Q&A Session at the Results Briefing Meeting for the second quarter of the fiscal year ending December 31, 2016

Time and Date: From 10:00 a.m. to 11:30 a.m., Monday, August 8, 2016

Venue: 18th floor, Daiwa Conference Hall

Respondents: Kazuaki Kotani, Representative Director, President & CEO

Nobutaka Osada, Representative Director, Deputy Chief Executive Officer and President of Aerospace Company

[Group-wide basis]

Q. What are your assumptions with regard to the business outlook for each segment from the next fiscal year onwards?

A. We expect growth in the aircraft equipment business and the precision reduction gears business; these markets are anticipated to expand from the next fiscal year onwards. Although we expect that markets for other businesses will become mature or stagnant, we have asked each business division to consider growth strategies for the market slowdown with growth as a keyword by gaining shares, expanding product lineup and so forth.

Q. What are the reasons behind the year-on-year decline in profits for equity-method subsidiaries?

A. Our two major equity-method subsidiaries are Harmonic Drive Systems Inc. (listed) and TMT Machinery, Inc. (unlisted). Harmonic Drive Systems Inc. has been profitable and we expect further growth in the future. TMT Machinery, Inc., on the other hand, has been suffering from a decline in orders received since the latter half of 2014 due to the negative effect of excessive production in the synthetic fiber market. We are afraid that a recovery may not be possible until the second half of next year, looking at market conditions.

[Precision equipment segment]

(Precision reduction gears business)

Q.The precision reduction gears business posted decreased revenues for the first half of the year compared with the plan for the period announced at the beginning of the current fiscal year. What was the factor behind this?

A. This was attributable mainly to the negative effects of a plunge in orders received from European robot manufacturers during the third quarter of the previous year (October – December 2015). This was also apparent from the financial results of our customers. They seem to have been affected by the VW scandal among other factors. However, these results are due to delays by customers in carrying out their plans, and their investment plans themselves have not been dropped.

Q. What is the progress on your plan to expand sales targeting industries other than the robot industry?

A. Although in the past we had been focused on sales of precision reduction gears alone, we commenced with sales of actuators by combining motors and the gears for the European and Chinese markets in October 2015. Since customers' evaluation of the products, including motors, has taken time, we are afraid that there is a risk of not achieving the sales target for this year.

Q. Is it possible that the precision reduction gears business has been affected by increased pricing pressure in response to a change in the competitive landscape for reduction gears (new manufacturer A, Chinese manufacturers, etc.)?

A. Although there have always been pricing pressures from robot manufacturers, which face pressure from automobile manufacturers as our ultimate customers, we are not aware of pricing pressure due to the rise of Company A and Chinese manufacturers at this stage. While we are constantly monitoring Company A in light of its business scale, there have been no effects observed so far. Chinese manufacturers do not have products that can compete with our QCD performance. High-performance robots are currently produced in line with demand from the automobile industry. However, if the need for robots with lower performance for general industries increases in the future, such as those with a shorter product time, etc., the situation may change.

Q. Sales of Chinese robot manufacturers have been growing. Are they producing low-performance products?

A. Very few robots for the automobile industry and articulated robots are made in China. We believe that Chinese manufacturers are focused on simple SCARA robots ,and so on.

[Transport equipment segment]

(Chinese railway market)

Q. What is the situation surrounding the high-speed railway market in China?

A. We predict that the number of railway vehicles to be launched in the Chinese high-speed railway market by 2020 will remain nearly unchanged. With regard to the risk of us losing market share, there is replacement risk from railway vehicles produced in China as well as risk that railway vehicle models from the former China CNR Corporation that uses brakes made by other manufacturers will be adopted as the standard.

As for the replacement risk from railway vehicles produced in China, while they will be introduced gradually for the purpose of building a track record toward exporting Chinese high-speed railways, it is unlikely that all railway vehicles will be replaced at once as we have seen in the case of subways. With respect to the risk of losing market share to brakes made by other manufacturers, it will be an opportunity for us to gain market share on the flip side.

In terms of subways, we forecast that the market will grow for direct-controlled municipalities and first-level cities, but not for other cities. We employ the strategy of concentrating our focus on the major five cities, including after-sales services.

While competition is expected to intensify from next year for inter-city transportation with a focus on semi-high-speed railway vehicles, we have yet to see the scale of the competition.

Q. What is the progress of the Chinese high-speed railway project this year?

A. We have received the annual business plan, based on which we have implemented our plan. However, each year our delivery tends to be delayed due to customer reasons. Although a slight risk has already been incorporated into our plan, there is a possibility that some projects scheduled at the end of year will be delayed.

(Maintenance, Repair and Overhaul)

Q. What is your view on the outlook regarding profitability for the transport equipment segment in the second half of this year and for next year?

A. With regard to Maintenance, Repair and Overhaul (MRO) service for railroad vehicle equipment, which accounts for a significant contribution within the transport equipment segment, MRO service for Chinese high-speed railways began last year, and further growth is expected in the future. The significant growth of MRO service in Japan during the period between 2013 and 2015 reflects a shift to a more aggressive MRO sales style. We may not necessarily be able to maintain this growth rate, but we are confident that continued sales expansion will be possible in the future.

