

Management Meeting: Q&A Summary

Date: 13:00 - 14:30, December 27 (Tue), 2016
Location: Kurita Water Industries Head Office
Speaker: President Michiya Kadota

Notice: This summary is provided for the convenience of those unable to participate in the management meeting. Please note that this is not a word-for-word transcript but a summary prepared by Kurita Water Industries Ltd.

Q. You have stated your desire to make an acquisition in North America for the water treatment chemicals business, but do you have the capacity to manage an acquisition in North America given the recent acquisition in Europe?

A. It would depend on the scale of the deal but, if we are talking about the acquisition of an existing company operating only in the US, the degree of difficulty would be much lower than the recent European acquisition, which spanned multiple countries. On this basis, I believe we should be able to manage the process smoothly.

Q. Would your target for M&A in North America be in the same product categories as your existing water treatment chemicals business?

A. For North America, yes. If the candidate were a large-scale company then the product range could be wider, but for a smaller company, we would be focused on water treatment chemicals.

Q. Is the operating profit margin for the ultra pure water supply (UPWS) business unchanged after recent contract revisions?

A. We cannot extend the term for depreciation. As a result, the margin on revised contracts will be depressed until the depreciation expense rolls off. However, the revision is designed to ensure that overall profitability over the life of the contract is unchanged. We believe the revisions have allowed us to deepen our relationship with the client and feel that this is a strong model.

Q. Is there a possibility that you might enter into UPWS contracts in China if a major client chose to build in China?

A. The risk premium we apply in evaluating investments might need to be raised to reflect various risk factors, but generally speaking, we do want to be proactive in taking risk. We recognize that it is challenging to fully capture the value of our product superiority when selling hardware outright, whereas the UPWS model makes it easier to highlight our technical superiority in achieving water treatment specifications or operations and maintenance services. We have already been highly rated by our Korean customer and are open to considering new challenges.

Q. To what do you attribute your success in the UPWS business with the Korean customer?

A. We understand that historically the customer's production had been affected by difficulties in operating and managing the water treatment facilities. We have significant accumulated expertise from our long track record in operating and maintaining such facilities. The customer has also benefited from reduced energy costs and speedy ramp-ups following maintenance, as a result of our expertise. These are benefits that the customer could only recognize by adopting this model. I believe the advantages of moving to this model have been greater than the customer initially expected.

For those customers with strong needs for waste water recycling, Kurita can also offer high level solutions. Our customers rate Kurita highly on the superiority of its system solutions, including its service network, rather than on the basis of individual hardware.

Q. You have indicated you aim to expand the water supply business model beyond the electronics industry. Can you be more specific about how this would work?

A. Our target customers would be small and medium scale (SME) manufacturers, and the pharmaceutical and power generation industries. The SME business would be undertaken by KWSS, but given the scale of a single project would likely be small, we are exploring ways to consolidate for better efficiency. For the power generation industry, the incumbents already have subsidiaries responsible for operations and maintenance. We are looking at targeting the independent power producers (IPPs).

At this stage, we have yet to quantify the scale of annual CAPEX. Outright sales of facilities are important from the standpoint of maintaining high levels of technological expertise. However, from the standpoint of profitability, we are very keen on developing service solutions and are considering all potential opportunities.

Q. What are the management metrics that you target?

A. I believe profitability is very important. I am deeply distressed by the recent decline in our profitability. While it is partly a function of the amortization of goodwill related to M&A, I would like to return to previous levels of profitability within 5 years, including goodwill amortization. I believe we should be able to improve margins through dynamic measures, such as reducing water quality analysis costs through rationalization in the domestic water treatment chemicals business.

Q. Do you think it would be possible to improve margins beyond the 10% OPM level you are targeting in the current medium-term business plan?

A. By concentrating management resources on a more narrowly selected customer base in the water treatment chemicals business and implementing reforms on how we sell water treatment facilities overseas, I believe that we can improve margins relatively quickly. We are also considering variations on the UPWS model to be applied to non-electronics industries.

Q. Assuming you successfully make an acquisition in North America, how would you see subsequent growth in the water treatment chemicals business? Would you continue to do more M&A or would you focus on growing what you had at that point?

A. I would not expect to achieve our aims in North America with a single transaction. There is a large water treatment market related to oil & gas in North America; we would be very interested in this field. In addition, the Kurita Group does not currently have a product lineup in either oil refining or pulp & paper to match that of the top players in this space. If we were able to acquire technology we currently lack, we would be interested in such areas, although our approach would likely be more to focus on building a comprehensive systems business, including operations services, rather than simply selling product in the same way as the majors.

Q. What is your decision-making process for winning overseas EPC orders?

A. Obviously we look at profitability, but our first step is to confirm that sales has shown a service solution proposal to the prospective customer. Going forward, I intend to base evaluations solely on the profitability of a given project at the time of completion and not on the absolute value of projects.

Q. Why is the profitability of the general industry facilities business so low?

A. The majority of the general industry business is outright sales of hardware with only a small proportion of high end projects, so the business is more prone to commoditization. On projects where even small players can compete, we are exposed to price competition. It is a business where it is challenging to emphasize the benefits of our strengths and where there are only limited market niches that demand Kurita's expertise.

