



Initiatives to Rebuild the Construction Machinery Business in China

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KOBELCO

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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	<div style="background-color: #FF0000; color: white; padding: 5px; display: inline-block;">Today's topic</div> <div style="font-size: 48px; color: #00FF00; opacity: 0.5;">←</div>
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	

Profitability improvement in construction machinery under Medium-Term Management Plan

(billion yen)



(2) Today's Topics

① Additional posting of allowance for doubtful accounts

※Including allowance pertaining to contingent liabilities

FY2015: ▲14.6 billion yen

FY2016: ▲34.3 billion yen (Q3: ▲31.0 billion yen)



<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

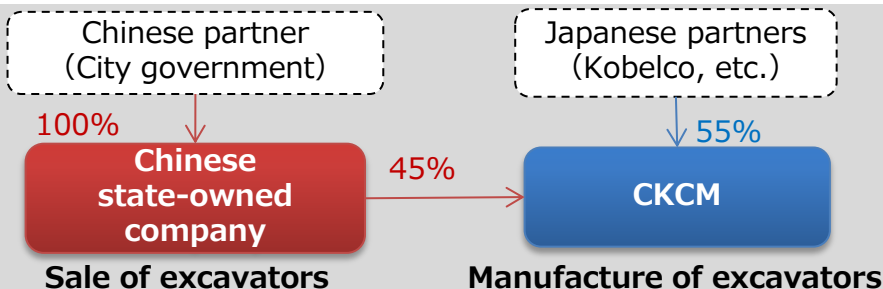
1994: Established an excavator manufacturing subsidiary (CKCM) with a Chinese state-owned company

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

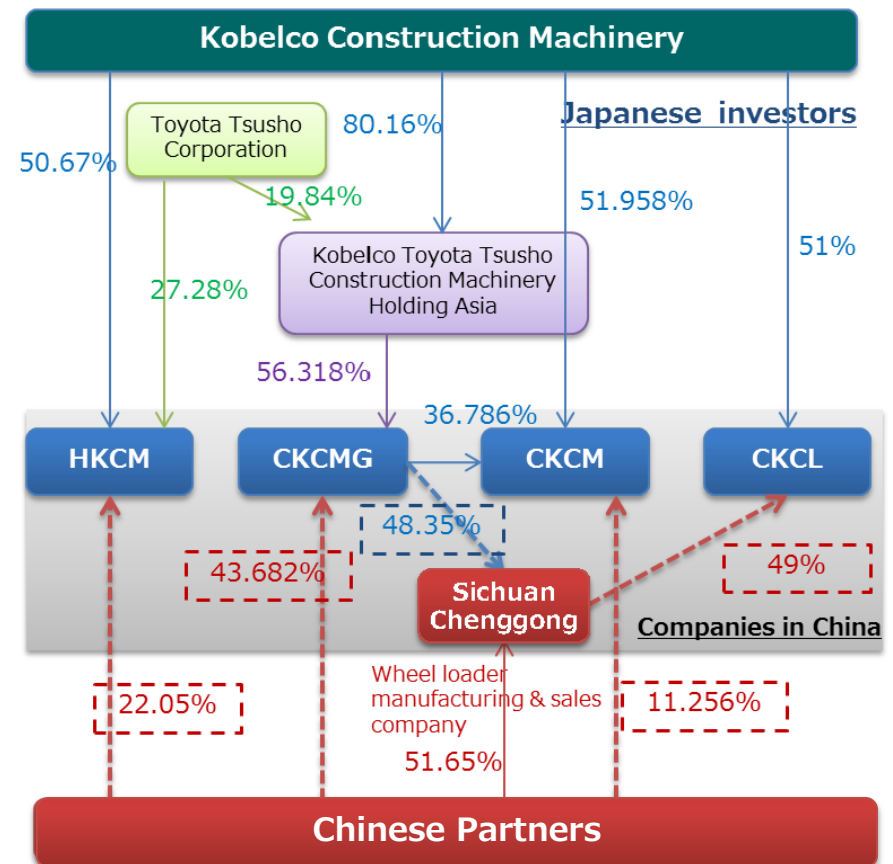
2007: Several JVs are established after 2007 (HKCM, CKCL, etc.)

