Initiatives to Rebuild the Construction Machinery Business in China

February 2, 2017
Table of Contents

1. Introduction
   (1) Position of Construction Machinery Business in Kobe Steel Group’s Medium-Term Management Plan
   (2) Today’s Topics
   (3) History of Construction Machinery Business in China

2. Additional Posting of Allowance for Retained Receivables
   (1) Sales Record of Construction Machinery in China
   (2) Allowance for Doubtful Accounts to Date and Changes in Situation
   (3) Change in Calculation Method of Allowance for Retained Receivables
   (4) Additional Posting of Allowance for Retained Receivables
   (5) Causes of Retained Receivables

3. Rebuilding the China Business
   (1) Restructuring of Capital Relationship and Dissolution of JVs with Chinese Partners
   (2) Restructuring of Sales Structure
   (3) Demand Forecast for Excavators in China and Unit Sales/Market Share Forecast
   (4) Restructuring of Production Structure
   (5) Forecast for Profitability Improvement in the China Business
1. Introduction
(1) Position of Construction Machinery Business in Kobe Steel Group’s Medium-Term Management Plan

Growth strategy for the three core business areas

- **Materials**
  - I. Initiatives for weight savings in transportation
  - II. Strengthening profitability in the steel business

- **Machinery**
  - I. Initiatives in the fields of energy and infrastructure
  - II. Strengthening profitability in the construction machinery business

- **Electric Power**
  - Initiatives aimed at stable profitability in the power supply business

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**Profitability improvement in construction machinery under Medium-Term Management Plan**

<table>
<thead>
<tr>
<th>FY2015 Forecast</th>
<th>FY2020 Forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>△14</td>
<td>+17</td>
</tr>
<tr>
<td>KobeCo Construction Machinery + KobeCo Cranes Ordinary income</td>
<td>+15</td>
</tr>
<tr>
<td>Rebuilding the China business + Sales increase</td>
<td>+15 (China +12)</td>
</tr>
<tr>
<td>Others</td>
<td>+17</td>
</tr>
</tbody>
</table>

Today’s topic

- China +9
- 30 or more
- Temporary worsening. Impact to be resolved.
(2) Today’s Topics

① Additional posting of allowance for doubtful accounts
   FY2015: ▲14.6 billion yen
   FY2016: ▲34.3 billion yen (Q3: ▲31.0 billion yen)
   ※Including allowance pertaining to contingent liabilities

<Consultations with Chinese partners on tackling business difficulties>
   • Reforming sales structure, improving receivables management
   • Resolving insolvency of sales subsidiary
   • Restructuring the production structure of manufacturing subsidiary

Difference of opinions between partners became significant.

② Rebuilding the China business
   • We decided to dissolve the JVs with the Chinese partners and initiate reforms to the China business by ourselves.
(3) History of Construction Machinery Business in China

- The Chinese partner has been in charge of sales, accounting and financing.
- Kobelco Construction Machinery has been responsible for manufacturing and technology from the start of the JVs until now.

**History**

1994: Established an excavator manufacturing subsidiary (CKCM) with a Chinese state-owned company

2003: Invested in a sales company (CKCMG) at the time of privatization

2007: Several JVs are established after 2007 (HKCM, CKCL, etc.)

- The Chinese partner has been in charge of sales, accounting and financing.
- Kobelco Construction Machinery has been responsible for manufacturing and technology from the start of the JVs until now.

**Structure at the time KOBELOCO entered the Chinese market**

| Sale of excavators (Chengdu) | CKONG: Chengdu Kobelco Construction Machinery (Group) Co., Ltd. |
| Manufacture of excavators (Chengdu) | CKCM: Chengdu Kobelco Construction Machinery Co., Ltd. |
| Manufacture of excavators (Hangzhou) | HKCM: Hangzhou Kobelco Construction Machinery Co., Ltd. |
| Manufacture and sale of cranes (Chengdu) | CKCL: Chengdu Kobelco Cranes Co., Ltd. |
| Manufacture and sale of wheel loaders (Chengdu) | Sichuan Chenggong: Sichuan Chengdu Chenggong Construction Machinery Co., Ltd. |

