EBARA CORPORATION Third Quarter of FY2023 Earnings Conference Q&A

Q&A during earnings conference held November 14, 2023

Participant 1: The first point, the progress of profit in Q3, if we take the Q3, three months, JPY23.2 billion or so, operating profit was generated, which looks quite high as progress, but on a management basis, how much higher did this Q3 profit go if you could tell us.

You have left the full-year profit unchanged, but normally, in the case of your company, profits are usually higher in Q4, so your plan is for profits to decrease considerably from Q3 to Q4. Please give us some more details if there are some special factors.

Hosoda: Q3 profits are somewhat uneven depending on the segment, but they are not far off from the internal plan.

We have not changed our full-year plan, but we are aware that the balance of profits between Q3 and Q4 is slightly different from that of previous years. We are currently analyzing the details, but at this point, we think this is the most likely landing point for profit.

Compared to previous years, Q4 looks a bit more conservative than Q3, and our analysis of the difference between Q3 and Q4 is divided into four major areas. The first is the exchange rate, the assumed exchange rate is done at the prevailing rate until Q3, and for Q4, the assumed exchange rate is JPY130 to the US dollar, and we are still looking at that. The first reason why Q4 figures appear to be small is that the actual increase in profit of 15 or so is possible at the current exchange rate of about JPY150 to the US dollar.

Secondly, as you mentioned, Q4 is usually very profitable, and one of the main reasons for this is that the energy business, and the service and support of the energy business are very profitable in Q4, and their profit margins are good, so there is a big tendency for profits to rise in Q4.

Since service and support have a short lead time from order to sales, it is sometimes possible to hold on in the last three quarters, and in past years, the service and support portion of the energy business has seen some of its best efforts in Q4. Specifically from the perspective of the current term, as I mentioned at the beginning of the term, service and support in the energy business was relatively good last term due to special demand after the pandemic, whereas this term is expected to be a little lower than the previous term. That was a slower decline than we had expected, so we have been relatively strong in Q1 and Q2 of the last term. However, in Q3, orders for the energy business began to decline, both in terms of quantity and in terms of quality, including modification projects. As I had expected from the beginning of the fiscal year, the energy business services are expected to decrease in Q4 compared to the very good situation in the previous fiscal year. Therefore, we are expecting a special factor that we do not expect a jump in profit in Q4 due to the service and support of the energy business as much as we do in Q4 of previous years.

In the energy business, as we have been saying since the beginning of the term, there are still some unprofitable service store restructuring projects scheduled for Q4, and we are planning to take strategic orders in new fields from a carbon-neutral viewpoint. We would take some projects in new fields that we need to take as investments for the future, even if we have to pay for them ourselves, in order to build up a track record. Considering this, I think there are some special characteristics that are a little different from usual.

However, if these Q4 projects are postponed to this fiscal year or next fiscal year, there is a possibility of an upward swing in profit for the current fiscal year. The second point is that such special factors in the energy business are different from previous years.

The third point is precision machinery, but precision is a little bit, much lower in Q4 than in Q3. Q3 was rather too good, and in contrast, the mix for Q4 is not so good, including the timing of sales of evaluation equipment, etc. So, we are expecting a slightly weak profit in Q4 this fiscal year.

Fourth is building service and industrial, which is enjoying a relatively higher profit margin due to the effect of price revisions and other factors, but this is due to the timing of price revisions, with prices going up first and suppliers raising their prices a bit, and then the issue of the timing gap between price increases and suppliers raising their prices a bit, we are now in a situation where we are enjoying increased profits due to price revisions.

In the future, there are plans to raise the prices of suppliers, and this is expected to be a factor that will push down profits. We also have a slightly conservative view of building service and industrial, so our analysis is that Q4 looks a little weak due to such a four-areas surge.

I believe that the most probable landing point is this time at JPY71 billion, but if there is some room for upward movement, energy may have room for upward movement. On the other hand, we have a sense that there may be some room for a slight downward swing in the precision machinery business, but we have placed the JPY71 billion in operating income as the landing point, as the area with the highest overall improvement potential.

