CFO Interview

Evolution of ROIC Management Drives Maximization of Corporate Value

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—— Under the VG2020 long-term vision (VG), OMRON strove to enhance corporate value, championing ROIC Management. Please wrap up OMRON's initiatives so far.

Under VG, with the aim of becoming a robust enterprise with growth potential, profitability, and ability to effectively respond to change, we pursued portfolio management based on return on invested capital (ROIC) and Down-Top ROIC Tree. I feel that our efforts are bearing fruit as OMRON's capabilities.

During the period covered by VG, we largely completed selection and decentralization of businesses. Now, the OMRON Group has a more resilient business portfolio. Termination of unprofitable products in each business has progressed, and the overall gross profit margin (GP ratio) has steadily improved. Moreover, Down-Top ROIC Tree has permeated workplaces as a result of our efforts to raise employee awareness. It is a great asset. I am pleased that individual workplaces understand the importance of their roles in achieving the Group's targets and the targets of individual businesses and that they are acting with a strong commitment. We will continue to leverage these initiatives as OMRON's abiding strengths in pursuit of our new long-term vision, SF2030.

Of course, we have some issues. We need to be capable of achieving self-driven growth, in other words, to contribute to further value creation. The essence of ROIC Management is management of value creation. It means optimizing resources and investing them in growth businesses. Earnings management is one of these processes, and it is only completed when reinvestment leads to value creation. Although we were able to enhance profitability under VG, with a view to the future, we need to be selective in regard to investment fields and stretch our ability to shoulder calculated risk and allocate resources appropriately in a timely manner. Evolving a business, such as the data business, requires developing capabilities to evaluate markets and business models, as well as selectively making investment decisions based on the time horizon for the results of investment. In addition, it is essential to invest in strengthening the business foundation over the medium to long term, including investment in supply chain management and digital transformation (DX), which we are promoting now. Along with the strategic investments in business mentioned earlier, it is becoming more difficult than ever to steer our course and balance investment with sustainable growth of profits.

—— A goal of SF2030 is to maximize corporate value. How will OMRON evolve ROIC Management to achieve this goal?

To maximize corporate value, we will transform ROIC Management from two perspectives.

First is "business portfolio management starting from social value." Under the SF 1st Stage medium-term management plan, by positioning businesses that will drive the creation of social value identified by each of our business companies as focus businesses, we will implement portfolio management for each business unit. In considering the long-term vision, we discussed thoroughly with our business companies. What kind of social value should be created? What are our customers' essential issues that should be resolved? Based on the social value we identified as a starting point, we backcast and reevaluated the markets we should address, the markets we should create, and our existing competitive advantages, and then set focus businesses.

Individual business companies will drive growth based on their focus businesses and maximize the value of their respective businesses. This will lead to enhancement of corporate value. The focus businesses will not only offer products but take various forms, such as a combination of products and services or a new service. So, portfolio management based on business units rather than products will be required. We will continue conventional product-based portfolio management (PPM) from the perspective of financial discipline for profitability.

At the heart of this business portfolio management is management of human resources. In other words, the key is to have the right people in the right places in line with the growth scenario of a business. Although focus businesses all target attractive markets with high growth potential, in order to maximize their growth potential, it is essential to have the best people and cultivate an environment in which employees' performance is maximized. This linkage of business portfolio management and human resources management is one of the characteristics of the medium-term strategy under SF2030.

Another aspect of the evolution of ROIC Management centers on "construction of a new management tree that systematizes enhancement of corporate value."

There are two main reasons for this. The first reason is that intangible assets will become more important as a business evolves. We aim at profit growth not only through cost competitiveness of products but also by creating high added value to solve our customers' essential issues. Many of the components that create that added value are related to intangible assets.

For example, in the case of -innovative-Automation of the Industrial Automation Business, the sources of our competitive advantage are a suite of innovative applications co-created by OMRON and leading companies in various industries, and our highly skilled engineers. In the case of the Healthcare Business, the know-how in obtaining permits and approvals and the trust of the medical industry we have cultivated over the years, as well as the blood pressure data collected and accumulated globally differentiate OMRON from its competitors and contribute greatly to the creation of value unique to OMRON. It is extremely important to link these intangible assets to the added value generated by each business, and at the same time, to have the metrics to measure the financial impact of investment.

