Second Quarter of FYE March 2017 Briefing Q&A

November 2, 2016
Fuji Heavy Industries Ltd.

Q ：Please discuss the details of quality costs related to airbag inflators and the present additional quality costs.

A ：SG&A and others are up by -¥150.7 billion in the analysis of year-to-year differences of the full-year plan, and this includes an increase of -¥62 billion in claims costs. As explained when announcing the first quarter results, recall costs related to airbag inflators are anticipated to be approximately ¥60 billion for the year. With ¥17 billion reserved in the previous fiscal year, the increase related to airbag inflators is approximately -¥43 billion. The remainder, approximately ¥20 billion, consists of quality costs other than airbag inflator related costs. Subaru is working to maintain and improve quality with a sense of urgency and keen awareness of the issues.

Q ：What is the inventory level and target of the U.S. sales subsidiary for FYE March 2017?

A ：It is around the same level as the inventory recorded at the end of September, or 48,600 vehicles.

Q ：The full-year U.S. incentive was estimated at $1,300 per vehicle. How will this be controlled in the future?

A ：While the incentive was $900 per vehicle in the previous fiscal year, the anticipated full-year average in the current fiscal year is $1,300, with $1,200 in the first half and $1,400 in the second half of the year. Compared to the industry average of about $3,400, this is still a low level. Also, the present additional incentives consist of reductions in monthly lease payments instead of customer cash (discounts). The proportion of leasing is very high in the sedan market, which includes the Legacy, so the idea is to further raise the proportion of leasing to increase the number of vehicles by reducing the monthly payment as a bit of an incentive. The approach of using cash incentives to increase volume would go against our business model, so we will definitely avoid that as we take care in selling each and every vehicle. While supply capacity in the U.S. is on the rise, we are closely watching sales trends and dealer inventory levels. Dealer inventory has been hovering around 20 days, but I expect that in the future, dealers will be able to keep enough inventory on hand for about one month. The industry average is about two months of inventory, but that would be excessive in Subaru's case, so we will maintain a desirable level of inventory while making fine adjustments in operations.

Q ：As local production at SIA rises to around 400,000 vehicles, what are the plans concerning power train production?

A ：Currently, for production in the U.S., engines are processed in Japan and assembled in the U.S., and transmissions are sent from Japan. Capacity at the Oizumi plant has been gradually increased in response to growth at SIA, which has exceeded expectations, and there is now adequate production capacity even if SIA sales rise to 394,000 vehicles, and then to 430,000 vehicles in FY 2018. So we plan to continue with the current approach, regardless of exchange rates.

Q ：Subaru currently does not provide sales financing, but as sales in the U.S. have risen over 60,000 vehicles in the month of August alone and annual sales are approaching 700,000 vehicles, what is the long-term perspective on this?

A ：We have gotten into the sales financing business only in Japan, and we have outsourced this to partners in the U.S. Every company has its own approach concerning the sales financing business, and there is the concept of actively incorporating profits from the financing business, although in Subaru's case we consider this one means of promoting vehicle sales. It's not that we have decided never ever to handle sales financing in-house, but seeing that our current policy of sales financing with partners is working well with Subaru sales, we are not planning any significant changes at present.

Q ：Previously, there was talk of aiming for about 800,000 vehicles and a 5% share if overall demand in the U.S. rose to 16 million vehicles. Has this thinking changed in the current business environment? Also, it was said that incentives would be strategically increased, but is the estimated incentive of $1,400 per vehicle in the second half of the year an appropriate level in terms of achieving a 5% share?

A ：The concept that we could sell about 800,000 vehicles with a 5% share if overall demand rises to 16 million vehicles is generally still valid. At a U.S. dealer conference that I attended the other day, some were saying that it could go as high as 1 million. Since our company is not rolling out a full lineup of products, our approach is to grow at a gentler pace with respect for each other's business models, rather than trying to suddenly step up sales by leaps and bounds in the next calendar year. We want dealers to earn solid profits and spend them by investing in the service structure. Based on that, I think the incentive of $1,400 per vehicle in the second half is just about right.

Q ：Yesterday, we heard that Toyota will establish a mobility services platform. How is Subaru thinking about this strategically? Will this become a problem for Subaru, as a player on the level of 1 million vehicles, if there are changes in the business environment in the future? What is the outlook on the very long term?

