# Message from the CFO

## Komatsu is pursuing improvements in corporate value through sustainability management and the growth strategies of the new Mid-term management plan.

**Takeshi Horikoshi**
Director and Senior Executive Officer
CFO

## Review of the previous Mid-term management plan (FY2019–FY2021)

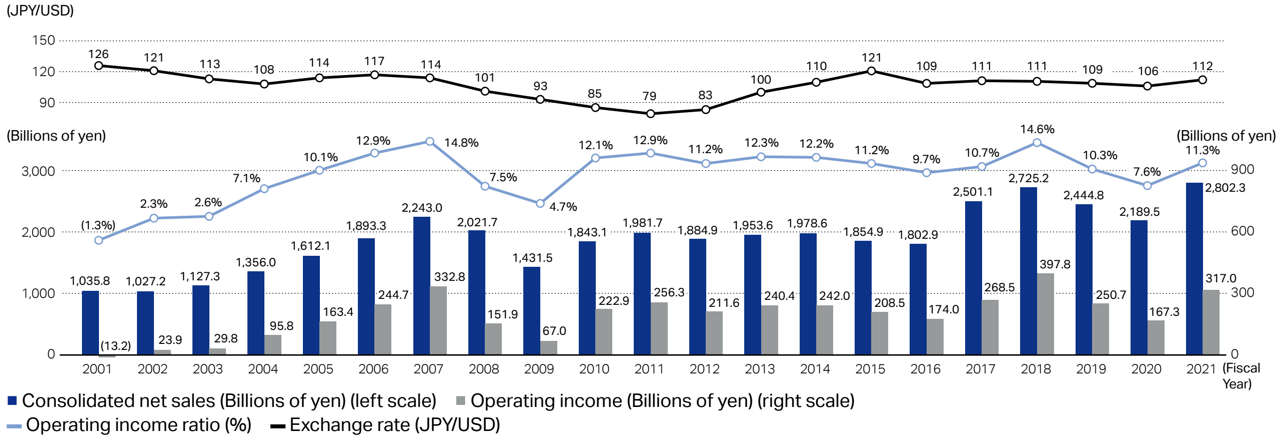
Over the three years of the previous mid-term management plan, we faced a challenging external environment due to the timing of the start of the demand decline and the spread of COVID-19 from the fourth quarter of FY2019. Regardless, we steadily moved forward with the growth strategies and structural reforms prescribed in the mid-term management plan, endeavoring to accomplish our management targets.

Progress toward our financial targets was impeded by the economic stagnancy that resulted from the pandemic as well as by the increased prices of materials and logistic cost that stemmed from shipping container shortages. As a result, improvements to the operating income ratio, an indicator of profitability, were sluggish. We were nonetheless able to achieve a sales growth rate, which illustrates our overall growth, that surpassed the industry average. Moreover, in FY2021, the final year of the previous mid-term management plan, we posted record-breaking net sales of JPY2,802.3 billion. We also reached the level of our management targets with return on equity (ROE), an indicator of efficiency, of 10.9%, higher than our target, and an improved net debt-to-equity ratio, an indicator of our financial position, of 0.28 times.

The retail finance business contributed to sales of construction and mining equipment by further strengthening its ties with customers, one of our strengths as a captive finance, and management targets of 1.5% to 2.0% for return on assets (ROA) and 5.0 or under for net debt-to-equity ratio were accomplished working to safekeep our credit by using KOMTRAX (Komatsu Machine Tracking System which is monitoring on the location and operating conditions of construction equipment ) for credit management.

As for our ESG targets, we made steady progress in improvements for accomplishing our goals for reducing environmental impacts by 2030. In addition, we maintained inclusion in the Dow Jones Sustainability Indices (World & Asia Pacific) and remained on the CDP A List (Climate Change and Water Risk).

