CFO message

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Review of FY2023

In fiscal year 2023 (from April 1, 2023 to March 31, 2024), marks the second year of our mid-term management plan, "DANTOTSU Value - *Together to "The Next" for sustainable growth*". we achieved record-high sales and operating profit for the second consecutive year, mainly due to high demand for mining equipment mainly in North America and Oceania and the positive effect of yen depreciation (Figure 1). In addition, cost increases due to inflation and material price hikes were absorbed by improved selling prices, and the operating profit ratio reached a record high of 15.7%, breaking the 14.8% of FY2007 after interval of 16 years (Figure 2).

Figure 1: Business results

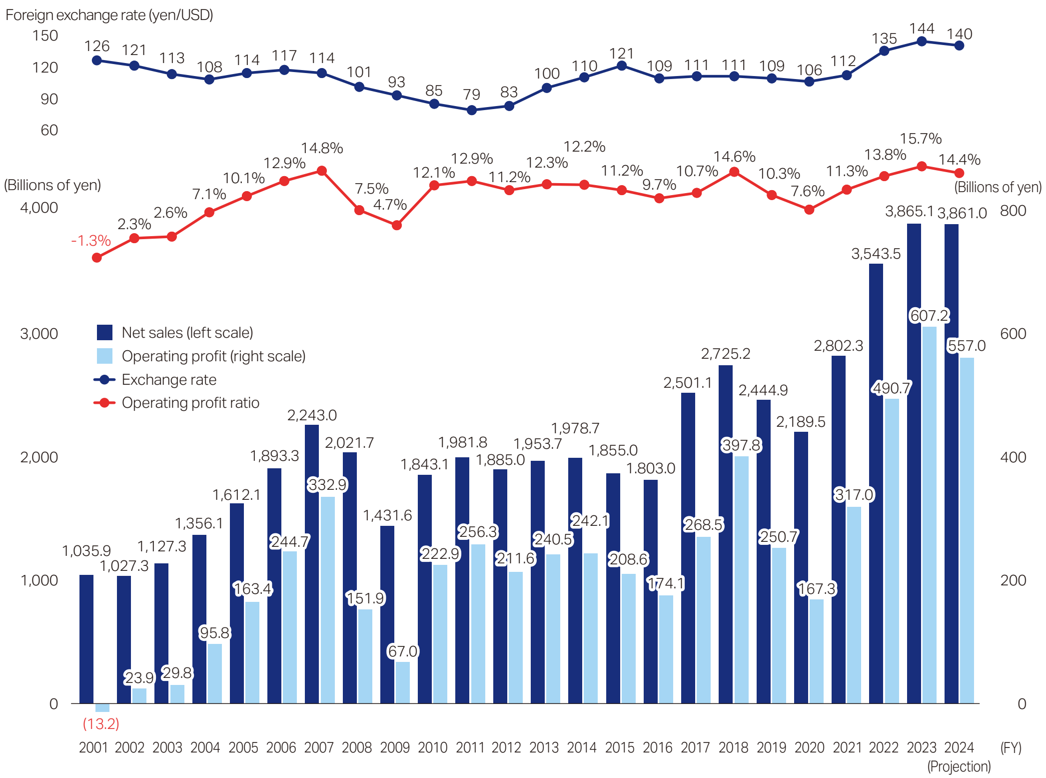
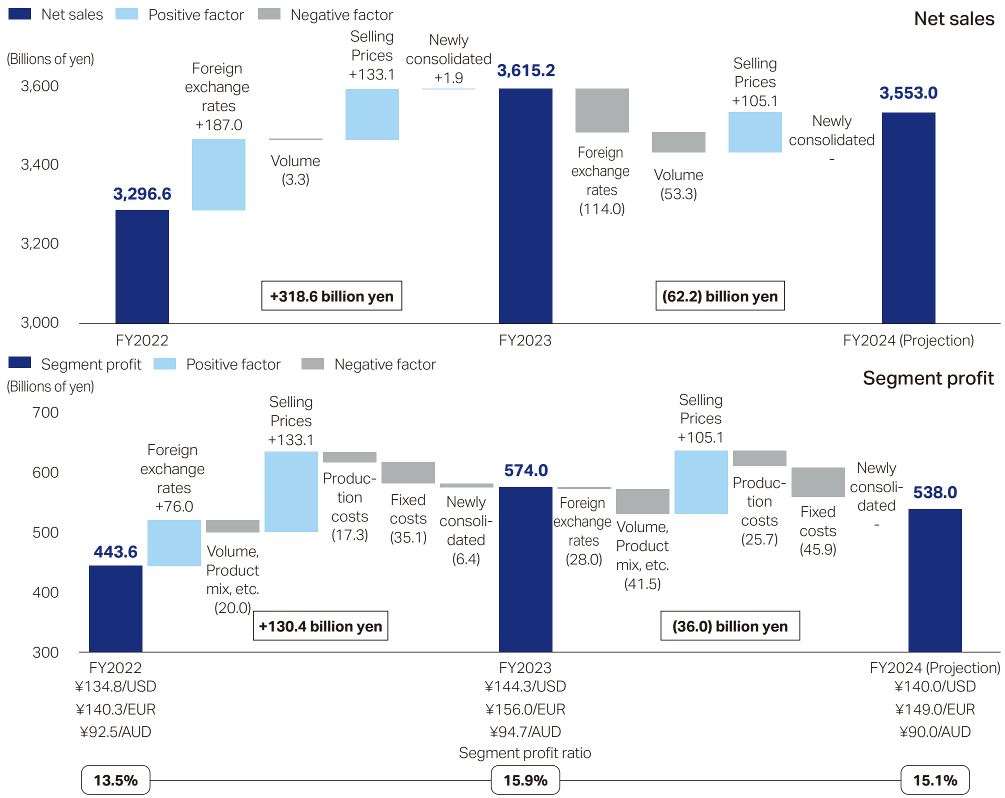


