Zeon Corporation
First Half of FY2024
Meeting Minutes from Results Briefing for Analysts
(October 28, 2024)

[Briefing Materials]
https://www.zeon.co.jp/en/ir/financial/bs/pdf/241028.pdf

[Explanations]
Yoshiyuki Sone, Director & Senior Corporate Officer
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In the H1 consolidated results, the growth rate of net income was lower than that of operating income. This was primarily due to a decrease in foreign exchange gains recorded under non-operating income and the absence of significant extraordinary income from the sale of investment securities recorded in the previous fiscal year.

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Today, we revised our full-year forecast for FY2024. The forecast for net sales has been revised upward to reflect increased assumptions for Asian butadiene in H2 and higher shipment volumes of optical films. Conversely, operating income and ordinary income were revised downward due to a reevaluation of the yen appreciation assumption and the impact of production issues in the COP production line at the Mizushima Plant. Net income was revised upward to include the disclosed gain on sale of investment securities.

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Naphtha prices declined slightly in Q2 but remained at high levels, similar to Asian butadiene.

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COGS included a 0.8B JPY deterioration due to inventory-related expenses, predominantly from optical films. A valuation loss for inventories was recorded under the lower of cost or market method in Q4 FY2023 following the 2024 Noto Peninsula Earthquake. However, after operations resumed in Q1, demand was robust, and shipments were stable. High factory operating rates led to improved fixed cost per unit, resulting in a reversal of the Q4 valuation loss in Q1. Routine inventory-related expenses in Q2 contributed to a significant QoQ difference, but this does not indicate a structural issue.

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The sales volume is represented using an index where Q2 FY2023 equals 100. Shipments of synthetic rubber decreased both YoY and QoQ due to regular maintenance at the Tokuyama and Takaoka plants. Latex and chemical shipments increased as demand recovered. Net sales rose YoY and QoQ due to price revisions in response to rising raw material prices, particularly for synthetic rubber. However, operating income declined due to lower shipment volumes of synthetic rubber and higher ocean freight charges.

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Operating income increased by 2.4B JPY, with a positive contribution of 2.3B JPY from increased sales quantities of synthetic rubber and chemicals. The performance of S-SBR in Singapore was notably strong.

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Despite shipment adjustments for regular maintenance at the Tokuyama Plant, the solid performance of S-SBR in Singapore contributed to a YoY increase in the cumulative sales volume of general-purpose rubber.

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A key point during this period is the increase in inventory levels due to stockpiling ahead of regular maintenance. This inventory is expected to decrease over the maintenance period.

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Similar to the balance sheet, inventory increased due to stockpiling for regular maintenance, worsening working capital. This situation is expected to be resolved as the maintenance period progresses.

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Non-operating profit and loss deteriorated YoY, mainly due to decreased foreign exchange gains as a result of yen appreciation. Extraordinary profit and loss also worsened compared to the previous year, primarily because the previous year had a significant gain on sale of investment securities.

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The full-year forecast has been revised to reflect net sales of 415.0B JPY and operating income of 23.5B JPY. The forecast for specialty materials was adjusted upward by 5.0B JPY in net sales, while operating income was revised downward by 3.0B JPY. The upward revision in net sales was due to steady sales volumes of COP and optical films. The reduction in operating income was attributed to production issues in one of the COP lines at the Mizushima Plant, which is expected to resume operations in about three months. Approximately 1.9B JPY in fixed and repair costs for this period were factored into the forecast. Additionally, a 0.6B JPY negative impact from supply disruptions at raw material suppliers, as well as lower shipments and prices in synthetic fragrances, contributed to the 3.0B JPY downward revision.

Net sales in the Elastomer Business were revised upward by 13.0B JPY, with no change in operating income. This was due to the absorption of the joint venture ZS Elastomer, which had minimal impact on operating income as it primarily operated as a trading company.

Additionally, due to the revision of the exchange rate to reflect yen appreciation and supply disruptions at raw material procurement sources, operating income is projected to remain flat.

