# A Conversation with the CFO

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**We invited Professor Shoichi Tsumuraya of Hitotsubashi University, an expert in financial accounting with specialization in disclosure and corporate governance, to meet with CFO Hisato Kozawa to discuss the new financial and capital strategies included in the 2021 Medium-Term Business Plan.**

## Basic Approach to Financial Strategy and Capital Policy

**Kozawa** Professor Tsumuraya, thank you for coming today. Through our conversation today, I hope to give readers of the MHI Report a greater understanding of MHI Group's roadmap to value creation and our financial and capital policies.

**Tsumuraya** Thank you for inviting me. From my position as an outsider to MHI, I look forward to asking you a variety of questions.

In preparing for our conversation, I looked back over MHI's past financial materials. It is my understanding that your company reached a major turning point in the wake of the 2008 Financial Crisis, after which focus shifted to financial policy stressing cash flow and the balance sheet. How do you rate your progress toward achieving your financial and capital targets so far?

**Kozawa** As you may know, one of our most important KPIs is what we call the "Triple One Proportion," or "TOP." TOP refers to an ideal 1:1:1 ratio of revenue, total assets, and market value. In terms of the relationship between revenue and total assets, i.e., asset turnover, I would rate our progress in achieving a robust business structure at around 90%. On the other hand, in terms of the ratios of both revenue and total assets to market value, I do not think we have even reached 50% yet. Increasing profitability in particular remains a challenge to raising our market value.

Tsumuraya I appreciate your offering such a clear picture of your view of the issues MHI currently faces. I think the way your company tracks its progress, that is by maintaining focus on medium and long-range targets spanning multiple business plan terms, is very effective.

At the same time, it is important to maintain a balance between short-term goals and medium to long-term goals. What is your thinking concerning timelines?

Kozawa At MHI, most of our businesses have long timelines, and I think our share price reflects our shareholders' and investors' expectations regarding our total performance over the medium to long term, rather than our short-term financial results. For this reason, MHI management places importance on optimizing our business portfolio with a long-term perspective and executing long-term strategies. Of course, in order to earn the trust of the capital markets regarding our medium and long-term strategies, I believe it is important that we achieve positive ongoing results in the short term as well. This is because, inevitably, our management will be evaluated based on short-term business performance.

## My Aims as CFO as Outlined in the 2021 Medium-Term Business Plan

Tsumuraya I understand that the new 2021 Medium-Term Business Plan was formulated using a backcasting approach starting from your company's vision for 2030, which is based on the approaches to financial and capital policies that you just explained. What are the main goals of the new Plan and its particular areas of focus?

Kozawa To begin, in recent years our business plans have successively gone unachieved, so the management team is firmly resolved to make sure the new Plan's targets are realized.

The 2021 Medium-Term Business Plan has two themes: developing growth areas, and strengthening profitability. In order to ensure smooth optimization of the business portfolio, we have deemphasized business scale, i.e., the top line, which we had stressed heavily up until now. We have taken this approach for two main reasons, first, because top line targeting can at times hold back business portfolio adjustments, and second, because we intend to pursue a business strategy focused on the balance sheet, rather than on the P/L.

In the new Plan, we focus on three financial indicators: business profit margin, interest-bearing debt, and return on equity. Our intent is to address one core issue: improving company-wide profitability. We will also seek to accelerate investments into new areas while maintaining financial discipline and to achieve ROE in excess of capital costs.

Tsumuraya From what you have just said, I sense that your company is placing extreme importance not only on profitability but also on business portfolio management, which is directly connected to total assets and capital efficiency. Although there are some sensitive aspects to this, I think portfolio optimization needs to be executed flexibly and dynamically, too.

Kozawa Yes, optimization of our business portfolio is extremely important, and this is something our management team is discussing seriously on an ongoing basis.

There are two points regarding business portfolio management that I consider most important. The first is for MHI Group to pursue businesses that offer us growth

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potential and potential value expansion, and to consider divesting businesses in which other companies are in a better position to achieve growth. Previously, we tended toward an approach centered on generating revenue through expansion; going forward, we will lay stress on who is better positioned to grow a particular business, MHI or another company. For the employees who work in the businesses concerned, it only makes sense that they will be happier and have a more positive outlook if they are in an environment conducive to growing their business.

The second point I always consider is whether or not a business offers MHI the potential to be Number One–or the Only One–in Japan. Of course, we also consider partnerships with international companies, mergers, and acquisitions. But given the current mature state of the Japanese economy, I believe consolidating dispersed resources will also be an important option, including from the perspective of industry reorganization.

