HONDA

Investors and Analyst Session for FY24 3rd Quarter Financial Results Q&A

Date/Time : February 8, 2024, 17:00-18:00

Speakers :

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Q：Analyst A

1. I would like to know your evaluation of Q3 performance. I believe there were some one-off expenses related to warranty expenses and restructuring costs for Yachiyo Industry. Could you quantify these and provide an evaluation of Q3 after organizing these one-time expenses?
2. Could you update us on your outlook for the US sales environment? Your sales have been robust YoY, I wonder how much improvement in the mix you anticipate for the next fiscal year. Additionally, I would appreciate it if you could mention anything about the trend in incentives. Since your HEV models are selling well in the US, please give detail such as how sales of HEVs in the US affect the overall performance.

A: Fujimura

1. Regarding the performance evaluation, the results for the three-months period are as you are aware. First, I would like to mention the figures related to one-time expenses. Warranty expenses increased by about JPY80B compared to the same period last year. This includes JPY55B for the seat weight sensor issue, which we reported to the authorities in February. About JPY45B of this was an additional expense over our 1% budget allocation. Together with about JPY45B in impairment related to the transaction with Yachiyo Industry, this FY includes one-time negative of about JPY90B, most of which are related to the automobile business. Operating profit was JPY380B and ROS was 7%, increased by JPY99B from last year. Approximately JPY160B each comes from motorcycles and automobiles.
   Regarding motorcycles, as in 2Q, despite the downturn in numbers due to economic slowdown and stricter loan screening in Vietnam and Thailand, where our profit margins were exceptionally high, increase sales in Brazil and Europe, including Turkey, contributed to positive earnings. Even though we faced negatives in Vietnam and Thailand, we were able to stabilize production, and the annual cost reduction efforts have resumed. We also make efforts to offset the decrease in volume through cost reduction measures. This, along with strong demand in Brazil and Europe, proper pricing, and the decrease in raw material costs, helped us achieve a balanced earning state. Achieving the highest level of quarterly earnings in this context is something we regard as a robust performance.
   For automobiles, the profit was JPY160B with an ROS of 4.2%. Compared to last year,

the impact of semiconductors has lessened, leading to an increase of 120K units in North America. I will talk about the market environment in North America later as you requested an update, but this is a positive situation. In Japan, production recovery from semiconductor shortages, including the collection of backorders, contributed to an increase of 20K units. In China, there was an increase of 70K units, but given that last year's figures were too low, the situation remains challenging. Despite the challenges mentioned, including the impairment related to Yachiyo and the warranty expenses, we achieved JPY160B with a ROS of 4.2%. Over nine months, it amounted to JPY460B with an ROS of 4.6%, positioning us at a level where we are generating four times the profit of last year. This is amidst significant challenges such as cost increases for parts, labor, and the impacts of inflation, and a tough sales environment. However, it demonstrates that the volume increase in North America is effectively harvested as a volume effect. Additionally, the robust performance of HEVs, effective pricing, a decline in raw material costs, and the benefits of a weaker yen can all be evaluated positively.
Regarding quality, it is hard to say it's one-time expenses, as there have been a few big ones lately. But if we adjust to the 1% level and exclude impairments, over nine months, it would be JPY600B with an ROS of 6%, showing that the automobile business has indeed become quite strong.

2. As for the situation in North America, as you rightly pointed out, sales have been solid. In 2Q, we mentioned logistical disruptions and a move towards maintaining dealer inventory at 30 days, down from the pre-COVID norm of 60 days. By the end of December, we finally reached the 30-day mark. With the recovery from semiconductor shortages, we surpassed 400K units for the quarter, reaching 430K units. This is the first time since 3Q of 2020, that we have exceeded 400K units. As you know, inventory levels and incentives for many companies have returned to pre-COVID norms. In this context, we are keeping incentives low and, given the significant costs involved in maintenance for dealers, both dealers and American Honda are in agreement on pursuing quality sales with a lean 30-day business model. The stage where anything that can be supplied can be sold is over, and the time has come when we must compete with our competitors with a standard inventory of 30 days and restrained incentives. I believe that this is the critical point, and our strong lineup of HEVs is the key to support this situation. The Accord and CR-V already have HEV models, which constitute 50% of the model mix. They are now able to generate profitability, and incentives are roughly half of petroleum. In June, we will launch the HEV version of the Civic, so we have high expectations for this segment.
Regarding production, up to 2Q, some suppliers experienced full-capacity production for the first time in a while, leading to labor shortages and equipment issues. However, by 3Q, things have stabilized, allowing us to achieve a production level of 400K units directly linked to sales, and we anticipate this will continue into 4Q.
Incentives for battery EVs possibly in relation to the IRA, we are launching the Prologue and ZDX. As you know, since some GM models are not eligible for IRA benefits, we are

currently considering how to price Prologue. Since it is our initial model, we aim to minimize incentives. GM is making efforts to restructure the supply chain to become eligible for incentives, and we are hopeful about this move as we approach the next fiscal year.