Figure 2: Factors influencing net sales and segment profit in the construction, mining and utility equipment business (FY2022 results - FY2024 projections)



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Outlook for FY2024 (final year of the mid-term management plan)

(1) Selling price increases

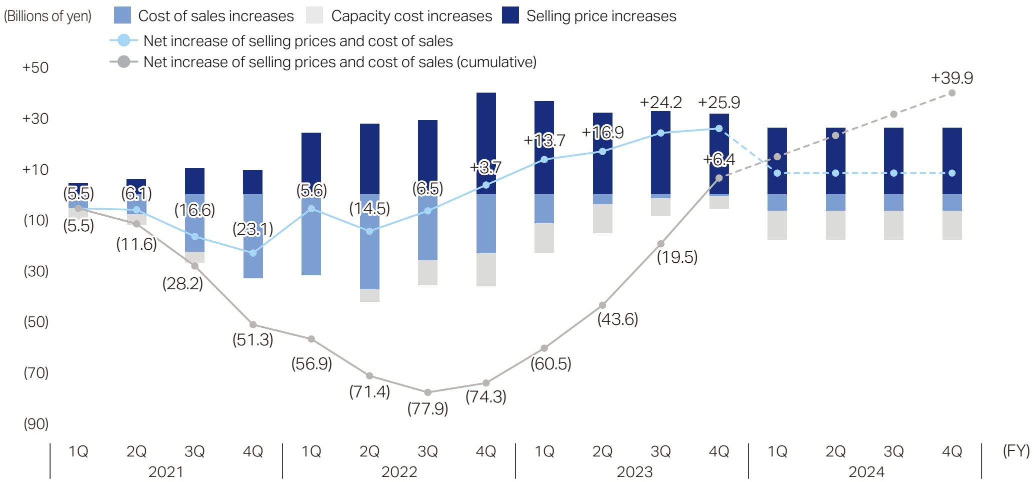
In fiscal year 2024 (from April 1, 2024 to March 31, 2025), we forecast lower sales and profits based on the assumption that the exchange rate will be 140 yen to the US dollar and expectations that demand for construction and mining equipment will decline due to persistently high interest rates and the economic slowdown. However, we plan to increase selling prices further by 100 billion yen, the same level as in the past two years. From FY2023, we began disclosing consolidated profit and loss by location and destination at meetings attended by regional managers, making it possible to compare consolidated profit and loss for each region under the same conditions. These disclosures further incentivized regional managers to increase selling prices. From FY2024, we will link the compensation of the top management of group companies to the consolidated results of each region, thereby further promoting the increase of selling prices .

