

**Nippon Steel Corporation, First Quarter FY2021 IR Briefing  
(August 3, 2021)  
Summary of Q&A<sup>1</sup>**

Presented by:

Takahiro Mori, Representative Director and Executive Vice President, CFO

Hidetake Ishihara, Managing Executive Officer

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◆ **Long-term contract prices**

**Q Will you talk about long-term contract prices? What was the background behind continually depressed domestic prices; how are you persuading customers to agree to an improvement; how long will it take for the improvement in prices; and is there any risk that customers may transfer production overseas?**

A The root problem of long-term contract prices lies in the fundamental question of "what is the right way to determine pricing." Long-term contract pricing was a system established by both Nippon Steel and our customers in pursuit of stability. The base mechanism is that, for most contracts, the cost of main raw materials – iron ore and coking coal – is to be reflected in the long-term contract price but that any other fluctuations in costs or other price determinant factors are to be negotiated and agreed on a case by case basis. This has led to a significant disparity between international market prices and our long-term contract prices.

We have injected substantial resources into stable supply, the development of high-grade products, and the provision of solutions. Nowadays, raw material prices and other costs fluctuate very significantly but we bear most of the risks of these cost fluctuations. In order to guarantee stable supply of the required amount of steel to our customers, even when steel supply and demand conditions are very tight, we need our customers to proportionately bear these costs, the value of high-grade products and solutions, and the material fluctuation risk in the supply chain and to allow us to secure internationally-appropriate margins. We have repeatedly and thoroughly explained these points during negotiations with customers. Japan's long-term contract prices are depressed internationally. Customers who are also engaged in overseas business are fully aware of this, as they purchase the same products at totally different levels of pricing overseas.

In the dramatically changing environment surrounding the steel market, we are negotiating with an unwavering resolve, and if we cannot swiftly agree on terms with customers, we may not potentially be

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<sup>1</sup> Based on information as of the date of the briefing.

able to guarantee stable supply of the entire volume required by customers. In that case, while Japan's long-term contract pricing mechanism has been built over many years in pursuit of stability, and it may be difficult to change it overnight, I believe that we must shift to a new pricing mechanism, away from the determination of pricing based on agreement.

With regard to your question on whether customers may move overseas or procure from other suppliers, I would say that these issues will also be solved as a part of the pricing mechanism.

**Q It appears that you are taking a much stronger stance than in the past toward the correction of long-term contract pricing. What triggered the change in stance?**

A Our basic perception is that long-term contract pricing is a major managerial issue, which has led to a disparity in profits with major overseas steelmakers. If our argument for changing this mechanism in the current supply and demand environment is not accepted, I do not think we will ever have such a chance in the future. While our business is currently good, I think we must solve this major managerial issue with an unwavering resolve at this time in order to make it sustainable.

◆ **Margin improvement**

**Q Among the business profit variance factors for FY2021 that have been revised from the previous forecast, an upward revision of ¥70 billion in the margin must be significantly attributable to the improvement in the export margin. Please share your views on the domestic margin. Also, what is the status of long-term contract prices in 1H FY2021?**

A Looking at domestic margins broadly by sector, spot market prices have been rising partly because we have advocated price hikes, but they are lagging behind the rise in the overseas market. The margin here is therefore improving in 1H. Going into 2H, we will further seek to improve pricing, as the cost of raw materials is expected to continue rising.

As for long-term contract prices, while we are still negotiating them in the current 1H with some customers, we are taking into account a certain level of margin improvement both in 1H and 2H. However, there is a delay between the revision of raw material costs and sales prices. So, if you separate out only 1H, when raw material prices are rising, the increase in raw material costs is greater, which makes the effective improvement in the margin difficult to see. In our assumption for 2H, the improvement is expected to be gradually reflected.

While I cannot comment on the status of long-term contract prices with individual customers, we have concluded negotiations with some customers and the ongoing negotiations with other customers are coming close to a conclusion.

Nippon Steel has invested resources in the development of high-quality products and has committed to stable supply to customers while taking risks, including fluctuations in the market prices of commodity raw materials. Nevertheless, a comparative analysis of profits with major steel manufacturers overseas clearly shows that the level of prices for domestic customers is completely different, and prices in Japan have remained far lower. Our customers know that Japanese steel prices are depressed, because they operate internationally and purchase products at prices that are consistent with international prices overseas. This is the background behind our ongoing price negotiations. At present, margins in the long-term contract business have become the biggest risk in Nippon Steel's business, and we are politely asking our customers for their understanding, in order to promptly correct the pricing.