Next, President Toyoshima will explain the measures being taken to achieve management that is conscious of cost of capital and stock price.

Tetsuya Toyoshima, President and CEO

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We take pride in being a specialty chemical company; over half of our operating income is derived from differentiated, high profit products. However, in Phase 2 of our current Medium-Term Business Plan, STAGE30, we aim to accelerate our transformation into a specialty chemical company. To this end, the core of our business strategy under the Medium-Term Business Plan is to shift our portfolio from low to high profit products.

Among our elastomer products, we have highly profitable items where we can position ourselves as the best owner. When considering how to retain these products while exiting from lower profit items, we had the opportunity to acquire land for a COP plant in the Shunan area. This allowed us to shift our elastomer portfolio from low profit products to the highly profitable COP.

Although we consider COP a high profit product, it is often perceived as mainly targeting optical applications with limited market growth. However, this view is inaccurate. Our COP and optical film businesses have shown consistent growth in past performance and are expected to continue experiencing steady demand.

We are confident that the new COP plant we are constructing will add significant value. Today, we would like to share our plans and the rationale behind them.

On the other hand, we recognize that portfolio realignment takes time, and we have given serious thought to how we can maintain and enhance shareholder value during this period. As a result, we revised our dividend policy to DOE 4% or higher and decided to add 10.0B JPY to purchase treasury shares in FY2024.

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This page outlines the projected sales growth rate and segment-specific ROIC during the STAGE30 period. The bubble size represents EBITDA.

First, COP and optical films are expected to experience significant EBITDA growth over time. With the new COP plant scheduled to start operations in FY2028, ROIC is projected to decrease in FY2030 compared to FY2026. However, even with this decline, the capital profitability is planned to exceed WACC.

For specialty chemicals and electronic materials, which include specialty solvents and etching gases for semiconductor manufacturing, EBITDA is expected to grow in line with the expansion of the semiconductor market, maintaining ROIC above WACC.

For battery materials, given the current subdued market conditions, we do not foresee an optimistic scenario where EBITDA significantly increases by FY2026.

Heading toward FY2030, we are factoring in market recovery based on objective market forecast data. However, we will continue to monitor market trends closely and make flexible management decisions as necessary.

For high profit elastomer products, we plan to maintain competitiveness by focusing on hydrogenated nitrile rubber, which is currently undergoing capacity expansion in the United States.

Conversely, as previously disclosed, we plan to withdraw from certain general-purpose elastomer products and downsize this business starting in FY2026.

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After announcing our portfolio restructuring, we received several inquiries. The first was about why we chose to establish the new COP plant in the Shunan area. The reason is that a capacity shortage for COP is expected by FY2028, and there is no room for expansion at the Mizushima Plant. Although we considered utilizing existing facilities outside Mizushima, we determined that building a new facility from scratch would be more economical than a scrap-and-build approach. We evaluated domestic and international site options from FY2021 and decided on Shunan for its proximity to Mizushima, facilitating raw material transport and staff support while being sufficiently distant to mitigate simultaneous damage risks. This was the reasoning behind the decision to build the new COP plant in the Shunan area.

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The second point concerns the reason for scheduling the partial withdrawal from Tokuyama elastomer production for FY2026. In summary, this decision was made to avoid causing inconvenience to our stakeholders. The petrochemical complex is interconnected by pipelines, and companies that use by-products extracted by us will need to find alternative suppliers. Additionally, as the production we plan to cease includes rubber for automobile tires, our customers will need to renew certifications from various organizations due to the change in raw materials.

We estimate that these adjustments will require approximately two years, which is why we have planned the withdrawal for FY2026.

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Additionally, our chemical plant shares utilities and common facilities across multiple production lines. This means that stopping one line shifts the fixed costs of these utilities and common facilities to the remaining lines.

In other words, if we were to withdraw from the production of our general-purpose elastomers earlier than 2026, we would only incur a loss of marginal profit, making it more economical not to withdraw immediately. By implementing a gradual downsizing, we can secure the profitability of our high profit products.

