Yokogawa Electric Corporation
Financial Results for 1st Quarter of Fiscal Year 2020

August 12, 2020
**Event Summary**

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Hitoshi Nara President and Chief Executive Officer
Junichi Anabuki Director, Executive Vice President, Corporate Administration Headquarters
Toshitaka Kobayashi General Manager, Investors Relations Department

**Presentation**

**Kobayashi:** Hello, everyone. This is Kobayashi of Yokogawa Electric. Thank you for participating in the conference call today despite your busy schedules.

The speakers in today’s conference call are Hitoshi Nara, President and CEO; and Junichi Anabuki, Director and Executive Vice President of the Corporate Administration Headquarters.

Anabuki will first give an overview of the results for the first quarter, followed by an explanation of the business forecasts. After that, Nara will provide a presentation centered on the basic policy for FY2020. We’ll have a Q&A session after Nara’s presentation.

Today’s presentation materials are available through the Tokyo Stock Exchange and on our corporate website, so we hope you will take a look at them. Let’s begin.
Anabuki: This is Anabuki of Yokogawa Electric. I’ll explain the business results in the first quarter according to the presentation materials.

On page four, we posted the key points of this quarter.

In Q1, sales declined, but operating income was on par with the previous year. Sales declined due to the impact of COVID-19 and foreign exchange rates, while operating income was on par with the previous year thanks to improvements in the gross margin and reductions in SG&A expenses. Profit attributable to owners of parent increased.

By segment, the Control segment posted lower sales but higher profit. In terms of organic growth, which excludes the impact of foreign exchange rates and the transfer of subsidiary shares during the previous fiscal year, orders were down 17.3%, sales were down 4.8%, and operating income was up 8.5%.

The Measurement segment posted higher sales and lower profit. The Aviation and Other segment posted lower sales and profits.

By region, business was tough across all regions, but Central and South America put up a good fight in terms of orders, while China also fought well in terms of sales.

By industry, the large project orders are down from the previous year. In addition, we saw an impact from COVID-19, resulting in tough conditions, mainly in energy-related industries.
As for our full-year forecasts, we had left the forecasts undecided at the time of announcing full-year earnings for FY2019. As a result of comprehensively considering the tough business environment, we have disclosed a forecast by range format this time, and we expect a decrease in both sales and profit.

We aim to distribute the same amounts of dividends as last year.
On page five, we give a summary of Q1 FY2020 results in a chart that compares the results with Q1 FY2019.

Orders came to JPY83.1 billion, sales to JPY82 billion, operating income to JPY6.4 billion, and profit attributable to owners of parent to JPY3 billion. Compared to the previous fiscal year, orders were down JPY21.1 billion, sales were down JPY8.3 billion, operating income was down JPY0.2 billion, and profit attributable to owners of parent shareholders was up JPY0.9 billion.

Impact of exchange rate and transfer subsidiary’s shares were JPY4.7 billion on orders and JPY4.1 billion on sales. Organic growth excluding these factors were orders down 15.9% and sales down 4.7%

Operating income was down JPY0.2 billion from last year, but profit attributable to owners of parent was up JPY0.9 billion. The increase in profit attributable to owners of parent was due to reflecting the dropout of inflated extraordinary losses booked last year.
On page six we show an analysis of factors moving operating income.

The impact of a lower gross profit on decreased sales that pushed down profit by JPY1.9 billion, but the gross profit margin improved. Other factors affecting profit were a reduction in SG&A expenses and other cost reductions, resulting in operating income of JPY6.9 billion. Although operating income exceeded the year-earlier level on organic basis, the impact of foreign exchange rates ultimately had a roughly JPY0.5 billion impact yielding a JPY0.2 billion decline in operating income.
On page seven, we show the business performance by segment.

The Control segment has largely moved in tandem with Company-wide performance. Both orders and sales include the impact of COVID-19, as well as foreign exchange rates and the dropout of a large job booked in the previous year. In terms of organic growth, excluding the impact of foreign exchange rates and the transfer of subsidiary shares, the Control segment posted negative orders growth of 17.3% and negative sales growth of 4.8%. Operating income increased on a higher gross profit margin and lower SG&A expenses.

