

# **Kawasaki Heavy Industries Ltd (KWHIY) Q4 2023 Earnings Call Transcript**

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**Body**

Kawasaki Heavy Industries Ltd (KWHIY)

Q4 2023 Earnings Call Transcript

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Company Participants

Katsuya Yamamoto - VP, Senior Corporate Executive Officer & Assistant to the President

Yasuhiko Hashimoto - President and Chief Executive Officer

Presentation

Katsuya Yamamoto

My name is Yamamoto. Thank you for your participation. Now I would like to present financial highlights. As announced today at 11:30 a.m. on the Tokyo Stock Exchange and on the Kawasaki website, our financial results for the fiscal year ended March 31, 2023 show that although we recorded a new record high in revenue, continuing a trend from the previous fiscal year, we had a decrease in profit due to a loss recorded in Aerospace Systems related to operational problems with the PW1100G-JM engine. However, business profit for the January to March period was higher than the previous forecast announced in February, and pre-tax income and net income were substantially improved due to a smaller foreign exchange loss, as the yen's depreciation accelerated toward the end of the fiscal year. As a result, net income for the period was ¥25.3 billion compared to the forecast of ¥12.0 billion. We therefore plan to pay full year dividends of ¥50, an increase of ¥10 from the previous forecast.

The business forecast for fiscal year 2024 is expected to show increases in sales in all segments due to an improving business environment compared to fiscal year 2023 and an expected increase in sales in Powersports & Engine to the start of operations at the new plant in Mexico. Revenue is expected to exceed ¥2 trillion for the first time, reaching ¥2.25 trillion, and business profit is expected to exceed ¥100 billion for the first time, reaching ¥130 billion, due in part to a rebound from the loss on the PW1100G-JM engine mentioned earlier. As a result, dividends are also expected to be ¥140, both record highs. This was a summary of our results for fiscal year 2023.

I will look at the results in more detail beginning on page three. Orders received in fiscal year 2023 amounted to ¥2083.4 billion. Net sales amounted to ¥1849.2 billion. Business profit was ¥46.2 billion. Profit before tax was ¥31.9 billion and net income attributable to owners of the parent was ¥25.3 billion. As you can see, the weighted average exchange rate was approximately ¥9 lower than that of the previous year, and US dollar-based transactions amounted to approximately $1.85 billion.

This chart provides a breakdown of orders received, revenue and business profit in each segment. As one shows, the Energy Solution & Marine Engineering segment reported a considerable improvement in profitability from the Ship & Offshore structure business and energy and marine machinery business resulting in a significant increase in profit compared to the previous year. As for two, Powersports & Engine reported a decrease in profit compared to the previous year due to increases in sales promotion expenses as inventory levels for motorcycles and four wheelers normalized, and the recording of recall-related expenses and Precision Machinery & Robots similarly reported a decrease in profit from the previous year due in part to lower demand in the Chinese construction machinery market and the impact of backlogged inventories. As a result of these developments, overall net sales increased by ¥123.6 billion year-on-year to ¥1849.2 billion, while overall business profit decreased by ¥36.1 billion to ¥46.2 billion.

Please see the chart for details. As can be seen in one, loss relating to aero engine was recorded as a decrease in revenue, resulting in a deterioration of cost of sales ratio. Looking at two, the main factor contributing to this result was an increase in selling, general and administrative expenses due to an increase in fixed costs at overseas subsidiaries as a result of the yen's depreciation. And looking at three, the main factors were cost reductions by a joint venture in China in Ship & Offshore structure, and improved profitability due to falling steel prices and the depreciation of Chinese Yuan. As a result, business profit decreased by ¥36.1 billion year-on-year to ¥46.2 billion. The statement of comprehensive income on page six shows a foreign exchange loss of ¥2.6 billion noted by four. However, this loss stood at ¥10.8 billion at the end of the third quarter and narrowed as the yen weakened during the January to March period. As a result, net income was ¥25.3 billion.