Sale of excavators (Chengdu)	CKCMG:	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.

Structure at the time KOBELCO entered the Chinese market



Current structure



2. Additional Posting of Allowance for Retained Receivables

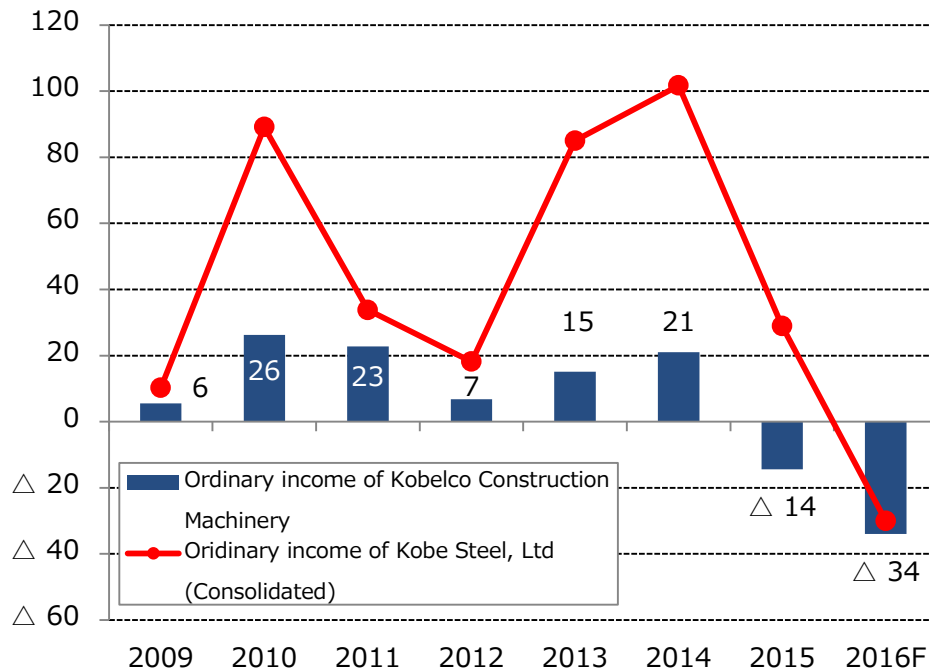


(1) Sales Record of Construction Machinery in China

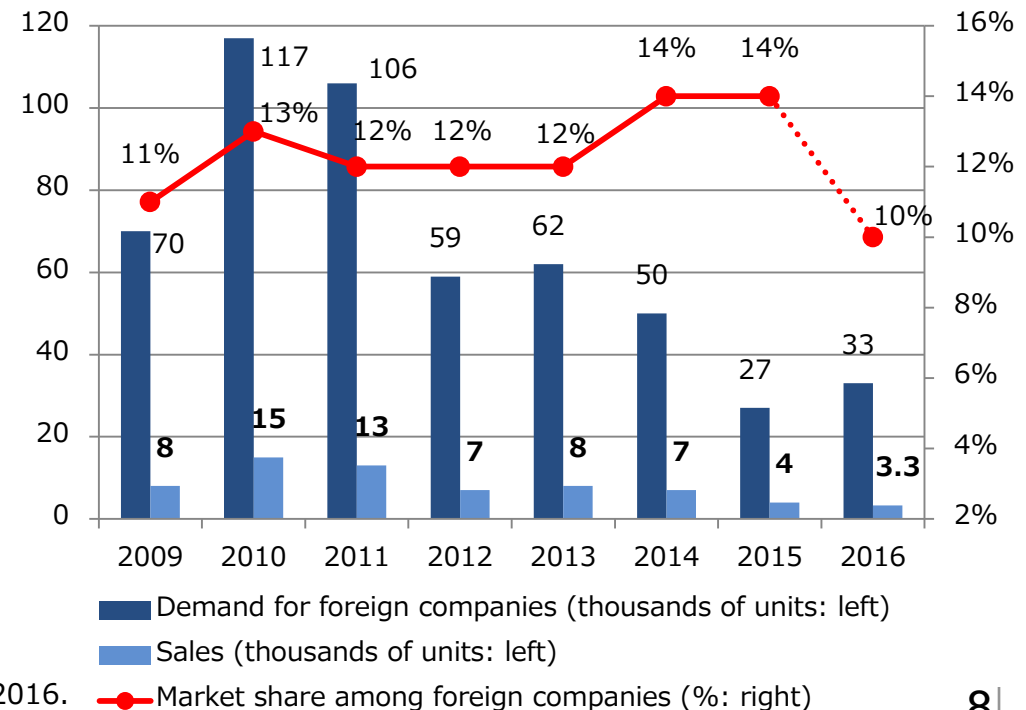
- ✓ The Construction Machinery segment holds an important presence owing to growth of the China business.
- ✓ Demand for construction machinery in China peaked in 2010 and continued to decrease until 2015.
- ✓ Although demand bottomed out in 2016, we put a priority on collecting receivables and unit sales and market share continue to decrease.

