2nd Quarter Fiscal 2013 Results Briefing Q&A
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Q: In the first half, your operating income was negatively impacted by higher overseas procurement costs due to a weaker yen and an increase in goodwill amortization. At the same time, you saw benefit in the aircraft and hydraulic equipment segment from the yen's depreciation in value. Overall first half operating income outperformed year-on-year, so why did you lower your full-year operating income forecast from the initial plan at the start of the fiscal year?

A: We downwardly revised our full-year operating income forecast to ¥18.5 billion, from our ¥22.0 billion operating income estimate at the start of the fiscal year. I will explain this from the views of both the company and individual business segments.

For the company overall, on a forex-neutral basis, we now estimate a wider sales decline and a drop in profit due to this sales decrease, in contrast with our forecast at the start of the fiscal year. Although we benefitted from a depreciation in the yen's value, personnel costs and bonuses increased and overseas procurement costs rose due to the weaker yen. Also, we estimate full-year operating income is likely to undershoot our plan at the start of the fiscal year, due in part to deterioration in product mix.

Looking at our business segments, we anticipate a decline in operating income in the aircraft equipment business, owing to a decrease in revenue from the after-sales service business due to sluggish performance at European airline companies. In the hydraulic equipment business, we look for a profit drop due to a shift in demand in China to compact models. In the new energy business development division, we forecast some sales for solar thermal power generation plants will disappear due to the postponement of projects but anticipate an increase in sales for wind power generators. However, we think earnings will decline owing to the difference in profit margins. Meanwhile, in the automatic doors business, we estimate profit will decrease due to a decline in added value as large-scale domestic projects wind down, and also due to prior investments for M&A in the US and an increase in goodwill amortization for Gilgen Door Systems AG, due to a weaker yen.

Q: Foreign exchange sensitivity to the Chinese renminbi was ¥38 million in the first half of FY 2013. However, in your revised full-year forecast, you are projecting foreign exchange sensitivity to be ¥36 million. Can you explain why you have revised the figure downward from the first half?

A: In the first half of FY 2013, the actual exchange rate for the renminbi was ¥15.44 to 1 renminbi. In our revised full-year forecast, we are assuming an exchange rate of ¥15.60 to 1 renminbi. We estimate operating income in the second half is likely to be squeezed by losses at the hydraulic equipment plant in Changzhou, China due to a low operating rate and costs to start-up a new marine vessels equipment plant. In light of these factors, in contrast with the first half, we think the foreign exchange sensitivity to the renminbi is likely to be smaller in the full year. We note that our earnings forecast at the start of the fiscal year did not take into account losses at the Changzhou hydraulic equipment plant. (In the initial plan at the start of the fiscal year, we estimated the foreign exchange sensitivity to the renminbi at ¥63 million.)

Q: What are your M&A policies and how do you plan to use your cash?

A: Thus far we favored organic growth. M&A was carried out to complement this growth. However, to achieve our FY 2020 long-term vision, it is crucial that we switch to growth strategies driven by M&A. At present, we believe the aircraft equipment business, the precision equipment business, and the marine vessels equipment business have the highest potential for growth in FY 2014. We expect performance in the marine vessels equipment business will touch bottom in the current fiscal year and grow in FY 2014. We believe the aircraft equipment and precision equipment businesses will drive the company's growth in the medium and long term. In the automatic doors business, due to the maturing market, we aim to increase sales via M&A and expand profits by implementing value chain management.

Meanwhile the business environment is murky for hydraulic equipment, commercial vehicle equipment, and railroad vehicle equipment. The hydraulic equipment business and the railroad vehicle equipment business are highly dependent on the market in China. In the railroad vehicle equipment business in FY 2014, we forecast a decline in domestic sales and are unable to forecast

sales in China.

Should growth become uncertain in a business, we are ready to respond with M&A to boost sales.

Our cash flows are improving. We plan to utilize our cash to sustain growth. We plan to retain a payout ratio of 30%.

Q: What is the potential of the precision reduction gears business and how much competitive strength do local Chinese robot manufacturers have?

A: There are four major robot manufacturers in China. They are Siasun Robot and Automation, GSK CNC Equipment, Estun Automation, and Anhui Effort Intelligent Equipment. These companies use our reduction gears but use motors and controllers manufactured by Chinese companies. From the perspective of the technological level of software, these companies are still behind Japanese robot manufacturers but the Chinese government plans to promote automation using robots manufactured by Chinese local companies. As the robot market grows, we believe it is likely that local robot manufacturers will opt to use reduction gears made by Chinese companies. At present, product performance of reduction gears made by local manufacturers in China varies greatly. Product life is also only one-fifth to one-tenth that of our products. However, we are keeping a close watch on trends as we do not know what the future has in store.

Q: In the presentation materials, the section on the precision reduction gears business indicates that FY 2013 sales in the precision equipment segment will only fall around 6% in comparison with FY 2011. Also, while you aim to cut the number of employees in FY 2013 by roughly 30%, you expect your operating margin to drop from 18% to 14.5%. Can you explain this?

A: In comparison with FY 2011, we expect operating income in the precision equipment segment to decline ¥1.7 billion in FY 2013. In FY 2013, we transferred the business of drive units for wind turbines to this segment from the aircraft and hydraulic equipment segment. We also expect the losses in the new energy business development division to widen in FY 2013 due to product mix (zero sales of solar tracking equipment, increase in sales of wind turbine drive

units). In light of this, we expect full-year operating income to deteriorate in the precision equipment segment.