Next, I will explain the factors behind changes in business profit. The depreciation of the yen against the US dollar compared to the previous period was a factor contributing to an improvement of ¥34.3 billion. However, even though cost increases due to price hikes and others were covered by appropriate price pass through and change in product mix and other factors, sales promotion expenses increased in Powersports & Engine, expenses related to recalls were recorded and reduced plant operations associated with lower demand in the Chinese market had a significant impact in Precision Machinery & Robot, contributing to a decrease of ¥13.1 billion in business profit. Additionally, losses recorded in aero engine resulted in business profit of ¥46.2 billion, representing a decrease of ¥36.1 billion from the previous year. A segment breakdown is provided on page eight for your reference.

Looking at factors behind changes in assets in the fiscal year, as is shown in one, accounts receivable increased in Powersports & Engine and Aerospace Systems as a result of sales expansion. Also, as indicated in two, inventories and fixed assets increased mainly in Powersports & Engine due to expanded production and the construction of a new plant in Mexico. Looking at factors behind changes in liability and net assets, as shown in four, interest bearing debt increased in Powersports & Engine, Rolling Stock and other areas. As a result, the net debt-to-equity ratio was 88%, slightly exceeding the standard of 70% to 80%. However, we will strive to achieve the target level in fiscal year 2024 by not only continuing to improve profitability, but also improving asset efficiency by promoting the collection of accounts receivable and controlling inventories.

As shown in one, operating cash flow was ¥31.6 billion, a year-on-year improvement of ¥8 billion, despite the fact that pre-tax income was lower than the previous year. Looking at investment cash flow, as shown in two, cash outflow for the acquisition of fixed assets increased mainly due to investments associated with the Mexico plants startup in Powersports & Engine. Overall investment cash flow increased by ¥12.3 billion. As a result, free cash flow decreased by ¥4.3 billion from the previous year.

Here I provide cash flow trends over the past ten years for your reference. As I mentioned at the beginning, we expect all segments to show revenue increases in fiscal year 2024. This expectation is despite our anticipating a year-on-year decrease in revenue due to the exchange rate, in part because we set the exchange rate that provides the basis for forecasts with a stronger yen than the actual exchange rate. As a result, we expect revenue to reach a record high of ¥2250 billion, representing an increase of ¥400.8 billion over the previous year. We expect business profit to increase by ¥83.8 billion to ¥130 billion, pretax income to increase by ¥78.1 billion to ¥110 billion, and net income to increase by ¥52.7 billion to ¥78 billion, all of which will be record highs.

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Factors behind these forecasts include an increase in profit due to higher revenue and rebound from the ¥58 billion recorded loss by aero engine in the previous year. As a result, after tax ROIC is expected to be 6.7%, up 3.9 percentage points from the previous year. This will exceed the anticipated weighted average cost of capital, or WACC. I should note that these forecasts are predicated on a foreign exchange rate of ¥140 to the US dollar. The amount of US dollar-based transactions is assumed to be $1.98 billion, an increase of approximately $130 million from the previous year.

This chart provides a breakdown by segment. Details are provided on each segment page. The slide shows the results for fiscal year 2023. Looking at orders, overall orders increased significantly from the previous fiscal year due to an increase in orders for the Ministry of Defense and for Boeing. On the other hand, looking at business profit, there was a year-on-year decrease attributable to the significant impact of losses recorded for aero engine. As for the outlook for fiscal year 2024, we expect orders, revenue and business profit all to increase, mainly due to anticipated increases in orders for the Ministry of Defense and for Boeing, as well as a rebound from the aero engine loss recorded in the previous fiscal year.

This page provides the results of orders in revenue, the number of aircraft sold to Boeing and the number of engines sold in aerospace and aero engine, respectively for your reference. This page shows quarterly revenue and business profit trends. Also provided for your reference, it gives a good overview of past trends. This page outlines our understanding of the business environment and order trends in the segment. It also presents specific efforts we are taking to achieve the forecasts. No major changes have been made from the previous announcement. Considering it important to lay the groundwork for business recovery and expansion in this segment, we have added promotion of operational efficiency and productivity improvement with an eye to seizing new business opportunities to specific efforts, so please use this as a reference.