Participant 1: Second point. You mentioned that precision machinery, as a whole, have not yet returned to that level, but looking at orders in Q3 and QoQ, there has been quite a recovery, and I would like to get an idea of whether the effect of China's legacy investment in this area is quite significant. The sales composition of precision machinery in China is not disclosed, but I believe it is no more than 20%. For example, looking at Q3 orders alone, I would like to know if the ratio of orders from China has increased considerably or not, and if you could please explain this area.

Hosoda: As I mentioned, the percentage of legacy investment in China is increasing, while looking only at the order figures, there is a sense that the market has bottomed out.

While our competitors in the semiconductor production equipment business also disclose their sales in China, several of them disclosed that the percentage of orders received in China increased to nearly half in July to September, while the percentage of our precision machinery business in China from July to September is not that high.

We are in a situation where the percentage is roughly at the 20% or so.

Participant 1: I see. Does that mean that the non-China is doing a little better if we look at QoQ?

Hosoda: Well, in the sense that things are basically getting better, China stands out, but globally, of course, there is a certain base load, but I don't feel that things are really getting better yet. I think it is still a work in progress.

Participant 1: On the third and final point, I would like to know more details on the energy orders and the upward revision part.

As of H1, I believe orders were revised upward for LNG-related projects. I think you mentioned that there were about three large projects involving LNG, amounting to more than JPY30 billion, but what do you think of the full-year forecast, if you divide it into LNG and other projects?

Hosoda: The answer to both. In the LNG business, there have been some unexpected orders, and there have also been some orders that we had expected, but the number of orders has gone up. LNG is increasing, but on the other hand, we are also starting to receive orders for the petrochemical area, including ethylene.

Participant 2: I would like to ask you two questions. First of all, I would like to ask you about the landing of orders for the precision machinery business, and the future outlook, as you mentioned earlier, to supplement some of what you said earlier.

Orders received in Q3 appeared to be quite strong, but orders in Q4 are expected to fall slightly such as JPY60 billion or JPY60.3 billion in Q4. Is this conservative, and can you tell us about the background to Q3 landing of that order and the outlook for Q4 onwards?

Hosoda: In terms of precision machinery, I still think Q3 was a little too good. As for the future, we are not yet in a situation of full-fledged recovery, and we will have to continue to watch the Chinese projects closely. Q4 may have a little bit of a break compared to Q3, but overall, we think the market may have bottomed out or is at a slightly lower level, and after leveling off at this figure, a full-fledged recovery is expected in H2 of the next fiscal year. I don't think at this point that I have more than a feel for this industry, more than a feel for that.

Participant 2: The reason this order was good in Q3 was that China had legacy projects on top of the base-load orders, which was good. Is it your understanding that this will calm down a little in Q4, so it will fall off in QoQ, is that how you see it?

Hosoda: Yes, it is true that there are more China projects than expected, but as to whether or not the China projects will continue, I think they will settle down, or rather, they will continue to appear since it is a national policy. But I am not sure how that area will settle down, or perhaps not increase drastically, but I am thinking that it will continue at a certain level in the future.

Participant 2: Regarding the operating profit of the precision machinery business, you mentioned earlier that there were quite a few negative projects up to Q3 and that there will be bad projects in Q4 as well. If you could tell us about the background of this year's rather poor performance, and whether the increase in sales to local Chinese customers would result in a negative impact, and conversely, whether this is something that will level out to a positive impact for the next fiscal year.

Hosoda: First of all, we do not see the mix worsening as the number of projects and percentage of projects in China increases. It is a little more complicated. The profit margin on individual projects varies depending on the customer and the process used by the customer, so it is a feature of our company, especially in the equipment business, that the profit margin depends on whether the products sold at the right time happen to have a good profit margin.

