Kaga Electronics Co., Ltd.
Top Management Meeting Hosted by Ichiyoshi Research Institute
Main Questions and Answers

Date and time: 4:00-5:00 pm, Monday, December 13, 2021

(Online Briefing)

<Points to note>
The “Main Questions and Answers” has been posted as a reference for the convenience of those who were unable to attend the financial results briefing. Please be aware that it is not a transcription of all matters discussed at the financial results briefing, but rather a brief summary of those points that Kaga Electronics deems to be key.
Please also note that the statements contained in this document that relate to the future, such as results forecasts, are based on information currently available to Kaga Electronics and certain assumptions that have been judged to be reasonable. Actual performance, etc. may differ substantially due to a range of factors.

Q&A about Medium-term Management Plan 2024

Q: The plan mentions “development of new products.” What is the status of that?

A: The Group companies handle new products. FEI in particular focuses on this, and over the past three to five years has begun to work with over 100 companies on new products and vendors.

Q: What industries do you expect the electronic components business to experience growth in?

A: In addition to automotive parts, where we expect natural growth, we intend to primarily grow the industrial machinery and communications equipment businesses.

Q: If there are any risks to Medium-term Management Plan 2024, what are they?

A: We have set a net sales target of 750 billion yen, including M&A, but we are not pushing ahead with M&A with this 750 billion yen target as our first priority. We have long made income the most important focus of management, and we think that achieving the 20 billion yen operating income target is more important.

Q: What is the Company doing to address SDGs, sustainability, and decarbonization?

A: Our sustainability goal is to shift entirely to renewable energy. Currently, 78.5% of our company-owned vehicles are EVs (EV, HV, PHV, and FCV), and as we had already been proactively adopting HV, this percentage is quite high. In addition, we are working on diversity, work–life management, and improving productivity.

Other companies will also have to address these issues, so we think it is a good business opportunity for the Company.

Q&A on H1 FY2022/3 financial results and business conditions

Q: What is your impression of earnings in H1 FY2022/3?

A: My straightforward impression is that in H1, we were able to increase both net sales and income even though employees could not go to work, as we used telework to achieve a target attendance rate of 20%–30% during the pandemic. In particular, there was a shortage of parts, so we had many demands from customers to stockpile parts, and in this regard, I am very pleased that we were able to meet customers’ requests.

Q: As an independent trading company, KAGA was able to utilize its underlying strengths during the parts shortage. Specifically, what strengths did you rely on?

A: I think that our involvement with EMS also had an impact, but our ability to procure parts is very high. If there are no parts in Japan, we go overseas to find them. This tradition is still alive and well at KAGA.

Q: The supply of electronic components is still tight overall. Production of some vehicles has started up, but how long do you expect the parts shortages to continue?

A: I have been answering such questions by estimating that it will last throughout 2022, but it could actually wind down earlier than we think.

In the past, if there were parts shortages, manufacturers would ask us to place orders for the next year, but now, I am hearing that we are sometimes asked for final orders through the year after next, at the longest. We have never experienced this before, and to be honest, I don't think anyone really understands these conditions.

Q: At the earnings results briefing for the full year, you explained that the ratio of SG&A expenses to net sales had undercut 10%. Do you expect the SG&A expenses ratio to continue falling?

A: We feel that the Group's SG&A expenses ratio is high compared to that of other companies, and intend to continue our efforts to reduce it. One reason is that we have many Group companies, and other than a natural reduction, we would like to further lower SG&A expenses by reorganizing Group companies.

Q: Can the gross profit margin of the Group companies be improved to about 15%, the same as that of Kaga Electronics itself? If this would be difficult, why?

A: The Group companies' profit margins differ depending on the products they handle. A 1% annual improvement would probably be difficult, but we have to see ongoing gains, even if they are slight.

For example, FEI primarily handles semiconductors, and the profit margin for parts is already set, which makes it difficult to double it. Similarly, EXCEL primarily handles LCD panels, and the profit margin for these is low, which makes it difficult to double profit margins. Kaga Electronics has transactions in a wide range of areas, and we can generate profits on some products, but are unable to on other products. However, transaction amounts are substantial for products with relatively high profitability, so we can increase the profit margin. The different products they handle make it difficult for FEI and EXCEL to achieve profit margins equivalent to Kaga Electronics, but I think it all comes down to how successful they are in bringing in orders with transactions that have high profit margins, as Kaga Electronics does.