As you can see the results for fiscal year 2023 in this slide, orders received decreased significantly from the previous fiscal year. However, this was a reaction to the large order received for the New York subway in the US that was recorded in the previous fiscal year. Revenue increased by ¥64 billion from the previous fiscal year due to an increase in deliveries of R211 Rolling Stock for the US. Meanwhile, profits also increased by ¥2.3 billion from the previous fiscal year due to an increase in revenue that came despite the impact of lower operations in Japan. In fiscal year 2024, we expect orders to increase from the previous year due to an anticipated increase in Rolling Stock for Asia, and we expect revenue to increase ¥14.1 billion from the previous year to ¥210 billion. In terms of profit, we expect profitability to improve with business profit reaching ¥7 billion and a business profit ratio of 3.3%, as mass production and delivery associated with the R211 project for the New York City Transit Authority gets into full swing.

This page shows orders received and revenue in the Japanese, Asian and North American markets. For your reference, it also shows revenue in after sales service, which has been a profitable business undertaking and the progress of the M9 project for the Long Island Railroad in the US.

This page shows quarterly revenue and business profit trends. There are no major changes from the previous announcement concerning the business environment and specific efforts. The slide shows the results for fiscal year 2023. Despite an increase in orders for naval equipment for the Ministry of Defense, orders received decreased reflecting the completion of orders received for waste treatment facilities and LPG/ammonia carriers in the previous fiscal year. On the other hand, revenue increased due to an increase in the construction volume of LPG/ammonia carriers and the robust energy business, while business profit increased significantly year-on-year due to an increase in equity method income. For fiscal year 2024, we set our forecast at ¥30 billion, which represents a decrease of ¥1.9 billion due in part to the fact that we set the exchange rate to have a stronger yen against the US dollar compared to the previous fiscal year. This forecast comes despite our expectation that revenue will increase in the marine machinery business, energy business, and plant business even amid a slight decrease in orders, and that business profit will increase as a result of increased revenue.

This page provides a breakdown of orders received and revenue for the Energy, Plant & Marine Machinery businesses and the Ship & Offshore structure business. This page shows quarterly revenue and business profit trends. There are no changes from the previous announcement in terms of the business environment and order trends in this segment. As you can see in the specific efforts, we have spelled out initiatives and aims in the area of state-of-the-art waste treatment facilities as part of our contribution toward the realization of a low carbon and de-carbonized society. As for our efforts to provide de-carbonization solutions, we note achievements that include the start of commercial operation of a hydrogen co-firing gas turbine in Belgium.

The slide shows the results for fiscal year 2023. Orders received and revenue decreased from the previous fiscal year, mainly due to a decline in hydraulic components for the Chinese construction equipment market and industrial robots in general, while business profit also decreased mainly due to revenue decreases, a decline in operations and inventory adjustments. For fiscal year 2024, we forecast profit of ¥7 billion, which represents an improvement of ¥8.9 billion from the previous fiscal year. This forecast comes from our anticipation that orders received will increase due to a rise in orders for hydraulic components for the construction machinery market and various types of robots, that revenue will increase due to an increase in robots for semiconductor manufacturing equipment as the semiconductor market recovers, and that business profit will improve as price pass through, cost reduction and fixed cost reduction measures executed to date contribute to better profitability.

This page shows orders received and revenue for the Precision Machinery & Robot business. Sales of hydraulic components to the Chinese market and a breakdown of robot sales by segment are also provided for your reference. This page shows quarterly revenue and business profit trends. There are no changes from the previous announcement in terms of the business environment and order trends.

I will now present the specific efforts for both the hydraulic and robot businesses, as they have been substantially updated. We newly announced that we will be reinforcing the after sales business as a measure aimed at developing the hydraulic business. Additionally, we will expand defense related products for the group in line with our expansion of the defense business. In the robot business, we have set concentrated investment in high value-added areas, strengthening of the medical robot business and strengthening of our brand power as strategic undertakings. Although these businesses have been significantly affected by the worsening market conditions, we expect to significantly improve the profitability of both businesses through these efforts.

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The slide shows the results for fiscal year 2023. The segment performed at about the same level as previously announced in February. For fiscal year 2024, we anticipate an increase in units sales supported by the startup of the new plant in Mexico, significant expansions of four wheelers and PWCs, and higher shares of motorcycles for developed countries with the introduction of new models. As a result, we expect revenue to increase by ¥127.6 billion from the previous year to ¥720 billion, and business profit to increase by ¥20 billion to ¥68 billion due to the increase in sales and the absence of recall related costs that were recorded in the previous fiscal year.