Tsumuraya I completely agree. This is something common to all industrial sectors. I think reorganization within Japan is needed to attempt joining the ranks of international conglomerates. In that respect, it is important to consider how to create cash flows from a long-range perspective, taking capital costs into consideration.

Kozawa I agree. There are businesses that currently generate weak profits but which have the potential to grow significantly by becoming part of MHI Group. At the same time, I think there are some businesses within MHI Group that could stagnate in the next several years, but which could be targets for resource investment at other companies. We should consider divesting such businesses as soon as possible. In the medium to long term, waiting to divest such businesses until after their earnings have fallen will only cause negative results for stakeholders on both sides.

Tsumuraya In conjunction with the Company's goal of strengthening profitability, besides business portfolio optimization and growing existing businesses, I believe that reducing SG&A is also important.

### Financial indicators over time

| | FY2018 | FY2020 | FY2023 |
|---|---|---|---|
| **Revenue** | ¥4.1 trillion | ¥3.7 trillion | ¥4.0 trillion |
| **Business profit margin** | 5% | 1.5% | 7% |
| **ROE** | 7% | 3.1% | 12% |
| **Total assets** | ¥5.1 trillion | ¥4.8 trillion | ¥4.5 trillion |
| **Interest-bearing debt** | ¥0.67 trillion | ¥0.9 trillion | ¥0.9 trillion |
| **Equity** | ¥1.7 trillion | ¥1.4 trillion | ¥1.5 trillion |
| **Debt/Equity ratio** | 0.4 | 0.6 | 0.6 |
| **Equity ratio** | 34% | 28% | 33% |
| **Dividend per share** | ¥150 | ¥75 | ¥160 |

## Plan to Strengthen Profitability

| | | Business | Business Environment Outlook | Measures |
|---|---|---|---|---|
| Overcoming COVID-19 impact | Measure 1: Minimize SpaceJet Costs +120 billion yen | SpaceJet | • Real aerospace recovery likely in or after FY2024 | • Minimize SpaceJet Costs |
| | Measure 2: Recover from COVID-19 impact +70 billion yen | Commercial Aviation<br>CRJ<br>Aero Engines | • Recovery of narrowbody aircraft will lead to faster recovery of CRJ and aeroengine businesses | • Reduce fixed costs<br>• Drive forward manpower saving and automation during COVID period |
| | | Turbochargers<br>Engines<br>Car Aircon<br>Logistics Equipment<br>HVAC | • Recovery to Pre-COVID levels expected by FY2023 | • Optimize overseas production bases<br>• Prepare for market recovery by improving productivity |
| Grow existing businesses and solve pre-COVID challenges | Measure 3: Grow existing businesses +20 billion yen | Logistics Equipment<br>HVAC | • Quick recovery from COVID impact<br>• Growing market in environment-responsive and automation technologies | • Proactively invest in environment-responsive and automation technologies<br>• Strengthen sales network |
| | Measure 4: Address challenged businesses, structural transformation; (including portfolio optimization) +30 billion yen | Steam Power<br>Environmental Plants | • Steep reduction in new-build coal power plants | • Big shift to services<br>• Reduce fixed costs<br>• Reorganize and integrate organization and bases |
| | | Metals Machinery<br>Engineering<br>Commercial Ships<br>Machine Tools | • COVID has frozen customer investment, competition is growing and profitability hit | • Shift to services to stabilize profits<br>• Eradicate losses in EPC* projects<br>• Strengthen marine engineering business |
| | Measure 5: Reduce SG&A +40 billion yen | HQ Corporate<br>Business Units & Group Companies | | • Aim for 20% reduction in SG&A<br>• Improve work processes, integrate organization, reduce headcount<br>• Diversify employment formats, reduce external expenditure |

| | | |
|---|---|---|
| Reduce workforce in line with business environment and embark on significant shift in workforce deployment | Global | ■ Reduced workforce due to lower production in steam power, metals machinery, turbochargers, logistics equipment, HVAC, commercial aerospace etc. (around 2,000 jobs) |
| | Domestic | ■ Reallocate around 3,000 of workforce due to expected reduction in steam power, commercial aerospace, commercial shipping<br>■ Undergoing program to reassign workforce to growth areas, transfer to organizations outside of Group (approx. 1,000 in H1 FY2020) |

EPC: Engineering, Procurement and Construction

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**Kozawa** I see cost structure reform as an ongoing issue, and during the three years of our 2021 Medium-Term Business Plan, we are targeting a 20% reduction in SG&A, which will be achieved through improvements in administrative processes and organizational and headcount adjustments.