■ Business performance (Ordinary income)

(billion yen)



■ Total demand in China, KOBELCO's unit sales and share of sales by foreign companies



*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

(Billion)

	At the end of FY2015		At the end of Q2 FY2016	
	RMB	JPY	RMB	JPY
① Receivables	1.86	34.3	1.63	25.3
② Payment in subrogation	1.89	34.6	2.02	31.2
③ Total receivables	3.75	68.9	3.65	56.5
④ Balance of allowance for doubtful accounts	1.15	21.1	1.35	20.8
Ratio of allowance (④/③)	31%		37%	
⑤ Contingent liabilities	4.51	82.8	3.63	56.2
⑥ Additional posting of allowance for receivables	0.76	14.6	0.20	3.3

■ Situation of receivables collection in FY2016

① Situation of receivables sold before FY2015

(billion RMB)

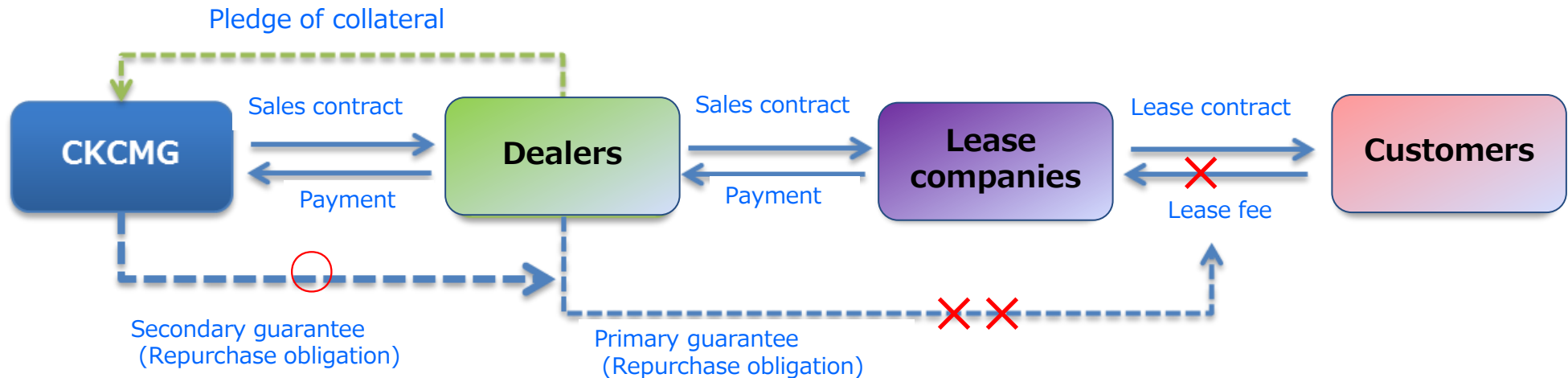
	Balance of delayed amount for collection at the end of FY2015 ①	Amount of collection ②	Ratio of collection ②/①
Receivables (excluding split sales)	0.86	0.36	42%
Payment in subrogation*	2.31	0.26	11%