**Current structure**

*Japanese investors*

- Toyota Tsusho Corporation: 80.16%
- 50.67%
- 19.84%: 51.958%
- 27.28%: 51%

*Kobelco Construction Machinery*

- HKCM (Chinese state-owned company)
- 45%: 55%
- Sale of excavators
- Manufacture of excavators

*Chinese Partners*

- Sichuan Chenggong
- 43.682%: 48.35%
- Wheel loader manufacturing & sales company
- 22.05%
- 11.256%
- 51.65%
2. Additional Posting of Allowance for Retained Receivables
The Construction Machinery segment holds an important presence owing to growth of the China business. Demand for construction machinery in China peaked in 2010 and continued to decrease until 2015. Although demand bottomed out in 2016, we put a priority on collecting receivables and unit sales and market share continue to decrease.

**Sales Record of Construction Machinery in China**

- Business performance (Ordinary income)
  - Ordinary income of Kobelco Construction Machinery
  - Ordinary income of Kobe Steel, Ltd (Consolidated)

- Total demand in China, KOBELCO’s unit sales and share of sales by foreign companies
  - Demand for foreign companies (thousands of units: left)
  - Sales (thousands of units: left)
  - Market share among foreign companies (%: right)

*Kobelco Construction Machinery and Kobelco Cranes merged in FY2016.*
(2) Allowance for Doubtful Accounts to Date and Changes in Situation

- **Balance of allowance for doubtful accounts**
  - At the end of FY2015: 1.15 billion RMB (21.1 billion yen), ratio of allowance 31%
  - At the end of Q2 FY2016: 1.35 billion RMB (20.8 billion yen), ratio of allowance 37%

- **Collection of retained receivables sold before FY2015 has not progress well in FY2016.**
- **We plan to reinforce receivables management and revise dealer policies**
  - (termination of contracts, filing lawsuits, etc.).
- **Receivables related to sales in FY2016 have been collected smoothly through revision of sales method.**

### Balance

<table>
<thead>
<tr>
<th></th>
<th>At the end of FY2015</th>
<th>At the end of Q2 FY2016</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>RMB</td>
<td>JPY</td>
</tr>
<tr>
<td>① Receivables</td>
<td>1.86</td>
<td>34.3</td>
</tr>
<tr>
<td>② Payment in subrogation</td>
<td>1.89</td>
<td>34.6</td>
</tr>
<tr>
<td>③ Total receivables</td>
<td>3.75</td>
<td>68.9</td>
</tr>
<tr>
<td>④ Balance of allowance for doubtful accounts</td>
<td>1.15</td>
<td>21.1</td>
</tr>
<tr>
<td>Ratio of allowance (④/③)</td>
<td>31%</td>
<td></td>
</tr>
<tr>
<td>⑤ Contingent liabilities</td>
<td>4.51</td>
<td>82.8</td>
</tr>
<tr>
<td>⑥ Additional posting of allowance for receivables</td>
<td>0.76</td>
<td>14.6</td>
</tr>
</tbody>
</table>

### Situation of receivables collection in FY2016

#### ① Situation of receivables sold before FY2015

<table>
<thead>
<tr>
<th></th>
<th>Balance of delayed amount for collection at the end of FY2015 (RMB)</th>
<th>Amount of collection (RMB)</th>
<th>Ratio of collection (②/①)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivables (excluding split sales)</td>
<td>0.86</td>
<td>0.36</td>
<td>42%</td>
</tr>
<tr>
<td>Payment in subrogation*</td>
<td>2.31</td>
<td>0.26</td>
<td>11%</td>
</tr>
</tbody>
</table>

*Includes delayed amount for collection in FY2016

#### ② Situation of 2016 sales: smooth collection
(2) Allowance for Doubtful Accounts to Date and Changes in Situation

- Example) Lease transaction (Contract term: maximum 3 years)

**Contingent liabilities**
Dealers guarantee to repurchase excavators against bank loans and lease contracts, which customers use when they buy machines.

