EBARA CORPORATION Second Quarter of FY2023 Earnings Conference Q&A

Q&A during earnings conference held August 14, 2023

Participant 1: First, let me ask you about Precision Machinery. I know that the external environment is becoming more challenging. I would like to know more details about where in particular orders have become more difficult for your company compared to three months ago.

On the other hand, although you have revised your earnings forecast downward, I believe you are assuming that orders will recover in H2 compared to H1. Given the market environment, it appears to be risky to achieve. While you have stated that the market is difficult and will not return this year, orders are expected to recover in H2. Please explain this.

Togawa: I will answer your first question, regarding market conditions being more difficult in Q2 compared to Q1.

Market conditions have certainly become more difficult, but we believe that they have calmed down a bit. In Q1, there were some cancellations, but in Q2, these were not cancellations but postponements of delivery dates. In that sense, things are calming down a bit. The plan reflects this.

Your second question is regarding the recovery in H2. Orders will recover in H2, but considering the current market conditions, we have once again reviewed the status of overall order accumulation. Although market conditions are difficult, this plan reflects the results of our review of each project. Although market conditions may be a little different, we believe that it is possible to achieve orders for this fiscal year.

Asami: Mr. Togawa, could you comment on the first question, to the extent you can, if possible, as to which areas have become more stringent?

Togawa: As reported in the press, customer's plans are shifting and there is some reduction of production. In light of this, we see market conditions as becoming more difficult.

Participant 1: Regarding H2, you mentioned that you are looking at each project one by one and building up a plan. Is the Chinese market improving good for your company?

Or, in the case of your company, the composition of China is not so high now. China is not supporting your performance, but if you build up projects, do you think you will be able to achieve this level in H2?

Togawa: I think China is booming. As a result of strengthening our sales force under the previous E-Plan 2022, we have been able to receive more orders, and China's share of our orders has risen slightly by two points. Therefore, we have decided on this plan, taking into consideration the fact that we can expect to receive many more orders in China.

Participant 1: Second, I would like an explanation regarding the factors behind the upward revision of JPY30 billion in orders for the Energy business, dividing it into the main body and service and support.

Also, operating profit for Energy has been revised up quite a bit. Is this just because of the upward revision in service and support sales, or are there other factors as well?

Also, it seems to me that business confidence has deteriorated regarding ethylene plants, and the momentum for service and support could drop off in the future. I would appreciate it if you could explain the status of service and support, including the risks in this area.

Miyaki: First, let me explain the upward revision of JPY30 billion in orders. Orders for products have progressed faster than planned, especially in H1. Please consider that most of the upward revision is due to orders for new products.

Second, I would like to discuss the upward revision of profit. As you mentioned, a large part of this is due to service and support, especially the contribution of the price revisions we have been making since last year, which have been well accepted by our customers.

However, the efforts made since the previous E-Plan 2022 in the product business to improve profit through selective acceptance of orders and front-loading, including design, have also been successful. This improvement in profit also contributed to this upward revision of operating profit.

Third, I would like to discuss business conditions, including ethylene. Last year, there was a special demand for repairs, which was a result of the fact that customers had been unable to make regular repairs for many years during the COVID-19 pandemic. We had indeed expected that the special demand would run its course and return to normal conditions this year.

As I have explained, H1 saw a continuation of the brisk business that began last year. However, a trend toward a return to normal conditions in H2 is already beginning to be seen in field services, particularly in the Middle East.

We are already beginning to see a return to normal conditions rather than a worsening of business conditions. As such, we have announced a revision of our full year forecast for orders.

Participant 2: First, I have a question about the Energy segment. You mentioned that at the beginning of the period, expenses would increase because of investment in next-generation energy and consolidation of service bases and spending on structural reforms. Were expenses generally in-line for Q2?

I would appreciate it if you could mention whether there is anything we can expect in H2 of this fiscal year about the optimization of service and support bases.

Miyaki: First, I would like to answer the question regarding the cost of structural reforms. The operating profit plan for this fiscal year is lower than last year's results. We explained two points at the February presentation. One is for service and support to return from special demand to normal conditions. Second, as you mentioned, investment in new areas and structural reforms.

Regarding the first point, service and support, as I explained earlier, the main reason for the upward revision is that the situation has not returned to normal as we had assumed at the beginning of the period. The structural reforms and the consolidation and elimination of bases that you pointed out are progressing smoothly as initially planned.