The Measurement segment shows that sales were solid. But due to the impact of upfront investments in the Life Innovation business, the segment posted higher sales and lower profit, continuing a trend similar to last year.

The Aviation and Other segment experienced sluggish demand for aviation-related equipment, resulting in decreased sales and profit.
Next, on page eight, we show a chart on orders and sales by region in the Control segment.

As a whole, as I mentioned earlier, organic orders decreased by 17.3%, JPY16.4 billion. If you look by region, orders have swung sharply into negative territory except for Central and South America. Region-wise, a significant slump was observed in India and North America. These are regions that have been hit especially hard by lockdowns. Orders in Japan were also down by more than 10%, indicating the heavy impact felt in Q1.

As for sales growth, the overall organic growth rate was negative 4.8% or a contraction of JPY4 billion in sales. Comparing sales by region on an organic basis, overall sales were down, excluding the relatively solid sales in China.
Next, on page nine, we describe orders by industry in the Control segment.

We have shown the quarterly trend starting with Q1 FY2019 orders on the very left. Upstream and downstream orders experienced sharp declines, especially in terms of energy-related orders. These industries were factors negatively affecting overall orders.
On page 10, we indicate our forecast range for business results, which we had left undecided previously.

Unfortunately, we are still unable to have a clear outlook on the external environment. Nonetheless, we have formulated our forecasts based on the assumption that results have bottomed in Q1 FY2020. Our basic scenario is that the economy will head for a gradual recovery towards the end of the fiscal year while striking a good balance between the gas pedal and brakes, whereby the gas pedal is the reopening of the economy and the brakes are measures to prevent the spread of COVID-19.

Each country will skillfully steer their economies by stepping on the gas and brakes as necessary. We expect that these conditions will last until the end of the year. As such, I think it will be an L-shaped recovery. It won’t be a V-shaped recovery, but instead a more gradual one. Meanwhile, it’s worth noting that concerns over a second wave of COVID-19 are already sprouting up across Japan and various other countries. However, the forecast range we provided this time doesn’t assume a second wave having a significant impact, such as forcing countries to have even stricter lockdowns and, thus, stagnating economies.

We estimate for the crude oil price would be somewhere between USD30 and USD40. We think this price range will persist probably through the end of the fiscal year, and that is the economic environment or macroeconomic moves on which we have formulated our forecasts.

Against this backdrop, we forecast orders between JPY350 billion and JPY380 billion, sales between JPY360 billion and JPY390 billion, operating income between JPY23 billion and JPY30 billion, and profit attributable to owners of parent between JPY14 billion and JPY19 billion. Given the current circumstances, we had no choice but to give our forecasts in ranges.
On the next page, we have written out a little more detail about our thoughts behind the forecasts by segment.

In the Control segment, as for system projects, we think investment decisions by customers will be delayed owing to a drop in energy demand, considering the current macroeconomic conditions. Although cancellations have thus far been sparse, there has continued to be delays overall. Under such circumstances, we have also seen an intensification of price competition, mainly in the system project business overseas. As a result, we expect orders to decline considerably.

Domestically, we saw a decline in orders in Q1 of more than 10% compared to the previous year. We assume that orders in Japan will head for a moderate recovery, given the resumption of economic activities to a large extent. But we think there are slight remnants of concern lingering around the possibility of a second wave of infections.

In the product business, we are seeing a certain degree of inquiries in the MRO and other business, and are relatively steady. But the impact of COVID-19 has continued to surface in North America, India, and other regions.

The sharpest declines in terms of growth rate have been seen in the consulting business. Strong impact has been felt in our face-to-face business model due to travel restrictions. Thus, KBC business remains tough. However, some numbers in Q1 point to gradual improvement, and we expect a recovery to some extent.

Region-wise, we think these impacts will be widespread, except for China, Japan, and Central and South America. Forecasts have been difficult to make, but based on these considerations, we have decided to disclose target ranges.
As for sales, we started with a considerable amount of order backlog. But, as described earlier, orders have been contracting, and progress on ordered projects is likely to be delayed as in Q1. Such delays could be a risk to achieving our forecasts.