Comparing the changes in selling price with changes in production costs since FY2021 (Figure 3), the increase in selling price exceeded the increase in production costs cumulatively for the first time in the fourth quarter of FY2023. We will reap the benefits of the increases in selling prices further in FY2024.

(2) Fixed cost control

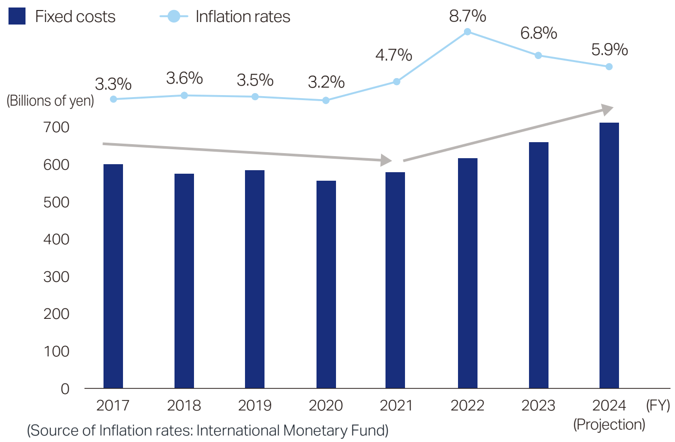
On the other hand, our basic policy regarding fixed costs is to keep them flat, regardless of sales fluctuation. In fact, for the five years from FY2017 to FY2021, despite various changes in the business environment and increases and decreases in sales, Komatsu has controlled fixed costs at a flat level through structural reforms and efficiency improvements. However, from the second half of FY2021, fixed costs increased due to rapid increases in labor costs and expenses against the backdrop of global inflation, in addition to accelerated strategic investments for future growth with an eye to carbon neutrality (Figure 4).

Figure 3: Increase in selling prices and production costs



Fixed costs in FY2024 are also expected to increase due to higher labor costs in each region caused by inflation and growth strategy investments in R&D and other growth areas. The cumulative fixed costs over the three years from FY2022 to FY2024 are expected to increase by more than 100 billion yen. In determining the level of fixed costs, we carefully check the breakeven point and marginal profit margin on an ongoing basis, as well as inflation, cost-effectiveness, and other external environment factors.

Figure 4: Fixed costs and global inflation



(Source of Inflation rates: International Monetary Fund)

Initiatives corporate value improvement

(1) Initiatives PBR improvement

Komatsu breaks down PBR (Price Book-value Ratio) into PER (Price Earnings Ratio) and ROE (Return on Equity). We then break down PER into its components 1) cost of capital and 2) expected cash flow growth rate, and ROE into 3) net income ratio, 4) total assets turnover, and 5) financial leverage. Finally, we compare each item with competitors to discuss and implement measures to improve PBR (Figure 5). In each item from 1) to 5), we explain our initiatives to improve corporate value at Komatsu.

Figure 5: PBR decomposition formula

• Komatsu key initiatives

PBR = PER (A) × ROE (B)

A PER = 1 / (1) Cost of capital − 2) Expected cash flow growth rate)

- 1) Cost of capital
  - Reducing performance volatility through increased sales of parts and services
  - Share buybacks
- 2) Expected cash flow growth rate
  - Investment in growth (R&D, Capital Investment, M&A)
  - Strengthening IR activities

B ROE = 3) Net income ratio × 4) Total assets turnover × 5) Financial leverage

- 3) Net income ratio
  - SVM
  - CC control
  - Selling price increases
- 4) Total assets turnover
  - Introduction of FCF as KPI
- 5) Financial leverage
  - Share buyback
  - Investments in growth (R&D, capital investment, M&A)
  - Strengthening retail finance operations

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1) Cost of capital

We assume that Komatsu's global level of cost of shareholders' equity has been around 8%. We set a management target of ROE of 10% or more, which is higher than the global level, and are work on both improving ROE and reducing cost of shareholders' equity to increase the equity spread (ROE - cost of shareholders' equity). In terms of the cost of capital reduction, our main initiatives are composed of reducing business volatility and conducting share buybacks.

