Message from the General Manager of the Finance Division

We will focus on maximizing free cash flow while maintaining ROIC in excess of the cost of capital.

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Chief Financial Officer
General Manager of the Finance Division

The Hitachi Metals Group aims to achieve an adjusted operating margin of 8% and return on invested capital (ROIC) of 8% in fiscal 2022, as set forth in the Medium-Term Management Plan (see pages 12-15). We are focusing on improving capital efficiency by maintaining ROIC above the cost of capital (7.5%) and maximizing free cash flow.

In addition, we will reform our business structure by withdrawing from unprofitable products and consolidating and/or eliminating business sites, and reform our cost structure by thoroughly reducing costs and expenses while optimizing personnel expenses. Our aim is to transform our profit structure into one resilient to fluctuations in demand. Using benchmark analyses in the global competitive environment for each business, meanwhile, we will accelerate business metabolism in each segment to optimize our portfolio of growth and core businesses. Through the steady implementation of our Medium-Term Management Plan, we will pursue an early recovery in our business performance and promote transformation to a robust profit base that enables us to secure resources for future growth investments.

A tender offer for the Company's common stock (hereinafter, the "Tender Offer") by a corporate consortium centered on Bain Capital (hereinafter, the "New Partner") is planned for the future. Through the Tender Offer and a series of transactions scheduled to take place thereafter, the New Partner intends to make the Company its wholly owned subsidiary. As a result, the Company will withdraw from the Hitachi Group, and the Company's common stock will be delisted. After these transactions, by promoting reforms under the New Partner, we will speed up decision-making processes, obtain investment funds, and introduce external know-how. Our aim is to recover our competitiveness, regain profitability, and increase corporate value through renewed growth.

Improving capital efficiency

The Group's cost of capital is calculated at 7.5%, but ROIC is currently below that figure. To build an earnings structure resilient to fluctuations in demand, therefore, we will lower our break-even point by reducing costs and swiftly improve ROIC by increasing profits and reducing invested capital.

To increase profits, we will continue expanding our lineup of high-value-added products and growth businesses while deploying IoT technologies to deliver *monozukuri* innovations that will improve product quality and reduce costs. In addition, we will use information technology to streamline administrative operations and thereby decrease fixed costs. We will also continuously review our business portfolio by downsizing, withdrawing from low-profit, non-core businesses, and spinning them off.

To reduce the amount of capital invested, we are working to shorten the cash conversion cycle (CCC) by formulating optimal production plans using IoT and sharing best practices through personnel exchanges within the Group. Under the Group's inventory management system, manufacturing sites and procurement departments are responsible for material inventories, manufacturing sites and business divisions are responsible for production inventories of work in process and products, and domestic and overseas sales companies and business divisions are responsible for distribution inventories. Going forward, we will strengthen our cross-lateral corporate functions to build a system for swift and accurate inventory management based on sales forecasts. At the same time, we will aim to further shorten the CCC with additional inventory reductions. Meanwhile, we launched the Reformed Human Resource Training Program to prepare human resources who will be *kaizen* (improvement) professionals. We are also implementing thorough management from the plant floor to inventories and warehousing. Despite our focus on inventory optimization, the actual CCC value for fiscal 2020 was 89.1 days, up 2.0 days from that of the previous year. This was due to significant declines in revenue and earnings, mainly in the first quarter, stemming from COVID-19. Other factors included increased production in the fourth quarter to address a greater-than-expected recovery in demand, as well as surging prices of raw materials.

Some of our businesses currently have ROIC figures that are significantly higher than their cost of capital, others that are earmarked for steady improvement, and others that will be lower in the short term due to the need for upfront investments. For this reason, we believe it is important to ensure that each business unit is managed with a focus on ROIC. By setting ROIC targets based on the profits and invested capital of each business segment, we are working to swiftly improve ROIC for the Group as a whole. In fiscal 2021, we will increase the effectiveness of ROIC-focused management by incorporating it into each action plan for management reform.

Improving cash flows

We are working to boost free cash flow by expanding profits, improving working capital efficiency, and making highly selective investments in priority areas.