As for operating income and other profits, the current spike in logistic costs, such as seen in air cargo due to reduced flights have had an impact. Intensifying price competition could also lead to a narrower gross profit margin. We’ve been working hard to maintain or increase the gross profit margin. Rapid efforts are being made internally that helped improve the gross profit margin in Q1, but projecting how far improvements can be made despite the challenging business environment is unclear. Efforts are being made group-wide to rigorously cut costs. On the other hand, I think that remote compatibility will be a key word in the future. Expenses will be allocated strategically for our business in the world with COVID and after COVID. Our policy is to continue to make IT investments with our eyes set on the post-pandemic world. At the same time, unnecessary costs will be eliminated while maintaining strategic expenses.

We’ve seen steady orders from China in terms of the measuring instruments business in the Measurement segment. But orders have worsened in all other regions, so we forecast a decline in orders. On the other hand, we are expecting the life science business, which is a pharmaceutical business, handling products such as confocal microscopes, will trend solidly.

Lastly, in terms of our Aviation and Other segment, we forecast that there will be a certain and considerable impact on the performance of the aircraft industry. We are braced for a considerable decline in this business.

That’s all for our outlook on this fiscal year.
On the next page, we have graphs that show our forecasts by segment for your reference.
Lastly, in terms of shareholder returns, we decided that we will maintain our annual dividend of JPY34 per share which is the same amount in the previous year despite the lack of clarity around the business environment. We based this decision on a comprehensive consideration of multiple factors, including the business forecasts that we disclosed, our financial standing, our cash flow status, as well as our dividend policy. Although we had left our dividend forecast undecided in the spring, we have decided to issue a forecast this time.

This concludes my explanation.

Kobayashi: Next, we’ll have a presentation by Nara.

Nara: Hello, everyone. This is Nara of Yokogawa Electric. Thank you for participating today despite your busy schedules.

As Anabuki explained just now, we expect a heavy impact from COVID-19 on our business this year, and it’s very difficult to forecast how the business will perform going forward. That said, we also see new business opportunities for the Company stemming from the emergence of social issues that have been brought to light by COVID-19. I’d like to talk about two points: the basic policy for this fiscal year and remotization or the so-called remote demand that is rapidly expanding right now, including the background behind those two points, the progress we’re making in business activities, and our future direction.
First, shown on page 23 is the basic policy for FY2020 that I explained in May. This year is the final year of TF2020, and we’re making efforts according to four main policies while completion of measures and reaping of benefits.

The first policy is to set forth and review the priorities of TF2020 measures we have been promoting. The second policy is to achieve further cost reductions through Group-wide optimization. The third policy is to remain fiscally strong. And the fourth policy is to position our business for the post-COVID-19 world, or in other words, to respond to the changes in social needs.

Based on these four policies, today, I would like to talk about the latest conditions surrounding the promotion of remotization and autonomy as well as their expanding requirements on the next slide, focusing on our company’s initiatives to respond to those changes.
First, page 24, the reason behind the expanding demand of late has been the review of plant operations to counter the spread of COVID-19. In other words, demand for the remote operation of factory facilities and services to support maintenance has increased in order to protect the health and safety of customer employees as a countermeasure against crowding in confined spaces.

Remote needs from customers have existed before, and we focused on expanding our OPEX business, such as product development and M&A. However, I get the impression that demand is rapidly expanding even further due to COVID-19.

Our measures in response to this have been to first strengthen our sales activities. Specifically, we have been actively holding webinars and virtual exhibitions to increase business opportunities. For instance, partly as a result of that, the number of inquiries for remote maintenance services has doubled from the previous year. Although the ratio is not high in value, we think it will contribute to improving earnings going forward.