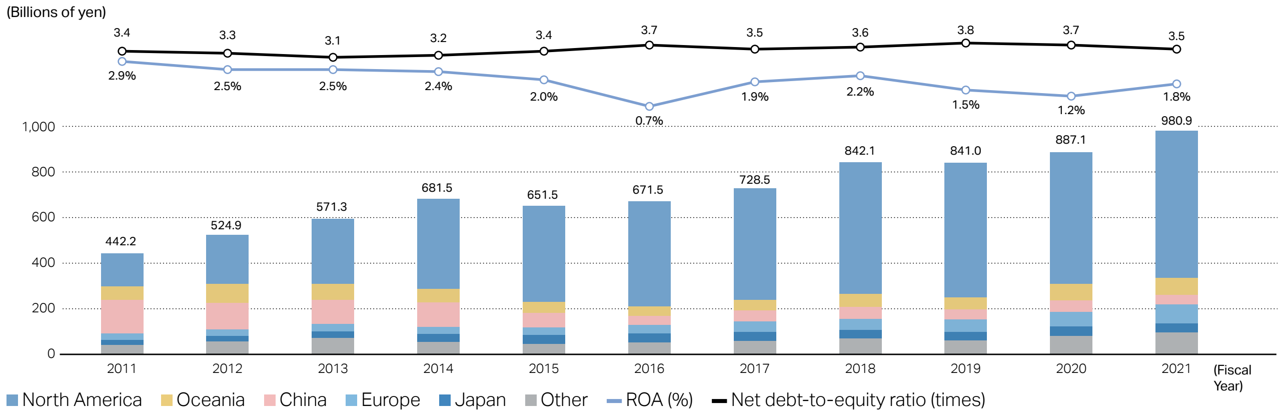
**Figure 1: Business results towards management targets of previous Mid-term management plan**




### Results for management targets of previous Mid-term management plan

| Management target | | | Fiscal Years<br>Index | FY2021<br>Result | FY2019–FY2021<br>Result |
|---|---|---|---|---|---|
| Growth | • Growth rate above the industry's average | | Sales growth rate | 28.0% | 2.4% |
| Profitability | • Industry's top-level operating income ratio | | Operating income ratio | 11.3% | 9.7% |
| Efficiency | • ROE of 10% or higher | | ROE | 10.9% | 8.4% |
| Financial position | • Industry's top-level financial position | | Net debt-to-equity ratio | 0.28 times | 0.35 times |
| Shareholder return | • Keep a fair balance between investment for growth and shareholder return (including stock buyback), while placing main priority on growth investment.<br>• Set the goal of a consolidated payout ratio of 40% or more | | Consolidated payout ratio | 40.3% | 49.0% |
| ESG | • Reduction of environmental impact<br>$CO_2$ emissions:<br>Decrease by 50% in 2030 from 2010<br>Renewable energy use: Increase to 50% of total energy use in 2030 | Reduction of $CO_2$ emissions from product use | Reduction of environmental impact | (19%) | ← |
| | | Reduction of $CO_2$ emissions from production | | (37%) | ← |
| | | Rate of renewable energy use | | 14% | ← |
| | • Evaluation by external organizations | Selected for DJSI (World & Asia Pacific) | Evaluation by external organizations | Selected for DJSI | ← |
| | | CDP A List (Climate Changes and Water Risk) | | CDP Climate Changes: A<br>CDP Water Risk: A | ← |
| Retail finance business | • ROA: 1.5%–2.0% | | ROA | 1.8% | 1.5% |
| | • 5.0 times or under for net debt-to-equity ratio | | Net debt-to-equity ratio | 3.51 times | 3.67 times |

**Figure 2: Assets and results of retail finance business**



## Management targets of new Mid-term management plan (FY2022–FY2024)

In the new mid-term management plan, we have continued to emphasize the previous plan's sustainability management and promote sustainability management with a positive cycle of improvement of earnings and ESG resolutions, we will strive for sustainable growth. We are keeping the same financial targets from previous plan. (please see page 35).