*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 (X) and repurchase obligations (X X) respectively, sales subsidiary CKCMG fulfills the secondary guarantee (O) 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

Types of credit	Method of evaluation of credit	Method of evaluation of contingent liabilities
Dealers with which contracts were terminated	Total amount of receivables and payment in subrogation	Total amount of contingent liabilities
Delayed credit	Receivables delayed + Total amount of payment in subrogation - Collateral assets	Balance of contingent liabilities x Actual conversion ratio to payment in subrogation
Normal credit	Balance of credit x Ratio of delayment	Balance of contingent liabilities x Actual conversion ratio to payment in subrogation

(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

(billion RMB)

Types of dealers	Balance of credit			Balance of allowance	Ratio of allowance
	Receivables	Payment in subrogation	Total		
Normal dealers	1.2	0.8	2.1	1.3	79%
Dealers with which contracts were terminated	0.3	1.2	1.5	1.5	
Total	1.5	2	3.6	2.8	
(JPY)	23.2 billion yen	30.9 billion yen	54.1 billion yen	42.6 billion yen	

Types of dealers	Balance of contingent liabilities
Normal dealers	2.6
Dealers with which contracts were terminated	0.1
Total	2.7
(JPY)	40.5 billion yen

Types of dealers	Balance of allowance	Ratio of allowance
Normal dealers	0.3	16%
Dealers with which contracts were terminated	0.1	
Total	0.4	
(JPY)	6.3 billion yen	

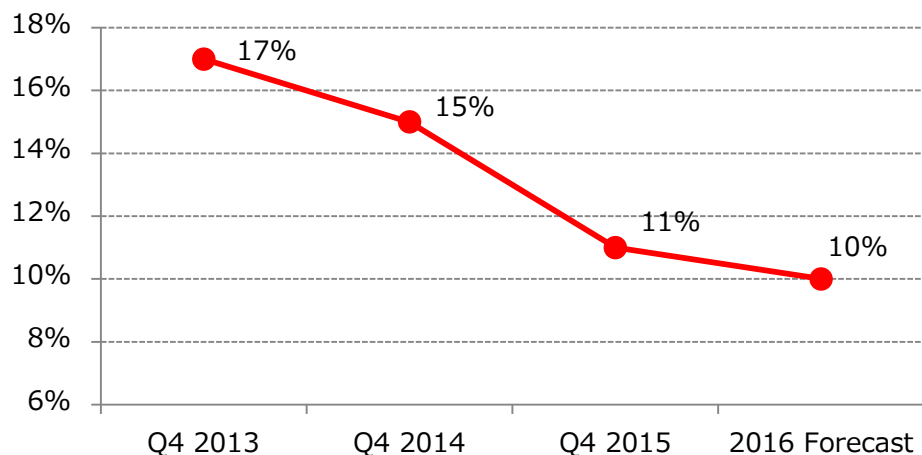
Total allowance	
Additional posting	Balance
1.3	1.6
0.6	1.6
1.9	3.2
31 billion yen	48.9 billion yen