The second reason is that recent changes in social structure and values have resulted in diversification of the elements constituting corporate value. In addition to the intangible assets of businesses I mentioned earlier, we need to make the necessary investments with regard to ESG-related issues, such as carbon neutrality and respect for human rights, and link them to corporate value. However, a systematized tree structure based on ROIC as the starting point alone does not adequately cover the elements and there is a risk of deterioration of the accuracy of the allocation of important management resources. So, we would like to establish a mechanism for enhancing corporate value by repeatedly establishing a hypothesis and then verifying it, and adjusting the metrics accordingly.

Currently, the OMRON Group is establishing a new management tree with corporate value as the starting point, and each business company is establishing a new management tree with business value as the starting point. We will strive to present a more concrete picture through our initiatives from now on.

—— OMRON invested over ¥100 billion in JMDC Inc. in fiscal 2021. What is the background and thinking behind this investment decision from the perspective of ROIC Management?

Regarding investment in JMDC, we thoroughly examined medium- to long-term returns and risks. We evaluated how to generate returns in excess of the cost of capital in terms of both traditional economic value and strategic value. The purpose of this investment is to create a data business, a new challenge for the OMRON Group. Essentially, the evaluation of investment is similar to the evaluation of a new business. It is not appropriate to use synergy measurements and valuations, which are used for evaluating existing businesses. We conducted evaluation along the timeline, discussed everything, and evaluated the short-term investment impact and the concept of the data business and its financial potential over the medium to long term. On the other hand, the strategic value is very clear.

JMDC has knowledge and expertise in the data business that OMRON lacks. OMRON has been building its business through trial and error. But by collaborating with JMDC, which has knowledge and expertise in a field with which we are unfamiliar, we can further increase the probability of success and the speed of transformation. This is one of the reasons for the decision to go ahead with the investment. Furthermore, by taking this opportunity created by our investment in JMDC, we would like to accelerate the data business not only in the Healthcare Business but also in the Industrial Automation Business and the Social Systems, Solutions and Service Business, in order to achieve the business transformation that the Group is pursuing.

Through the investment in JMDC, management is shouldering a calculated risk. In terms of risk management, we proceeded with the utmost care. Specifically, we conducted risk assessment of the investment separate from OMRON's business strategy. The investment in JMDC is recorded as investment securities on OMRON's balance sheet. We examined JMDC's financial strengths, the value of its data platform, barriers to entry, future growth potential, and so on, and the project team and the Board of Directors had many discussions. Of course, there is a risk of possible impairment, but with OMRON's current financial position, such risk can be sufficiently absorbed.

JMDC's bottom line on a non-consolidated basis was expected to be ¥3 billion at that time, and thus OMRON, with a 33% stake in JMDC, was expected to have about ¥1 billion as its share of profit. Considering the return on investment alone, it is 1% on investment of ¥100 billion, which is below the hurdle rate (cost of capital). Are we to keep this ¥100 billion in cash or invest it? When considering the options, the essence of ROIC Management is to look five or ten years ahead and to select the option that will enhance future corporate value. Through the investment in JMDC, OMRON will create a new data business, which will significantly increase the total return over the medium to long term. In due course, we will report on the progress made. You can count on us.

—— What is OMRON's policy on cash allocation and shareholder returns under the new medium-term management plan?

Under SF2030, in order order to maximize corporate value, we established a new cash allocation policy. It prioritizes investment in growth and on this basis, we will enhance shareholder returns. This indicates OMRON's strong determination to continue growing. Starting with this new medium-term management plan, we have set operating cash flow as one of the management indicators.

