Message from the CFO

To Solve Social Issues of the Future ROIC Management to Maximize Earning Ability

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Earning Capacity and Responsiveness to Change Displayed in the Midst of Adversity

——The capabilities of a company can be tested based on how well they are able to respond to drastic changes in the environment. As CFO, how would you sum up fiscal 2019?

In response to the impact of the trade friction between the United States and China that has continued since fiscal 2018, we revised our business forecasts downward when we announced our second quarter financial results for the fiscal year. In the fourth quarter, just as we started to see signs of recovery from that impact, we were struck by the unforeseen blow of the COVID-19 pandemic. Looking back now, it was an extremely harsh year. Even so, we reached the end of the fiscal year with better results than we had expected during the year.

Since fiscal 2011, OMRON has upheld Value Generation 2020 (VG2020), its long-term vision for the company that focuses on the growing capability, earning capacity, and responsiveness to change. I strongly believe that the reason we were able to overcome the harsh conditions of fiscal 2019 was that our earning capacity and responsiveness to change have steadily improved.

The main focus in the evaluation of earning capacity is gross profit (GP) margin (gross profit on net sales), which is an indicator of our capacity to generate profits. This is the most important index for OMRON to measure the value we have provided to customers. No matter how excellent the products we manufacture may be, we cannot increase our GP margin unless we can communicate the value those products offer appropriately and have customers buy them at appropriate prices. GP margin is, in a nutshell, our overall ability to earn profits that is a measure of the company's ability to get things done as a manufacturer, from planning to development, production, and sales. It includes its efforts to reduce costs, including variable costs, its ability to supply products in a timely manner, and its ability to improve customer value by proposing solutions. In that respect, in fiscal 2019, despite a decline in net sales, we achieved our highest ever GP margin of 44.8%, which gave us a major confidence boost. This is the outcome of the efforts that we have steadily pursued for over 10 years, with a focusing on that ability to earn profits.

In terms of responsiveness to change, I believe that continuous review of our business portfolio is key. In fiscal 2019, as well as the grave decision we made to sell off our Automotive Electronic Components Business (AEC), we proceeded to wrap up our Backlights Business, which had been a pending issue. This was the result of rebuilding our business structure in line with Portfolio Management, which is one of the pillars of ROIC Management that OMRON has been pursuing. Such a rebuilding of business structure is another major factor that contributed significantly to the increase in GP margin by 3.6 percentage points* over the previous year. With the addition of the gains on the sale of the business, our financial position has become extremely strong.

* When the Automotive Electronic Components Business is excluded from the FY2018 results, fiscal 2019 GP margin is an increase of 0.4 percentage points over the previous year.

—— President Yamada has said that, among the three abilities that we have focused on in the long-term vision, the growth power to push up our top line (net sales) further will be our challenge going forward. How would you support it?

I think that continuing to invest in future growth will be important. To this end, we will need to further enhance the operational excellence of our existing businesses. We will improve our GP margin by eliminating unreasonableness and waste, improving productivity, and providing value at an appropriate price. Then, the question becomes how much of the resources generated through those efforts we can divert into growth areas. No matter how excellent your growth strategy is, you cannot sow the seeds of growth without those resources. Of course, there is no guarantee that investments will generate growth, but it is a prerequisite for growth that you must continue to take risks and invest in future growth.

The entire company will work on ambidexterity in our management, deepening existing businesses, and exploring and establishing new businesses to push up our top line and acquire the capacity for self-driven growth. Some challenges may be difficult to overcome by one company alone. While ensuring the flexibility of our operations, we will also set our sights on partnerships, strategic alignments, M&As, and alliances.

—— Due to the COVID crisis, the business performances of many companies in fiscal 2020 remain unclear. What is OMRON's outlook? Our plan target is to maintain a high level of GP margin at 44.8%, despite a forecast decline in net sales of 13%.

Regarding GP margin, the negative impact of exchange rates has been taken into account, so the plan target is unchanged from the previous year. If, however, we were to discount that impact, the forecast would be a substantive increase in GP margin of about 0.7 percentage points. We have already achieved a record high of 45.3% in the first quarter of fiscal 2020, so we anticipate that we will be able to achieve our target of 44.8% for the full fiscal year.