Another negative catalyst for operating income in this segment is the per-unit depreciation cost for precision reduction gears, which has been increasing since FY 2011, due to depreciation expense incurred in FY 2011 in tandem with capital investments. Meanwhile, we are making progress reducing personnel and enhancing production efficiency. In the precision reduction gears business, operating income is currently at the same level as in FY 2011. We plan to boost our plant operating rate by 20% in the second half. This should in turn pull up our operating margin.

Q: In the medium/long term, Japanese and European robot manufacturers are expected to increase production in China. Without production capacity in China, I think it will be difficult to generate profit. Do you plan to set up a production plant in China in the medium/long term?

A: We established a sales joint venture with Shanghai Mechanical & Electrical Industry in China. We aim to achieve our FY 2016 sales goal for the precision reduction gears business (1.6-fold growth versus FY 2013). After implementing capital investments in FY 2011, our monthly precision reduction gear production capacity is 50,000 units. It is possible to boost our monthly output capacity to 60,000 units if we inject capital into facilities expansion. We have ample capacity to fulfill an expansion in demand over the next few years. We aim to continue manufacturing precision reduction gears in Japan, providing that we are able to maintain our competitive edge. However, we believe the option is always open to set up a plant in China, should we come under heavy price pressure. We already have a partnership with Shanghai Mechanical & Electrical Industry. If the need arises, we will enlist the cooperation of Shanghai Mechanical & Electrical Industry to quickly implement production in China. Also, around 50% of the product manufactured in the precision reduction gears business is delivered to customers in Europe. From the viewpoint of our Business Continuity Plan, we are looking to see how we should better respond to customer needs.

Q: You downwardly revised your full-year earnings forecasts again this year. I realize the strength of each of your business segments varies but all four of segments are underperforming initial plans made at the start of the fiscal year, which means not all of your businesses are growth businesses. I personally think a key factor in the next mid-term plan is likely to be whether you stick with the in-house company system. What are your thoughts on this?

A: We recognize there are advantages and disadvantages to the in-house company system. At present, the only cross-functional collaboration is in the enhancement of Product Lifecycle Management, which is being promoted by the Technology and R&D Division. The horizontal expansion of our businesses is weak. It is vital that we eliminate the sense of sectionalism that stems from each in-house company creating its own individual business plans. We are looking into increase the deployment of cross-functional collaborations between our businesses.

One plan calls for joint business development with Shanghai Mechanical & Electrical Industry in the precision reduction gears business, and another is to expand sales of commercial vehicle equipment in the US and European markets, by expanding our partnership with Parker Hannifin beyond the aircraft equipment business and conducting sales through the company. At the Kobe plant in the railroad vehicle equipment business, we set up the Digital Engineering Center to conduct tests of products for the B737-MAX, once an order has been confirmed at the aircraft equipment business, to shorten the lead time to delivery.

Q: Your product lineup even includes products such as 3D printers. Your product lineup appears to be too extensive. As you are aggressively implementing M&A activities, is there a possibility that you will downsize your business portfolio?

A: We are always examining whether we should sell or exit a business. This includes our mainstays. Sales at CMET, our subsidiary that handles 3D printers, are around ¥1.0 billion. We plan to grow sales at CMET to ¥10.0 billion. To this end, our existing lineup of high-end products is insufficient, so we are planning the development of mid-range products. Many Japanese companies are letting growth opportunities escape due to their preference for high-end products. In light of its current scale, CMET cannot be compared with major overseas

companies but we plan to expand CMET via M&A and the development of new businesses, including the supply of quasi high-end products. To accomplish this, Nabtesco has to first use CMET's products to get a feel for its products to put together new ideas and improve the company's ability to respond to the needs of its customers.

Q: Chinese robot manufacturers are expected to grow. Since you only have a minority interest in the joint venture with Shanghai Mechanical & Electrical Industry, does it have no impact on earnings in precision reduction gears business?

A: Business in China is different from that in an advanced economy like Japan. The Chinese government plays a major role. It is highly likely that decisions made by the government will determine which direction we take. To the best of our knowledge, Shanghai Mechanical & Electrical Industry is the best partner for us for business development in China, where the culture, politics, and infrastructure are all different. Our partnership with Shanghai Mechanical & Electrical Industry began in 1996 when the company invested in the establishment of our hydraulic equipment plant in Shanghai. We have built a relationship of mutual trust. We believe it is better to partner with a state-owned company in China, rather than a private company.

Q: Please explain why you want to accelerate your M&A. This year is your company's 10 year anniversary. Although a substantial amount has been invested in M&A over the past 2-3 years, it has been at the sacrifice of profits. Isn't it more appropriate to create strategies that would allow you to reap the benefit of the M&A deals carried out in recent years rather than embarking on new M&A deals to expand your top line? Why are you in such a hurry to increase your M&A activity?

A: We believe that it is imperative that we attain the goals set out in our long-term vision. We carefully considered the best methods for reaching these goals. It is our belief that we will have to lower our goals if we stick with our traditional policy of relying on organic growth complemented by M&A. Another option is to

maximize profit and set our dividend payout ratio at a fixed level. However, when we considered what was necessary to achieve these goals, we landed on M&A. If increasing M&A activity means an increase in risk and we have to sacrifice profit, there is a possibility we will abandon this method. To achieve our goals for FY 2020, we have set goals for each of our companies. We believe that M&A is an option when organic growth is insufficient.