The closure of the Canadian site has been brought forward, so the cost was recorded in Q1.

It is difficult to give specific locations, but we plan to further promote the consolidation and elimination of locations over the three years of the E-Plan 2025.

Participant 2: Second, I would like to ask about Precision Machinery.

Earlier in the Q&A session, there was an explanation that the Company made a forecast for order volume by accumulating individual projects. However, I understand that the component product line is delivered to a wide range of customers.

From that perspective, what are your plans for H2 of this fiscal year, particularly regarding the certainty of orders? For example, I think there are shades of gray compared to 3 months ago, depending on the application, such as memory. I would like you to touch on that as well.

In addition, I would like you to mention operating profit. I would like an explanation of the profitability factor in the analysis of changes in operating profit. In Q1, I believe you explained that the product mix and service and support are deteriorating factors for profitability.

Were each of these factors seen in Q2, or was it just due to changes in service and support? Could you please explain a little more about the factors?

Togawa: First, regarding orders in the component business, I feel that memory is going a little worse than in Q1.

On the other hand, regarding logic, we believe that certain innovative areas have begun moving. In the end, the situation is affected by demand, since it is according to the semiconductor manufacturing equipment used by customers.

After reviewing them individually, we revised them downward, albeit slightly, compared to equipment.

Profitability has not changed much in Q1 and Q2, and service and support is more sluggish than planned. Also, in Q2, some highly profitable projects were shifted to Q3, and some unprofitable projects were moved up from Q3 to Q2. The product mix caused another drop in profitability in Q2.

Participant 2: Is there a possibility that the negative impact of the product mix on profit will gradually decrease or turn into a positive impact from Q3?

Togawa: Yes, we think so.

Participant 3: I would like to ask two questions.

The first may be a continuation of the first questioner. I understood you to be discussing the profitability of service and support in the Energy business, which has been able to revise its selling prices with the H1 operating margin at 9.2% and projected to fall slightly for the full year. Does that mean the revised selling prices and strong service and support is ending in H1? Is H2 volume down with a weak selling price?

Miyaki: First, we have been revising prices since last year, and the revised prices remain unchanged. Its contribution is not limited to H1 but will continue in H2 and beyond.

In this context, you pointed out the difference between the operating margin of 9.2% from Q1 to Q2 and 8.8% for the full year. First, the target for the full year is the result of a close examination of the projects we have on hand.

For another, the overall idea is that rather than a deterioration in profitability from 9.2% to 8.8%, we believe our overall operating margin for the business will settle around 9%.

Therefore, it is not that there will be particularly unprofitable projects in H2. For the full year, we are forecasting an overall operating profit of JPY14.5 billion, and operating profit margin is expected to settle around 9%, the same level as H1.

Participant 3: If the current pace continues, do you expect this business to meet the E-Plan 2025 company-wide target of 10% ROIC? Or is it still a bit difficult?

Miyaki: E-Plan 2025 calls for a target of 12% operating margin in 2025 for the Energy business. As explained in the E-Plan 2025 presentation, these three years are positioned as three years for further profit improvement and three years for transformation toward growth businesses.

After spending on what needs to be done in 2023 and 2024, we will achieve an operating margin of 12% in 2025. Our target for this fiscal year is around 9%, but we are proceeding with our business based on the assumption that we can achieve an operating margin of 12% by 2025 after doing what we need to do this year and next.

Participant 3: Second, I would like to ask about revenue in China for the Building Service and Industrial business. Regarding the market environment, you mentioned that the COVID-19 pandemic has ended. However, I have not heard much good about Chinese construction investment.

In your understanding, is the increase in revenue in China in the Building Service and Industrial business due to market factors or sales efforts? I would like to get your comments on whether the macro story is consistent or different from the movement of your company.

Nagata: As you pointed out, the macro market environment in China is not very good. As seen in the fact that some customers are struggling with cash flow.

On the other hand, our performance is better than last year when we were affected by the lockdown, and we are still seeing continued investment in some industrial sectors, and our order intake has been successful. The market environment is not great, but some industries and some government investment projects are moving, and this leads to orders and revenue for our business.

We cannot rest assured about the future, so we will keep a close eye on H2 and into the next fiscal year.

Participant 4: I would like to ask three questions.

