CFO Message

Achieve Robust Regrowth by Implementing ROIC management

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Strengthen Portfolio Management in Anticipation of Future Business Environments

OMRON has been implementing management based on return on invested capital (ROIC) since 2013. Specifically, ROIC management consists of the Down-Top ROIC Tree approach and portfolio management. With the Down-Top ROIC Tree approach, the effects created by actions at each frontline are quantified and linked with the components of ROIC so that all organizations take ownership of the achievement of the ROIC target. Portfolio management is for improving low-profitability businesses and promoting allocation of investment to growth businesses. The purpose of this ROIC management structure with two elements is to achieve profitability exceeding the cost of capital and to enhance corporate value through sustainable growth of sales and profit (See Figure 1).

However, ROIC declined significantly to 1% in fiscal 2023 and is expected to be around 1% in fiscal 2024. This decline is mainly attributable to (1) a significant decline in gross profit margin (GP ratio) due to supply chain disruptions during the COVID-19 pandemic, (2) a significant decrease in profit in the Industrial Automation Business (IAB) and the Device & Module Solutions Business (DMB) against the backdrop of decreased sales, especially in Greater China, reflecting stagnant capital investment in the semiconductor, EV, and PV industries and other sectors, and (3) recording of costs for structural reform. Nevertheless, even in this phase, the GP ratio is already on a recovery trend thanks to prompt actions at each frontline using the Down-Top ROIC Tree (See Figure 2). Moreover, optimization of labor costs and expenses is progressing through headcount optimization and review of business processes, and recovery of profitability is in sight.

On the other hand, for sustainable growth of sales and profit, it is important to evolve the portfolio of products and services that will make this possible. Specifically, we are currently strengthening portfolio management from two perspectives. Firstly, business valuation in anticipation of future business environments. In recent years, capital investments in the semiconductor and EV industries have become larger, and the fluctuation of supply and demand for factory automation (FA) equipment has increased accordingly. Moreover, the Chinese market, which has been a driver of global economic growth, is experiencing slower GDP growth and local companies are becoming a source of stiffer competition as they increase their speed of execution and enhance QCD (Quality, Cost, and Delivery). Conventionally, we identified

Figure 1 OMRON's ROIC Management

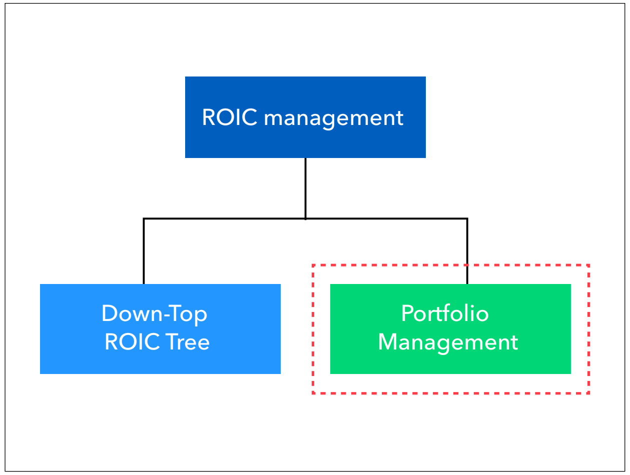
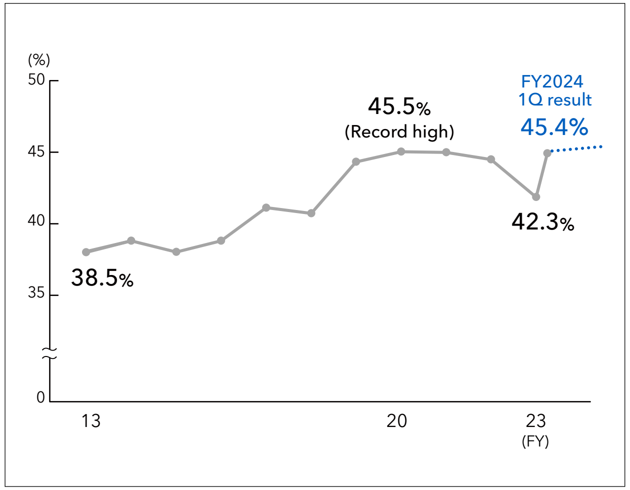