From a model mix perspective, we must sell EVs, but if they do not sell well, there are complications with the CAFE and GHG mix, making calculations difficult. Naturally, increasing ICE, including HEVs, improves the mix. However, we will carefully consider the sales plan for the next fiscal year to understand the situation better.

Q：Analyst B

1. About the sustainability of profitability in the motorcycles segment, it seems that the situation has improved somewhat in advanced countries compared to before. I am wondering about the sustainability of this improvement. Additionally, if regions like Vietnam and Thailand, which have been underperforming, start to recover, is there an opportunity for overall improvement? I would appreciate your thoughts on the future direction and profitability of the motorcycles business.
2. About evaluation of 3Q results, if we add back JPY90B, that would give us JPY470B. On the other hand, after accounting for 4Q, we are looking at JPY170B, implying a reduction of about JPY300B in profit, which seems somewhat weak even considering normal seasonality. I would appreciate an explanation of the factors behind this QoQ variation.

A: Fujimura

1. Regarding the sustainability of profitability in the motorcycle business, achieving a 20% level this fiscal year is a very high level and shows that our efforts have paid off. As we have mentioned before, the motorcycle business operates in regions with high volatility, and we have always strived to build a business constitution that is resilient to fluctuations. While we do not disclose the break-even point for each factory or country, we have established a system in each country, especially in Asia, where we can generate profits even if volumes decline. In Brazil, despite a long-term decline in volumes and significant depreciation of the BRL, we have implemented substantial measures. Now, although Thailand and Vietnam face declines, other countries including Brazil are able to support us firmly.

   Regarding advanced countries, particularly Europe, we cannot be comfortable about their sustainability. The concern stems not just from the leisure market and its associated demand but also from the recent spike in energy prices across Europe. This spike has prompted a shift from four-wheel to two-wheel vehicles, leading to an uptick in sales. Yet, the key question is how sustainable this increase in sales will prove to be, which requires careful observation.

   The vehicles we are selling in Europe are mainly shipped from Kumamoto prefecture, and the effect of the weak yen significantly contributes to our profits. Therefore, the

sustainability of the leisure demand and the current exchange rate conditions are the variable factors we need to consider.
Recently, especially in Turkey, which is not traditionally a leisure market, we have seen significant market growth. This is due to a change in the licensing system that allows individuals with a car license to also drive motorcycles up to 125cc, leading to the market doubling or even tripling in size over the past year. While the numbers are not yet massive, this growth is promising, and we expect it to continue.
This is a positive aspect of our business in advanced countries. As I mentioned earlier, creating a business that is resilient to fluctuations is key. We aim to maintain our current model where if one country experiences a downturn, another can compensate for.
Regarding Vietnam, the economy continues to struggle, but we are hopeful that by the fall of 2024, we may start to see a recovery. We are looking forward to the latter half of the next fiscal year.
Overall, I believe there is an opportunity for increased volumes next fiscal year. We will provide a more detailed update during our announcement in May.

A: Kawaguchi

2. The actual result for 3Q is JPY380B. Subtracting the cumulative figure from the full-year forecast of JPY1,250B leaves us with an operating profit of JPY170B for 4Q. This implies an expected decrease in operating profit of about JPY200B.
As Fujimura mentioned earlier, we accounted for a slightly higher recall cost and an impairment of approximately JPY50B related to the reorganization of Yachiyo Industry, totaling a one-time negative of JPY100B in 3Q. Excluding these, the real difference might be about JPY300B less, as you pointed out.
Regarding the JPY300B difference, one factor is the difference in the exchange rate assumptions. The average rate for 3Q was JPY148, and for 4Q, estimate at JPY140. Including the differences in European and Asian currencies, we are incorporating a negative impact of about JPY80B due to exchange rates. Therefore, excluding this exchange rate assumption difference, the net difference would be about JPY220B.
Half of this JPY220B, approximately JPY130B, is related to R&D expenses and SG&A, which might seem higher in 4Q. R&D expenses are slightly concentrated in 4Q due to the timing of model development. For SG&A, with an increase in volumes, we have allocated a bit more to advertising and promotional expenses in 4Q. So, of the JPY130B difference, about half is related to development expenses and the other half to SG&A.
Continuing with the major factors, next is the area of costs. Overall, we are incorporating a decrease of about JPY60B from the 3Q to 4Q as a contributing factor to the decline in profits. Out of this JPY60B, approximately JPY40B is attributed to inflation, particularly from our suppliers in North America, where costs have risen. We have been consulting with each supplier individually, adjusting our purchase prices accordingly, but this has led us to incorporate a negative impact of about JPY20B for 4Q.

