CFO's Message

By integrating a focus on strong financial foundations into our corporate culture, we are now poised to achieve our Triple One Proportion (TOP) objective.

Cash Flow Management as an Integral Part of Our Corporate Culture

Since the beginning of the 2010 Medium-Term Business Plan, MHI Group has been trying to emerge from a protracted slump in earnings by prioritizing the management of balance sheets and cash flows as a way of improving our asset turnover ratio, an area improvable through our own efforts, rather than focusing on the operating margin, which is vulnerable to external influences. To manage our balance sheets—a consideration that had been given short shrift up to then—we launched our strategic business evaluation system, began reforming the business processes of each Strategic Business Unit (SBU), and set the cash conversion cycle (CCC) as a key performance indicator (KPI). In our 2018 Medium-Term Business Plan, we adopted what we call "TOP"—Triple One Proportion—as a proprietary comprehensive KPI, and have since monitored the state of our company by examining the balance of our revenue, total assets, and market value.

In managing our cash flows, we have been able to shorten our CCC dramatically (from 161 days in fiscal 2010 to 28 days in fiscal 2018) and reduce our working capital substantially. In specific terms, whereas in fiscal 2010 we required more than ¥1 trillion in

Masanori Koguchi
Director, Senior Executive Vice President, CFO

working capital*1 to secure roughly ¥3 trillion in net sales, in fiscal 2018 we were able to bring in approximately ¥4 trillion in revenue with less than ¥350 billion in working capital. Moreover, operating cash flow has exceeded ¥400 billion in each of the last two years: sufficient amounts to cover the cash outlays incurred by development of the MRJ (SpaceJet) business. In fiscal 2018, free cash flows (FCF) inclusive of investment cash flow reached an unprecedented ¥243 billion.

I firmly believe that these improvements in our financial position are not merely a temporary occurrence. In each business segment and at every workplace, I get a true sense that all employees are taking steps to improve business terms, thinking seriously how to improve productivity and shorten their CCC, and sharing their ideas for Groupwide initiatives that will not only generate cash, but also improve the competitiveness of each business itself. As an example, previously our air-conditioning and refrigeration operations were suffering from low profitability, but after shortening their CCC, productivity at our production base in Thailand was raised threefold, generating robust profits today. In our commercial aircraft and defense businesses too, improvements made at workplaces have shortened their respective CCCs and today are contributing to enhanced profitability. When employees see tangible results from methods they themselves have devised, it creates a sense of achievement and builds confidence; initiatives then become ongoing, thereby becoming part of MHI's corporate culture. Reforms are carried out in three phases: first, systems and organizations; next, business processes; and finally, corporate culture. Today we are now in the final stage.

Examples of Productivity Enhancement Initiatives

Commercial aircraft business (Oye Nishi Plant, Aichi)

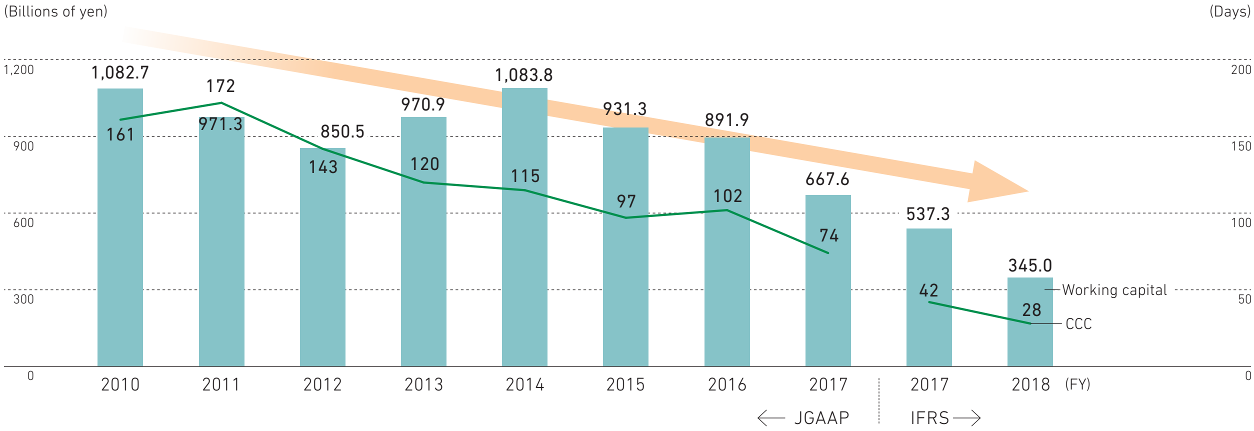
Production lead time has been shortened by automating work processes, improving production technologies and design, etc. Also, production was successfully increased to 14 Boeing 787s per month, while keeping facility expansion to a minimum, dispelling the conceit that production increases invariably require capital investment.

Air-conditioning & refrigeration business (MACO*2, Thailand)

Production lead time has been reduced by focusing on made-to-order production based on secured daily units instead of production based on anticipated monthly units, and switching from conveyor-type production to cell production for wide-variety small-lot production. As a result, inventory assets have been reduced and productivity improved more than threefold.

*1 Working capital = trade receivables + inventories − trade payables − advanced payment received on contracts (on a Companywide basis)
*2 Mitsubishi Heavy Industries–Mahajak Air Conditioners Co., Ltd.