On the other hand, there were questions about whether it would be better to completely withdraw from the plant given these challenges. Referring back to page 29, our elastomer products include high profit items that can achieve an ROIC exceeding WACC, and continuing their production is considered beneficial for enhancing corporate value. Furthermore, the polymer production technology developed at the Tokuyama Plant is a foundational element for various specialty materials products and is a source of our competitive strength. We believe there is still room to improve the profitability of our elastomer business. Moving forward, we will work on the profitability of the elastomer business while considering the restructuring of our overall production system.

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Halting part of the elastomer production and incurring depreciation costs for the new plant are expected to temporarily lower ROIC in FY2028. However, EBITDA is projected to grow steadily through FY2030.

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In FY2023, approximately 60% of our net sales in specialty materials came from COP and optical films. Looking ahead, we project that by 2030, net sales will exceed 100.0B JPY, with an ROIC of over 10%. However, the ROIC for COP at this stage is not indicative of its full potential. The new plant, set to begin operations in 2028, will use the declining balance method for depreciation, which will initially suppress NOPAT during the early operational phase.

By 2035, we expect net sales to reach approximately 130.0B JPY, with an ROIC in the mid-20% range. This level would significantly exceed WACC, supporting the business as a highly profitable venture.

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This page presents a plot of production volume and net sales from FY2014. The data accounts for daily production levels, adjusted for the impact of biennial regular maintenance. The overall trend shows an upward trajectory for both production volume and net sales, correlating with capacity enhancements. This growth is expected to continue steadily beyond FY2024.

By FY2028, the combined production capacity of the current Mizushima Plant and the planned Takaoka Recycling Plant will approach its practical upper limit, making the construction of the new COP plant essential to avoid opportunity loss. This decision was deemed necessary to capitalize on the projected growth opportunities.

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We anticipate sales growth across various applications for COP, but today we want to highlight the primary growth factors. For the optical segment, small sized lenses are mainly used in smartphone cameras. The smartphone market is widely considered mature, and we share this view. However, with the increasing demand for high-resolution cameras, the need for high-performance COP has risen. Our strategy involves leveraging new product development to gain market share, enabling growth independent of overall market expansion.

Our plastic-based devices have become the de facto standard in the medical field, but the market still relies heavily on glass and other materials. As the biopharmaceutical market, including vaccines, expands, we foresee further growth in our sales.

For semiconductor containers, as fine semiconductor technology advances, our products are recognized as holding the top market share in the fine semiconductor domain. We aim to expand our share in semiconductor containers currently using polycarbonate.

Finally, in terms of retardation films, while the TV market's overall growth is leveling off, our films are used in large-screen TVs of 55 inches and above. With the global trend toward larger screen sizes, our product strategy envisions a different scenario than the overall TV market, where the market for screens 55 inches and above continues to grow.

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The ROE target for FY2026 has been revised from 9% to 10%. To achieve this, we are enhancing shareholder return. We have adopted a new dividend policy with a DOE of 4% or higher. The current share buyback program, capped at 10.0B JPY, will be expanded by an additional 10.0B JPY, bringing the total for FY2024 to 20.0B JPY.

We believe the current ROIC target is insufficient, so we are considering raising it. Once the specific figures are finalized, we will provide further details.

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Changes related to cash flow focus on shareholder return and interest bearing debt. The increase in cash outflow from strengthened shareholder return will be offset by increasing interest bearing debt financing.
We have received feedback that the D/E ratio of 0.3 by FY2026 is too conservative. However, according to our current financial plan, funding needs will peak between FY2027 and FY2028, after which the D/E ratio is expected to exceed 0.3 in some years.

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Our updated shareholder return policy stipulates a DOE of 4% or higher and share buybacks totaling 20.0B JPY in FY2024 and an additional 20.0B JPY in FY2025–FY2026. Future share buybacks will be flexibly adjusted according to market conditions and funding requirements.

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