Figure 2 GP Ratio



low-profitability and unprofitable businesses based on past performance and implemented portfolio management to achieve improvement. However, this approach alone proved inadequate in the recent business environment, and we regret that it resulted in a situation that undermined business stability. Reflecting on this experience, we now conduct valuation of businesses in anticipation of future business environments in addition to valuation based on actual performance results. In particular, regarding IAB's business environment, restructuring of global supply chains is accelerating to avoid geopolitical risks, and we are strengthening business valuation not only in terms of products and services but also from an area perspective.
Secondly, capital allocation with a focus on high-growth, high-return businesses. OMRON currently has 64 product and service businesses. In order to accelerate sales and profit growth, we will implement more focused capital allocation than ever before. In particular, IAB, with its wide range of products, will focus its own resources on products that can achieve sales and profit outperforming market growth so as to maximize business performance. Selection of target products is being finalized and speedy introduction of competitive products and services will be promoted. Moreover, market growth is expected for storage batteries and power conditioners of the Social Systems, Solutions and Service Business (SSB) and for blood pressure monitors and portable electrocardiographs (ECG) of the Healthcare Business (HCB).
By investing appropriately in these products and services that have the potential for sustainable growth far into the future, we will build a stronger position than ever before. The same is true for the Data Solution Business (DSB) in this regard. In this area, we were able to lay a stepping stone through the acquisition of JMDC Inc. in fiscal 2023. Leveraging JMDC Inc.'s capabilities, DSB will accelerate value creation not only in the healthcare domain, but also in the factory automation and social solutions domains. Restructuring of the portfolio with an eye to future business environments is the cornerstone of ROIC management as it ensures sustainable sales and profit growth. I recognize that completing this initiative is one of my principal tasks.

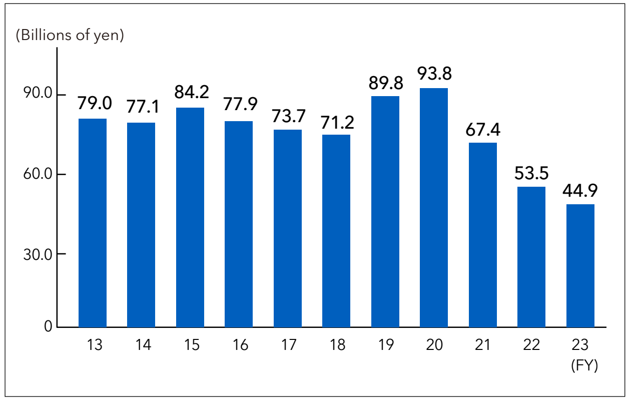
Operating Cash Flow to Enter Re-expansion Phase

Although OMRON's operating cash flow had been stable at around JPY 70 billion to JPY 90 billion, it declined significantly in fiscal 2023 against the backdrop of a decrease in IAB's sales and a large increase in inventories (See Figure 3). In fiscal 2024, we expect operating cash flow to remain at a lower level than in the past because recovery of financial performance will be limited and one-time costs for structural reform will be recorded.
However, operating cash flow is expected to move into an expansion phase again from fiscal 2025 onward. Inventories, which pressurized cash generation, are expected to normalize along with a gradual recovery of orders because the effectiveness of procurement control implemented in fiscal 2023 is becoming apparent. In addition, IAB has begun to restructure its supply chain management (SCM) system so as to be able to respond quickly to market volatility. Moreover, since the reduction of the ratio of selling, general and administrative expenses and optimization of headcount and the labor cost structure are progressing as planned, and the recording of one-time costs for structural reform will be completed in fiscal 2024, we expect operating cash flow to recover to a near historical level from fiscal 2025 onward.
In terms of capital allocation, we will accord the highest priority to investment for structural reform in fiscal 2024, but from fiscal 2025 onward, we will make solid investment to support sales and profit growth under the new portfolio plan. Furthermore, we will continue to invest in IT including restructuring of SCM systems, so that we can quickly identify changes in the market and enhance our ability to effectively respond to such changes. We also recognize the importance of shareholder returns in enhancing corporate value, and will maintain a policy of dividends on equity (DOE) of around 3% to ensure sustainable and stable dividends, while making appropriate decisions on share buybacks in view of the stock price and investment situations.