Reduction of Working Capital (Management Efficiency Enhancement)



Reuse of Fixed Assets and Conversion to Current Assets Are Key to Achieving TOP

Much has already been accomplished from the initiatives taken thus far, but insofar as achieving our ultimate goal—TOP's 1:1:1 balance in revenue (business scale), total assets, and market value—we are still only partway there, with a balance at 0.8:1:0.3 as of the end of fiscal 2018.

One challenge we face toward achieving TOP is revenue expansion from growth-oriented investments. Under our 2018 Medium-Term Business Plan, we are focusing on "dynamic" capital allocation, making use of our strengthened financial foundations. But finding worthy growth areas to invest in is not easy, and as a result, in fiscal 2018 we ultimately allocated more capital to reducing interest-bearing debt than we had originally planned. From the standpoint of maintaining a proper balance between business and finances—the crux of our financial strategy—today we are in a phase where we should be concentrating on growing our business; and I am fully aware of my duty, as CFO, to direct how to appropriate capital into growth-oriented investments, including inorganic growth.

Status of Capital Allocation Plan: Fiscal 2018 Results

Regular cash inflow
(excluding extraordinary factors*3)

Approx. ¥570 billion/¥1,320 billion
(planned allocation during period of 2018 Medium-Term Business Plan)

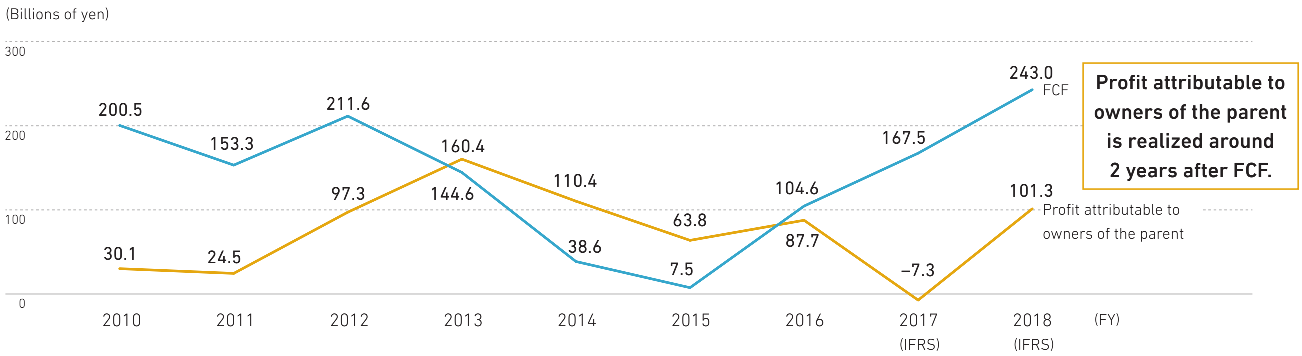
New business and risk management	Reducing interest-bearing debt	Shareholder return (dividend)*4
Approx. ¥370 billion/¥960 billion	Approx. ¥150 billion/¥50 billion	Approx. ¥50 billion/¥190 billion

*3 Expenditures relating to the cruise ship and MRJ businesses and the project in South Africa *4 Including dividends for non-controlling shareholders

Another major challenge for us is how to make new use of our fixed assets or turn them into current assets. In terms of reaching our goal of improving the turnover ratio on our balance sheets, I think we are about two-thirds of the way there, but this has been achieved mainly by elevating the efficiency of our current assets, which account for about half of all assets. Insofar as our fixed assets are concerned, although these have expanded to roughly ¥2 trillion since fiscal 2014—largely through M&A activities—revenue have not grown proportionately and our asset turnover ratio is gradually deteriorating. To address this issue, from fiscal 2019 forward we will undertake a shift in stance, from old to new and from "hardware" to "software." For example, we will replace old machinery with new, highly productive machinery, or use the funds from selling a factory to invest in a business partner that will lead to a new business.

To make our fixed assets more efficient, expanding our market value—the foremost key to achieving TOP—will be of prime importance. This is because

Profit Attributable to Owners of the Parent Increase (Correlation with Cash Flow)



non-cash expenses relating to fixed assets—depreciation costs and the like—significantly erode our net profit (profit attributable to owners of the parent), impeding growth of our market value. Normally, over the long term, free cash flows—the remainder after expended funds are subtracted from acquired funds—becomes virtually synonymous with net profit, and at MHI our net profit tends to lag approximately two years behind our free cash flows. Previously, in the event that factory operating rates were low and revenue was unable to fully cover depreciation costs, or if unnecessary operation and maintenance costs were incurred continuously, booked expenditures would be knocked out of balance with earnings, and net profit would become unable to keep up with free cash flows. In order to tie free cash flows securely to net profit, the reusing of fixed assets and conversion to current assets is vital.

In fiscal 2018, we generated a free cash flow of ¥243 billion even including extraordinary factors, so as a Group we have already exhibited the capability to generate free cash flows exceeding ¥300 billion. If, by raising the turnover ratio of our fixed assets, we can securely book that level of net profit with an assumed capital cost ratio of 6%, our market value will reach the ¥5 trillion targeted under TOP. To begin, we will carry forward our reforms further toward achieving a market value of ¥2.8 trillion in fiscal 2020, the final year under our 2018 Medium-Term Business Plan.

Challenges and Solutions: Toward Achievement of TOP