We have forecast operating income of ¥30 billion for this fiscal year, despite an anticipated significant decline in net sales of 13% year-on-year. We will steadily reduce fixed costs by ¥20 billion yen per annum as planned, but I think that the strengthening of GP margin, which indicates the ability of our core businesses to earn profits, will be a major contributing factor.

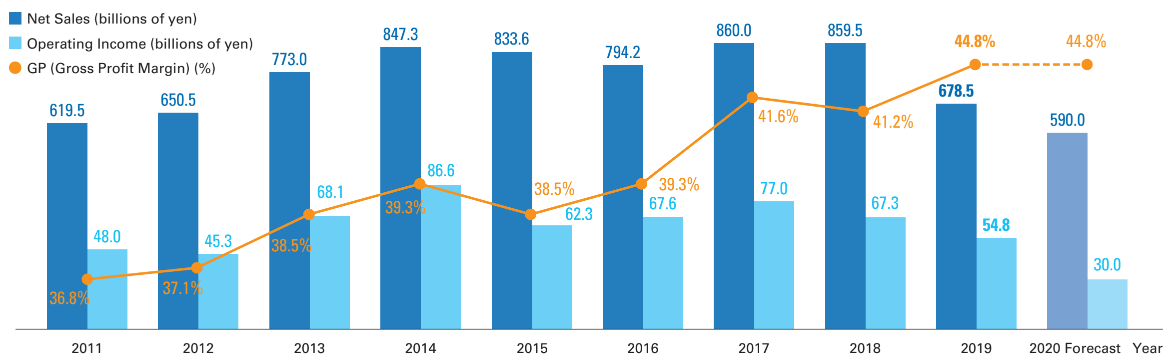
Fiscal 2020 is expected to be even more difficult than the previous year, but it is the understanding and cooperation of the people on the ground that has allowed us to set these targets. Behind those efforts is management based on the OMRON Principles. What does society expect of us and how can we contribute to society? The fact that the OMRON Principles are shared by all employees globally undoubtedly works as a driving force for us to get through these difficult times together. A sense of crisis alone is not enough to make people take action. Something that connects people to others is needed. For OMRON, that something is the OMRON Principles.

FY2020 Plan (Billions of yen)

	FY2020 Plan	Y/Y
Net Sales	590.0	–13.0%
Gross Profit	264.5	–12.9%
Operating Income	30.0	–45.2%
Net Income	16.5	–78.0%
Gross Profit Margin	44.8%	+0.0pt*

* +0.7 pt if exchange rate impact is excluded

Net Sales, Operating Income, GP (Gross Profit Margin) Results (FY2011-FY2020)



To Soar in the Post-COVID Era

—— President Yamada has positioned fiscal 2020 and 2021 as a period of preparation and transformation in anticipation of the post-COVID era, and says that the company will work on three challenges ((1) establishment of new businesses, (2) shift to service-based businesses and recurring businesses, and (3) overhaul of operations and digitalization).

We will accelerate our challenge to shift our business model from goods to services. To this end, it will be necessary to establish incubation mechanisms for the generation of new businesses. This includes co-creation with external parties.
Meanwhile, we will work on a review of our cost structures to reduce fixed costs and further reinforce our profitability. While our GP margin, which indicates earnings capability, has increased, problems remain with the level of SG&A (selling, general and administrative expenses), so we will need review efficiency and cost structure thoroughly.
In addition, digitalization needs to be addressed urgently to improve the operational excellence of our existing businesses. With the need for a global overhaul and integration of our main systems, we are currently working at fever pitch on the overall conceptualization and design. This will entail changes in formats and procedures, which may cause discomfort and confusion on the front line. However, unless the entire company works together to overcome this, we will not be able to establish the foundations for data-based management. The next two years will be a critical period in our digital transformation (DX).
With strong will and determination and, of course, with the appropriate level of funding, we will pursue this to completion.

—— So, you are saying that the next two years will be a critical period in OMRON's history?

Because the COVID crisis has significantly changed the assumptions of our business, we redefined fiscal 2020 and fiscal 2021 as periods for the acceleration of transformation that will lead to the next stage of our growth.
The time of the 2008 global financial crisis was still an era of quantitative expansion, but that will end due to the COVID crisis and we will likely see qualitative shifts in many areas. I maintain a strong sense of crisis that, unless we can adapt to this change, we will not be able to survive. To enhance our responsiveness to change and to soar in the post-COVID era, we will accelerate our transformation over these two years.

