Q&A Summary

Event Name: Q1-3 FY2024 Financial Results Briefing

Date: February 4, 2025

Speaker: Hisato Kozawa, Member of the Board, Executive Vice President, and CFO

Questioner 1

Q: Regarding the order intake forecast, is Gas Turbine Combined Cycle (GTCC) the main driver of the guidance increase in Energy Systems? Furthermore, although the Aircraft, Defense & Space segment forecast remains unchanged, order intake performance was strong in Defense & Space, so if things continue at this rate, will orders outperform the initial plan?

Kozawa: Almost all of the increase in the Energy Systems order intake guidance comes from GTCC. This was a slightly conservative revision, as we expect order intake to improve a little more in the full year. There was good progress in Defense, and I think we will be able to exceed the initial plan for order intake, but we were not in a situation where we felt we could increase the guidance, so we left it unchanged for now. Depending on the contracts we book going forward, actual performance may be slightly higher than this.

Q: Order intake performance in Nuclear Power was good, but is there any increase in the outlook?

Kozawa: Order intake in Nuclear Power during the previous fiscal year was very high, so it is unlikely we will reach that level. I do not have the impression that orders are significantly higher than the initial plan.

Q: Regarding the business profit forecast, please explain the background of the revisions in each segment. Is the performance in Plants & Infrastructure Systems sustainable? Furthermore, with regard to the change in Others, Corporate & Eliminations, was this only to reflect the losses from equity method Special Purpose Company (SPC) investments?

Kozawa: The losses from equity method SPC investments (-¥20 billion) account for the entire revision in Others, Corporate & Eliminations. In the Aircraft, Defense & Space segment, Commercial Aviation experienced a certain amount of foreign exchange effects, which was a positive factor compared to the beginning of the fiscal year. Another reason for the upward revision is that revenue was recorded for Defense projects which were booked since last fiscal year, and the margins of which are relatively higher than previous levels. We decided to increase our Plants & Infrastructure Systems guidance as there has been gradual improvement in a variety of projects and product lines. The forecast in Energy Systems included a buffer of ¥20 billion at the beginning of the fiscal year, of which ¥10 billion was used in Q3, but ¥10 billion of this remains. On top of that, additional profit from progress in various projects has had a positive effect.

Q: Within the revision (+¥20 billion) to the business profit forecast in Aircraft, Defense & Space, foreign exchange effects based on your foreign currency sensitivity is expected to be less than ¥10 billion. Is it correct to understand that Defense accounts for more than half of the total increase?

Kozawa: Foreign currency effects were around the amount you mentioned. Looking at the breakdown of this ¥20 billion, more comes from Defense. Furthermore, in the Space business, launch vehicle launches have stabilized, which has had more of a positive impact than initially anticipated.

Questioner 2

Q: You booked orders for many gas turbine units during the three months of Q3, but could you provide some additional information on your customers' intended uses for these gas turbines, as well how orders are trending? Are these orders linked to recent data center demand, or do they represent demand from previous trends? There are also new developments within the industry, such as the joint venture between GE and Chevron. Is MHI considering further expansions to your GTCC business by partnering with third parties?

Kozawa: Orders in the US increased in Q3, but these projects are not of the kind directly linked to data centers, which are attracting attention. However, there is a move—mainly among power utilities—to use gas turbines as stable power sources in order to respond to the rising demand for power, including from data centers, so you can say that these projects are indirectly related to data centers. This has been happening not only in the US but also in Japan as represented in the recently released draft of the 7th Strategic Energy Plan, and a number of companies have procured a proportionate amount of plants in response to the rising demand for power. Partnering with oil majors is not a new business model, but generally speaking it is a possibility. There are no specific plans right now, but I would not rule out any possibility.

Q: Are there any cases where the profitability of the Nakoso and Hirono SPCs will decline in the future? In other words, if plant availability rates decline further, will profitability decrease again? Furthermore, how much in cash outflows resulted from the acquisitions?

Kozawa: MHI acquired additional equity stakes in the SPCs, because we believe they will be profitable. We believe we will be able to further improve profitability by improving the facilities. Therefore, we do not believe that the SPCs' profitability will have a significant impact on MHI's financials. Of course, there would be risk of impairment if a major unexpected problem occurred and the plants became inoperable, but we do not believe that there is a significant risk of that. We have made considerable improvements through recent modifications, and we believe that a certain level of operation will be possible in the future. If an unexpected event occurred, we would incur losses whether or not we had increased our equity stakes. Moreover, we cannot provide specific figures on the cash outflows associated with the acquisitions.

Q: Was the ¥10 billion of the risk buffer used for a project in Energy Systems? Furthermore, although overall profitability in the GTCC industry is increasing, it does not appear that GTCC contributed to “Changes in revenue, margin improvements” in terms of the company’s Q1-3 results as shown on the Profit Bridge. What kinds of plusses and minuses are involved here?