In terms of growth, we chose the sales growth rate as an indicator that will allow us to effectively gauge our position in the industry. Moreover, the target for this indicator has been set to be ambitious enough to place sufficient pressure on management, but we think that this target is necessary for us to continue to grow. The indicator also incorporates our strong desire to continue growing, through both M&A activities and organic growth. To achieve this growth target, the new mid-term management plan calls for us to promote the "Smart Construction Digital Transformation" solution and its overseas expansion, develop and launch electrified vehicles to contribute to carbon neutrality and conduct other investments in growth areas. Our indicator for profitability is the operating income ratio, which is an important indicator for measuring the value of a company. Efforts to improve this ratio will include setting prices for our products that are suited to an industry leader and cutting fixed and other costs. For efficiency, we use ROE, a comprehensive indicator that accounts for profitability, asset efficiency, and financial leverage, as our management indicator. Accordingly, we will remain mindful of cost of equity as we monitor performance. We will continue to use the net debt-to-equity ratio as our indicator for our financial position. A strong financial position is imperative to ongoing growth in the market of the construction and mining equipment business, where demand is highly volatile.

We believe that sustainable growth cannot be achieved with only one of these goals. Accordingly, we will be allocating management resources with the goal of accomplishing these targets in a balanced manner.

Komatsu has not established numerical targets for growth, profitability, and financial position. We have set and disclosed such targets in the past. However, demand is incredibly volatile in the construction and mining equipment business. As a result, past numerical targets had lost their meaning in the first year of the respective three-year plan. Instead of numerical targets, we have therefore chosen to set the targets like achieving a growth rate above the industry's average for growth and the industry's top level for profitability and financial position.

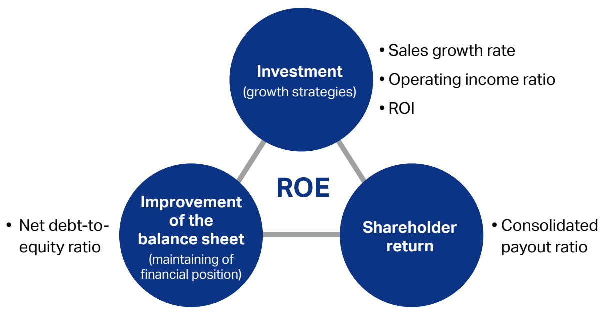
## Shareholder return and cash allocation policies

When thinking about cash allocation, it is first important to look to the expansion of operating cash flows, which generate the funds to be allocated. In addition to growth, through improvements to the sales growth rate and profitability increases via a higher operating income ratio, we also use return on invested capital (ROIC) as an internal indicator for improving ROE. Through exhaustive management of ROIC, we aim to improve asset efficiency.

It is important to allocate cash in a balanced manner to investments, for growth strategies to balance sheet improvements, for maintaining of financial position and to shareholder returns. Given the current health of our balance sheet, We believe that conducting efficient growth investments is of the utmost importance to ensuring that we can continue to provide stable shareholder returns. In fact, more than 50% of operating cash flows is used for investing activities. Investments in growth areas and R&D for building future foundations will be a priority going forward. At the same time, we control capacity cost by reallocating bugets and human resources from existing business areas to growth areas. Moreover, we are looking into the possibility of accelerating projects by utilizing outside resources, through technical partnerships and M&A activities, alongside our own resources, rather than trying to do everything ourselves.

To improve our balance sheet, we are acting in accordance with a policy of limiting borrowings to a level that will allow us to maintain our current single A credit rating. At the same time, we are regularly monitoring the potential amount of additional borrowings in order to prepare for future fluctuations in demand using the criteria one notch higher credit rating.

Figure 3: Cash allocation policy

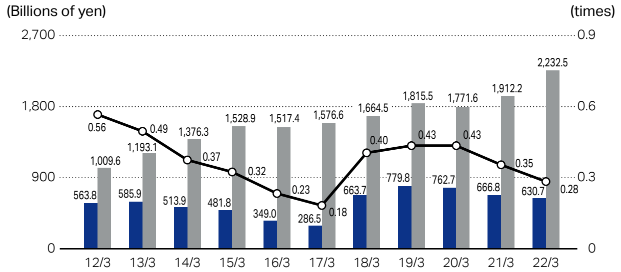



As for dividends, Komatsu will continue to issue stable dividend payments based on comprehensive consideration of factors such as consolidated performance, future investment plans, and cash flows. Specifically, we target a consolidated payout ratio of 40% or more. We will also maintain our prior flexible approach toward stock buyback. Decisions to conduct stock buybuck will be made when there is allowance in our financial position after performing the necessary growth investments and issuing dividends in accordance with the dividend policy. These decisions will be based on an overall assessment of factors like our capacity to generate future cash flows, investment plans, and stock prices.