A ：The automotive industry has entered an era of major structural changes, including automated driving, reduced environmental impact, ridesharing, and connectivity. However, the effects of each of these challenges will be different for manufacturers with sales on the order of 10 million vehicles, compared to companies like Subaru with sales on the order of 1 million vehicles. For instance, a transition to ridesharing could lead to a reduction in sales volume, and increased vehicle connectivity could have a larger impact on commodity cars. Since Subaru is a smaller scale company that produces distinctive cars on the order of 1 million vehicles, I think we will need to consider which changes will have the largest impact from Subaru's perspective, and then focus on those according to their order of priority. As Subaru has already announced, we will place a higher priority on trends that are certain to impact every carmaker regardless of size, such as electric vehicles. You asked about ridesharing, and although we will study it, I think it will be fine to take our time with that.

Q ：In the sales volume and mixture in the year-to-year variance analysis of the full-year plan, the amount of upward correction in terms of profit seems large, even if the correction is partly due to upward revision of the number of vehicles. What is the reason for this, the mix of sales regions or pricing of the new Impreza?

A ：In the year-to-year variance analysis of the full-year plan, the sales volume and mixture variance is +¥135.3 billion, including ¥93.1 billion in the overseas new-car business. Last year's overseas sales volume was 812,600 vehicles, and the currently revised quantity is 903,800, an increase of about 91,000 vehicles. In terms of a gross profit rate based on exchange rates of ¥121 in variance analysis from last year, I don't think this increase in the number of vehicles is such a surprising figure.

Q ：How do you consider the role of alliances? And what sorts of opportunities exist?

A ：There are limits to the ability to handle all research and development independently, including the area of reducing environmental impact, and I believe that for small and medium carmakers to survive in the automotive industry, it will be necessary to make alliances with large carmakers whose production is on the order of 10 million vehicles. For the sake of the Japanese automotive industry as well, this would be a very good move as a loose coalition to protect Japanese manufacturing. Japanese carmakers are sources of support for their respective regions, and this is undeniably an important industry for Japan. Therefore, I think it is quite natural and understandable that the move to develop alliances will gather momentum.
Risks may be involved as an integral part of opportunities, but our focus will be on enhancing the Subaru brand. If there are multiple companies with the same business model and they differ in size, the smaller companies will naturally tend to be eliminated. The only way for our company to survive will be to focus on added value, including differences in distinctive qualities, differences in business models, differences in targets, and differences in markets and products. That means we will pour all of our efforts into enhancing the brand strength of Subaru, and to that end, we will change the name of Fuji Heavy Industries and get out of the industrial products business. I do not see any other way for the company to survive.

Q ：While some of the U.S. dealers have expressed high expectations for future sales, that appears to be contradicted by the increase in incentives. Apart from offering preferential interest rates to increase the proportion of leasing, are incentives really rising? What is the target for the proportion of leasing?

A ：Customers have told us that they go to the dealership and can't find cars, and the incentives are very low, and they wonder why Subaru isn't trying harder. The estimated annual average incentive of $1,300 per vehicle is much lower than the industry average of $3,400 per vehicle. Even though the absolute number is rising, I don't think customers see this as a major change. The purpose of the increase is to correct the disproportionately low level of incentives at Subaru, and the intention is definitely not to increase sales volume through cash incentives. Because many Subaru vehicles are SUVs, we do not have a specific target for the proportion of leasing. We want to grow sustainably by taking care with each and every sale and not doing anything to disrupt our existing business model.

Q ：With regard to the policy on dividends, the dividend payout ratio is still at 40% even with the current plan revision. This could be taken as sending the message that you want to improve performance as much as possible without raising the dividend policy ratio over 40%, but I would like to hear an explanation about the order of priority.

A ：Our stance on shareholder returns has not changed. The method we use is continuous and performance-linked, keeping the dividend payout ratio in the range of 20 to 40%, with comprehensive consideration for the three aspects of capital profitability, financial soundness, and shareholder returns. We will closely monitor increases in the shareholders' equity ratio, the ROE outlook, and cash levels in the future. If it becomes necessary in the future, we will look at revising the present policy on returns, which calls for a payout ratio between 20% and 40%, but since we are following the existing approach for the time being, dividends are set at ¥144.