 billion yen, as you have said previously?

A. We will not yet have reached that level of sales by FY2024.

<Pharmaceutical Sector>

- Q. In your overview of the next three years on slide 47, you have drop offs in income for FY2022 and FY2023, followed by a sudden sharp recovery, and Sumitomo Dainippon Pharma's Corporate Business Plan has 120 billion yen forecast for FY2025, so it seems like you are forecasting that FY2022 will be the bottom, and it will improve from there. On the other hand, looking at consensus figures, Sumitomo Dainippon Pharma's operating income is expected to fall into the red in FY2024, so I would like to hear your explanation for why you think that, on this point, there is a possibility that the market's view is wrong. With regard to the size of the growth in income from FY2023 to FY2024, it seems the market thinks it will not grow this much, and I think this is extremely important, so I would like to hear your answer.**
- A. It is true that, because our exclusive sales period for Latuda in the US will end in February 2023, sales in FY2023 and beyond will drop sharply, and we think it will depend on to what degree we can recover through sales of the treatments we are working on as replacements for Latuda, such as Gemtesa, as well as Orgovyx and Myfembree, which we are jointly promoting with Pfizer. Those three treatments launched in 2021, and sales have started, so if this leads to an increase in sales in line with expectations, I think we will approach the numbers that Sumitomo Dainippon Pharma has announced for FY2025. Currently there are restrictions on the promotion of new treatments due to the impact of COVID, so there is also a possibility that the recovery in financial results may be delayed. A significant portion of the core operating income for the Pharmaceuticals Sector for FY2024 consists of Sumitomo Dainippon Pharma, so while this is a qualitative assessment, I would like you to understand that at the present stage, we are expecting income in line with what we have publicly announced.
- Q. Looking at the positive and negative factors behind changes in core operating income for the Pharmaceutical Sector between FY2021 and FY2024, it appears that there is a negative factor of about 60 billion yen for a decrease in volume, but while the decrease in Latuda sales volume will be significant, on slide 61, you explain that you are aiming to the drop in Latuda sales volume with your three treatments of Orgovyx, Myfembree, and Gemtesa. Of that negative factor of about 60 billion yen in volume, even if we exclude the 30 billion in one-time profits this period, it seems that the negative factor is too large, but what is your view?**
- A. Is this not due to the differences in gross margin ratio between Latuda and the other three treatments? First, new treatments such as relugolix, because they were acquired from other companies, have licensing expenses, and furthermore, because both profits and costs are halved due to co-promotion, the gross margin ratio is different from treatments like Latuda, where all the benefit accrues to us.

<Capital Investment and Lending>

Q. I am concerned that ROI for Energy & Functional Materials is relatively low. On slide 27 you state that you will invest up to 70 billion yen in products such as battery materials and super engineering plastics, so it looks as if you will be investing quite heavily in Energy & Functional Materials as well. In addition, you are investing 90 billion yen in IT-related Chemicals, which has a higher ROI than Energy & Functional Materials, and where your move to shift toward semiconductor materials has been well received, so should you not increase that figure a little bit? For Health & Crop Sciences, as well, you have said that you are considering acquisitions in the biorationals space, but is a budget of 90 billion yen enough? Could you please explain again about the variations in your investment strategy with a focus on ROI?

A. These are just a bunch of numbers added together, they are one estimate that reflects how we will evaluate our investments over these three years, taking into consideration our management intentions in terms of the scale of the amount. These numbers were formulated while envisioning all sorts of possibilities, and the 70 billion yen figure for battery materials and super engineering plastics is a figure premised on the assumption that our demonstration plant for our firing process for cathode materials, which has extremely high production efficiency, is successful, and that we are able to enter the cathode materials market in a major way. In addition, because it is possible that a single acquisition may exceed 90 billion yen in Health & Crop Sciences, for example, and there is a possibility that we may use our buffer of around 80 billion yen there, or some similar circumstance, we will flexibly adjust based on circumstances. Please do not think of these numbers as too rigid, please understand them as flexible assumptions.

Q. Is it your sense that battery materials and super engineering plastics are near the upper limit, while there is a possibility that Health & Crop Sciences may be increased a little further?

A. In terms a general sense, I see no problems with your understanding.

Q. With regard to the IT-related Chemicals Sector, is there a possibility that, by accelerating investment in semiconductor-related materials, you will be able to increase capital investment amounts?

A. Because investment amounts in the medium-term forecast were not arrived at separately, issue by issue, it is difficult to say anything concrete at the current stage, but one factor that could lead to an increase in investment amounts is a production facility in the US, which we are currently considering, and depending on what products are made and at what scale, there is a possibility that things will change significantly.

Q. For your numerical management targets on slide 45, looking at the comparison between FY2021 and FY2024, while you have an increase in core operating income and operating income of about 50-60 billion yen, the increase in net income attributable to the owners of the parent is just 10 billion yen. I think a significant increase in profits at a subsidiary that is not wholly-owned might be a factor, but in that case, would it not be best to acquire 100% ownership, or invest separately? I would like to ask about the balance of your investments and the impact it has on net income attributable to the owners of the parent.

A. We are conscious of the point you have raised as an issue. Because this has some relationship with the amount we can budget for investments, however, we would like to consider those sorts of measures with an eye toward the proper timing.