First, in the construction and mining equipment business, we are building a business structure to maintain consistent high revenue without being affected by fluctuations in demand. Specifically, in order to increase the ratio of "parts and service (aftermarket business)," which is expected to generate stable sales volume and high profit margins, we are making operational improvements, such as promoting sales of genuine parts through warranty with maintenance contracts at the time of new car sales (Figure 6).

Secondly, as for share buyback, the Board of Directors fully discusses and establishes criteria for implementation consideration to avoid unbalanced and unsustainable decisions (Figure 7). The two required criteria include financial soundness and the shareholders' equity ratio, while the five supplementary criteria include ROE, free cash flow (FCF), net cash, dividend payout ratio, and PER. The Company resolved to implemented a share buyback program of up to 100 billion yen between April and September 2024 upon comprehensively considering the status of fulfillment of the above criteria.

Figure 6: Distribution of sales in the construction, mining and utility equipment business

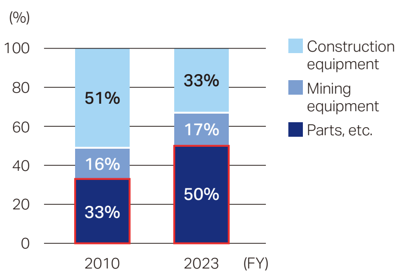

Figure 7: Criteria for share buybacks

	Item	Criteria
Mandatory criteria	1) Financial soundness	Rating
	2) Capital	Shareholders' equity ratio
Supplementary criteria	1) Efficiency	ROE
	2) Ability to generate source of funds (projection)	Consolidated FCF
	3) Ability to generate source of funds (current)	Net cash
	4) Total dividend amount	Dividend payout ratio
	5) PER	Same as left

2) Expected cash flow growth rate

Our internal analysis indicates that this item, "Expected cash flow growth rate," is the one that needs the most improvement compared to competitors. To accelerate growth, Komatsu allocates management resources to growth areas with an emphasis on R&D investments, capital investment, and M&A.

Based on our cash allocation policy, we allocate cash for the following three purposes: (1) capital investments (growth strategies), (2) shareholder returns, and (3) balance sheet improvements (preparation for future M&A activities) (Figure 8). We believe that growth investments are the most important factor to continue stable shareholder returns. To this end, our policy aims to allocate approximately 50% of operating cash flow to capital expenditures and to always be prepared for future M&A.

Figure 8: Basic cash allocation policy for period of mid-term management plan (FY2022–FY2024)

Operating cash flow	Capital investments	Standard investments	35-45%	Allocate around 50% of operating cash flow to investments for growth
		Lease/rental investments	5-15%	
		Total	Around 50%	
	Shareholder returns		Around 40%	Consolidated payout ratio of 40% or more
	Preparation for future M&A		Around 10%	Constant examination of possibility of utilizing external resources

In FY2023, Komatsu acquired American Battery Solutions (ABS), a U.S. battery manufacturer, to accelerate our electrification business and achieve carbon neutrality. We also acquired iVolve, an Australian provider of operation management systems for construction and mining equipment, to create smart and clean workplaces of the future at small and medium-sized mining sites. Komatsu conducts M&A every year and will continue to actively utilize M&A as one of the important means of growth to fill the shortfalls in the future vision of our business portfolio (Figure 9). After conducting acquisitions, we monitor the contribution of the acquired companies on a regular basis to increasing our corporate value by comparing the ROI of the acquired company with WACC and the synergistic effects on our consolidated performance.