Q: KAGA FEI and EXCEL have made progress in improving profitability and bringing in new customers, but their profit margins are not high compared to Kaga Electronics. Can KAGA FEI's profit margins be increased further?

A: FEI has made more progress in improving its profit margin than expected at present, but I think that further gains are possible. Moreover, FEI focuses on the EMS business. They can design semiconductors and plates, and this process naturally leads to EMS. With this business model, we expect earnings to continue to increase.

EXCEL primarily sells LCD panels, and sells those procured both in Japan and overseas to mainly overseas customers. This is a good model, but in Japan, Kaga Electronics, FEI, and EXCEL all do business with the same customers, so we are considering streamlining these functions within the Group—for example, consolidating them into one company—so that our sales activities will be more efficient.

Q: KAGA FEI's gross profit margin in H1 was 9.3% and its operating income margin was 1.6%, but by contrast, EXCEL's gross profit margin was 7.1% and its operating income margin was 3.3%. Why was EXCEL's operating income margin higher?

A: Sales of modules for LCD panels overseas have low profit margins, and in addition, they account for a high percentage of sales, but we tried to improve efficiency by, for example, simplifying the organization in Japan. We reviewed all other transactions with low profit margins and left only those making profits, and I think this led to good results, primarily in Japan.

Q: EXCEL had a substantial pachinko-related business. What is its dependence on pachinko sales, especially given that the pachinko industry is shrinking?

A: This business is ongoing. While it is true that the pachinko industry is shrinking, there has not been any major impact. The decrease in sales is made up for by growth in other businesses.

At their peak, pachinko-related sales surpassed 70 billion yen for the Group overall, accounting for about 40% of sales, but at present, they are less than 20 billion yen for Kaga Electronics on a parent basis, and less than 10 billion yen for EXCEL, and this business has also declined significantly as a percentage of sales.

Q: KAGA FEI does not have an image of being the kind of company that aggressively cultivates new products and new business partners. Is this actually the case?

A: FEI originally had a sales team responsible for breaking into new areas, but the loss of major commercial rights left all employees with a strong sense of crisis. At that point, Kaga Electronics sent over personnel, which led to good results. In addition, awareness is going through reforms, with a greater emphasis on income and a review of transactions with low profitability. When there have been examples of success, they have spread throughout the company, so I think the corporate climate has changed.

Q&A about EMS Business

Q: Some other EMS companies in Japan struggled in H1, so why were KAGA ELECTRONICS' results so strong?

A: We had to suspend operations at some of our overseas factories due to lockdowns taken as measures to prevent the spread of COVID-19, and we had to deal with parts shortages, so H1 was extremely tough for the Company. The impact of COVID-19 continues to linger, particularly in ASEAN, in H2 as well. Our H1 financial results were strong despite this because China recovered from the pandemic sooner than expected, and we received many requests for increased production. Another factor was solid growth of sales at the Mexico factory.

Q: Can the EMS business sustain the current profit margin?

A: We will try to keep it at this level, but this business has intense competition with other companies, and it may fall in the future. However, we have business partners in a variety of industries, and have decided to revamp any businesses that have low profit margins. In this new approach, instead of running factory operations at a low profit margin with great difficulty even when sales are down, we will focus on other business. We hope to maintain our current profit margin not just by going after sales, but by achieving balance in a wide industry.

Q: Is the EMS business affected by parts shortages, higher distribution costs, and a spike in the price of materials?

A: It is affected, but we work together closely with customers and strive to prevent it from having a significant impact on financial results.

Q: With sales expected to grow in the EMS business, automotive products will likely be affected significantly. What is your view?

A: The automotive market is growing. In our Next Medium-term Management Plan, we predict that the EMS business will have 150 billion yen in sales in fiscal 2024. In the case of the automotive market, customers issue their forecasts for the next few years, and we plan capital investments, such as boosting line capacity, in line with these forecasts, so we are confident about the feasibility of these forecasts. In addition to the automotive market, we also expect solid growth in industrial machinery and healthcare equipment for the US. In addition, in the air-conditioning area, we have received many requests from customers who are planning new factories and would like us to manufacture nearby. We plan to invest in factories that meet these customers' requests, and expect sales at a certain level.

Q: What percentage of sales do automotive parts account for?

A: Based on earnings at end-March 2021, automotive parts accounted for 28% of sales, air conditioning for 20%, industrial machinery for 20%, consumer electronics and communications for 14%, and office equipment and healthcare equipment for 8% each.