Apart from that, there is an increase in labor costs, centered also in North America, contributing to a negative impact of JPY20B from 3Q to 4Q.
I have explained about JPY40B of the total JPY60B cost increase, and the remaining JPY20B is partly due to seasonality. We often adjust rebates with our suppliers in 4Q, resulting in a payment of about JPY20B, totaling a JPY60B worsening from the 3Q to 4Q in terms of costs.
The rebates are purely seasonal and can be considered as a difference in conditions. As for other JPY40B, since production will begin stabilize in the next fiscal year onward, we will consult with each of our supplier, as we did this year, to promote production efficiency, and reflect cost reductions as much as possible.
Other factors include differences in incentives and the volume in China, which we have projected to be slightly lower in 4Q. Due to high dealer inventory levels, we have incorporated a volume of about 160K units for China in 4Q, so there's a decrease in volume compared to 3Q affecting royalty income. Taking all these factors into account, the total difference is about JPY300B, excluding exchange rates, making it JPY220B.
Regarding the potential upsides and downsides mentioned, one possible upside could be the exchange rate. We have factored in an average of JPY140 for the US dollar throughout 4Q. If the yen continues to move as it has, and if currencies in South America and Europe remain stable, there might be some upside potential there.
Additionally, regarding the costs of raw materials, especially precious metals, which have been on a downward trend throughout the year, we have conservatively assumed a halt in the decline for our forecasts. However, if the decline in precious metals continues at the same pace, depending on global automotive demand, there might be some upside potential there as well. On the downside, we have incorporated quite a stringent view of Asia. As Fujimura mentioned earlier, we have not factored in the impact of the earthquake, and we are continuously sharing information and coordinating with our suppliers daily. If the recovery from the earthquake is slower than expected, it could negatively impact our domestic volumes, which would be a downside risk. However, at this point, we do not anticipate any significant upsides or downsides.

Q: Analyst C

1. Could you explain the rationale behind the share buyback announced this time? If we add JPY200B and JPY50B and include dividends, it seems to amount to a total shareholder return of 55%. I would like to confirm if such actions are part of your company's broader goals. Additionally, regarding the 0 Series and batteries, I sense an intention to build a vertically integrated business model. Could you please discuss the balance between such upfront investments and your future direction for shareholder returns?
2. This fiscal year, if we add up one-time factors, it seems they amount to more than JPY200B, considering the Yachiyo incident, the quality issues announced in 2Q, and those announced in 3Q. Therefore, my understanding is that there is an underlying strength of

about JPY1.4 to JPY1.5 trillion. Looking into the next fiscal year, since you mentioned that volumes might see a slight increase, can we consider this base as the foundation for your company's sustainable earnings moving forward? If there are any points where this might not be the case, I would appreciate your clarification.

