Message from the Executive Officer (Finance & Accounting)

We will support the sustainable improvement in corporate value by securing the investment funds to realize an early recovery and transformation of the financial base.

Yasuaki Fukumoto

Executive Officer In Charge of Group Finance and Accounting
General Manager of Finance & Accounting Division

FY2023 Summary

In fiscal 2023, we recorded losses (losses due to special factors) due to the additional inspection program for PW1100G-JM engines incurred in the Aero Engine, Space & Defense Business Area and a loss related to the settlement of litigation involving a consolidated subsidiary in the Resources, Energy & Environment Business Area. Consequently, we recorded the largest operating loss to date, which significantly impaired our financial base, and we were unable to achieve a performance level that met the expectations of our stakeholders.

Summaries of the main items are as follows.

1 | Business performance

We recorded an operating loss due to the losses resulting from special factors. The financial base has also been adversely affected to a large extent, and we recognize that this recovery should be a top priority.

If we exclude the losses due to special factors, operating profit surpassed 100.0 billion yen, and we are confident that we have steadily strengthened our ability to generate operating profit. Operating cash flows, on the other hand, remained at 62.1 billion yen, and we were unable to generate operating cash flows of over 100.0 billion yen as we upheld in the “Group Management Policies 2023”. We will take steps to further strengthen our cash generating capabilities and use this to secure the investment funds to realize transformation.

2 | Shareholder returns

In terms of shareholder returns, we distributed the same level of dividends as in fiscal 2022. Although we recorded a net loss for fiscal 2023, we focused on stable shareholder returns because the loss due to special factors was a nonrecurring factor that would not affect our performance from fiscal 2024 onward.

3 | Stock price

The stock remained weak throughout fiscal 2023, but In July 2024, the stock price recovered to a level at or above the level before the special factors occurred. However, we regard that there is still a gap between the stock price and the intrinsic value of the Company considering our profitability and growth potential.

Early Recovery and Further Reinforcement of the Financial Base

Total equity (consolidated basis) at the end of fiscal 2023 decreased approximately 54.0 billion yen compared the end of fiscal 2022. Although the probability of occurrence is extremely low, we were reminded of how large the impact on business performance would be when a business risk materializes in the civil aero-engines business.

Excluding the losses due to the additional inspection program for PW1100G-JM engines, we have evaluated that we have the ability to generate stable operating profits at the 100.0 billion yen level, and we believe that achieving the operating profit target in fiscal 2025 upheld in the "Group Management Policies 2023" of 127.5 billion yen to be well within reach. We will make an early recovery of the damaged financial base by refining this earning power. Furthermore, we will identify the risks of each business, assess acceptable risks, and work to reinforce our financial base to withstand the occurrence of risks.

The keys to early restoration lie in the expansion of LCB (lifecycle business) and management of business fluctuation risk.

LCB is characterized by the high profitability margin that can be expected compared to new constructions as well as the low risk of business performance fluctuations. The Project Risk Management Division monitors the screening process before orders are received and cost management and risk assessment after orders are received, from a standpoint independent of the business divisions, to address the risk of fluctuations in business performance related to new and large-scale construction projects. The division has accumulated know-how for controlling the emergence of risks.

We believe that these initiatives will lead to stable generation of profits and will quickly restore the financial base.

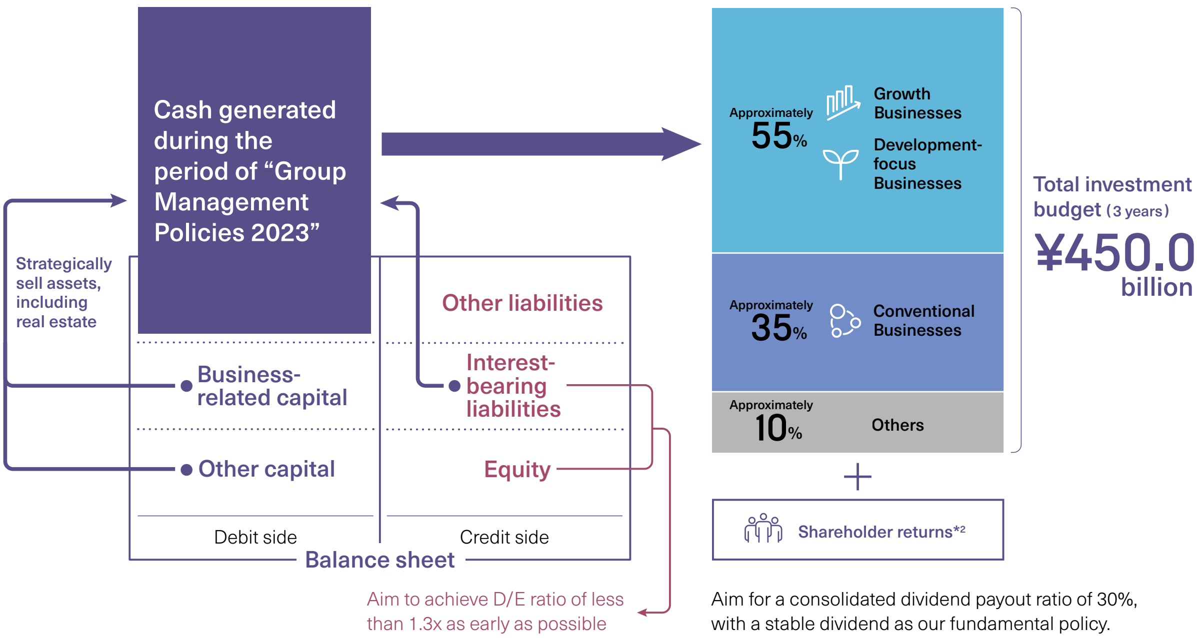
Securing Investment Funds to Realize Transformation