We also have a full lineup of remote solutions. In the past, we used cloud engineering solutions in Bangalore, India, to improve the efficiency of both customers and our own Company. Furthermore, in terms of factory acceptance tests (FAT), so-cold witness inspection, the mainstream method of face-to-face inspections is starting to shift to remote inspections. Project managers, engineers, and others are all starting to be able to conduct tasks remotely.
For example, such as by putting the actual machine in India, and connecting it to Singapore and Japan to conduct the FAT, the overall efficiency of projects is increasing and customers have also been very happy with this process. This is the case of monitoring from the head office or the case of harsh sites such as difficult to access locations in high altitudes of 4,000 meters or in extremely harsh working environments.

By doing so, I think we are able to display to the greatest extent possible the trust we have earned from “Do not stop” and “Do not escape”. Although there is much to be improved in terms of the lineup and resources, we intend to continue to carry out these activities with the enthusiasm to become a global leading provider in the world of remotization and autonomy, we call IA2IA, by building relationships of trust through our global structure and robust customer base.
Lastly, page 25, I would like to explain our direction on this slide, which we also shared with you last time.

Yokogawa is a resilient company with the power to withstand COVID-19.

Yokogawa’s business is centered on areas that will grow in the post-COVID-19 world.

We are set on building a sustainable society and creating new opportunities for growth.

We ask all of you, including shareholders and investors, for your continued support.

Thank you for your attention.
Question & Answer

Q: In the analysis of operating income in Q1, could you tell us a little more about the reasons why the gross margin improved and SG&A expenses decreased in Q1? Also, please tell us if we should expect this to be sustained in Q2 onwards. We’d like to know your views for the full year.

A: We believe we performed well in the current competitive environment for gross margin in Q1. A relatively high degree of contribution came from domestic operations. Activities to reduce costs and improving efficiency in order to secure the gross margin have been quite successful. On the other hand, temporary factors such as sales of JOBs with high gross margins were included, so we cannot say with confidence that the improvement in gross margins will continue after 2Q on the same scale as in 1Q. However, we have a response that we have been able to improve our gross margin even in such a severe environment as this one in Q1, so we will continue our efforts to improve our gross margin.

As for SG&A expenses, the greatest contribution came from travel expenses decrease and entertainment expenses decrease which were associated with travel restrictions. Separately, we reviewed non-urgent activities. These efforts have contributed to cost reductions. In addition, government subsidies around the world were also included as reversals of SG&A expenses, so that has also played a part in the lower SG&A expenses. On the contrary, once the economy reopens and orders start moving again, SG&A expenses will increase as activity expenses, so we do not think that a decrease in SG&A expenses of the same scale will continue after 2Q.

Q: Regarding the investment stance of customers, could you explain your outlook by region and industry?

A: The reason why we have decided to disclose our earnings forecast in ranges is difficult to read the investment trends of our customers because they do not seem to have established management policies yet. We have the impression that new business conversations are starting gradually as economic activities reopen after the bottom of April and May, but we still do not have an idea of the timing in which inquiries will translate into orders.

Under this business environment, major customers of our clients in the upstream and downstream industries have announced that they will reduce their capital investment by 20% to 30%. Thus, we think the impact may be greater in Southeast Asia and the Middle East, where energy-related industries are strong. As for North America, conditions are bad right now even when looking at information on competitors in terms of North America, we think this is a region with a large degree of risk. On the other hand, although the figures are small, the food and pharmaceutical industries have shown very strong growth.

Q: Could you tell us the size of the remote demand?

A: There was already demand for remote from major accounts, but COVID-19 has stoked this demand further, resulting in a considerable increase in demand for remote operations from customers in various industries. The number of inquiries related to remote operations has doubled from last year, though we haven’t aggregated the exact amount yet.
Q: Under extraordinary losses, there are loss on retirement of non-current assets amounting to JPY0.9 billion. Please explain the content of these costs. Also, are you expecting the similar items included in the full-year forecast?

A: This is not an impairment loss. Under promoting our transformation, this is a temporary expense that will be necessary mainly in the course of reforming our cost structure overseas. This is not a major extraordinary loss in the full-year forecast.

Q: For almost the past six years, you have continued to state that the keyword is transformation, but I think the current business environment surrounding your company is also changing. I think a new medium-term plan will start from next year, what do you think will be important in the next medium-term plan?