This page shows revenue for motorcycles for developed countries, motorcycles for emerging markets, four wheelers and PWCs, and general purpose engines. In addition to units sales of motorcycles by country, it shows wholesale plans for fiscal year 2024 and the categories of motorcycles for developed countries, motorcycles for emerging countries, and four wheelers and PWCs. This page shows quarterly revenue and business profit trends. This page provides a market overview and describes specific efforts in the Powersports & Engine segment. No major changes have been made from the previous announcement.

Looking at shareholder return, we plan to pay year end dividends of ¥30 per share for fiscal year 2023, which is an increase of ¥10 per share from the previous announcement made in February. Consequently, we anticipate that the full year dividends will be ¥50 per share. We currently plan to pay dividends of ¥140 per share for fiscal year 2024.

Here I would like to report on three project topics. To begin with, I would like to give our outlook for the Aerospace Systems business, which we expect to grow at a high rate going forward. In the civil aviation market, passenger demand has surpassed pre-COVID levels and returned to a growth track. This development has brought our airframe component sales to Boeing and our aero engine revenue back completely to pre-COVID levels and we expect growth to continue. In addition, our defense business will grow significantly in line with the government's policy of doubling the defense budget to 2% of GDP by fiscal year 2027. With this growth as a backdrop, we aim to achieve a business profit ratio for the segment as a whole of 8% in fiscal year 2025 and 10% in fiscal year 2027. We will aim for even higher growth with Aerospace Systems as a core business.

On this page I wish to look at the Mexico plant, which started mass production of off road four wheelers on the 24th of last month and give our outlook for the four wheeler business. The off road four wheeler market continues to expand, mainly in North America. We expect it to grow at a rate of 6% or 7% per year in terms of monetary amount through 2030. We will double our standard production capacity to 100,000 units to respond to the growing demand. We will also introduce attractive products in high performance and high priced segments that we have not entered in the past. Through these actions, we plan to raise revenue from the four wheeler and PWC business to ¥300 billion, approximately double the fiscal year 2022 level by fiscal year 2025. We are conducting our first major Kawasaki promotion in North America in conjunction with the launch of the new RIDGE series. This promotion is generating positive feedback and orders from numerous users and dealers. We expect to see continuing growth in the off-road four wheeler business.

Next, I would like to conclude my presentation of project topics by introducing our hydrogen business, which we are building as a core next generation business. We recently announced the completion of the basic design of our hydrogen platform, a digital management system that will support domestic and international hydrogen trade by centrally managing and visualizing the distribution of hydrogen. We plan to complete design and development before the end of 2025 and begin commercialization in around 2028. We anticipate that visualizing hydrogen distribution will enable the easy ascertainment of CO2 emission reduction benefits and other attribute information at each stage of the hydrogen supply chain. This will help facilitate hydrogen transactions and the application of such information and the non-financial disclosures of all parties involved. In this way, we will help realize a hydrogen-based society by not only providing physical infrastructure such as liquefied hydrogen carriers and liquefied hydrogen tanks, but also by contributing to the early establishment of an international liquefied hydrogen supply chain by collaborating with third-party certification organizations and other related parties on the non-physical side.

Given that this presentation concerns Kawasaki's year end results, I would like to take a look at ESG related topics. In this first slide I will explain our framework for providing support packages corresponding to the various phases of disaster relief. We have applied this framework in cooperation with national and local governments in response to recent large scale disasters. When the Noto Peninsula earthquake struck in January of this year, we not only made a monetary donation but also transported supplies using our Z-Leg helicopter arrangement service. We also introduced a volunteer leave system that lets our employees participate in disaster relief volunteer activities. By continuing to develop systems for promptly responding to large scale disasters, including those I just mentioned, we will take proactive actions as a company that swiftly addresses changing social issues.