In our "Group Management Policies 2023", we have set a total investment budget at an unprecedented scale and decided on a policy in which 1) the source of funds for investment will be funded by generating ongoing operating cash flows of 100.0 billion yen or more, and 2) about half of the total investment budget will be allocated to the Growth and Development-focus Businesses.

Without the special factors, we recorded 175.0 billion yen as EBITDA (total of operating profit and depreciation) for fiscal 2023, and we give it a certain amount of credit. However, the actual operating cash flows remained at 62.1 billion yen. This means that we are not converting profits to cash efficiently, so our cash generation capabilities must be further strengthened.

From fiscal 2024 and beyond, we expect cash outflows

Envisioned Cash Allocation



related to the additional inspection program for PW1100G-JM engines. Therefore, we will consider systematic sales of assets, including real estates, and use of financial leverage within the scope of maintaining financial discipline.

Structural Reform of Balance Sheet to Reinforce Cash Generation Capabilities

We believe that the largest factor that is inhibiting the efficient conversion of profits to cash is the growing size of the balance sheet. The balance sheet shows the status of capital investments needed for future growth, and also has the characteristics of a risk buffer and a source of shareholder returns. Therefore, we will aim for a level that suits our medium- to long-term vision and strategy, but we are aware that our current balance sheet is not in an ideal state.

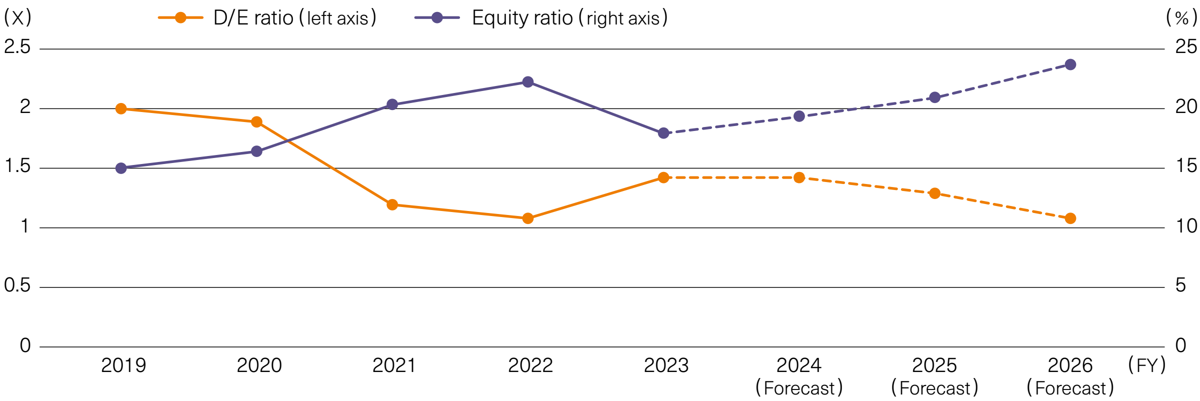
For this, in fiscal 2024, we will review the cash generating structure itself, including business and contractual practices, in addition to strengthening our existing efforts, such as reinforcement of inventory management to prevent excess and backlogged inventory, and obtaining the advances received for construction projects. To conduct a structural reform of the balance sheet, our review will not only be on working capital. We will also consider the ideal state of possessing fixed assets and investment assets in line with the business strategies.

Furthermore, the D/E ratio at the end of fiscal 2023 deteriorated to 1.43x. We maintained our A- rating in the latest ratings (as of November 2023) by the rating agencies. However, we are aware that the ratings are subject to the early restoration of the financial base. Therefore, we will first recover the D/E ratio to below 1.3x, a level that is considered to be needed to maintain the ratings.