[Aircraft and hydraulic equipment segment]

(Hydraulic equipment business)

Q. What is the status of production in China regarding the hydraulic equipment business?

A. In the hydraulic equipment business, while unit sales of excavators in the Chinese market are expected to decrease by 5% year-on-year for the current fiscal year, we assume that production by construction machinery manufacturers will increase by 10% year-on-year due to a decline in inventories available in the market. Looking at the results through the second quarter of this year, sales have remained mostly in line with the plan so far for the first time in the past few years despite some differences in the level of performance among customers.

(Aircraft equipment business)

*Responses to the questions with regard to the aircraft equipment business are given by Nobutaka Osada, President of Aerospace Company, unless otherwise specified.

Q. Can you provide a breakdown of sales by target market for the aircraft equipment business?

A. The domestic defense market and the private aircraft market each account for approximately 50% of sales. The MRO market for private aircraft accounts for approximately 20% of sales in the private aircraft market.

Q. In the aircraft equipment business, is the profitability of MRO higher than that of Original Equipment Manufacturing (OEM)?

A. The profitability of MRO is higher.

Q. How much profitability is there in this business? Can you exceed this level and profitability in the future?

A. We do not disclose the profitability of individual businesses. However, we can say that the profitability of this business has been improving, although not significantly, on the back of the growth in sales in the private aircraft market and an increase in demand for MRO service. As the volume of work increases, we can also expect an increase in operation profit.

(Kotani) Profit from the aircraft equipment business has been increasing every year in line with the growth of sales in the private aircraft market. As far as the private aircraft market is concerned, revenue peaks after five years of sales, when repair needs become necessary. We aim to raise the ratio of sales from after-sales-service business to more than 30% of total sales in the private aircraft market.

Q. In the aircraft equipment business, do you expect that revenues will increase but profit will decrease for FY 2017 and FY 2018 due to an increase in depreciation resulting from large-scale investment for achieving medium to long-term growth?

A. Mass production is expected to commence in FY2017 and FY2018. The growth in profitability is expected to slow down due to an increase in depreciation during this period. However, we do not believe that there will be a temporary deterioration in profitability, since the positive effect of mass production and enhanced productivity will likely compensate for the increase in depreciation.

Q. In the aircraft equipment business, are research and development expenses posted on the income statements on a real-time basis?

A. They are posted on a real-time basis.

Q. Other companies seem to have posted a loss from OEM sales. Is the business profitable at Nabtesco?

A. Yes. OEM sales have generated profits for us.

Q. With respect to the sales forecast for the aircraft equipment business described on the "Our Vision" page, what is the reason why you forecast that the current level of sales for existing aircrafts will be maintained in the future? (P17 of Business Introduction of Aerospace Company)

A. As sales for the defense market are expected to remain unchanged, we should be able to secure sales volume for existing aircraft. In the private aircraft market, sales of the B787 will be solid for the next 10-20 years and sales of the B767 are likely to be maintained for the next 15 years. Taking this into consideration, we are confident that we will be able to maintain sales volume for existing aircraft.

Q. How will the MRO ratio in the aircraft equipment business change in the future?

A. While the current ratio of 20% will not change significantly, we think that the absolute value will increase. Due to a change of the business model in the repair market, the business landscape has become more difficult than before. For example, although each airline used to have supplementary parts, they are now jointly possessed by three companies. While MRO sales account for 50% of total sales at some European and U.S. companies, we will continue to make efforts to expand sales by targeting an MRO ratio of approximately 30%.

[Industrial equipment segment]

(Automatic door equipment business)

Q. How much has the conversion of Nabco Systems Co., Ltd. into a consolidated subsidiary contributed to sales and profit in the financial results for the first half of the year?

A. The conversion contributed to sales by approximately 4.0 billion yen after elimination of inter-segment transactions. Although it also contributed to profit, we cannot disclose the details.

(Industrial equipment segment)

Q. What are the reasons behind the improvement in profitability of the industrial equipment segment expected for the second half of the current fiscal year?

A. This is attributable to the automatic doors business. The business is for the mature market, and its business model is based on growth through M&A of sales distributors in markets such as Japan, Switzerland, North America, etc. Since M&A always entails transient cost, profitability deteriorates when the cost balance is poor. This time, we strive to maintain a slightly better balance.

We aim to grow the automatic doors business as a “cash cow” by establishing a system to constantly secure profits regardless of transient cost.

Q. Do you believe that you can achieve the full-year operating income target for the industrial equipment segment?

A. With respect to the profit target for the current fiscal year, the newly-consolidated Nabco Systems Co., Ltd. will have a significant impact. However, since only two months have passed since the start of the Post Merger Integration (PMI) process, there is still a risk that the target may not be achieved. As far as overseas subsidiaries are concerned, most are likely to achieve their targets despite differences among them in performance level. Overall, we believe that we will manage to achieve the target at this stage.