**Figure 4: Allocation of operating cash flows**

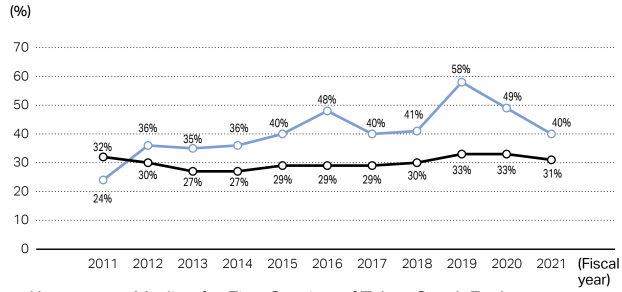
| (Billions of yen) | | 2013–2015 % of total | 2013–2015 Amount | 2016–2018 % of total | 2016–2018 Amount | Excludes acquisition cost of Joy Global % of total | Excludes acquisition cost of Joy Global Amount | 2019–2021 % of total | 2019–2021 Amount |
|---|---|---|---|---|---|---|---|---|---|
| Net cash provided by operating activities | | 100% | 982.7 | 100% | 607.1 | 100% | 607.1 | 100% | 950.3 |
| 1. Investments / Sales | Investments | | (580.8) | | (808.2) | | (492.1) | | (563.5) |
| | Sales | | 82.9 | | 109.9 | | 109.9 | | 65.9 |
| | Subtotal | (51%) | (497.9) | (115%) | (698.2) | (63%) | (382.1) | (52%) | (497.6) |
| 2. Net change in borrowings | | (27%) | (260.9) | 61% | 368.9 | 9% | 52.8 | (5%) | (49.3) |
| 3. Shareholder returns | Dividends | | (160.6) | | (209.5) | | (209.5) | | (234.4) |
| | Stock Buyback | | (30.0) | | — | | — | | — |
| | Subtotal | (19%) | (190.6) | (35%) | (209.5) | (35%) | (209.5) | (25%) | (234.4) |
| 4. Others | | (3%) | (33.3) | (11%) | (68.3) | (11%) | (68.3) | (18%) | (169.0) |
| Total | | (100%) | (982.7) | (100%) | (607.1) | (100%) | (607.1) | (100%) | (950.3) |

Figure 5: Net debt-to-equity ratio




■ Net interest-bearing debt = Interest-bearing debt – Cash and equivalents – Time deposits (left scale) ■ Shareholders' equity (left scale)
▬ Net debt to equity ratio (times) (right scale)

Figure 6: Consolidated payout ratio




▬ Komatsu ▬ Median for First Section of Tokyo Stock Exchange

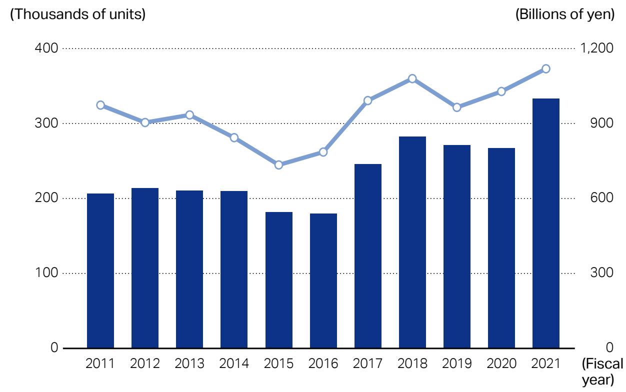
## Current business environment and risk management

### 1. Increased demand and supply chain disruption following decline in impacts of COVID-19

In FY2021, we saw a rapid recovery in demand for the construction and mining equipment following a decline in the impacts of the COVID-19. In FY2022, the demand is expected to show a favorable increase. Meanwhile, the global container ship shortages and disruptions to logistics networks that emerged in 2020 caused a rise in logistics costs as well as delays in shipments. Coupled with the impacts of semiconductor shortages and obstacles to procuring parts, these factors created ongoing difficulty in adjusting production to match changes in demand and sales volumes.