**Payment in subrogation**
When customers and dealers fail to meet their payment (×) and repurchase obligations (××) respectively, sales subsidiary CKCMG fulfills the secondary guarantee (○) by payment in subrogation.
（3）Change in Calculation Method of Allowance for Retained Receivables

- Taking into account that payment delays often happen in Chinese business practices, KOBELCO had used a method to calculate the uncollectible amount by evaluating the solvency* of dealers.
- Taking into account that the recovery of retained receivables regarding sales before 2015 has not progressed, an additional allowance was posted against all retained receivables and contingent liabilities from dealers with which transactions were stopped.
- As for retained receivables, we changed the method of calculation and evaluated collectability limited to collateral assets.
- As for contingent liabilities, allowance is calculated with the actual conversion ratio** from contingent liabilities to payment in subrogation.

* Solvency of dealers: Assets minus debt
** Actual conversion ratio: Amount of payment in subrogation / balance of contingent liabilities

### Revised calculation method of allowance

<table>
<thead>
<tr>
<th>Types of credit</th>
<th>Method of evaluation of credit</th>
<th>Method of evaluation of contingent liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dealers with which contracts were terminated</td>
<td>Total amount of receivables and payment in subrogation</td>
<td>Total amount of contingent liabilities</td>
</tr>
<tr>
<td>Delayed credit</td>
<td>Receivables delayed + Total amount of payment in subrogation - Collateral assets</td>
<td>Balance of contingent liabilities x Actual conversion ratio to payment in subrogation</td>
</tr>
<tr>
<td>Normal credit</td>
<td>Balance of credit x Ratio of delayment</td>
<td>Balance of contingent liabilities x Actual conversion ratio to payment in subrogation</td>
</tr>
</tbody>
</table>
(4) Additional Posting of Allowance for Retained Receivables

- We additionally posted a total allowance of 1.9 billion RMB (approx. 31 billion yen) in the third quarter. (Balance of allowance 3.2 billion RMB)
- Ratio of allowance against receivables in the third quarter is as follows:
  - Receivables: 79%
  - Contingent liabilities: 16%

### Situation of allowance at the end of Q3 FY2016

*Balance at the time of posting allowance

<table>
<thead>
<tr>
<th>Types of dealers</th>
<th>Balance of credit</th>
<th>Ratio of allowance</th>
<th>Total allowance</th>
<th>Balance of credit</th>
<th>Ratio of allowance</th>
<th>Total allowance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Receivables</td>
<td>Payment in subrogation</td>
<td>Total</td>
<td>Receivables</td>
<td>Payment in subrogation</td>
<td>Total</td>
</tr>
<tr>
<td>Normal dealers</td>
<td>1.2</td>
<td>0.8</td>
<td>2.1</td>
<td>1.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dealers with which contracts were terminated</td>
<td>0.3</td>
<td>1.2</td>
<td>1.5</td>
<td>1.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>1.5</td>
<td>2</td>
<td>3.6</td>
<td>2.8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(JPY)</td>
<td>23.2 billion yen</td>
<td>30.9 billion yen</td>
<td>54.1 billion yen</td>
<td>42.6 billion yen</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Types of dealers</th>
<th>Balance of contingent liabilities</th>
<th>Ratio of allowance</th>
<th>Total allowance</th>
<th>Balance of contingent liabilities</th>
<th>Ratio of allowance</th>
<th>Total allowance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Normal dealers</td>
<td>2.6</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dealers with which contracts were terminated</td>
<td>0.1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>2.7</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(JPY)</td>
<td>40.5 billion yen</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Total allowance</th>
<th>Additional posting</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>31 billion yen</td>
<td>1.3</td>
<td>1.6</td>
</tr>
<tr>
<td>48.9 billion yen</td>
<td>1.6</td>
<td>1.9</td>
</tr>
<tr>
<td>6.3 billion yen</td>
<td>1.9</td>
<td>3.2</td>
</tr>
</tbody>
</table>

We additionally posted a total allowance of 1.9 billion RMB (approx. 31 billion yen) in the third quarter. (Balance of allowance 3.2 billion RMB)

Ratio of allowance against receivables in the third quarter is as follows:

- Receivables: 79%
- Contingent liabilities: 16%
<Supplementary explanation about allowance of contingent liabilities>

- Balance of 0.4 billion RMB, ratio of allowance 16%
- Conversion ratio from contingent liabilities to payment in subrogation has been decreasing.
- Ratio in FY2016 is estimated to be 10%.
- We expect that the conversion is going to decrease further from FY2016 onwards through improved receivables management.
- Balance of contingent liabilities at the end of the third quarter in FY2016 has decreased to 2.7 billion RMB (40.5 billion yen).
- Finance period is maximum three years and the ratio of receivables after FY2016 is increasing.
- Once payment is delayed, contingent liability is converted to payment in subrogation and no payment delay occurs with regard to the current balance of contingent liabilities.
- We recognize that the risk for contingent liabilities is lower than the risk in collecting receivables.

### Conversion ratio from contingent liabilities to payment in subrogation
(result of conversion / balance of contingent liabilities)

- Q4 2013: 17%
- Q4 2014: 15%
- Q4 2015: 11%
- 2016 Forecast: 10%

### Balance of contingent liabilities
(billion RMB)

- Q4 2013: 8.0
- Q4 2014: 6.8
- Q4 2015: 4.5
- Q3 2016: 2.7
Causes of Retained Receivables

In the environment where payment delays often happen in Chinese business practices, the Chinese partner’s sales initiatives, credit management and receivables management toward dealers were insufficient.

Under a sales policy that prioritized increasing the sales of new machines and increasing market share, credit management and receivables collection were insufficient.

Under these circumstances, when the business environment in China worsened significantly, the sales subsidiary was late in dealing with the drastic worsening financial condition of dealers and customers.
3. Rebuilding the China Business
Restructuring of Capital Relationship and Dissolution of JVs with Chinese Partners

KOBELCO agreed with the Chinese partners to dissolve the JVs. The Japanese partners will focus on the excavator business. A Chinese partner will take over the wheel loader business. The crane business, which belongs to KOBELCO, will be liquidated.

From now on, KOBELCO will take the initiative in rebuilding the China business.

Structure after dissolution of JVs

<table>
<thead>
<tr>
<th>Structure after dissolution of JVs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kobecl Construction Machinery</td>
</tr>
<tr>
<td>Toyota Tsusho Corporation</td>
</tr>
<tr>
<td>Kobecl Toyota Tsusho Construction Machinery Holding Asia</td>
</tr>
<tr>
<td>HKCM</td>
</tr>
<tr>
<td>CKCM</td>
</tr>
<tr>
<td>CKCMG</td>
</tr>
<tr>
<td>CKCL</td>
</tr>
</tbody>
</table>

Content of dissolution agreement

1. **Equity transfer from Chinese partners to Japanese partners**
   - i) All of the equity held by Sichuan Chenggong in CKCL (49%)
   - ii) All of the equity held by Chinese investors in CKCMG (43.682%)
   - iii) All of the equity held by Chinese investors in CKCM (11.256%)
   - iv) All of the equity held by Chinese investors in HKCM (22.05%)

2. **Equity transfer from Japanese partners to Chinese partners**
   - i) All of the equity held by CKCMG in Sichuan Chenggong (48.35%)

KOBELCO expects the impact of the equity transfer and acquisition will be immaterial on its business performance.

Schedule

1. Entering into final contract: By March 2017
2. Transfer of equity: Around October 2017
(2) Restructuring of Sales Structure

- **Revision of sales policy:** Prioritize receivables management and collection of receivables than sales of new machines.
- **Policy on dealers:** Continue the current dealer system, but select and consolidate dealers.
- **Receivables management:** Strengthen management of dealers and establish a credit management division (provisional name) separately from the sales division.

① Policy on Dealers

- It is realistic to keep the current dealer system same as the other competitors to deal with the huge number of customers.
- Basically we will continue sales activities with current dealers, but will terminate contracts with dealers from who we are unable to collect receivables.
- In areas where we don’t have dealers, we will consider selling directly or entering into contracts with new dealers. We will consolidate dealers in areas where several dealers exist and strengthen the sales structure.