Maximizing corporate value requires a constant cycle of "value creation and reinvestment," and operating cash flow is the key to this cycle. ROIC Management has strengthened OMRON's ability to generate cash year after year. We will reinvest the cash in the Industrial Automation Business and the Healthcare Business, which are the drivers of the Group's growth. In addition to the growth investments required for existing businesses, we will make the necessary investments to create new business models so as to enhance OMRON's medium- to long-term growth potential. To ensure growth, we will also

Investment Plan

	Forecast for the most recent 3 years FY2019-2021 (cumulative total)	SF 1st Stage plan FY2022-2024 (cumulative total)
Growth investment (including M&A)	¥140.4 billion	¥200.0 billion
R&D investment	¥134.3 billion	¥165.0 billion
Capital investment (including DX investment)	¥91.3 billion	¥130.0 billion
Investment for carbon neutrality	¥3.8 billion	¥20.0 billion
Investment in human resources development	¥2.0 billion	¥6.0 billion

make investments to transform our organizational capabilities across the Group. There are three priority fields for investment. Firstly, investment in human resources. For business transformation, it is important to develop the capabilities of individual employees who will be engaged in the transformation and to create an environment that attracts diverse human resources. To this end, we will invest ¥6 billion in human resources, about three times the amount invested during the previous medium-term management plan, centering on global recruitment and implementation of human resources development programs.
Secondly, promotion of DX. Our goal of creating new data-driven businesses requires business infrastructure suitable for such businesses. It is necessary to transition from the conventional structure focused on products to one that is optimized for offering solutions centered on combinations of products and services. At the same time, in the course of this transition, enhancement of operational efficiency through standardization of business processes is a must to prevail over competition in the market. We will execute this medium- to long-term investment according to the plan.
Thirdly, supply chain management. As you are aware, the environment surrounding the supply chain is becoming increasingly complex, including geopolitical risks and responses to global environmental issues. The current challenges are not transient and are irreversible owing to structural changes in society as a whole, and we must restructure our supply chain to adapt to such changes.
In addition, with respect to business transformation and transformation of organizational capabilities, carbon neutrality is another key investment theme for the OMRON Group. Climate change is a social issue that OMRON should address as a corporate citizen. Indeed, companies increasingly recognize addressing the issue as a precondition for engaging in business.
Under SF2030, we will promote initiatives with a view to realizing a decarbonized society, not only to fulfill our social responsibility to eliminate CO_2 emissions, but also to link such initiatives to enhancement of OMRON's competitiveness. By developing products that contribute to resolving global environmental issues and by offering energy management and other solutions through the Industrial Automation Business and the Social Systems, Solutions and Service Business, we aim to achieve OMRON's sustainable development while contributing to that of society.
Under SF 1st Stage, we plan to invest approximately ¥20 billion, about five times the amount invested during the previous medium-term management plan. Plans call for capital investment in energy saving and energy generation to make our 76 sites in Japan carbon neutral.
OMRON now uses the dividends on equity (DOE) ratio as the sole indicator for its shareholder returns. This is to reduce the impact of short-term performance fluctuations on shareholder returns and ensure stable and continuous dividend payment. Our policy of prioritizing investment in business growth remains unchanged under SF 1st Stage. For example, if there is a good M&A opportunity, we will use retained cash as well as appropriate financing methods to seize it in a timely manner.
Our aim is to strongly implement the virtuous cycle of value creation and reinvestment. This is the key to maximizing corporate value and rewarding shareholders.

Cash Allocation Policy during SF 1st Stage

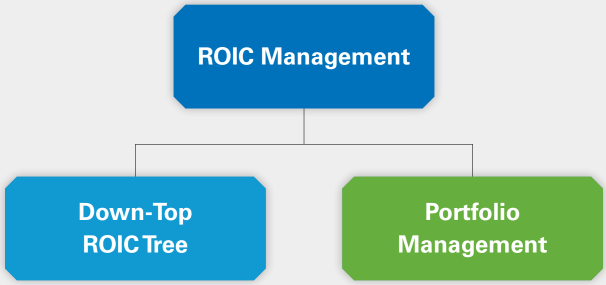
1) Aiming to maximize corporate value through the realization of the long-term vision, OMRON prioritizes the necessary investment to create new value from a medium- and long-term perspective. During SF 1st Stage, priority will be placed on investments in human resources and R&D to solve social issues and innovate driven by social needs; capital investments in production capacity increases and digital transformation (DX); investment in growth initiatives such as M&A&A (merger, acquisition, and alliance); and investment in sustainability initiatives such as decarbonization, reduction of environmental impacts, and respect for human rights in the value chain. On this basis, OMRON will return profits to shareholders in a stable and sustainable manner.
2) Such investment for value creation and shareholder returns will be, in principle, sourced from internal reserves and operating cash flows that are generated continually, with appropriate financing facilities used as necessary. We will maintain a degree of financial soundness that allows us to seek financing regardless of the current financial situation.