(4) Additional Posting of Allowance for Retained Receivables

<Supplementary explanation about allowance of contingent liabilities>

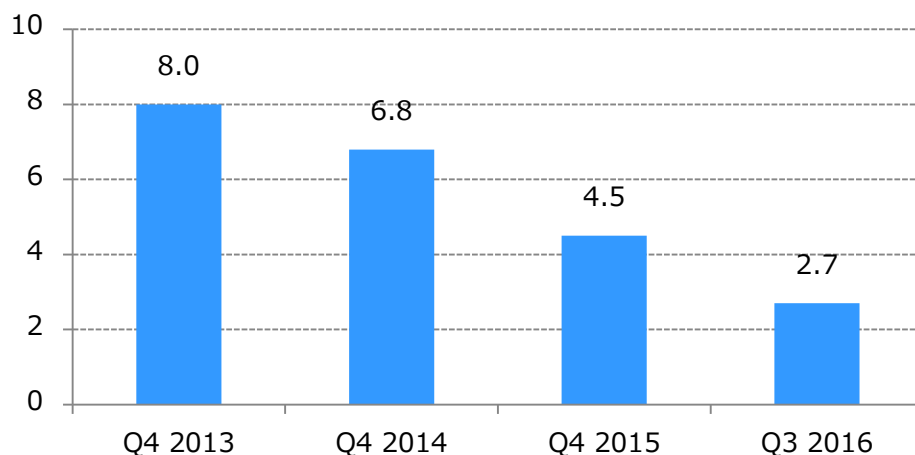
- ✓ Balance of 0.4 billion RMB, ratio of allowance 16%
- ✓ Conversion ratio from contingent liabilities to payment in subrogation has been decreasing.
- ✓ Ratio in FY2016 is estimated to be 10%.
- ✓ We expect that the conversion is going to decrease further from FY2016 onwards through improved receivables 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)



■ Balance of contingent liabilities

(billion RMB)



(5) Causes of Retained Receivables

<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

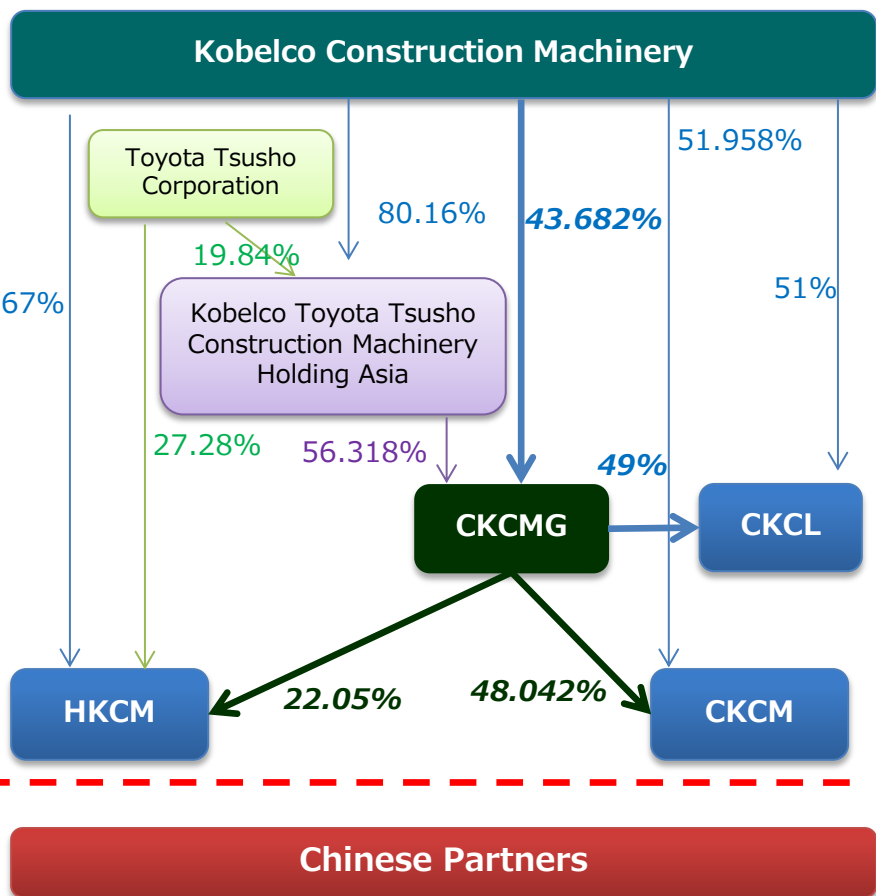


(1) Restructuring of Capital Relationship and Dissolution of JVs with Chinese Partners

- ✓ 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

■ 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.