In this sense, we call it a mix, but it also includes the timing issues, and the ratio of service and support to products. In this fiscal year, the ratio of service and support sales, mainly dry vacuum pump overhauls, decreased compared to the previous year, reflecting a slight decline in customers' factory utilization rates. From this perspective, the service and support ratio is a little lower, and the mix in this sense is also worse than last year, which is the situation in the current financial year.

Participant 2: How do you feel about the next term? Also, as a way of thinking.

Hosoda: The service and support ratio is greatly affected by the utilization rate of the customer's factory, so I think we will maintain the current status unless the utilization rate increases. The rest of the mix depends on the timing of orders for low-profit items and their sales, which is difficult to predict, but I think it will be on par with this fiscal year or slightly better than this fiscal year.

Participant 3: First question. I would like to know about the profit margin in the precision machinery. What I would like to confirm is the profit margin for the three months of Q3, and I believe that it has landed at a high level this time, both in terms of QoQ and YoY.

On the other hand, in the current QA flow, if anything, you must be talking about the deteriorating ratio of service and support or rather likely to get worse as a profit margin, low utilization ratio, so please tell us why this area has enjoyed a high profit margin.

At the beginning, in your earlier explanation, there was a reference to the presence or absence of a test model, but if you could explain if that alone explains the current profit margin, or if there are other factors that are included, if you would like to explain more?

Hosoda: My earlier response was as an explanation as to why the operating profit margin of the precision machinery segment is lower this fiscal year compared to the previous fiscal year.

When we divide the current term into three months, Q1, Q2, and Q3, the profit margin in Q3 is very high, which is true. There are differences in the mix of sales for each project.

In Q3, relatively high-margin projects that were originally scheduled for sales in Q1 and Q2 were postponed to Q3 and sold in Q3. As a result, the profit margin for the three months from July to September was exceptionally high.

On the other hand, Q3 had a relatively small percentage of evaluation equipment with low profit margins, though not necessarily zero. Please understand that the profit margins in Q1, Q2 and Q3 arise from such a mix of relationships.

Participant 3: The second question is about energy. You disclosed the breakdown of the upward revision for energy in the Q&A session earlier, but I wonder if you could tell us a little more about the background behind your company's strong order flow in the LNG area.

I am aware that in the current situation, FID, final investment decisions for LNG projects have indeed been made in some areas, but I am also aware that there are aspects that are being decided mainly in the United States. From this perspective, I wonder if the fact that your company is in a position to benefit from regional factors is also a tailwind, or if the way LNG plants are being built, including carbon neutrality, is also changing. In this area, can you tell us if your products are being evaluated, meaning that I want to check whether they have the potential to grow in the future in terms of structure?

Hosoda: The oil and gas base of our energy business is centered on a subsidiary called Elliott, which is a company based in North America.

In this sense, the LNG project, which is gaining momentum mainly in North America, can appeal to customers in a relatively positive way, including the presence of the brand.

On the other hand, our compressors and turbines have been mainly manufactured by Elliott, and recently, we have been working on a pump that was originally manufactured by Ebara Corporation, a cryogenic pump, which is for transporting LNG, and we are now working on a project for LNG, including cryogenic pumps, to approach customers as an energy business. In the past, compressors and pumps were sold separately, but now they are sold together, and both are receiving orders at the same time.

Therefore, I think that the Group's collective strength, or the overall strength of the LNG market, has increased a little in the recent restructuring, if we look at it positively.

I don't mean to say that the orders we're getting right now are significantly affected by that, however, from a medium- to long-term perspective, compressors in LNG plants used to be driven by gas turbines, but there is a big trend toward motor-driven compressors in the future, as the trend toward carbon neutrality and so on.

For gas turbine-driven compressors, compressor manufacturers that have gas turbines were relatively strong competitors, however, by switching to motor-driven compressors, the weakness of not having a gas turbine has diminished a little. I think that the wind is blowing positively in the LNG market for compressors for the mid- to long-term.

Participant 3: Additionally, just to confirm, is it correct to say that there are some potential pipelines that your company can see to some extent, and that you will be able to get orders in the next fiscal year and beyond?