A: Fujimura

1. Regarding the share buyback, we have set a total of JPY250B, adding JPY50B to the previously announced JPY200B at the start of the period. We aim to complete this JPY50B purchase within a relatively short timeframe, preferably within FY2024. While it is not confirmed yet, there might be further announcements in the future, so we want to conclude this phase within the fiscal year, setting the purchase at a level that does not disrupt the market too much.
   Our stance remains essentially the same as what we have communicated before, with significant emphasis on the issue of PBR. Nearly all executives agree that addressing our PBR, which currently stands at about 0.7, is a critical responsibility. As I mentioned earlier to the media, the reasons for our low PBR can be categorized into past, present, and future factors.
   One reason is the excessive increase in our equity ratio. Over ten years, our equity has doubled from JPY6 trillion to JPY12 trillion, necessitating action on this front.
   The present concerns the long-standing issue of low profitability in our automobile business. While there have been one-off factors making it difficult to discern, we are seeing a path towards significant improvement, as we have been explaining.
   Looking to the future, in the BEV era, it is about how Honda can find and fight with a winning strategy. Increasing the resolution of our vision and presenting it as a tangible fact is crucial. This involves a bold move towards aggressive growth investments. We believe we have enhanced the resolution and demonstrated what Honda's BEVs are at CES, and we plan to continue updating our strategies moving forward. We plan to discuss this again at the beginning of the next fiscal year, and within the Company, we are considering holding a technical briefing to further clarify the supporting technologies. We aim to further enhance resolution of these technologies and continue to engage in communication and dialogue. Therefore, addressing the accumulation of equity from the past and considering returns are essential under this perspective. This is the underlying motivation behind our decision on shareholder returns this time.
   While we do not specify a total return ratio, the JPY250B for this fiscal year, as you mentioned, adds to what was announced at the start of the year. Regarding the world of battery EVs, which we started discussing two and a half to almost three years ago after the announcement made by our CEO, Mibe, the aspects of vertical integration and what we need to focus on as our core in electrification, such as materials, battery technology, and production techniques, are becoming clearer as we advance the discussion on what kind of business model to create. It is becoming apparent that the required investment

might be more significant than initially anticipated.
However, the pace of electrification, including regulations, especially the acceptance in the current Western markets or political acceptance, may vary. Still, the movement towards achieving carbon neutrality will not change. We hold this as our dream and responsibility as a mobility company, and we have no intention of easing our efforts. However, we must remain flexible and will continue to navigate this path accordingly.
Indeed, as I mentioned earlier, we need to balance the past, present, and future effectively. It is not about allowing business performance to decline after it has improved. Even in 2030, 60% of our business will still be in ICE vehicles, so we must continue to generate cash through our business. While considering these factors, we think about returns and plan our cash allocation within the Company accordingly. I cannot provide specific numbers today, but we intend to maintain a balanced approach.

2. Regarding the underlying earnings strength excluding one-time factors, we are currently projecting an operating profit of JPY1,250B for the year, and with the exchange rate at around the JPY140 level, similar to last year's average, close to JPY135. Considering the exchange rate assumption is at a level of nearly 135 yen and this year's guarantee cost is 350 billion yen, this is approximately 150 billion yen more than the budget assumption of 1% guarantee cost. Including the JPY44B related to Yachiyo and other one-time gains, after adjusting for these, it is fair to say our underlying strength is around JPY1,350B, which translates to an ROS of about 6.9%, nearly 7%. We feel this level indicates a solid footing.

Q：Analyst D

1. I would like to inquire about your thoughts on production for the next fiscal year. Considering that production was just under 1.2 million units in 3Q, and given that one of your factories in Ohio, North America, is currently undergoing renovation, I assume you are nearly at full production capacity. Could you confirm if this understanding is correct? Particularly, given that demand in North America is expected to remain strong into the next fiscal year, I wonder if there's potential for an upside in production.
2. I would like to hear a bit about the profitability of the automobiles segment. Excluding motorcycle business earnings, it seems that automobiles earnings in Asia, particularly in 3Q, might have had a significant impact. Considering the competitive environment in China and its profitability, entree of Chinese OEMs into Asian market, I would appreciate any insights you could provide on this situation.

A: Fujimura

1. Regarding whether we are at full production in North America, we are in that situation. There is still some room to increase production to a certain extent, and this includes HEVs and EVs, though the EVs are not produced by us. However, please understand that we are already at a level where we cannot significantly increase production.

2. As for Asia, the situation varies by country, but as of 3Q, India and Malaysia are performing well. In India, partly due to economic growth, we have been competing with two models, but the Elevate, introduced in September, has been very well received. In 3Q, we sold 27K units in India, half of which were Elevate. In Malaysia, we sold 26K units in 3Q, benefiting from the recovery from semiconductor shortages and the launch of the WR-V in July. There are also unconfirmed reports that the government is considering incentives for HEVs, which could bode well for future expectations, though this remains an uncertain factor.

   Then in Thailand and Indonesia, these are precisely the markets where the entry of Chinese OEMs poses significant concern for Japanese OEMs. The market situation in Thailand was challenging in 3Q, but we saw a slight increase, thanks to the recovery from semiconductor shortages. However, the economic environment and stricter loan approvals are significant bottlenecks.