First, I would like to ask about the status of revenue in the Precision Machinery segment, particularly with respect to CMP equipment. Three months ago, we were told there was difficulty in increasing revenue due to the lack of progress in customer acceptance inspection. What was the situation in Q2? Are there any changes in that outlook?

Togawa: The situation in Q2 has not changed much.

Customers are not in a hurry to get up and running, and the acceptance inspection situation has not changed significantly. However, for those items that had not been inspected in Q1, almost 100% of them have been inspected as of now.

However, since we have been shipping one after another in Q1 and Q2, the situation has not yet changed in that it is taking longer than usual for the acceptance inspection.

Participant 4: Second, I would like to ask about the outlook for capital investment. What is the background to this downward revision by approximately JPY10 billion in the Precision Machinery segment? If this is for the delay, will that amount be posted in the next fiscal year, so will capital investment for the next two years be much the same? I would like to know your thoughts on the current term and your view on the next two to three years.

Togawa: In this fiscal year, we plan to construct a CMP production building in Kumamoto and an equipment-related development building in Fujisawa. This is being executed as planned, but there will be a JPY10 billion for the mass production building in Kumamoto, which will shift the cost from this fiscal year to the next fiscal year.

Therefore, the expense will be recorded in the next fiscal year. We plan no major changes in the next two to three years.

Participant 4: Incidentally, is the background for shifting this something intentional or is it an unavoidable external factor? I would like to ask about the intention behind this shift. Is it postponed, perhaps, because orders are weaker than expected?

Togawa: We would like to do it as planned, but we are a little behind schedule due to external factors such as late delivery dates and materials being hard to obtain due to price hikes. We hope to complete the project as soon as possible, as planned.

Participant 4: Third, on page 22, the Company has disclosed WACC by segment this time. I would appreciate comments on the current level of ROIC by segment, quantitatively if possible.

Asami: We shifted to a five in-house company system in January of this year. Since then, in managing our business based on ROIC, we have been trying to execute our business strategy by properly viewing ROIC and WACC.

This is still our first year and we are still trying things out. After one or two years, when the situation has stabilized, we would like to publish ROIC and other information by business.

I hope you understand that as of today, we are not yet at the stage of disclosing this information.

Participant 5: My first question is regarding the operating margin of the Precision Machinery segment that was shown as 14.7% at the beginning of the term with the operating profit plan at JPY18 billion. This profit plan was changed to JPY24 billion in May, and now it is JP23.4 billion. The profit margin is gradually increasing compared to the plan at the beginning of the term.

The explanation may be that it is due to the mix of projects and the service and support ratio, but I am concerned about whether such a high profit margin can really be achieved in H2. What changes from the assumptions made at the beginning of the period are causing the profit margin to rise so much in H2?

Togawa: I believe that the project mix is the most crucial factor.

We had expected that the mix of projects would improve a little from Q2 and that profitable projects would sell well, but the situation is rather that sales are coming from those with low profit margins. However, the percentage of good profit margins has been increasing in H2.

As for the impact of service and support, we expect it to be much the same throughout the year this year as compared to previous years. The cause is that the occupancy rate of customers is not increasing easily. Usually, there is a rush demand in H2, especially in December, and both service and support sales and profit increase considerably.

Although we expect some rush demand, we believe the impact will be smaller than in previous years. In conclusion, I hope you understand that the plan is based on a mix of projects.

Participant 5: Could you tell us what changes you see in the project mix?

I would like to know about the differences between different types of machines, customers, regions, and timing.

Togawa: Comparing equipment and components, equipment such as the CMP is more affected by the difference in mix. Depending on the type of process, the options mounted will vary. Options are relatively profitable, so the profit margin will vary depending on options mounted.

Also, the larger the customer, the tougher it is to negotiate the price, so we would like you to understand that this also reflects the influence of the customer's purchasing power.

Asami: I would like to add something. I think it would be good for you to understand that the profitability varies considerably from customer to customer. In our case, especially in the case of CMP, we have some ideas of which customers are using EBARA's products. Whether a customer invests or not will determine where sales will be made.

And whether the customer's profitability is high or low also depends on the options and equipment specifications, as Mr. Togawa just explained. In H1, there was a large portion of customers with low profitability. Toward H2, the percentage of customers who are relatively more profitable will increase.