A: Under the new medium-term management plan, we will continue to accelerate transformation to increase our corporate value and increase our degree of contribution to society.

We think the most important thing is to transform the Company into one that is ready to compete on equal footing with global competitors. We have a strong trust relationship with our customers, a strong customer base including installed base, and a global support structure. With COVID-19, there are many things that can be done remotely, but ultimately there will be situations where we have to support customers on the ground, so we are in a position to work closely with and contribute to customers through our stance.

Yokogawa is a company that has always been very strong in operational technology or OT at manufacturing sites. We aim to leverage our main knowledge in OT and blend that with IT to draw on DX to enhance our value and the value of customers. Ultimately, we think this is what will contribute to social value.

In particular, we feel that the thinking about existing plants and new plants have recently changed a little among customers. As for existing plants, customers are now very concerned about how to improve the efficiency of site operations, how to ensure occupational safety, and how to operate them without human intervention. For new plants, we are faced with the challenge of how to simplify facilities and operate autonomous plants through unmanned operations. For us, this means that we must think of how to provide solutions and contribute to the existing plants, Simultaneously, we intend to propose the simplification of operations and facilities through autonomous operations for new projects that will emerge going forward.

Q: As for gross margin, you explained that you were able to control and improve costs mainly in Japan in the 1Q. I believe you also explained your outlook for the current fiscal year that there is a risk of a deterioration in the gross profit stemming from a slight worsening of conditions pertaining to COVID-19 and the intensification of price competition. I’d like to know if you’ve already factored in the impact of the gross profit margin as a negative impact on profit in the current fiscal year? Please tell us about the concept of gross profit margin for the full year, considering the competitive situation.

A: While many companies are posting lower sales and profits, we are also facing an extremely difficult business environment not only in Japan but globally, just as in the time when the Lehman crisis occurred, demand for lower prices through cost reductions has been strong overall. At the moment, there are few cancellations of JOB, but we think competition will become fiercer in the industry against the backdrop of delayed decisions overall concerning these jobs.

While we have incorporated these factors into our full-year forecasts to some extent, we believe that we can cover them to some extent through activities to secure gross profit such as cost reductions in engineering,
efficiency improvements, and cost reductions through intensive purchasing of procured items, in which we have been focusing on over the last few years and in which we have delivered a certain degree of results in Q1.

Accordingly, we expect that price competition will have some impact, but we believe will be able to cover it through cost reduction and other activities.

Q: With the expansion of COVID -19, more companies are becoming interested in ESG. The oil majors are starting to actively announce message to the public that they will reduce crude oil and gas production by 40% by 2030. By the time we get over COVID -19, I think we will enter an era in which the number of conventional plants will decline. What kind of world do you have in mind and what kind of discussion do you have for your company’s next medium-term management plan?

A: Our view is that the prevailing conditions still allow the production of oil, but various trends in relation to ESG will certainly lead to a reduction in demand.

But there are regional differences. The European energy company, for example, has declared a shift to renewable energy, and they’ve already decided to only keep the refineries that are competitive and to close the rest. On the other hand, I have an impression that the oil majors in the United States are still working hard on oil.

Thus, from the perspective of the oil industry, I think there will be investments in optimization and streamlining to generate cash aimed at survival in competitive refineries. As for that, we would like to continue our conventional business.

From the perspective of renewable energy, our core competencies of measurement, control, and information are shared axes, and can be used in all industries and in manufacturing. Although we have worked relatively hard in the oil majors, our future vision for taking the next step is leveraging our core competencies and also influencing customers in industries other than oil. With this in mind, we are discussing the following long-term and mid-term plans.

Q: I think the trend towards decarbonization is also having an overlapping impact on LNG, how about the situation of LNG?

A: There has been an impact on LNG as well, but we think LNG is still expected to continue as a low-carbon hydro fuel. However, we don’t think there is a strong demand like before.

Q: Is the hydrogen supply chain a business opportunity for your company?

A: Hydrogen is an energy with a very large potential going forward. We’ve already conducted various investigations, and we think this will be a business with a capacity on par with LNG over the long term.

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