Figure 9: M&As executed in FY2019-FY2023 (the construction, mining and utility equipment business)

FY of announcement	Field	Company name	Overview	Location
2019	Underground hard rock mining	Timberock International Ltd.	Manufacture of underground hard rock drilling and bolting products	Canada
	Mining equipment business	Immersive Technologies Pty Ltd.	Mining equipment simulators for training machine operators	Australia
	Forestry equipment business	TimberPro, Inc.	Forestry machine and attachments manufacturer	U.S.A
2021	Mining equipment business	Tramac corporation Ltd.	North American mining equipment attachment distributor	Canada
2022	Underground hard rock mining	GHH Group GmbH*	Manufacture of underground hard rock mining equipment	Germany
		Mine Site Technologies Pty Ltd	Provider of operational optimization platforms for underground mining that leverage communication devices and position tracking systems	Australia
	Forestry equipment business	Bracke Forest AB	Development, manufacture, and sale of application-specific attachments for silviculture	Sweden
2023	Battery manufacturer	American Battery Solutions, Inc.	Development and manufactures a wide variety of heavy-duty and industrial battery packs, using lithium-ion batteries for commercial vehicles	U.S.A
	Surface Mining and Quarrying	iVolve Holdings Pty Ltd	Development and sales of fleet management system for small to mid-tier miners, contractors, and quarries	Australia

*The acquisition completed in 2024.

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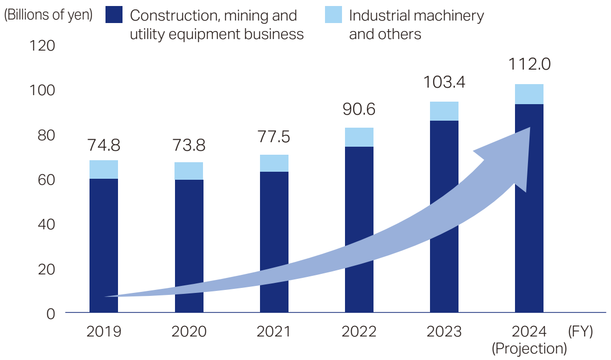
Komatsu aims to reduce CO_2 emission by 50% in 2023 from 2010 levels. We also aim to achieve carbon neutrality by 2050 (challenging goal). To achieve these goals, Komatsu invests heavily in research and development for the future, including for fuel cells, hydrogen engines, and biodiesel engines. We also research and develop hybrid technology, diesel electric, tethered electric, and battery electric, which are already in practical use (Figure 10). These important investment projects are managed separately as mid-term management plan projects. Budgets are allocated to these projects on a priority basis due to the risk that future growth may be significantly impeded if ordinary fixed cost management is applied to reduce these investments.

We will further strengthen our IR activities to clarify the Komatsu growth strategies described above and facilitate understanding among investors.

Figure 10: R&D expenses and major R&D themes



Construction, mining and utility equipment business	New power sources (fuel cells, hydrogen engines, biodiesel, etc.)
	Power agnostic truck
	Mobile battery bank with storage battery functionality
	Open technology platforms for mining
Industrial machinery and others	Light sources for semiconductor lithography system (excimer lasers)

3) Net income ratio

In profitability management, we use direct cost accounting, which clarifies the definitions of variable and fixed cost items and applies them consistently to the entire group, enabling us to compare profitability in each region. This is the basis of our global cross-sourcing operation for production, which enables us to produce products with the same specifications and quality at production bases around the world.

Overseas markets account for 90% of Komatsu's sales, and 70% of our employees work outside of Japan. The number of top management of overseas subsidiaries has also increased to national employees. We keep management indicators as simple as possible so that they can be intuitively understood by diverse nationalities and employees who are not in accounting positions. For example, in profit and loss calculation, we define SVM (Standard Variable Margin), CC (Capacity Cost), and CC headcount (headcount considered as fixed cost) as management indicators to improve profitability through continuous sales price increases, fixed cost management, and cost reduction. We will continue to improve profitability by continuously increasing sales prices, managing fixed costs, and reducing costs.

4) Total asset turnover ratio

Komatsu introduced ROIC in FY2017. To properly manage working capital, we have been monitoring the cash conversion cycle on a regular basis by expanding and implementing the invested capital in the ROIC calculation formula to *working capital + property, plant and equipment*. However, ROIC has the disadvantage that the impact of earnings is so large that the indicator improves even if asset efficiency deteriorates if earnings improve, and that the business units cannot directly perceive the improvement due to the "ratio" display. In addition, the ratio display meant that business divisions could not directly perceive the improvement.

From FY2023, we introduced free cash flow (FCF) as a management indicator for each group company with the aim of further improving ROIC for the entire company. The purpose of this measure is to enable each group company to realize whether its asset efficiency is good or bad in terms of the amount of money rather than the rate.