Shareholder Return Policy during SF 1st Stage

1) With priority being placed on the investment necessary for value creation over the medium and long term, annual dividends will be based on "dividends on equity (DOE) of around 3%." Taking past dividend payments also into account, we intend to ensure stable and sustainable shareholder returns.
2) After making the above investments and distributing profit to shareholders, OMRON will distribute retained earnings accumulated over the long term to its shareholders through strategic share buybacks and other measures.

ROIC Management

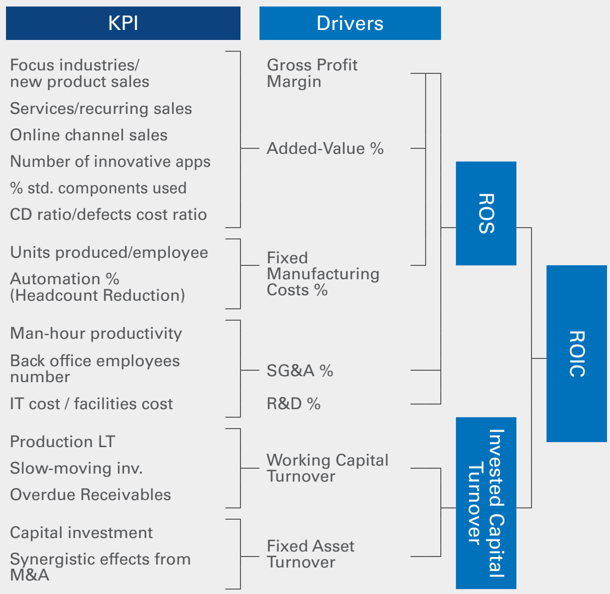
ROIC management consists of Down-Top ROIC Tree and Portfolio Management.
OMRON encompasses a number of business divisions with varied characteristics. We believe ROIC is an excellent measure for assessing business performance fairly for each business. Using operating income or operating income margin as an indicator doesn't account for variances due to the nature or scope of a business. ROIC, on the other hand, measures return on invested capital, providing a fair assessment.



Down-Top ROIC Tree

Down-Top ROIC Tree breaks ROIC into key performance indicators for each department, allowing us to improve ROIC at the most basic operating level. Using simple ROS or invested capital turnover as ROIC indicators are ineffective, since they do not relate directly to front-line operations. On-site managers would have trouble thinking of ways to improve ROIC using these indicators. However, we can break ROIC down into automation/head count reduction or facilities turnover as KPIs of manufacturing departments. With these indicators, managers can finally see how their goals tie directly to ROIC improvement initiatives. At OMRON, one of our greatest strengths is our unified approach to improving ROIC from the ground level up.

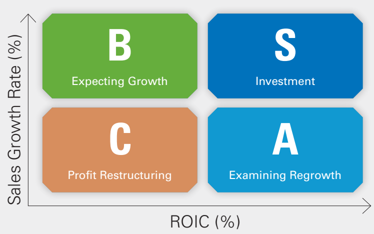
Down-Top ROIC Tree



Portfolio Management

OMRON consists of approximately 60 business units, each subject to a portfolio management system that assesses the economic value of the unit according to (1) ROIC and (2) sales growth rate. In this way, OMRON management can make proper and timely decisions related to new business entry, growth acceleration, restructuring, or divestiture to drive improvements in OMRON Group value.
We consider both the economic value and the market competitiveness of a business to allocate limited resources in an optimal manner. This assessment system allows us to identify the growth potential of each business unit, making an optimal allocation of our resources.

Assessing Economic Value



Assessing Competitiveness