Hosoda: Yes, the LNG projects will be done over a relatively long period of planning, so of course there are a number of pipelines that have been raised and listed.

Participant 3: Please tell us about China. I was wondering if you could give us a sense of how you see the sales and earnings from the business in China growing, and if you could explain, to the extent you are comfortable, the profitability of this China base alone and the sales composition. In terms of the sales composition of this China base alone, which part is basically the largest, what is the percentage of profit margin, and so on.

Hosoda: We do not disclose sales and profits by business segment in China. Building service & Industrial business includes mainly pumps for construction and industry, as well as chillers. There are four companies here. Three energy business-related companies that make pumps for oil and gas or electric power, etc., one company involved in incinerators of environmental solutions business, and three precision machinery-related companies, each with room to expand their respective businesses.

Of course, the largest growth right now is in the precision machinery area, and I believe that the plan is to continue to grow in this area, including in the future.

As for building service & industrial, I think it will depend on how much infrastructure development is planned in the future according to China's national policies, and how much our products will be involved in that area. In that sense, we are expecting overall growth.

In building service & industrial, right now, it's probably 20% or 25% of China, or something like that. The next most common is precision machinery at the moment, followed by energy, and that's about it, roughly in that order at the moment.

Participant 4: This may be a pinpoint or localized question, but I would like to ask about the consolidation of service locations for the energy business.

I understand that it is scheduled for Q4, and from what you have explained so far, we feel that the situation is quite favorable, especially for LNG.

In that context, I thought maybe there are service locations that are not profitable, not connected to the overall trend, but what is the background here and what kind of products service locations are being consolidated or eliminated? I would like to hear about such aims and how big they are.

Hosoda: A service and support base in the energy business, as a base, is not that big. However, as you know, the oil and gas market is in the midst of a major trend toward carbon neutrality, etc., and the market for conventional refineries and fossil fuels is expected to decline in the future. Other areas, including LNG, are currently doing well, and as we shift to other new energy sources in the future, I believe the market itself, including customers, is undergoing an overall change.

Under such circumstances, the geographic positioning of customers and their geographic locations have been changing on the map, as to where the business is booming and where it is not.

We have been in the oil and gas service and support business for a hundred or so decades, and we have built locations where there are many customers, many maintenance needs, and many service needs at any given time, but at the same time, as customers shift, there are sometimes cases of consolidation and closure.

This term, one location in Central and South America remained in Q4, but in that situation, regardless of the one location in Q4, there are several locations that need to be consolidated and eliminated, and that is the background of what we are actually doing.

Participant 4: Just to confirm, the one location in Q4 is in Latin America, and the consolidation is something that is done rather regularly and is not something unusual?

Hosoda: Yes, a service and support store is not a product manufacturing facility, so it does not contain very large, large-scale machinery and equipment. From this perspective, consolidation is not that extensive, but it is something we have done relatively once every few years, not limited to this term.

Participant 5: I would like to ask a little about the impact of the exchange rate. In the presentation material, it says that the impact of the yen depreciation is limited. I think the impact of the recent depreciation of the yen has been at the JPY151 level, but is it correct to say that the impact of the yen's depreciation on our business performance has been limited or that some of the impact has been positive?

Another point, I believe that LNG and other products for the petroleum industry have grown, especially in North America and Asia. For example, if you have any details on what products have particularly increased in sales or won in orders, we would like to hear from you.

Hosoda: In terms of the impact of the yen's depreciation on the landing point for this fiscal year, as I mentioned earlier, at the current pace of about JPY150, operating income of about JPY1.5 billion will again positively affect the entire company upward.

In terms of annual sensitivity to exchange rates, operating income for one year against the US dollar is roughly JPY300 million, and JPY1 move against the US dollar usually results in a sensitivity of about JPY300 million.

As for the second point, in the LNG or oil and gas industry, we deal with compressors used in LNG plants, turbines, and pumps. Please understand that orders for these products and related service and support have been strong.