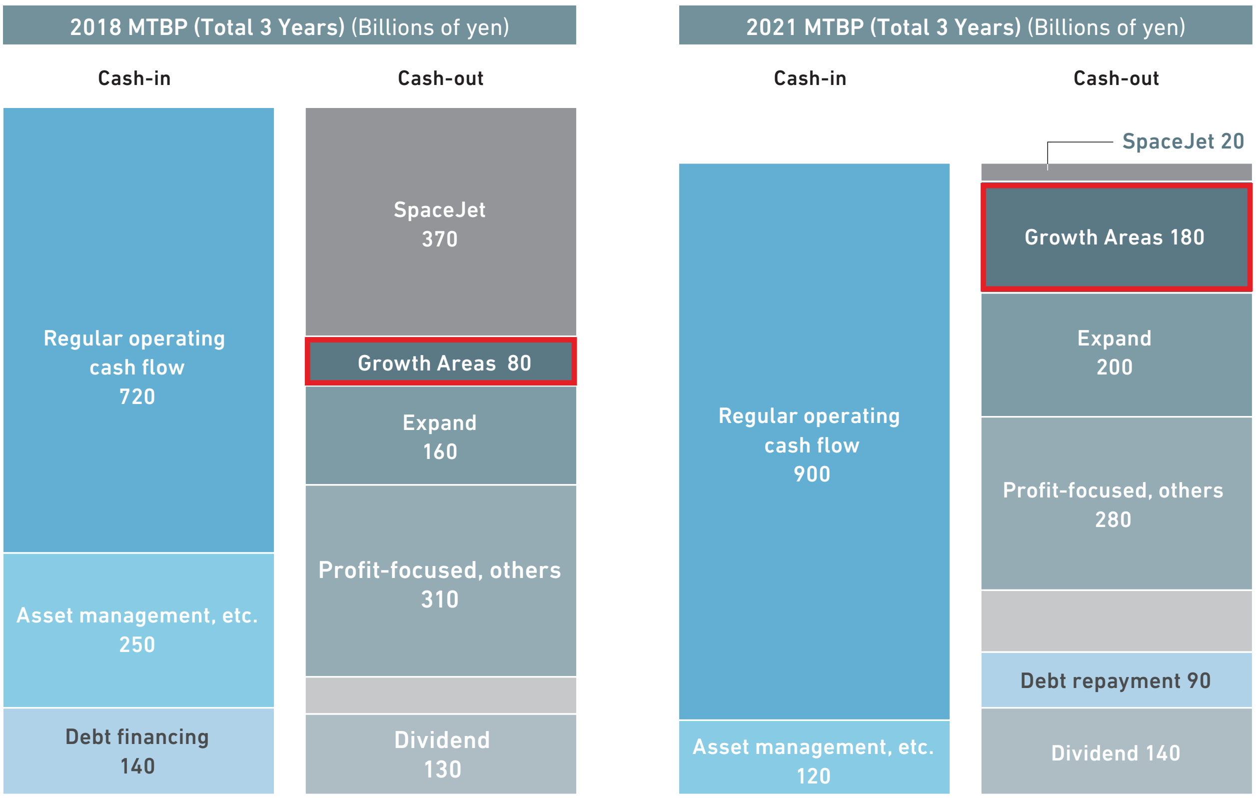
I think there is still great room for improvements, especially with in administrative processes in indirect departments and IT systems. We have already promoted function sharing and consolidated purchasing. Now, we are examining how to reduce fixed and operating costs and raise our administrative efficiency by improving our IT systems. We also plan to allocate the human resources secured through these initiatives to growth areas and other business activities.

## Investment Plans and the Company's Position on Dividends

**Tsumuraya** In reference to the growth areas you spoke of earlier, next I would like to ask you about MHI's investment plans. The Company has cited two growth areas targeted for investment: Energy Transition and New Mobility & Logistics. What investment plans do you have in mind for these areas?

### Capital allocation plan

- **Strengthen operating cash flow by improving profitability, continue to monetize through asset management**
- **Shift investment away from SpaceJet and into priority growth areas** (energy transition, new mobility & logistics)



Kozawa We see both of these growth areas as business opportunities that will be realized by 2030. During the three years of the 2021 Medium-Term Business Plan, we plan to invest a total of 180 billion yen into these areas. This is an amount we believe to be indispensable at the current stage.