Kozawa: The ¥10 billion of the risk buffer was used in Energy Systems. The Profit Bridge only shows YoY changes and is affected by the kind of projects that recognized revenue and profit during the same period in the previous fiscal year. However, our analysis shows that, overall, profitability in GTCC and Steam Power—when excluding one-time expenses—is improving.

Questioner 3

Q: Regarding the Nakoso and Hirono SPCs, are the power plant operation businesses now consolidated companies, since you acquired equity stakes from Entity A and Entity B? If so, in which segment would they be included? Also, how much will these businesses contribute to profitability?

Kozawa: MHI acquired equity stakes equivalent to the two entities’ investments, increasing our ownership stake from 40% to 90%. However, the SPCs are limited liability companies, and while our economic stake is 90%, the management of the company is split equally among MHI and the remaining investors, making them jointly controlled companies. After discussing with our audit firm, we decided that the SPCs should be treated as equity method affiliates. While MHI originally built the power plants, this case is being treated as a pure investment. Since the SPCs are held by a division directly controlled by me, the CFO, we have included them in the Others, Corporate & Eliminations segment. We believe that the SPCs themselves will generate steady cash flow in the future, but this is not something that will have a significant impact on MHI’s financials overall. We estimate that there will be a positive impact in the single-digit billion yen range each year.

Q: You increased the order intake forecast by a large amount. Please let us know about the background for this. Did you outperform the competition more than expected, or was the timing of order booking simply earlier than projected? Also, if this is due to the pulling in of orders, can we still expect a strong order pipeline in the next fiscal year?

Kozawa: Regarding the increase in orders, we have not booked orders from unexpected project, but rather we initially had a rather conservative view on the timing of potential orders. I cannot comment about FY2025 yet, but market demand is very strong, and the pipeline of inquiries is quite substantial. That said, we also have to take production capacity into consideration, and there is also competition, so it is not clear whether order intake will continue to increase in FY2025.

Questioner 4

Q: Did the strong demand for gas turbines and the increase in advances received from customers, i.e. contract liabilities, contribute to the increase of the FCF forecast from negative ¥100 billion to breakeven? Also, demand for gas turbines is expected to remain strong for a while, but how should we think about cash flow going forward?

Kozawa: In addition to GTCC, an increase in advances received associated with strong orders in Metals Machinery was a major factor in the increase in cash flow. Although payment terms in GTCC were not originally so great, the market environment is strong, and GTCC has been able to secure advances within their contracts. Therefore, GTCC is expected to make positive contributions to cash flow for a while. However, these advances will eventually be used at some point, so even further positive impact is not expected.

Q: Cash flow is better than at the beginning of the fiscal year, but there has been no change in shareholder returns. Your target under the 2024 Medium-Term Business Plan is Dividend on Equity (DOE) 4% or above, but can we expect further increases to dividends?

Kozawa: Since this improved cash flow is coming from advances received, we will eventually reach a period of cash outflows. We will consider shareholder returns after these projects generate a proper amount of profit. We are aiming for dividends based on DOE 4% or above, so it will depend on how much equity we have at the end of the fiscal year. This is not the right time to make any decisions on this topic, so have not revised our target as of the Q1-3 financial results.

Q: How fast will you need to expand gas turbine production capacity? Previously, you said you would increase personnel by 10% and capacity by 30%, but since orders are so strong, will you need to increase capacity even more? Also, while demand for gas turbines in North America is strong, what should we expect in terms of risks from tariffs?

Kozawa: We have a certain amount of capacity in both Japan and the US, so we are not going to increase capacity much more than the plan that was mentioned previously. From past experience, if we get too carried away with capacity increases, there will eventually be a dip in the market, so we want to proceed in a systematic way with a certain amount of moderation. If we end up requiring even more capacity, we will use resources to increase efficiency and throughput. On the topic of tariffs, we do not know how the situation will evolve, but many of the gas turbines we deliver in the US are already produced within a localized supply chain. While some parts are exported from Japan, in terms of overall costs, the portion is not that large. While I cannot say there would be no impact, I think it would be at a level that we could mitigate or pass through to the customer.

Questioner 5

Q: Was the ¥20 billion in losses from equity method SPC investments caused by one-time costs, or did they occur because of the poor state of plant operations? If the state of operations is bad, this seems to contradict your comment that the SPCs will be able to generate steady cash flow going forward. Please also mention your level of certainty that the current situation where these companies are generating losses due to low output will turn around soon, i.e. in FY2025 or thereafter.

Kozawa: The one-time expenses incurred in Q3 resulted from the settling of costs that had been left unprocessed at the SPCs at the time we took over the leadership role. By so doing, the accumulated losses were settled all at once, which caused us to recognize one-time losses. Going forward, I believe that there will be no problems with the SPCs' profitability, even if a considerable amount of risk is factored in, as long as operations proceed as we expect.

Q: You used ¥10 billion of the risk buffer in Q3 for some international projects. Is there a risk that additional expenses will continue to be recorded for these projects?