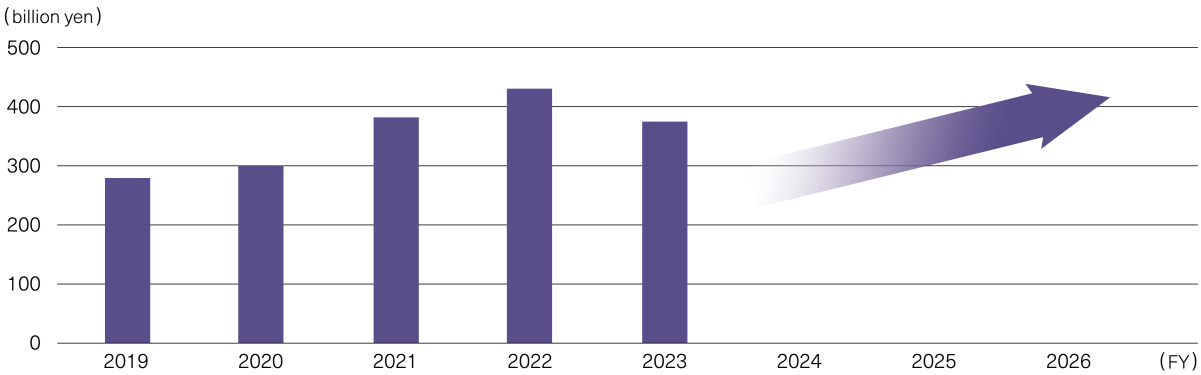
Working Toward the Implementation of Management That Is Conscious of Cost of Capital and Stock Price

The share price temporarily declined due to the losses related to the additional inspection program for PW1100G-JM engines. However, it has recovered to a level close to a record high in July 2024, with PBR standing at around 1.8x. We believe this is the result of

D/E ratio and Equity ratio



Trend of the equity ratio



the market's certain level of recognition of our efforts to strengthen profitability and our strategies to achieve sustainable high growth.

However, we believe our corporate value (market capitalization) considering factors such as our profitability and growth potential to be at least over 1.5 trillion yen (as of July 2024). If the market is convinced and can relate to our strategy for generating stable profits and cash, as well as our growth story for the future, we believe that the gap between the theoretical stock price and the market stock price will be narrowed, and we can aim for a PBR of around 3 times.

We estimate cost of capital (WACC: weighted average cost of capital) to be approximately 4%–6%, and if we can achieve 8% in ROIC, we can secure a sustainable growth and profitability. ROIC is an indicator that we can use to deploy in order to set and manage KPI in accordance with the issues of each division. However, we prioritize the use of operating profit margin as KPI for profitability and CCC (Cash Conversion Cycle) for improving capital turnover rate, and we are working to disseminate these KPIs within the Group. When I actually visit business divisions and affiliated companies and talk to the people there, I feel that there is a growing understanding and awareness of operating profit margins and CCC.

Approach to Shareholder Returns

We are continuing to consider the most effective ways of returning profits to our shareholders, depending on the circumstances. We regard that the current dividend policy, "the basic policy in stockholder returns is stable dividends, while aiming for a consolidated dividend payout ratio of more than 30%", would lead to the best shareholder return under the current circumstances and that it would best meet the expectations of our shareholders.

We recorded a net loss for fiscal 2023, therefore we had the option of either reducing dividends or not distributing dividends. However, we were confident that we were right on track in reinforcing our earnings power and that there will be no changes in our growth scenario. Therefore, we prioritized our principle of stable dividends and provided dividends at the same level as fiscal 2022.

For the time being, our priority is to quickly restore our impaired financial base and secure the investment funds to realize transformation, which we believe will lead to increasing the shareholder value over the medium to long term. Therefore, we believe that increasing dividends through increased profits should be the basis of our return policy and that decisions regarding share buybacks, which have a negative impact on equity, should be made after careful considerations.

Achievement of "Group Management Policies 2023" and Creation of Corporate Value Thereafter

The "Group Management Policies 2023" compiles the strategies that should be implemented in three years to create the Company's long term value. To implement these strategies, I believe that my role as an officer in charge of Group finance and accounting at the moment is to restore the impaired financial base as quickly as possible and to secure the investment funds to realize transformation.

In terms of the medium- to long-term value creation, we will have deep internal discussions on the business portfolio for 20 and 30 years from now, and the financial and capital strategy to support the portfolio. We will communicate the results of these discussions more carefully than ever before. I have explained the way we set KPI in order to achieve ROIC that exceeds the cost of capital, but cost of capital also plays an important role in the discussions on the future business portfolio. In addition to viewpoints such as the extent of the market's potential growth and whether our Company has a technological advantage or whether our growth story meets the market growth, we must closely examine whether we can stably achieve a ROIC that exceeds the cost of capital. It is necessary to make a judgement on whether to accelerate or decelerate business expansion based not only on short term business performance, but also with a medium- to long-term financial perspective.

At the same time, we also place importance on ESG initiatives, such as measures to address climate change, empower diverse human resources, and respect for human rights. We anticipate that it will take ESG initiatives 20 or 30 years for them to be reflected in accounting profits and corporate value. Therefore, when we promote ESG activities, we will incorporate a medium- to long-term viewpoint to consider whether such activities will lead to the sustainable growth of the society and our Group.

We recorded our largest losses in fiscal 2023. However, we will achieve the highest profit ever set in the "Group Management Policies 2023" as a management target during the period without fail. We will also create and implement a financial and capital strategy with the aim of becoming a Company that achieves sustainable high growth while solving social issues 20 or 30 years from now. We also intend to increase opportunities for dialogue with our stakeholders and will work to improve our corporate value while reflecting the opinions we receive in our management.