<Digital Transformation>

Q. In terms of your management platforms, you have said that Phase 1 of your digital transformation is mostly complete, and that you will be getting to the heart of Phase 2, the core of which is customer satisfaction, and while I get the impression that you are making steady progress, I am sure there are some differences in progress and initiatives between departments. If possible, what sorts of initiatives will you use to change the customer experience, and will that make engagement with your company stronger?

A. In our DX Strategy 2.0, the question of how to use DX in each business in order to increase competitiveness was very important. The key points for competitiveness differ from business to business, so for example in businesses like IT-related Chemicals, where development is life or death, the root of competitiveness is how quickly we can respond in development with the customer, so we will take an approach focused on how we can use DX in that area. In addition we also have customers and businesses where there is a great deal of interest in logistics and stable supplies, so in that case the key point will be how we can incorporate shared digital technology between us and the customer. We have just started working on this, so we are at the stage where first we need to pin down the key points for competitiveness in each business, and then consider how we will make use of DX. We are not starting from DX, we are starting first from issue recognition. We think that after a little more time for execution, along with training business translators and other personnel, we will have some successful use cases to show you.

Q. I have some sense of how you will use DX in IT-related Chemicals, automotive-related business, and Essential Chemicals, and I think you are planning to use MI at the development stage in the life sciences as well for database creation, but I do not have a good sense of how you will actually use DX to increase customer satisfaction in fields such as agricultural chemicals and healthy agriculture-related fields, for example, so could you give us some guidance there?

A. To give an easy-to-understand sense of what farmers are looking for, we are thinking of flying a drone around to check the fields for disease, and provide the farmer with a set of information that includes an identification of the disease, as well as a treatment that will work for it and the best timing for applying it. We are currently in initial considerations of whether we can use DX here. I think a number of companies have made approaches in this area, but I have not heard of examples of someone who has achieved success with this as a business. From a perspective of enhancing competitiveness, supply chains for agricultural chemicals are quite complex because the manufacturing process is extremely long, if you include intermediates, and because there is generally only one season a year, it is a business where there is some difficulty in predicting demand. For this reason, we are currently working to use DX to bring visibility to the global supply chain and increase the accuracy of predictions, which we hope will lead to improved customer satisfaction by preventing shortages and similar issues.

<Other>

Q. As commodity prices have increased, and as the price of crude oil has shot up significantly in particular, I think the price of naphtha is now around 80,000 yen/kl, while you are assuming 50,000 yen/kl in your medium-term forecasts. I would like you to once again comment on whether the high oil prices are positive or negative for your company's overall performance. In addition, I would like you to discuss the impact of increasing commodity prices more generally, including whether the increase in the price of grain as a soft commodity will be a tailwind for your agricultural chemical business.

A. I think it is one of the unique features of our company that these changes in commodity prices are neutral for the company as a whole, despite pluses and minuses for different sectors, because while high commodity prices are a negative factor for the many products we have where it is difficult to pass on raw material price increases, at the same time they are a positive factor for Petro Rabigh, which buys its raw material, ethane, at a fixed price, so the margins increase. I think that for FY2022, one of our major management issues will be how to pass on the high raw material costs, including oil prices, in our product pricing. For example, for products like olefins, the more a product has become commoditized, the more widespread formula-based pricing is, but the more value-added a product is, the less formula-based pricing is used. For this reason, in negotiations regarding passing on costs, there will be questions about the value we add, and whether our product is really the only option. In the short term, I think this will be a serious management issue.

As for grain prices, that is a clear tailwind. Because the incomes of farmers will increase, they will be more willing to purchase agricultural materials, including agricultural chemicals, so the business environment will improve significantly. Because there will also be cost increases on the raw materials side for our agricultural chemicals and materials, however, this will also tie into questions of how to pass on costs, but overall I think it will be a tailwind.

Q. On slide 39 you show trends for sales revenue for Sumika Sustainable Solutions, but I would like to ask what the figures are for ROI for these products, both currently and looking ahead. If that is difficult, it would also be fine if you could say whether they have currently exceeded their capital costs or not, as with the graph showing capital invested and NOPAT on one of the later slides, but could you please comment on current and forward-looking estimates?

A. At the moment, I only have figures for sales revenue, so I cannot answer.

Q. Then how should we think about current and future estimates for products designated Sumika Sustainable Solutions?

A. Unfortunately, Japan has not yet become a society where environmental costs are visible and where people are willing to pay for environmental costs. At the moment, we understand that ROI and NOPAT are determined based on a product's competitiveness and the product's supply-demand relationship, but we have not been differentiating on this basis, designating only high added-value products as Sumika Sustainable Solutions or not designating low added-value products.

Q. Do you mean to say that by around 2030, for example, we will become a society where people will pay for environmental costs as well?

A. I hope that we become that sort of society, and I also think that we ourselves need to develop products that show these sorts of costs. For example, among our current Sumika Sustainable Solutions products, products like propylene oxide and separators generate the most revenue. Even with regard to circular polarizers, our polarizers are designated products because they contribute to reducing environmental burdens by using a manufacturing process that uses less iodine, but the earnings capability of polarizers have not been very high until now, so currently it is difficult to link the value of environmental contribution and profitability.

(END)

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