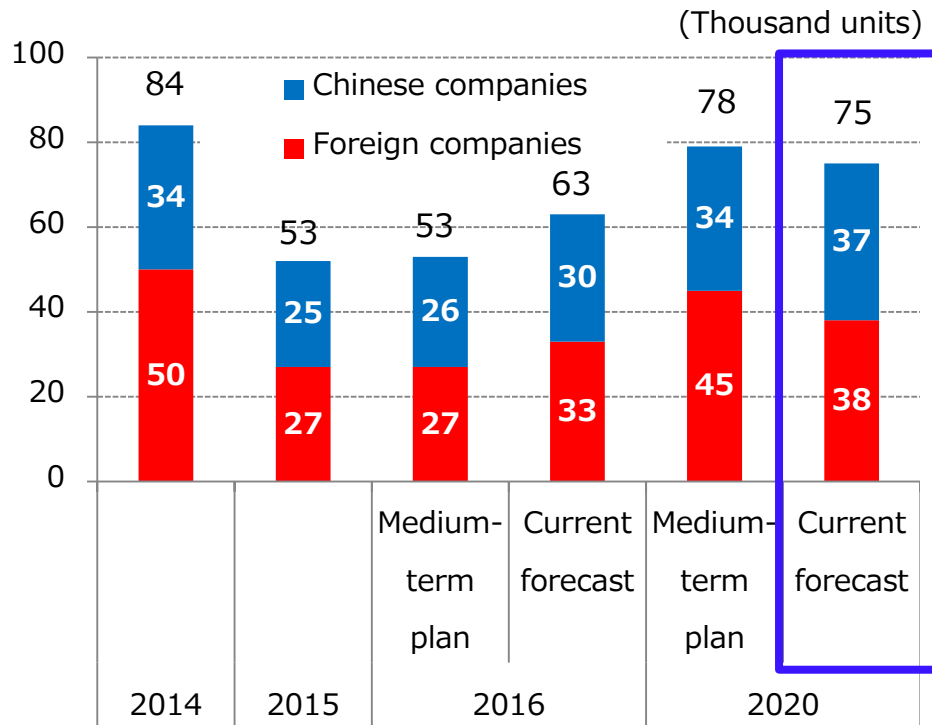
② Strengthening of Receivables Management

- 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.

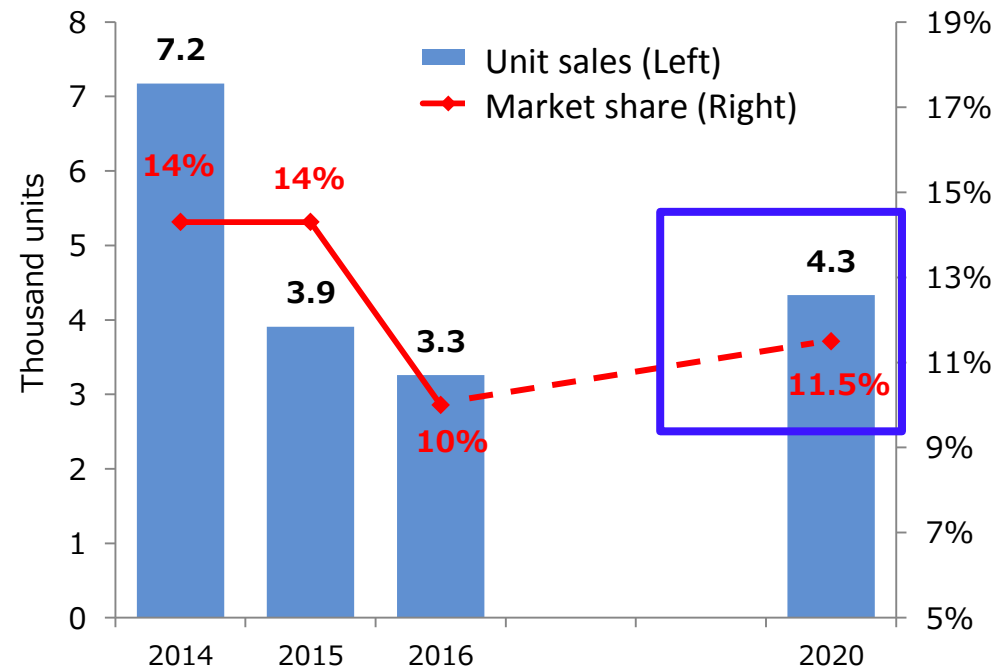
(3) Demand Forecast for Excavators in China and Unit Sales/Market Share Forecast