For this reason, we will need to ramp up production to accommodate demand and sales volumes in FY2022. At the same time, we carefully monitor future demand trends so that we can make timely adjustments to production in order to maintain appropriate levels of inventories.

Figure 7: Demand for seven major construction equipment models and inventories




▬ Demand for seven major construction equipment models (Thousands of units) (left scale) ■ Inventories (Billions of yen) (right scale)

## Current business environment and risk management

### 2. Inflation and interest rate increases

The financial authorities of countries worldwide are increasing policy interest rates against the global inflation trend, and these interest rate increases are resulting in higher financing costs. Komatsu's principal capital resources policy is to prioritize stable funding while being careful not to exceed funding demand. Accordingly, we seek to diversify source of funding and repayment schedule based on the guidelines. We has also implemented a global cash management system in which overseas subsidiaries participate to improve consolidated funding efficiency while also serving as a safety net by allowing funds to be distributed to overseas subsidiaries from the head office in Japan in emergency circumstances.

### 3. The depreciation of Yen

Ongoing yen depreciation trend due to differences between the monetary policies of Japan and those of other countries changes in trade balances. Komatsu's basic policy for mitigating exchange rate fluctuation risks is to use natural hedging under its standard operations. We also utilize financial products (derivatives) as necessary to reduce the impacts of rapid fluctuations in exchange rates. As for our balance sheet, we have developed regionally based funding and cash management systems to match assets with liabilities denominated in the same currency (Figure 8). Similarly, for earnings we engage in currency matching for sales and costs by producing the main units of equipment where they will be sold. Development and production of components with a large impact on product quality (engines, hydraulic equipment, electric equipment, etc.) is primarily conducted in Japan. Accordingly, the associated costs are denominated in yen, meaning that yen depreciation can have a short-term positive impact on earnings (Figure 9).

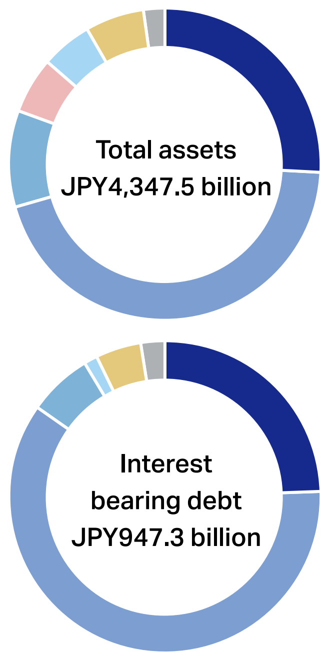
**Financing ratio guidelines (consolidated)**

Direct : Indirect
50 : 50, in principle, maintain within range of 35%–65%

Long-term : Short-term
50 : 50, in principle, maintain within range of 35%–65%

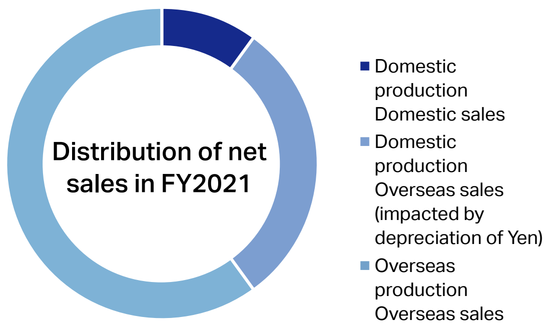
Variable interest : Fixed interest
50 : 50, in principle, maintain within range of 35%–65%

Figure 8: Balance sheet composition (as of March 31, 2022)




■ Japan ■ North America ■ Europe / CIS ■ China ■ Asia
■ Oceania ■ Others

Figure 9: PL impacts of foreign exchange influences (Construction, Mining, and Utility Equipment Segment)




### 4. Growing geopolitical risks

Construction and mining equipment has always been a business with high volatility in demand. Meanwhile, our current external environment features significant geopolitical risk, as seen in the deteriorating relationship between the United States and China and the Ukraine situation. To counter the growing geopolitical risks, we are working to build a corporate constitution that is resilient to fluctuations. We are therefore broadening and diversifying our range of earnings sources by expanding our forestry machine, hard rock mining, and aftermarket businesses.