The plan is to add a twist to the standard cash flow statement and break down the sources of FCF generation into four categories: (1) profit, (2) working capital, (3) fixed assets (depreciation - investment), and (4) M&A. We aim to clarify the sources and absolute amounts that should be improved directly and focus on improvements while maximizing future cash flow. The plan is to maximize future cash flows while focusing on improvements by clarifying the "sources" and "absolute amounts" that should be improved directly (Figure 11).

The plan is to have the managers in charge of each region plot the position of each company on the axis of profit and FCF on a four-quadrant chart to help managers a sense of urgency and drive cash flow generation (Figure 12).

Figure 11: Free cash flow

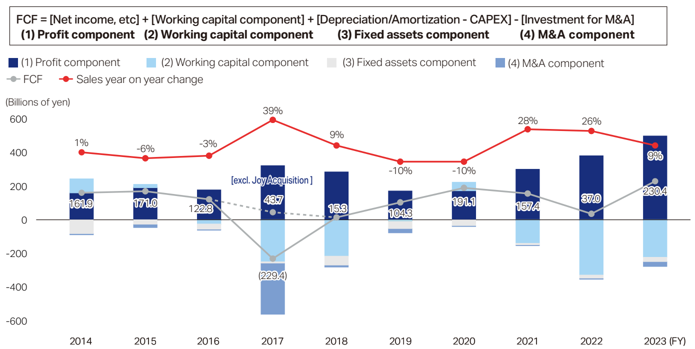
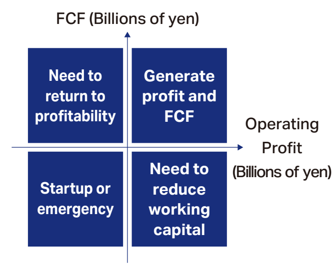


Figure 12: Free cash flow by company four-quadrant graph



5) Financial leverage

In terms of the balance sheet management, we intend to keep our debt at a level that will enable us to maintain our current S&P and Moody's single-A ratings (Figure 13). In FY2023, our rating improved from AA- (stable) to AA (stable) under the R&I rating agency. We believe this is due to the progress in our geographic diversification of sales and the increased depth of earnings derived from the parts and service business (aftermarket business), which is less susceptible to economic downturns.

Regarding dividends, we will continue our policy of maintaining a stable dividend payout ratio of 40% or more on a consolidated basis, taking into account consolidated financial results, future investment plans, cash flow, and other factors. As in the past, we intend to flexibly implement share buybacks based on the comprehensive consideration of fulfillment status of the above criteria. (Figure 14).