Participant 5: Understood. I would like to ask one more question to Mr. Asami. Six months have passed since the new internal management structure was put in place. Please let us know if there were any good or bad responses to what you did.

For example, I understand various events, such as the ability to operate pumps and chillers as a single unit, which were handled separately in the former-FMS segment. What are your impressions of the actual business operations over the past 6 months? The point is, if you continue as you are, the hurdles for the Precision Machinery business are quite high for the medium-term plan.

On the other hand, if you can accumulate a little more in former-FMS and Environmental Solutions, I think you can manage to achieve the medium-term plan. In that sense, how do you look back on the first six months of the new structure?

Asami: I have two points about this. One is Energy.

Custom pump oil and gas and compressor turbines, which were facing the same markets, used to have little communication in terms of quotes or customer service. However, after Mr. Miyaki became the sole head of the segment, we integrated the previous monthly meeting for custom pumps and the monthly meeting for compressors and turbines and started a monthly company meeting for the Energy business. A sense of unity created through this integration.

Until now, the management of the compressor and turbine business had never been to the Chinese base where we are doing custom pumps. They had never been to the other EBARA subsidiary that does energy business. Such people have visited those subsidiaries and have perceived their advantages. This gave us the potential to move toward the energy market as a unified energy segment.

Infrastructure was part of the custom pump business overseas. Now, under the leadership of the president of the Infrastructure business, we are now thinking about infrastructure as a keyword for handling overseas projects of custom pumps, Chinese subsidiaries of custom pumps, Vietnamese subsidiaries, and other projects, and considering strategies for them, which is a good thing.

For Building Service and Industrial, we have direct access to customers, especially for industrial pumps, with no difference between custom and standard pumps. Also, there is a movement to see if water pumps for refrigeration and chillers can be applied somewhere as a solution. In that respect, I am glad we made the change.

In the Environmental business, as I have said since last year, it is getting harder to get the projects we want. So, we will work on ways to get them.

We will continue to focus on ensuring profitability through appropriate price proposals at the time of order receipt and systematic budget execution after receiving orders, including operation and maintenance.

There are still many issues to be addressed, but we will work hard to improve profitability in FY2025 so that we can get the projects we want.

Participant 6: I would like to ask about Energy again. Regarding the market environment, there was talk of active North American projects in the LNG market and movement in the oil and gas downstream. Orders in H1 were also significantly positive compared to the previous year, and the forecast for the full year has been revised upward.

What about its continuity? Are orders expected to increase still further in the future?

Since the H2 forecast is flat compared to the previous year, do you expect the level to remain as high as it is now? Is that somewhat predictable based on oil prices and LNG project deals? Earlier, there was talk about integration with compressors. What do you expect in terms of inquiries due to such factors?

Regarding profit, you mentioned earlier about service and support and the price increase. Will the brisk LNG downstream activity still only partially contribute to revenue and profit this year from a lead-time perspective? I would like to know what your outlook is and what you envision for revenue and profit.

Miyaki: First, regarding continuity, as you pointed out, LNG, petroleum, and petrochemicals, which are mainly ethylene rather than downstream petrochemicals, are firm and booming.

LNG, in our view, is, for one thing, a bridge from existing oil and gas in the transition to new energy sources in the future, and for another, an oil and gas energy source with a lower CO_2 load.

The second point is the energy security issue caused by Ukraine and Russia. The market is growing as an alternative to pipelines. Not only compressors, but also cryopumps in LNG terminals. It is our view that there is continuity.

The reason for the large increase in orders for petrochemicals, especially ethylene, since last year, is due to the increase in demand for petrochemical products from a growing global population and rising living standards in emerging countries. Last year, the COVID-19 pandemic had just ended, and customers were very reluctant to make investment decisions, but this year they are making investment decisions, and orders are coming in.

Demand is the base, and customers are making investment decisions. I think there is continuity for this year and next year. On the other hand, refining, especially for EVs, has been going in the same direction as the megatrend and has not emerged as much as before. This is the way we see the market. As for this year and next year, we believe there will be some continuity.

Regarding profit contribution, LNG and petrochemicals are product businesses. As you just pointed out, in product businesses, lead time is longer, and profit contribution will be from the end of H2, Q4 onward, to next year.

However, next year, the market environment for service and support will return to normal. Products will contribute to profits, but the question is how the business as a whole will fare as the service and support market returns to normal. The overall feeling is as I explained.