The Energy Transition is one of our core business areas. There are some aspects of the Energy Transition that are already underway, so in addition to purely strategic investments, we will invest resources in existing projects. Altogether, we are assuming total investments on a scale of around 200 billion yen. MHI Group is in a position to play a central role in the Energy Transition, especially as concerns hydrogen energy infrastructure. Downstream, i.e., in the hydrogen usage area, we will proceed with the design, manufacture, and validation of hydrogen-fired gas turbines for use in power generation, an area already under development. Upstream, i.e., in the hydrogen production area, we will invest in companies outside the Group that have promising technologies in order to build a hydrogen solutions ecosystem which will contribute to the achievement of Carbon Neutrality.

Turning to New Mobility & Logistics, here we will need to enter new areas to MHI Group or create totally new businesses. As a result, it is essential that we pursue mergers, acquisitions, and alliances with third parties. We therefore will need to secure adequate funding swiftly and flexibly and also move forward with technical demonstration with the goal of commercialization.

While actively investing in these areas, in parallel we will continue to maintain and strengthen our financial foundation. Under the financial strategy carried out by the previous CFO, the Company succeeded in reducing its interest-bearing debt despite making large-scale investments in the Commercial Aircraft segment. I believe this set the foundation that has enabled us to steadily procure funds even in the midst of the COVID-19 pandemic. With our 2021 Medium-Term Business Plan also, we will make our financial foundation even stronger by minimizing interest-bearing debt while proceeding with investments in growth areas.

Tsumuraya In the 2021 Medium-Term Business Plan, MHI is targeting historically high dividends in FY2023, the final year of the Plan. The target is roughly double the dividends executed in fiscal 2020. What is this projection based on?

Kozawa While our current dividend payout ratio is 30%, we expect to achieve the shareholder return target you mentioned by meeting our profit goal for FY2023.

That said, we believe that in addition to reaching the target, it is equally important for dividend payouts to be stable, in order to respond to the medium and long-range expectations of our shareholders and investors, as discussed earlier. Accordingly, after we have reached a certain dividend payout level by achieving the 2021 Medium-Term Business Plan, we may need to reconsider our dividend policy. For example, instead of a payout ratio that fluctuates according to the previous fiscal year's profit levels, another feasible option might be to keep dividends at a stable level and use DOE – dividends on equity ratio – which takes cost of equity into account, as an index to inform our dividend calculations.

Tsumuraya Critics have pointed out that short-termism and other harmful effects result from relying wholly on payout ratio as an indicator of shareholder returns. Adopting DOE or some other barometer could be one solution to this problem, so I hope you will discuss this matter thoroughly in your company.

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## Sustainability and Dialogue with Stakeholders

Tsumuraya Today, sustainability is becoming an issue of increasingly greater importance from the standpoint of dialogue with the capital markets. An increasing number of companies are publicizing their contributions to achieving SDGs, but my personal impression is that, even now, only a few companies actually incorporate these issues into their business strategies. That said, MHI Group's 2021 Medium-Term Business Plan truly does include plans for solving the world's problems. In your position as CFO, what are your views on sustainability?

Kozawa In the 2021 Medium-Term Business Plan, we laid out our vision to link our growth strategy to addressing humanity's problems, so I believe we have taken a step forward in that respect.

Sustainability as we think of it is rooted in Our Principles* and the Three Principles of Mitsubishi Group on which they are based. And while this philosophy, which has been in place since the Company's founding, is very dear to our hearts, we must also focus on monitoring changes in the society around us and responding as necessary to the expectations and demands of society at each point in time. In that respect, I believe we need to engage in a dialogue with society and the capital markets and to demonstrate our commitment through new initiatives.

* See page 10: Philosophy ("Our Principles")

Tsumuraya Were those the motives behind the green bonds your company issued in FY2020?

Kozawa Yes, exactly. Some suggest that going forward, rather than relying wholly on corporate bonds, eventually the greater part of financing will derive from green procurement. So we decided to issue green bonds to get an understanding of the market's expectations towards them. I believe pursuing initiatives of this kind on a continual basis is needed to have a true dialogue with the market.

Tsumuraya I agree that when engaging in dialogue with the capital markets, continuity is important. Before we close, I would like to ask you about your hopes for the future in your position as CFO.

Kozawa I would like for the progress of our strategies to be apparent in the three financial indicators I noted earlier–business profit margin, interest-bearing debt, and return on equity–and in the results we achieve from business portfolio optimization. We will continue providing detailed explanations to our shareholders and investors about the initiatives we implement each year, and we will devote ourselves completely to demonstrating results by successfully achieving our 2021 Medium-Term Business Plan targets.

Tsumuraya I'm deeply impressed by your dedication to producing immediate results while firmly maintaining a consistent long-term perspective, and I believe your financial strategy and capital policy are extremely well focused. I think we discussed some very interesting things today.

Kozawa Thank you very much. We greatly appreciate your taking the time to be with us today.