   Furthermore, with battery EVs reaching nearly 27% by December, there is a significant need for measures regarding their expansion. Although it could be said we are somewhat behind, the popularity of HEVs remains very high. In terms of profitability, our HEV models in Thailand are at a considerable level compared to Honda's performance in other countries, so we will continue to fight by expanding our lineup.

   The key issue is battery EVs, where we have to wait a bit longer. Starting in 2026, we plan to launch a small BEV in Asia and Japan and will gradually introduce more models from there. Our strategy will likely involve bridging with HEVs in the meantime. In Indonesia, the situation is challenging due to stricter loan approvals, with all companies facing high inventory and intense competition over incentives. We are maintaining our market share amidst this, but there are reports of Chinese competitors building new factories. Unlike Thailand, Indonesia does not have incentives for HEVs, so we need to consider a different approach, and it is a situation that requires careful attention.

Q：Analyst E

1. About North America, in the next fiscal year or over the next two to three years, there has been talk from American auto companies about significant increases in labor costs. For GM, it is USD1.3B by calendar year 2024, which translates to over JPY200B. Considering the production scale, it could mean nearly JPY200B increase for your company as well, if we simply go by production ratio. What is your view on this? I assume these costs include not just direct labor but also increases in supplier labor costs. Could you share your current understanding of how labor costs in North America might change next fiscal year and the year after?
2. About motorcycles in ASEAN and emerging markets in general, will you aim to maintain a high profit margin or focus on increasing profit by gaining market share? There have been significant price increases, and I understand that this has improved profit margins. However, end prices have risen quite a bit. Honda has traditionally played a role in

providing mobility, but prices have reached a considerably high level, suggesting there might be room to expand the market by making mobility more affordable. Is there a possibility that the strategy might shift back to focusing on volume over profit margins? Or, given the impending shift to electrification, do you plan to maintain high profitability and transition to next-generation products? It is a bit of a vague question, but I'd like to understand the relationship between volume and profit in your strategy.

A: Fujimura

1. Regarding labor costs in North America, we have already implemented a wage increase from January, with an 11% increase from the start of the year. From April, there will be a 3% increase for the fiscal year, and from 2025 onwards, a 4% increase annually, which I believe brings us to a level not much different from that of the Detroit Big Three.
   This fiscal year, the impact is about JPY15B, and of course, this will have a full 12-month effect next fiscal year, plus an additional 3%. As you mentioned, suppliers are also experiencing labor cost increases, so combined with direct materials and external costs, a 1% price increase roughly translates to an impact of about USD100 million. For the next fiscal year, we are looking at an increase exceeding JPY100B, around JPY140B compared to this fiscal year.
   However, it is about how much of this can be absorbed by the American economy, which is fundamentally driven by inflation. Therefore, I believe it will likely be passed on through pricing. This, of course, will depend on the competitive environment, but logically, as I have mentioned earlier, that is what we are considering.
2. In major countries where we operate, even in places like Vietnam and Thailand where we hold around 80% market share, we are very conscious not to disrupt the market with our pricing.
   Our discussions in the SED evaluation meetings and about pricing are quite meticulous. We consider market trends, competitors' movements, customer acceptance, and future pricing levels while setting our prices. Therefore, regarding the current situation where prices have increased, setting prices while considering both the price and volume has been our practice for a long time, leading us to where we are today. We are not particularly worried about the current situation impacting our approach moving forward.
   Regarding electrification, it varies by country, but we still see significant opportunities for market expansion, especially in what we refer to as "next countries". Motorcycles continue to be an essential means of transportation for our customers, so the potential for market growth is substantial, and we believe there is still room for growth in ICE.
   In that sense, regarding your question on whether we aim to increase volume or profit, I believe we are looking at both. We plan to utilize the profits earned there to advance towards battery EVs, as we have set a goal for carbon neutrality in the motorcycle world as well.

Following question on 2.

Until about Q2, you mentioned a sustainable profit margin of about 15% for the motorcycle business. Based on your current discussion, is the potential decrease primarily a concern for exports to advanced countries, while the strategy in emerging markets remains to increase volume and maintain or even improve profit margins from the current level?

A: Fujimura

Following question on 2.

For advanced countries, it is uncertain how demand will evolve, but as I mentioned, with an ROS of 15%, we operate in regions with high volatility and have built a business model with a very strong variable cost structure, allowing us to remain profitable even in downturns. However, if the entire ASEAN market faces a downturn, achieving an ROS of 20% might be unrealistic. We aim to build a structure where if one area falls, another can compensate, allowing us to aim for around an ROS of 15%.