Q. Do you believe that it is possible to improve profitability by changing how you sell hardware in the general industry business?

A. If you have highly technologically sophisticated hardware, it would be possible to increase value add by combining this hardware with services. However, simply converting the business to a service solution model would not lead to major improvements. As an example, if we were to target demand for the treatment of waste materials with a system solution combining waste water treatment and sludge reduction, I believe you can improve margins. However, if you are competing only with hardware, there are many players and differentiation is challenging. That said, we absolutely must retain technological superiority in this area, so on that basis, I think having an EPC business is fine.

Q. Is there a possibility that IoT will bring players with strengths in networking into the water treatment market?

A. Going forward, I believe that we will see the development of platforms for manufacturers that incorporate elements of infrastructure, such as electric power, focused primarily on

large-scale plants. We aim to have water treatment standards incorporated into such platforms. When this happens, it will enhance the value of data that has correlations to production, such as the operation data we get from the UPWS business. We intend to leverage such data.

The IT Strategy Division, which was established in October, integrates the IT resources that had existed separately in each of the individual businesses. This group is focused on creating a framework to enable IoT for manufacturers.

Q. With regard to the UPWS business, I had the impression that you had a strong aversion to applying this model overseas in the past. How sustainable is your policy of being more proactive overseas?

A. It is challenging to see a future for this business without operating overseas. It is true that in the past, we were very concerned about foreign exchange or labor risks. However, we now have a better understanding of risks that we might not have been aware of previously. Once you have a good grasp of the risks, it then becomes a question of whether or not to take the risk. We did discuss risks when considering starting the business in Korea; looking back, we would not have understood the degree of risk if we did not proceed. The business in Korea is actually doing better than we had initially expected.

Q. Will there come a point in time where Kurita will undertake the UPWS business at Chinese liquid crystal display (LCD) or semiconductor plants?

A. The range of profitability for a project can be relatively wide depending on the services proposed or the scale of the operation and maintenance required. Customers' needs can vary widely depending upon the type of semiconductor being fabricated or the scale of the plants; some plants may or may not have requirements for waste water reclamation. As such, each project must be assessed individually to determine whether UPWS is the most effective solution.

That said, China semiconductor CAPEX is estimated to be ¥5 trillion; within this, there will probably be some projects that will be UPWS. We are at the early stage of the process of winning business but will monitor developments closely.

Q. Are there businesses where you can transplant know how accumulated domestically to expand overseas?

A. I believe the chemical cleaning business done by Kurita Engineering is competitive. There is demand for cleaning not only for regularly scheduled maintenance but also when there is capacity consolidation at major petrochemical complexes. This is a business that requires comprehensive technologies, including pipe cleaning and waste water treatment, so I think this could be a good model which we could apply to overseas petrochemical complexes. Unfortunately, the domestic business is very busy, which limits the availability of management resources.

Q. Are the barriers to entry for the UPWS business not that high for the overseas market?
Also, which industries will you focus on?

A. In terms of industry focus, at the outset, we will concentrate on high end applications such as LCD or semiconductors, similar to what we have done in Japan. It is difficult to emphasize the advantages of this model unless the prospective customer shares information about operation and maintenance costs, energy costs or costs associated with past service stoppages. If we have this information and are able to get a foothold with even one line, the benefits are much clearer to the customer, which makes it easier to expand. The key will be bundling Kurita's know how effectively, by accumulating skill and experience to standardize operating procedures.

Q. What do you think is the annual maximum for UPWS CAPEX spend?

A. Taking into account the production framework we are currently putting in place for EPC, I would estimate we could invest up to ¥50 billion, assuming our current balance sheet levels. We determine the specifications for the facilities in UPWS. Also, standardization should generate efficiencies.

Q. How interested are you in the opportunity related to ballast water?

A. There are many players in the space for the treatment of ballast water, which makes it challenging to add value. It would only become attractive if you could incorporate it into a ship's automated operating control platform and capture other peripheral opportunities.

Q. Given that the foundation for your domestic business is stable, does your corporate culture make it difficult to be more aggressive overseas?

A. It is certainly true that Kurita's business is order-driven and our strong relationships with domestic customers has allowed us to grow profits consistently over time. However, we are now entering a phase where the overseas business will be a major driver of growth. We recognize that we need to put in place strategies for competing overseas and refine our business models over the next 2-3 years.

Q. On the back of overseas M&A, should we expect growth in the water treatment chemicals business will come gradually over time, rather than an immediate spurt of growth on the back of cross-selling technologies or products?

A. The business model for chemicals is virtually the same, regardless of whether it is domestic or overseas. My impression from the European acquisition is that behavior patterns and perceptions of value are similar. With regard to technology, good technology is immediately viable. There are differences in water quality, so you need to do an assessment, but once the assessment has been done, good technologies can be applied immediately.

Q. For emerging markets, can we expect to see growth when demand emerges for products and services similar to Japan or, is this already the case and is it simply an issue of expanding the local footprint to grow?

A. Our major overseas customers tend to be in heavy industries like oil refining, steel and pulp & paper, although we have seen growth more recently in electronics and automotive. However, in Japan, our coverage extends down to small scale operators whereas our overseas business is still limited to large scale customers. From this perspective, there is still significant room to grow. Once the sales network is in place, we should be able to grow revenue.

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