Next, I would like to give an overview of our revised executive compensation system and explain its objectives. The revised system includes a reduction in the component paid in fixed amounts and an increase in the amount paid based on performance, which varies depending on net income and level of target achievement. We also added to our performance evaluation indicators by bringing in items linked to employee engagement indicators and contributions to CO2 emissions reduction. By doing so, we aim to accelerate efforts to reform our corporate culture and work toward a de-carbonized society. We also introduced a stock price index as a long-term incentive to strengthen awareness oriented toward higher corporate value. The ratio of fixed, short term and long term shares was previously five to three to two. However, in the case of the president, for example, the ratio becomes one to one to one at the current stock price level as a result of this revision. Through the new system, we are committing ourselves to better value sharing with our shareholders and other stakeholders and to improving our corporate value over the medium to long term.

Next, I would like to mention that Kawasaki has been certified as an A List Company for the second consecutive year by CDP, one of the world's leading ESG evaluation organizations. CDP assesses strategies for addressing climate change and efforts to reduce CO2 emissions. A List Company is its highest rating. We believe this rating in CDP's climate change report is recognition of our proactive efforts and transparency of disclosure and performance. We are the only company in the shipbuilding and heavy equipment sector to receive the A List ranking in two consecutive years. We will continue to contribute to the early realization of a de-carbonized society by providing solutions aimed at achieving carbon neutrality.

In addition, the Kawasaki report we issued last year was selected by the Government Pension Investment Fund as an example of a highly improved integrated report. It also won our first award for excellence at the Nikkei Integrated Report Awards. The Kawasaki report contains information on major ESG topics for fiscal year 2023. I encourage you to take a look at it. The following pages provide information on capital investment, depreciation and amortization, research and development expenses, the number of employees at the end of the fiscal year, and other information for reference. Beginning with this report, actual and forecast orders received and revenue for Ministry of Defense will be presented on page 44. Please refer to that page for the pertinent information.

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This concludes my explanation.

Yasuhiko Hashimoto

I am President Hashimoto. I will now explain the specifics of our announcement of financial results for fiscal year 2023 and the outlook for achieving a business profit margin of 10% as described in our Group Vision 2030. First, in financial results for fiscal year 2023, there was year-on-year growth in sales but a decrease in profits. This was due to the recording of expenses pertaining to the PW1100G-JM engine. Had it not been for this item, I believe we would have achieved our highest ever profits with business profits for Aerospace Systems recovering to pre-COVID levels and company-wide business profits exceeding about ¥100 billion.

Now, let's look at each business sector. In our made [Phonetic] to order business, major contributors to increased profits included not only Aerospace Systems, but also Energy Solution & Marine, in particular improved profitability of our Ship & Offshore structure business. Factors underlying this are a strong improvement in profits due not only to favorable performance of the shipbuilding business of our equity method affiliate in China, but also to the start in Japan of continuous construction of 13 LPG ammonia carriers. For Rolling Stock, profits have stabilized due to the shift to full scale mass production of the R211 project for the New York subway. In our mass production business, on the other hand, Precision Machinery & Robots booked a loss for fiscal year 2023 due in particular to worsening of the market in China. However, starting from this fiscal year, our previous efforts to pass through prices and reduce costs should contribute to improving profits.

In the Chinese construction machinery market, progress has been made in clearing out inventory and orders this year are expected to exceed those of last year. We also expect to see growth in our semiconductor robot business and make steady improvements in other areas. In our Powersports & Engine business, we expect to see strong growth in our four wheel business due to the start of operations at our new plant in Mexico. Our defense business has recently been garnering attention and we are performing at a level higher than indicated at last year's Group Vision 2030 progress report meeting. For example, we have seen greatly increased orders in both fiscal year 2023 and 2024. In light of these circumstances, we expect as the outlook for our company's results in fiscal year 2024, presented today to set new all time records for orders received, sales, profit and dividends, however, the business profit margin of 5.8% will only slightly exceed the figure of 5%, which our company has set as a minimum. As we move toward realizing our Group Vision 2030, we will strive through our business to achieve a business profit margin of 8% in fiscal year 2027 and a business profit margin of at least 10% in all business fields in 2030. We hope you will provide us with even greater guidance and encouragement in the future.

Thank you for listening.

Question-and-Answer Session

End of Q&A

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