- Q The expected margin improvement from FY2020 to FY2021 forecasts, and from the previous FY2021 forecasts to the revised forecasts can be mostly explained by the carry-over effect of raw materials. Is there any other factor in margin improvement?**
- A What you stated may appear to be the case numerically, but the interpretation may vary depending on how to consider the material carry-over. In terms of raw material prices, there is a carry-over in which the raw material purchased at the previous quarter's contract unit price arrives on a delayed basis in the current quarter. In the meantime, in terms of the sales price, there is also the lead time from order receipt to production and shipment, resulting in a time lag of 2-3 months between the market price and the shipping-based sales price. We are therefore looking at how prices can be improved against actual raw material procurement costs, including carry-over, and how margins can be improved.
- Q Prices are changing in exports, the domestic long-term contract business, and the domestic spot market business. Changes in the sales mix – shipments to which customers in which areas – will become increasingly important in observing changes in margins. At the anticipated stage of reducing production shipment volume, you may need to take the stance of not hesitating to suspend supply to customers who do not accept a price increase. Is it also possible that the weighting of exports may change as a trend? Will you share your view on the direction of changes in the sales mix one year or two years later and beyond, and how it will help improve margins.**
- A As stated in Nippon Steel's medium- to long-term management plan, we intend to increase the ratio of high-function, high-grade products and to raise the average marginal profit per ton, and thereby change the sales mix. Since the steel supply and demand balance is so tight, and we will further reduce our product capacity and supply volume in 2H, various adjustments will have to be made. Considering what will be fair adjustments at that point, we may have to think about the supply-demand balance, price levels, and other factors.

We do not think exports are our raison d'être. Our prime responsibility is sustainable supply of products to customers in the domestic long-term contract business and the domestic spot market business. Therefore, we are unlikely to maintain exports at the current high level.

◆ **Trends in China**

**Q What is your view regarding China's supply policy? Until last Thursday, the market had been expecting China to be oriented toward reducing production and exports, with the aim of being carbon neutral, and there had been pressure to raise steel prices and lower raw material prices. Last Friday, however, at the Communist Party Congress, the direction was changed to the policy of holding the view that carbon neutrality does not have to be rushed, that the economy is also important, and that price increases should be avoided although this does not refer only to the steel industry. This Monday, the steel market took the view that an increase in crude steel production may be tolerated to a certain extent in China, which resulted in a sharp rebound in the iron ore market and a substantial drop in the steel market. As just described, the steel-related market in China appears very fluid.**

**A** In China, policy announcements and remarks by key officials tend to drive the market, but we think that carbon neutrality is essentially a determinant factor of the Chinese government's supply policy and that they are concerned about being accused by the U.S. and Europe of excessive CO<sub>2</sub> emissions driven by excessive production. Therefore, in the big trend toward achieving carbon neutrality, China's supply policy of promoting imports, curbing exports, and reducing domestic production is expected to continue on an annual basis rather than on a temporary basis, in our view.

**Q It is said that China is aiming to reduce production on the back of a move toward becoming carbon neutral, but the Chinese government's target for CO<sub>2</sub> emission reduction is set at 2030, or 2025 at the earliest. Can we really expect a significant production cut in 2H FY2021?**

**A** Quite clearly, the Chinese government has been giving guidance for a production cut in 2H. At the Communist Party Congress at the beginning of 2021, the government decided that steel production in 2021 would not exceed the level of 2020. However, production in 1H increased by about 15%, so at the Communist Party's 100th Anniversary Congress in early July, the government issued very strong guidance to balance the books by 2H. This guidance is unlikely to be immediately overturned. Anticipating the U.N. Climate Change Conference (COP26) to be held in November, I believe that a production cut in 2H will proceed in earnest.

**Q How do you view the steel demand outlook in China?**

**A** I cannot think of any factor that could cause China's steel demand to fall quickly at this point. In order to avoid any deterioration in China's economy when the world economy is going to rise during the trade war, China is likely to support current demand by taking various measures. However, as we assumed in our

medium- to long-term management plan, we believe that in the long term, demand in China will decrease when infrastructure demand has run its course. No one knows when this will come. In sum, we have not changed the view that it will be okay over the next few years but demand will then eventually fall.