Participant 6: I do not think that LNG projects are able to be built in a day or two. Am I correct that you are making these comments with some understanding of what projects are coming in 2024, 2025, and 2026?

Miyaki: As you pointed out, we, in our discussions with our customers, see projects through up until 2026 and 2027. My explanation includes orders for projects not only for this year and next year, but also until about 2026 or 2027.

Participant 6: One more question, on page 23, you mention the transfer of the pump business from SKF. Can you tell us a little bit about the scale of this now?

I have the impression that the Company has acquired Hayward Gordon and various others and is slowly expanding in size. I think the actual effect of this will not be seen until next year, but please tell us as much as you can.

Nagata: The size of this M&A deal is smaller than the traditional M&A deals, such as Hayward Gordon or Vansan. Their current sales scale is about JPY1 billion.

Naturally, we are looking to incorporate this into our business and further grow it by creating synergies. We plan to use our sales network to expand its business, especially in markets where they have not been before, such as Japan and China.

Participant 7: Regarding price increases, I would like to ask which products in particular can be said to have contributed to operating profit.

Also, in the Energy business, what products mainly contributed to revenue? You mentioned compressors and pumps earlier, but could you please confirm this again?

Asami: Is your first question about the price increase about the entire company?

Participant 7: Yes.

Asami: We had to raise prices on all standard pumps, all precision products, and all energy products due to the rising costs of energy, electricity, and other raw materials. Basically, all our products.

Additionally, we are allowed to increase prices in the Environmental business when there is inflation. We hope you will consider that this is being done as well.

So, we raised prices on both products and service and support where there was room for negotiation and after communicating with customers. This excludes deals where the price was already determined for a certain period.

As for the Energy business, price revisions for both new products and service and support have contributed, I believe.

Mr. Miyaki, please provide any additional information on this question.

Miyaki: As for energy products, I mentioned compressors and pumps earlier. Specifically, there are high-pressure pumps for petrochemicals as well as compressors for petrochemicals and LNG. For LNG in particular, there is a cryogenic pump used at LNG receiving terminals. We raised the prices of those.

Participant 8: I would like to ask about page 23.

Regarding the optimization of service and support locations in the Energy business listed on the right side, I would like to ask for a more detailed explanation of the background behind the relocation or closure of each location. In short, I would like to know what the aim is.

Likewise, I would like to ask about the acquisition of the machine tool-related business on the left side of page 23. To begin with, I had an image that your company did not do much machine tool-related business. How much do you believe the machine tool market is? I would like to ask you about your machine tool business, including the acquisition.

Miyaki: There are two major backgrounds. For one thing, in our business model, we have service centers, such as so-called repair shops, supervisors, and field service personnel dispatch centers, located near our customers.

These are Elliott Group's service centers focused on compressors and turbines. In the past, petrochemical and petroleum refining were centered on Europe and the US, in addition to Japan. Therefore, the starting point is to place more of them, especially in the US, but also in Europe.

The main reason for this is that the focus of petrochemicals and petroleum refining has shifted from Europe and the US to Asia and the Middle East, where there is a greater preference for higher value-added products.

Accordingly, we have relocated from our former location to a new location to be closer to our customers and provide support.

Second, the in-house companies were reorganized to become the in-house Energy Company, and as Mr. Asami explained earlier, it handles custom pumps and compressors/turbines. Considering support from the customer and market perspectives, we considered how to integrate and utilize our existing compressor/turbine and custom pump locations.

With these two points as a backdrop, we intend to move forward with consolidation and optimization over the E-Plan 2025's three-year term.

Nagata: Our business for machine tools is currently limited to a few customers in Japan, and our share of the overall market is not very large.

The purpose of this acquisition is to expand our product line, to capture SKF's high market share in Europe, and to use their product line to enter markets such as Japan and China where we have sales channels.

The overall market is expected to be several tens of billions of yen, and the purpose of this M&A is to capture a share of that market.

Participant 8: You just mentioned Japan. There are various machine tool companies in Japan, and I think the market is promising to some extent. What are your thoughts on that area?

Nagata: The largest markets are, of course, Japan, the US, Germany, and China. Of course, as you know, there are many machine tool manufacturers in Japan, so we think this is very promising.

Asami: We would like to expand our business globally by taking advantage of EBARA's brand power, sales channels, and relationships with customers.