- ✓ 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 KOBELCO 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



Forecast of unit sales and market share among foreign companies



(4) Restructuring of Production Structure

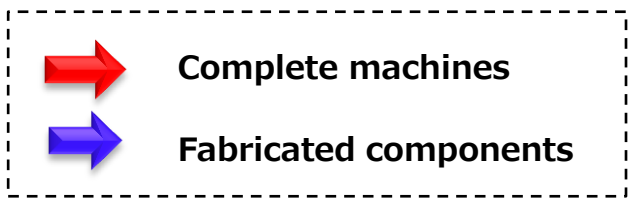
- ✓ Original plan was to reduce production capacity from 12,500 to 10,500 units for the Chinese market.
- ✓ New plan is to consolidate production at Chengdu (CKCM) to increase profitability even when demand is sluggish. Hangzhou (HKCM) will make and export complete machines and serve as a supply base (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.

	Original medium-term plan	
	Production Capacity (Units/year)	Destinations
Chengdu (CKCM)	5,500 (Current 7,500)	Western China
Hangzhou (HKCM)	5,000	Eastern China
		Overseas
Total	10,500 (Current 12,500)	

New structure	
Production Capacity (Units/year)	Destinations
5,500	China
5,000	Overseas (export from China)
10,500	

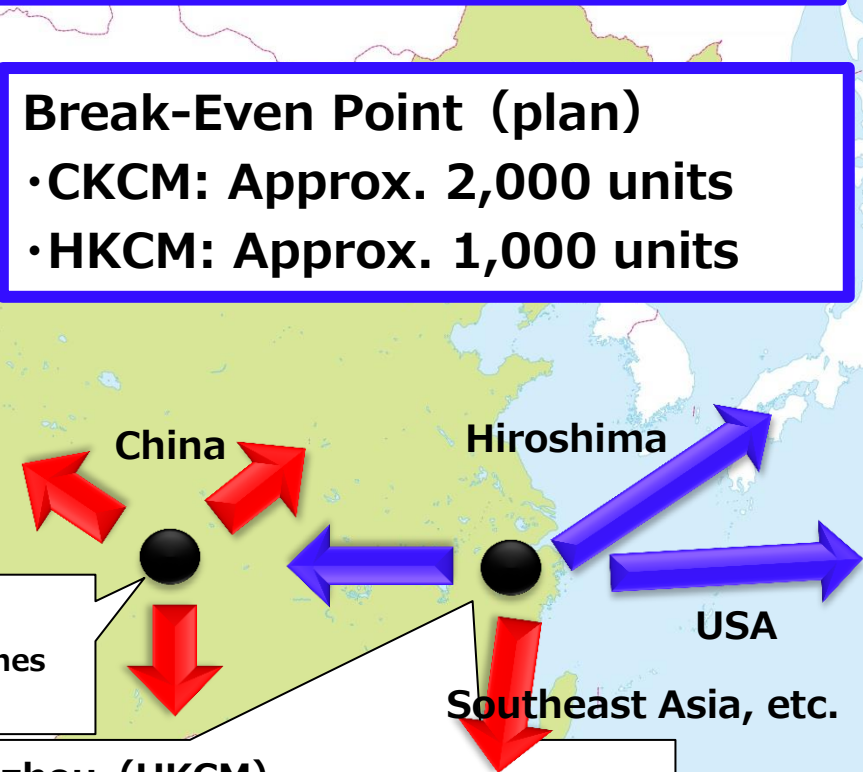
Break-Even Point (plan)

- CKCM: Approx. 2,000 units
- HKCM: Approx. 1,000 units



Chengdu (CKCM)
 ► Base for complete machines in Chinese market

Hangzhou (HKCM)
 ► Base for export of complete machines and fabricated components