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Figure 13: Komatsu ratings

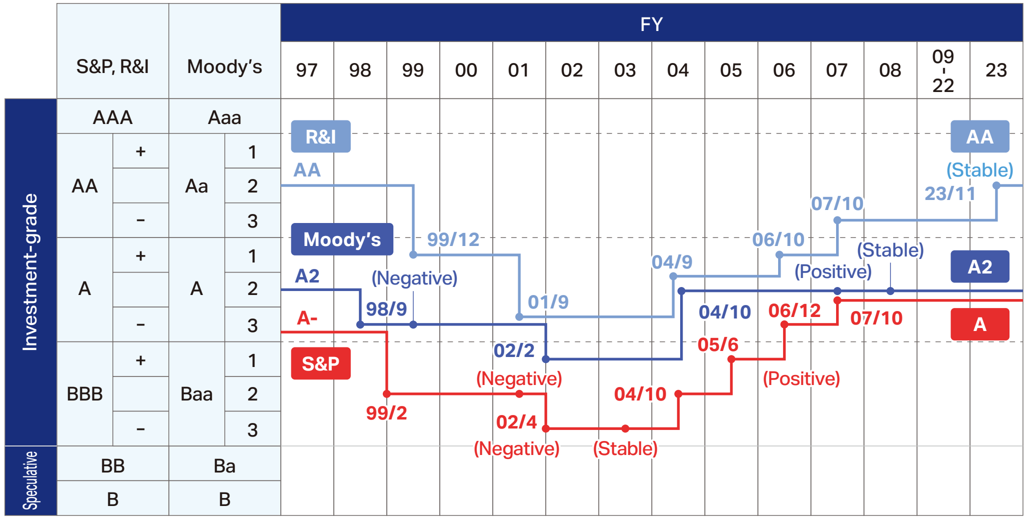
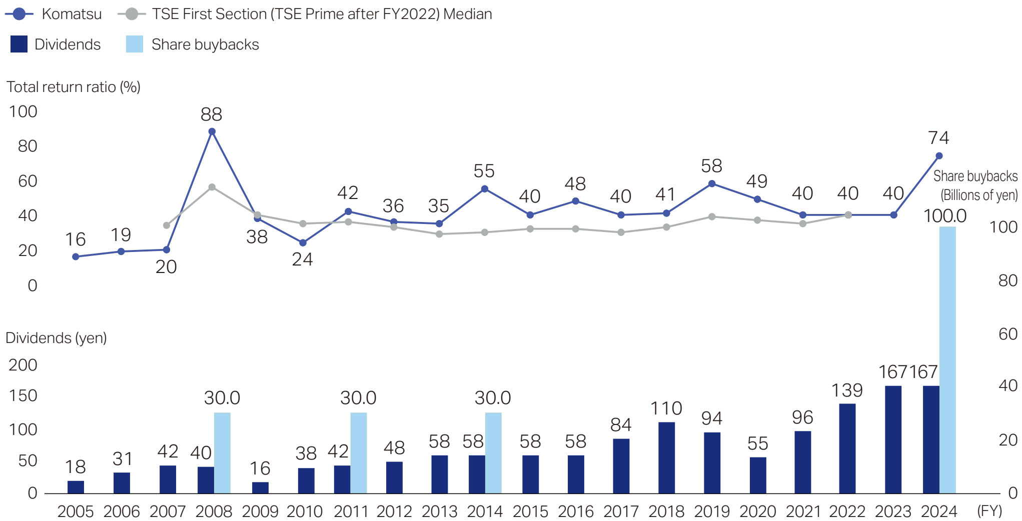


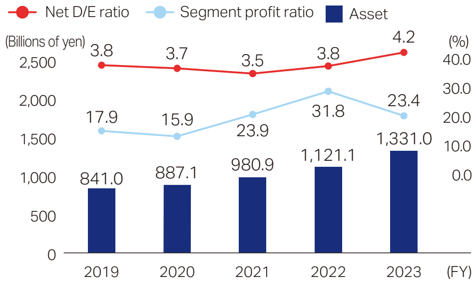
Figure 14: Dividends, share buybacks and total return



Komatsu has regarded our retail finance business as an important sales promotion tool for construction and mining equipment. The business has expanded progressively to strategically important regions, with its asset size increasing 1.6 times over the past five years.

The retail finance business is relatively profitable. Due to its financial nature, the net debt-to-equity ratio of the business is at a higher level than that of the construction equipment and vehicles business. This indicates that Komatsu can improve ROE in two ways: by improving profitability and by expanding financial leverage. We will continue to strengthen our retail finance business while monitoring the soundness of the business (Figure 15).

Figure 15: Retail finance business performance



(2) Verification of corporate value

Komatsu verifies regularly our improvement of corporate value from a finance and accounting perspective using two indicators. One is the total of market capitalization and net interest-bearing debt, which focuses on invested capital. The other method is the cumulative EVA® (Economic value added; net operating profit after tax – cost of capital), which focuses on ROIC and WACC (weighted average cost of capital). In both cases, we confirmed improvement in FY2023.

We also conducted a quantitative analysis of social impact of our core business in FY2023 using Impact-weighted accounts, proposed by Harvard Business School*. We calculated the impact for the Autonomous Haulage System (AHS) and DX Smart Construction, which are priority activities in the mid-term management plan. Our calculations confirmed that we have achieved significant effect. We believe one of the roles of the finance and accounting division is clarify the impact of such ESG investments to help resolve ESG issues and enhance corporate value.

* Joint analysis with ABeam Consulting Ltd. Impact-weighted accounts has evolved from the Harvard Business School's Impact-Weighted Accounts Initiative to now the International Foundation for Valuing Impacts (IFVI).

Figure 16: Changes in corporate value and EVA