To Reduce the Cost of Capital

So far, I have focused on improving ROIC, but we recognize that reducing the cost of capital is also an important factor in enhancing corporate value, and will continue to pursue an initiative in this regard. The cost of capital is currently at around 8%, higher than in the past, due in part to interest rate increases. For reducing the cost of capital, of course, establishment of a stable profit and growth structure remains of primary importance. However, from the perspective of financial value, we will also reinforce two initiatives.
Firstly, financial discipline. OMRON's shareholders' equity ratio was 58% as of the first quarter of fiscal 2024, and interest-bearing debt was about JPY 200 billion due to the financing of about JPY 85.5 billion for the investment in JMDC Inc. in fiscal 2023. However, net interest-bearing debt (net debt) after taking into account cash and cash equivalents is about JPY 40 billion, without any major concerns about

Figure 3 Operating Cash Flow



the soundness of the current balance sheet, which we consider to be an appropriate level with sufficient capacity for investment in growth. Balance sheet evaluation should be performed, taking into account strategy and the timeline, and management is conducted under appropriate financial discipline while grasping future cash flows (See Figure 4). We thoroughly evaluate corporate value from various angles, in particular, when executing M&A. In verifying the return on investment, we not only control liabilities based on the EBITDA plan, but also clarify the impact of risk-weighted assets, such as goodwill, and set a cap on risk-weighted assets for the entire balance sheet. By doing so, we maintain a balance between growth and financial soundness. In addition, OMRON has long been eliminating cross-shareholdings in accordance with the corporate governance guidelines. We will continue to respond appropriately in accordance with the guidelines.

Secondly, dialogue with capital markets. Although we have been placing importance on dialogue with capital markets, I believe that we should further strengthen the dialogue. I myself have received many thought-provoking opinions and advice in the course of dialogues with numerous investors and shareholders since last year. Business valuation and suggestions from investors' perspectives are stimulating and valuable factors that may trigger improvement of the quality of our strategy and acceleration of its execution. In retrospect, no dialogues were more fruitful than those in which we received candid critical comments.

We emphasize dialogue with investors and shareholders also from the perspective of appropriate stock price formation. The goal of the structural reform underway is to ensure sustainable growth, but many initiatives are still in progress and there may be a time lag between the necessary investment and returns. This is because we think it is necessary to formulate an equity story and share it with investors as a tool to facilitate their understanding and create a situation in which investors can support us in our efforts to increase OMRON's corporate value. To this end, both the Group's Corporate Planning Department and Investor Relations Department have been placed directly under the CFO from the current fiscal year. Under this structure, we will engage in transparent, consistent, and continuous dialogue and disclosure of our vision and progress, ensuring linkage to enhancement of corporate value.

To Our Shareholders

In conclusion, let me mention that structural reform launched in the current fiscal year is making steady progress, and we are implementing companywide initiatives to achieve transformation into a stronger OMRON. As we achieve progress in strengthening the earnings base, we are accelerating each of our initiatives with our sights set on medium- to long-term sustainable growth. My role is to ensure appropriate risk management and allocation of management resources to maximize the outcome of each business's initiatives. OMRON possesses many tangible and intangible assets that have been cultivated over the years, and many of our businesses have growth potential to address growing markets. We will identify businesses that address the three social issues defined in our long-term vision SF2030 and are capable of sustainable sales and profit growth, and make solid investment leading to the next stage of growth and returns. By reinforcing this cycle, we aim to enhance corporate value and contribute to our shareholders and society.

Figure 4 Management to Strengthen Financial Discipline