—— President Yamada has heralded the concept of Selection and Decentralization. As CFO, how would you put this concept into practice?

In order to survive and thrive in the post-COVID era, each existing business will need to enhance its autonomy, increase its speed, and take up the challenge of creating new value. At the same time, we will also need to take into full consideration the risks of keeping our businesses too fixed. OMRON currently has selected a business portfolio that comprises the three business domains of factory automation, healthcare, and social solutions, with the addition of the Electronic and Mechanical Components Business (EMC), but there is no guarantee that we will be able to continue with these domains forever. To build up the OMRON of the future, we need to generate businesses that will become new "pillars".
So, how to go about that? The key to that question is *decentralization*. As we select business domains that leverage our own strengths, we will strive to decentralize them to an appropriate degree to generate new business. You could say we will *select* how we go about that decentralization.
OMRON started with control devices. The founder leveraged this technology to enter the healthcare business, later expanding the business into social systems such as automatic ticket gates at railway stations. If we had defined ourselves solely as a manufacturer of control devices, neither the Healthcare Business nor the Social Systems, Solutions and Service Business would ever have come into being. In other words, OMRON has been selecting its core technologies and decentralizing its business domains for a very long time.

—— Selection and decentralization also works because OMRON has established ROIC Management, is that correct?

Exactly. Decentralization also requires discipline. This means instilling a mechanism, namely ROIC management, to strengthen discipline in all companies and business units, be they existing or new, and maintaining centripetal force. We need to achieve a high degree of balance between concentration, as a centripetal force, and decentralization, as a centrifugal force.
Precisely because the OMRON Principles underpin that balance, we will be able to unite everyone in the same direction. We apply this to ROIC Management as well. Known as the Down-Top ROIC Tree, this process breaks ROIC down into the key performance indicators (KPIs) such as automation rate and the facilities turnover rate to find out how efficiencies achieved through improvements in business processes on the front

line lead to improved results. The Down-Top ROIC Tree serves to visualize this analysis.

In addition, we thoroughly implement Portfolio Management, which evaluates businesses based on their economic and market values and imposes a hurdle ROIC rate of 10% on our approximately 60 business units. We have set this criterion at 10% because it would cover OMRON's estimated cost of capital of 6%, and we have informed all businesses that a failure to reach that target would be equivalent to a loss of corporate value. We have established a rule that, if a business's ROIC falls below 6%, it will be given a certain grace period in which to recover, and if the business is still unable to meet that bar, we will start considering divestiture. On the other hand, we also see growth potential as an important indicator. This is because growing businesses require larger investments and tend to be less profitable. In some cases, we may make further investments in such businesses, despite their being less profitable, to accelerate their growth. (Category B in the diagram at the bottom of the next page)

The indication of clear divestiture criteria actually allows employees to engage in new businesses with peace of mind.

—— Finally, what will OMRON do to meet the expectations of its shareholders?

Despite announcing forecasts of lower net sales and income for the first quarter at the end of July, I understand the favorable reception of this announcement from the market to be an expression of the expectations of our stakeholders toward OMRON. My sense is that, because we are firmly holding to our long-term vision, more companies are evaluating OMRON from a long-term perspective. To meet these expectations and continue to increase our corporate value, we will implement cash allocations based on capital efficiency in the order of growth investments, stable dividends, and treasury stock.

Our standard for cash-on-hand is one to two months of monthly sales at normal times. This is a range of approximately ¥50 billion to ¥100 billion yen. In the current fiscal year, with the profit from last year's sale of the Automotive Electronic Components Business and in preparation for drastic changes in the business environment in with-COVID times, we have increased that amount to approximately ¥200 billion, which is equivalent to three to four months of monthly sales. Through the flexible use of this cash-on-hand, we will steadily implement investments for future growth even in the with-COVID era.

Regarding dividends, although we have forecast falls in sales and income for this fiscal year, we will continue to pay a dividend of ¥84 per share. Due to the current difficulties in predicting the business environment, we will allocate capital appropriately in accordance with the DOE (Dividend on Equity) criteria.

While maintaining discipline, by investing capital to ensure future growth, we will enhance our corporate value and meet the expectations of shareholders. As CFO, I will fulfill that responsibility.

Business Units Subject to Portfolio Management (FY2019)