## Green Bond Issuance

In November 2020, MHI issued its first green bond.* The proceeds from the issuance were earmarked for renewable/clean energy businesses (wind, geothermal and hydrogen power systems), thereby facilitating the achievement of a decarbonized society. Through these businesses, we will help achieve the UN's seventh Sustainable Development Goal, "ensuring access to affordable, reliable, sustainable and modern energy for all," in addition to providing society with a better-balanced mix of energy infrastructure.

*Green Bonds are unsecured corporate bonds where the proceeds or an equivalent amount will be exclusively applied to finance or re-finance, in part or in full, new and/or existing eligible Green Projects and which are aligned with the four core components of the Green Bond Principles.

### Green Bond Framework

| | |
|---|---|
| Bond name | Mitsubishi Heavy Industries, Ltd. 36th Series Unsecured Corporate Bond (with Inter-bond Pari Passu Clause) (MHI Green Bond) |
| Maturity | 5 Years |
| Issuance amount | ¥25 billion |
| Interest rate | 0.14% |
| Date of issue | November 24, 2020 |
| Redemption date | November 21, 2025 |
| Use of proceeds | New or existing businesses or projects relating to renewable energy or clean energy (wind, geothermal and hydrogen power systems) |
| Acquired rating | AA- (Japan Credit Rating Agency, Ltd.: JCR) |

### Preparation of Green Bond Framework and Acquisition of Second Party Opinion

In preparation for issuance of its green bond, MHI Group has established the MHI Green Bond Framework in accordance with the Green Bond Guidelines of the International Capital Market Association (ICMA). With respect to evaluation of the green bond's suitability, the Company has received a second party opinion (SPO) from Sustainalytics, a third-party institution, attesting to the bond's conformity with ICMA's "Green Bond Principles 2018" and the "Green Bond Guidelines" (FY2020 edition) issued by the Japanese Ministry of the Environment.

#### Overview of Green Bond Framework

We set eligibility criteria, designate qualified businesses/projects and evaluate and select projects through a three-step process. First, MHI's business divisions select businesses and/or projects to be funded by green bond proceeds. Second, the finance department confirms compliance with the eligibility criteria. Third, the CFO makes the final decision. MHI will annually report on the allocation of proceeds to eligible businesses and/or projects, management of proceeds, and social impact on its corporate website, or in a timely manner whenever any significant change occurs. The first report will be made public within one year from the green bond issuance.

- **Eligible businesses and/or projects:**
  Renewable energy/clean energy business (wind, geothermal, and hydrogen power generation facilities/businesses)
- **Eligibility Criteria:**
  Expenditures for, and refinancing of, the Group's renewable energy/clean energy business (such as R&D funds, business development and operation funds, and working capital) that meet the following criteria
- Hydrogen power generation businesses and/or projects for 100% hydrogen combustion
- Geothermal power generation businesses and/or projects that emit less than 100g $CO_2$/kWh
- Investments in corporations that are exclusively engaged in the renewable energy/clean energy business or generate at least 90% of their sales from renewable energy/clean energy-related business
- Of the expenditure for the business and/or project, capital investment expense, etc. (CAPEX) was made within 7 years preceding the green bond issuance date

### Reporting (FY2020 data)

In May 2021, MHI publicly reported the FY2020 data tabulated below. MHI also publishes annual reviews from Sustainalytics on its website.

#### Allocation reporting (As of March 31, 2021)

The entire proceeds from the green bonds' issuance (¥24,893 million) were allocated to renewable energy businesses (partially to refinance an offshore wind power facility). None of the proceeds remain unallocated.

#### Impact reporting

Environmental benefit metrics for the businesses/projects funded with proceeds from the green bonds' issuance are tabulated below.

| | FY2016 | FY2017 | FY2018 | FY2019 | FY2020 |
|---|---|---|---|---|---|
| Newly installed power generation capacity (MW) | 365 | 816 | 864 | 785 | 804 |
| Assumed annual power output (MWh) (upper row: annual totals, lower row: cumulative totals) | 981,602 | 3,176,087 | 5,499,659 | 7,610,776 | 9,772,989 |
| | 981,602 | 4,157,689 | 9,657,348 | 17,268,124 | 27,041,113 |
| Expected annual reduction in $CO_2$ emissions (kt)* (upper row: annual totals, lower row: cumulative totals) | 490 | 1,600 | 2,770 | 3,840 | 4,930 |
| | 490 | 2,090 | 4,860 | 8,700 | 13,630 |

*Calculated using average emission factors and average capacity utilization rates respectively published by the International Finance Corporation and International Renewable Energy Agency.