Q: It is often said that generating profits is difficult in the automotive parts business. What do you think?

A: It is certainly true that the profit margin is lower for automotive parts than for healthcare equipment and industrial machinery. However, it is also an industry in which transactions are spread over a long duration, which makes it easier to identify trends several years ahead. Fluctuations are intense, but business strategies can be considered over the long term, so there are also merits.

Q&A about M&A

Q: Many of the M&A thus far have targeted trading firms, but will you consider EMS businesses' manufacturing process or manufacturing businesses as targets for M&A in the future?

A: There have been two cases of M&A related to the EMS business recently, namely KAGA EMS Towada in Aomori Prefecture and Kyokuto Electric in Tottori Prefecture. These had impressive merits, including the acquisition of manufacturing technicians, as well as higher sales. We will consider such M&A anytime there are good opportunities.

Q: Of the 750 billion yen sales target for the final fiscal year of the Medium-term Management Plan 2024, 150 billion yen of this is slated to come from M&A. What is the status at present? Do you have any M&A planned?

A: I'm afraid I cannot say whether we have any specific plans or not.

Q: What are your thoughts on industry reorganization?

A: I think that we'd like to be actively involved in industry reorganization. That said, I feel like many managers of other companies in this industry feel that reorganization will probably be needed in the future, but not in our own time. Reorganization can result in merits of scale, and with more trading companies around the world consolidating so that their overall number has fallen, I doubt that so many trading companies can survive in Japan alone. This is another reason I think that we should consider reorganization.

Q: Are there priorities or guidelines for the targets of M&A?

A: We do not make distinctions between trading companies and EMS, and consider all possibilities if there are merits for the Company as long as they are related to the electronic and electric sector. Recently, we acquired the wireless module business from Taiyo Yuden Co., Ltd.

Q: Are you considering M&A with the aim of acquiring technicians, as with the acquisition of Kaga EMS Towada?

A: If there is no business, there is no place for technicians to work, so we do not consider M&A with only technicians in mind. "Technology" refers to manufacturing technology, and we put priority on how skillfully they can be utilized in EMS factories. Our EMS factories operate globally, and a lack of technicians is always an issue. The Towada acquisition had the merits of giving us manufacturing technology and expertise on quality assurance. Towada has many young employees, as well as a foundation for providing education from a young age, which makes for a good education environment.

Q: Does acquiring technicians lead to improved product development and profit margins?

A: In the case of the EMS business, the manufacturers usually develop products, but our goal is to begin working together from the development and design stage, so we are focusing on acquiring manufacturing technology at present. Manufacturing technology determines how efficient factories can be, and is the lifeline of EMS. If the manufacturing technology isn't good, then we cannot generate a profit no matter how much we manufacture.

Q: Can Kaga EMS Towada's technicians exert their skills at other bases?

A: They are already actively participating at bases in Japan and overseas. We have started a rotation between overseas employees and Towada employees, and hope to energize our human resources going forward as well.

Q: In general, there is a trend for companies to be divided by role, so that a design company does the designs, a manufacturing company does the manufacturing, and a sales company carries out sales, but as the auto industry shifts more to EV and makes progress with automated driving technology, a management style in which a single company can do it all cannot be sustained. Has Kaga Electronics considered acquiring a Tier 1 factory?

A: We would certainly consider it if there was a good opportunity. If we can acquire a Tier 1 factory, we would be able to strengthen our EMS business.

Q: President Kado has moved ahead with the reorganization of the Group companies, but there are a large number of companies in the Group, and the number will only increase again with new acquisitions. An increase in the number of Group companies is not necessarily something that pleases capital markets and stock markets. What are your thoughts on this?

A: I also think that the Company is being traded at a conglomerate discount, so I would like to reduce the number of companies, but I think that the corporate reorganization within the Group still lies in the future.

Of the 67 Group companies, 44 overseas Group companies are either electronic parts sales companies or EMS factories, and run electronics parts businesses and EMS businesses, which are our core businesses. Overseas, as the sales office and factory are a single company, and are located in different countries and cities, it may appear that there are a lot of companies. By contrast, we have 17–18 Group companies in Japan, of which five or six are not involved in electronic parts and EMS. So the majority of the Group companies run businesses related to our main businesses.

Several years ago, we consolidated three companies in the CSI business into one, and are also consolidating companies in other businesses.