In fiscal 2020, net cash provided by operating activities amounted to ¥52.6 billion, down ¥53.4 billion from that of the previous year, due to the significant impact of the decline in profit. On the other hand, net cash provided by investing activities totaled ¥2.2 billion, up ¥58.7 billion year on year. This was due mainly to reductions of investments in response to the deterioration of our business performance, as well as proceeds from the sale of shares in former Mitsubishi Hitachi Tool Engineering, Ltd. (now MOLDINO Tool Engineering, Ltd.). As a result, free cash flow improved ¥5.3 billion, to plus ¥54.8 billion in fiscal 2020.

Clarifying the investment decision-making process

We have rebuilt our processes and criteria for capital investment. For capital investments made by business divisions, corporate divisions participate from a preliminary review stage, when the screening process before decision-making and responsibilities of the screening division manager are clearly laid out. Going forward, we will review and strengthen management of the decision-making process for small investments, whose decisions have traditionally been delegated to business units.

In addition to upgrading equipment and streamlining, increasing production capacity, establishing new centers, and investing in safety, we invest in mergers and acquisitions and the like. Ordinary investments and strategic investments are separately defined and classified in terms of investment decision-making, recovery of investment, and other aspects. As a measure to prevent recurrence of inappropriate quality practices, moreover, we will invest around ¥10 billion to build a system that can automatically generate and manage inspection data appropriately with minimal human involvement. We will introduce the system sequentially at each manufacturing site by around 2024.

Proposals for strategic investments emphasize cash flow, and investment decisions are based on a current valuation using discounted cash flow (net present value or NPV), ROIC, and the investment recovery period.

Balance sheet management

We are streamlining our balance sheet to improve our financial position and raise capital efficiency. During the year, we promoted structural reform by shortening the CCC to reduce working capital, using the Hitachi Group's cash pooling system (CPS) to consolidate surplus funds and borrowings across the Group, and adopting a selection and concentration policy. Total assets at the end of fiscal 2020 stood at ¥972.2 billion, down 1% year on year.

Our basic policy is to source funds needed for growth-oriented investments from cash generated by businesses and cash on hand. To avoid missing growth opportunities, however, we will engage in flexible fund procurement with a view toward maintaining or reducing our debt-equity ratio (currently in the 0.4–0.5 times range) and retaining our A+ credit rating from Rating and Investment Information, Inc. (R&I).

In fiscal 2020, we reduced net interest-bearing debt (interest-bearing debt minus cash and cash equivalents) ¥49.2 billion from that of the end of the previous fiscal year. We achieved this by decreasing working capital through inventory reductions and other measures and improving investment cash flows to stabilize our funding base. As of March 31, 2021, the Company's long-term corporate and unsecured bonds were rated A+ by R&I.

Cash allocation

The Group's basic policy for determining the distribution of profits to shareholders is to comprehensively take into account the operating environment, business results, and future business outlook, together with the need to retain internal reserves for medium- and long-term growth.

For enhancing shareholder value, we aim to distribute profits with a balance between shareholder returns and share price increases through business growth, with a view toward increasing total shareholder return (TSR). Under the new Medium-Term Management Plan, we will target business growth to achieve higher share prices, concentrating resources in high-profit, high-growth areas, implementing structural reforms, and strengthening our operational foundation. We will also work to ensure stable dividends with a target payout ratio of 30%.

We recognize that share buybacks are an effective way to return profits to shareholders. At present, however, we consider it reasonable to invest for strategic growth with high returns, and for this reason we will focus on business growth and expansion through strategic growth-oriented investments in R&D and high-value-added product areas.

At its meeting on April 28, 2021, the Board of Directors resolved not to pay a year-end dividend for fiscal 2020 and interim and year-end dividends for fiscal 2021, in light of the planned Tender Offer for the Company's common stock by the New Partner.

* "Adjusted operating income" refers to operating income (as shown in the consolidated statement of income) excluding other income and other expenses. We use it as an indicator to show the actual state of management without the effects of business restructuring and the like.