## ESG targets and new role of accounting and finance divisions

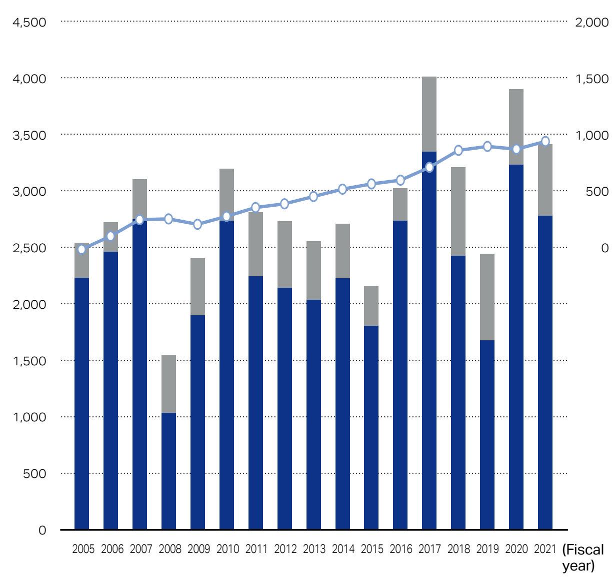
In the new mid-term management plan, Komatsu once again set ESG targets, as it did in the previous mid-term management plan. In addition, the new plan puts forth the challenging goal of achieving carbon neutrality by 2050.

We have also set key performance indicators (KPIs) for promoting the steady progress of initiatives to resolve ESG issues through the three pillars of growth strategies and then we are managing the progress toward these KPI's. (please see page 36,44). Project management divisions will be responsible for confirming the degree of accomplishment of KPIs and the benefits of the associated investments. Accounting and finance divisions, meanwhile, will be tasked with checking to make sure that those benefits are reflected in financial results.

Komatsu issued its first green bonds in July 2020. The projects associated with these bonds were moving ahead as scheduled, and we completed the allocation of the funds of JPY10.0 billion in FY2021. The issuance of these green bonds has provided a new opportunity to promote understanding of Komatsu's initiatives among stakeholders and has resulted in the broadening of our investor base. The amount of ESG bonds issued around the world is growing with each coming year. Some of these are conventional ESG bonds of the same nature as the green bonds of Komatsu, having a limit on the ways that procured funds can be used. At the same time, we are also seeing the emergence of a new type of ESG bond in which interest conditions are tied to the degree of accomplishment of targets for ESG-related KPIs. Such trends in ESG bonds warrant attention from the perspective of diversifying fund sources.

The foundation of Komatsu's management is to maximize its corporate value through the pursuit of "quality and reliability". We believe that "Corporate Value" represents the total sum of trust the general society and our stakeholders place in Komatsu. Since recording an operating loss in FY2001, Komatsu has proceeded to move forward with structural reforms and selective focus on our core business. These efforts have enabled us to grow into a company that is poised to target net sales of JPY 3 trillion. We took an accounting approach toward verifying the long-term improvement to corporate value over this period. In this verification process, We looked at two indicators: the increase in the total of market capitalization and net interest-bearing debt with a focus on invested capital and aggregate EVA® (Economic Value Added; Net Operating Profit After Tax – Cost of capital) with a focus on ROIC and WACC (Weighted Average Cost of Capital). Both of these indicators showed an increase in corporate value equivalent to roughly JPY1 trillion in comparison with FY2005, when economic value added since FY2001 was essentially zero. This increase is indicative of the positive evaluation of stakeholders for the initiatives Komatsu has advanced thus far. However, the recent global rise in interest in ESG means that our external environment is moving to a new stage in which our prior efforts will not be sufficient for realizing further improvements in corporate value. In the future, accounting and finance divisions will need to play a new role in supporting the resolution of ESG issues if Komatsu is to achieve sustainable growth while earning the understanding and support of stakeholders.

Figure 10: Review of corporate value




■ Market capitalization (left scale)
■ Net interest-bearing debt (left scale)
— Aggregate Economic Value Added (right scale)

Details on green bonds are available on Komatsu's corporate website.
https://komatsu.disclosure.site/en/themes/191