② Strengthening of Receivables Management

- Strengthen monitoring of receivables management and credit management of dealers.
- Separate internal audits from the sales division in CKCMG and establish a credit management division to strengthen credit management and monitor dealers.
(3) Demand Forecast for Excavators in China and Unit Sales/Market Share Forecast

Although we do not forecast a significant increase in demand in the medium term, demand for machines supplied by foreign companies is expected to be 38,000 units, assuming that demand for excavators will gradually recover owing to continued public investment.

We will focus on strengthening receivables management and proceed with:
1) Re-entering areas that KOBELEC had given up by establishing new dealers or consolidating dealers
2) Strengthening the financial condition of dealers
(Target in 2020: Unit sales of 4,300 units, market share of 11.5%)

**Forecast of total demand**

<table>
<thead>
<tr>
<th>Year</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chinese companies</td>
<td>34</td>
<td>27</td>
<td>33</td>
<td>37</td>
</tr>
<tr>
<td>Foreign companies</td>
<td>50</td>
<td>26</td>
<td>63</td>
<td>75</td>
</tr>
</tbody>
</table>

**Forecast of unit sales and market share among foreign companies**

<table>
<thead>
<tr>
<th>Year</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unit sales (Left)</td>
<td>7.2</td>
<td>3.9</td>
<td>3.3</td>
<td>4.3</td>
</tr>
<tr>
<td>Market share (Right)</td>
<td>14%</td>
<td>14%</td>
<td>10%</td>
<td>11.5%</td>
</tr>
</tbody>
</table>
(4) Restructuring of Production Structure

- Original plan was to reduce production capacity from 12,500 to 10,500 units for the Chinese market.
- New plan is to consolidate production at Chengdu (CKCM) to increase profitability even when demand is sluggish. Hangzhou (HKCM) will make and export complete machines and serve as a supply base (branch factory of mother factory in Hiroshima, Japan) for fabricated components.
- Production capacity in Chengdu will be maintained at 5,500 units/year for the Chinese market, and the capacity in Hangzhou will be 5,000 units/year for export.

### Break-Even Point (plan)
- CKCM: Approx. 2,000 units
- HKCM: Approx. 1,000 units

### Original medium-term plan vs. New structure

<table>
<thead>
<tr>
<th>Destinations</th>
<th>Production Capacity (Units/year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Western China</td>
<td>Chengdu (CKCM) 5,500 (Current 7,500)</td>
</tr>
<tr>
<td>Eastern China</td>
<td>Hangzhou (HKCM) 5,000</td>
</tr>
<tr>
<td>Overseas</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>Original medium-term plan 10,500 (Current 12,500)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Destinations</th>
<th>Production Capacity (Units/year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>New structure 5,500</td>
</tr>
<tr>
<td>Overseas (export from China)</td>
<td>5,000</td>
</tr>
<tr>
<td>Total</td>
<td>10,500</td>
</tr>
</tbody>
</table>

Complete machines
- Base for complete machines in Chinese market

Fabricated components
- Base for export of complete machines and fabricated components
(5) Forecast for Profitability Improvement in the China Business

**FY2017**
- Restoring profitability

**FY2018**
- Consolidation of production in Chinese market

**FY2020**
- Ordinary income target: 7 billion yen/year

**Rebuilding the China business**
- Factories:
  - Chengdu (Inland)
  - Hangzhou (Coastal)
- Chinese domestic market
- Export from China

- Fabricated Components
  - Hiroshima, Japan
  - USA
  - Others

- Complete Machines
  - Supplemented a factory in Hiroshima, Japan
1. We provide reliable and advanced technologies, products and services that satisfy customers.
2. We support each employee in developing his or her abilities, while respecting mutual cooperation within the Kobe Steel Group.
3. Through continuous efforts for innovative change, we aim to enhance our corporate values.
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- Political situation and trade and other regulations
- Changes in currency exchange rates
- Availability and market conditions of raw materials
- Products and services of competing companies, pricing policy, alliances, and business development including M&As
- Strategy changes of alliance partners