(5) Forecast for Profitability Improvement in the China Business

FY2017 **Restoring profitability**

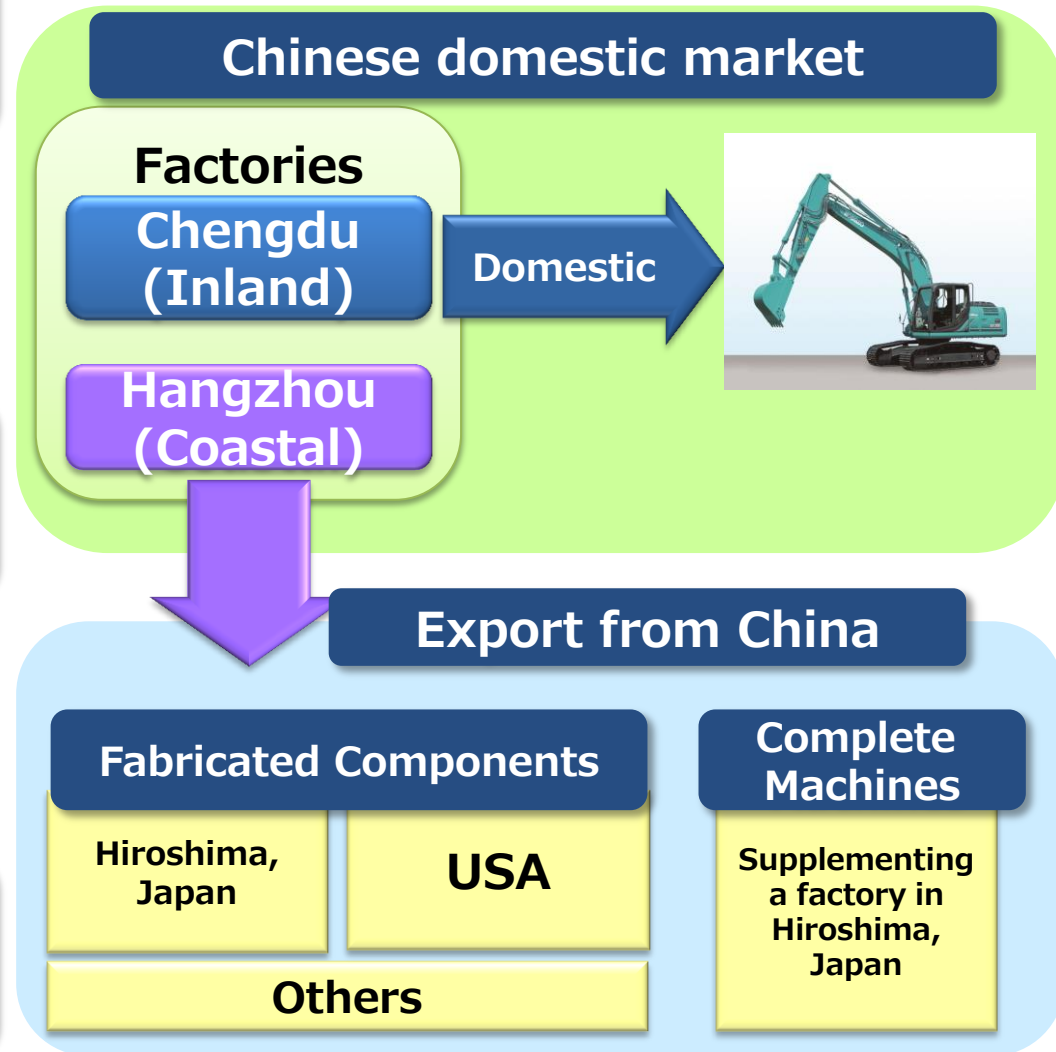


FY2018 **Consolidation of production in Chinese market**



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

Rebuilding the China business



The Kobe Steel Group's Corporate Philosophy

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.

Cautionary Statement

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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**