◆ **Assumptions for profit forecasts**

**Q Concerning your forecasts on this occasion, at what point of time are the market conditions that you used for the assumptions on raw materials in 2H and what kinds of risks were incorporated?**

A Although the iron ore market has fallen recently, the current forecasts assume that the market will remain at its pre-decline level in 2H. The hard coking coal market currently remains at a high level but the price is expected to stay at roughly the current market level in 2H. Taking China's policy of a production cut into account, prices of iron ore and coking coal are more likely to decline, rather than to keep hiking up.

**Q What are profit variance factors from 1Q FY2021 to 2Q?**

A There are positive factors and negative factors behind the expected change in profit from 1Q to 2Q. As the impact of negative factors is estimated to more than offset the impact of positive factors, overall profit is projected to decrease by ¥84 billion.

Positive factors include the impact from the anticipated price increase stemming from the probable settlement of the unsettled negotiation regarding a rise in long-term contract prices for 1H. If the price increase is agreed in 2Q, this will be retroactively applied to transactions in 1Q, boosting profit in 2Q.

As for negative factors, Nippon Steel manages fixed costs on a six-month basis, which means recording higher fixed costs in 2Q, namely, the latter half of 1H. This will have a major impact. The same is true for expenses for disposal and demolition, which tend to be concentrated in the latter half of 1H, becoming another major negative factor. The seasonality of dividends received, that is the fact that they are concentrated in 1Q, and an increase in depreciation costs in 2Q are also negative factors.

**Q Please tell us about the difference in inventory valuation between 1Q and 2Q and the fluctuation in raw material carry-over.**

A The inventory valuation gain is expected to be the same at ¥50 billion in both 1Q and 2Q. The raw material carry-over is expected to decrease by ¥4 billion in 2Q relative to 1Q.

◆ **Steelmaking group companies**

**Q Starting with this briefing document, you have changed the consolidated business profit variance classification, and the steel group companies have been divided into "domestic group companies" and "overseas group companies." What does "overseas group companies" include?**

A "Overseas group companies" include group companies engaged in overseas steel business that we directly own, as well as the overseas operating companies of our domestic group companies, such as Ovako AB, which is a wholly-owned subsidiary of Sanyo Special Steel.

**Q Another change in the consolidated business profit variance classification is to include the change in raw material interests in "other," instead of "steel group companies." How is this change reflected in "other" in the current forecasts for FY2021, which decreased by ¥43 billion from the previous forecast?**

A Profits from raw material interests are expected to increase in proportion to the rise in raw material prices. Concerning the decrease of ¥43 billion in "other," it is unclear how the business environment will change from 2Q to 2H FY2021 and this uncertain element is incorporated in the profit forecast.

◆ **Non-steel segments**

**Q According to your profit forecasts for the non-steel segment in 2Q, the Chemicals & Materials segment is expected to record a profit decline on a sales gain, despite the current favorable conditions, while the Systems Solutions segment is expected to post a decrease in profit in 2Q vs. 1Q. What are the factors behind these forecasts?**

A The Engineering & Construction segment and the System Solutions segment are basically project-oriented, so the profit trend is uneven depending on when revenues are recognized and profits are generated. Revenues and profits also tend to be concentrated in 2H of the fiscal year. Generally speaking, we tend to adopt conservative forecasts for undetermined areas.

In the Chemicals & Materials segment, the strong results in 1Q were attributable to the recovery in demand for needle coke and the rise in the chemicals market, and the forecasts for 2Q and beyond are conservative. There is a good chance that profit will increase in 2Q and beyond.

◆ **Profit attributable to owners of the parent**

**Q Among the revisions made from the previous forecasts for FY2021 to the current forecasts, the upward revision is greater for profit attributable to owners of the parent than for business profit. Is there any special reason for this?**

A There are two main reasons. First, the upward revision in business profit is mainly due to the increase in profit at equity method affiliates such as AM/NS India and Usiminas. Since income from investments accounted for using the equity method is already after tax, the change in business profit will directly affect the change in profit attributable to owners of the parent.

The second reason is the impact of deferred tax assets. As a result of the losses up to FY2020, we have

a large amount of losses brought forward from the previous term. In contrast, deferred tax assets for accounting purposes could only be recorded within the range of tax loss carryforwards in line with future earnings forecasts. However, as earnings grew, additional deferred tax assets could be recorded, boosting profit attributable to owners of the parent.

End

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