Kozawa: These are projects that are in progress, but we believe that we have booked provisions for all possible losses at present. That said, there is a non-zero risk of further losses.

Questioner 6

Q: Is it fair to assume that the one-time expenses related to the Nakoso and Hirono SPCs will fall out in FY2025?

Kozawa: Yes.

Q: When comparing FY2024 and FY2025, will some of the positive factors affecting business profit in FY2025 include rebound from the ¥20 billion in one-time SPC losses and whether or not all of the risk buffer is used in FY2024?

Kozawa: Yes. Furthermore, we expect that gains on the sale of land will be very large this year, but this will decrease in the next fiscal year.

Q: Does that mean that the ¥50 billion in gains in FY2024 will decrease in the next fiscal year?

Kozawa: Yes.

Q: If you have any update on last year's media reports regarding Mitsubishi Logisnext, please share them with us.

Kozawa: I have nothing to comment on at this time.

Q: Do you think any decision will be made on Mitsubishi Logisnext before your new management team assumes their new positions?

Kozawa: I cannot answer that question. Generally speaking, I think it is good to make quick decisions when possible.

Q: I would like to ask about GTCC capacity. The total order backlog in Energy Systems in Q1-3 was around ¥5 trillion, including Nuclear Power and Aero Engines. This is equal to around 2.5 years' worth when compared to total Energy Systems revenue of ¥1.8 trillion, which seems like a considerable lead time. What kind of things are your GTCC salespeople currently saying to customers? Customers are having to sign contracts for systems that will be delivered 3 years from now, and I think they are impressive for being willing to make purchases under those terms. I think that there are large risks and opportunities associated with agreeing on prices under such conditions, and this seems abnormal to me, but what is MHI's view on this?

Kozawa: The current backlog includes long-term contracts, such Long Term Service Agreements (LTSA), especially in GTCC. That said, in actuality, our gas turbine production slots are now filled for a considerable period of time. Initiatives at the factory level have not changed, considering that, even if we received an order for a large frame gas turbine today, it could not be installed next year, for example, as the plant site would have to be prepared. However, regarding capacity and production schedule issues, it is true that in some cases we will not be able to manufacture gas turbines within the timing requested by some customers. We will therefore continue to pursue negotiations while maintaining close communication with our customers—but making sure not to get carried away trying to satisfy everyone all at once.

Q: Considering that it is a seller's market, it is clear that MHI is booking orders at a good price point, but the main battleground is the US, where inflation is likely to be severe in the future. If there is more inflation than expected two to three years in the future, I assume that your margins will eventually decline. Offshore wind turbines, where the market crashed all at once despite support from subsidies, is a typical example of this. I hope that something like that does not happen with gas turbines.

Kozawa: Of course, those kinds of risks are not zero. We are discussing the terms and conditions of the contracts with our clients regarding various aspects of these projects and are putting countermeasures in place.

Questioner 7

Q: You increased the business profit forecast to ¥380 billion, but if we do the math, the business profit target for Q4 is around ¥116 billion, which gives me the impression of being a little low considering typical seasonality. Are there any particular concerns for Q4, or has the nature of the business changed over the past year such that you do not book as much profit in Q4 as in the past?

Kozawa: In the case of MHI—and this is different from mass-market goods—I think it would be wrong to look at our earnings based on patterns in each three-month period and judge whether our performance is good or bad based on the balance of each quarter. Our revenues are increasing every year. Furthermore, we are now seeing significantly more profit starting in Q1 than before. Moreover, I do not think the forecast for Q4 is too low.

Questioner 8

Q: In Energy Systems, if you add back the ¥10 billion in one-time expenses, the business profit margin in Q1-3 becomes around 12.9%. Can this figure be regarded as close to the normalized profit margin in this segment? At the same time, profitability at the time of order booking has improved, and profit margins are increasing. How much room is there for further improvement in profit margins in Energy Systems going forward? I think that profit and revenue will increase as the number of profitable projects grows.

Kozawa: Just to be clear, GTCC is not the business that incurred ¥10 billion in one-time expenses. Profit margins are rising now, and I think that they are on the right track. It is good that we are able to execute these businesses without any abnormal projects. At this point, I do not imagine that profit margins will reach 15%. Going forward, I believe that we will have to reliably achieve profit margins of over 10% to around 12% even as revenue increases, and I think this is possible.

Q: Since demand for gas turbines is very strong, can we expect that both the top line and business profit will grow into the future?

Kozawa: Yes. In GTCC, we are looking to invest in production capacity increases, and if all goes well, revenue will grow, and profit will follow. Regarding the point that the profit margin in Energy Systems would have been 13% without the ¥10 billion in one-time expenses, I think this figure is very high. Also, the fact that we were able to limit the one-time expenses to ¥10 billion may have been the best-case scenario. I think it would be great if we could reliably achieve 12-13% margins in this segment in the future.

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