

Progress on Kawasaki-ROIC Management

April 28, 2015

Kawasaki Heavy Industries, Ltd.

Examples of Progress on 5 Actions

The ultimate goal of Kawasaki-ROIC management is the **improvement of enterprise value**, through the increase of capital efficiency, and planning and execution of strategies for future growth. The realization of Kawasaki-ROIC management comprises of 5 Actions. The examples of progress on 5 Actions disclosed in July 2014 are as follows.

【Actions】

Action 1	Plan and execute growth strategies through the strengthening of core competence in each BU
Action 2	Set our optimal financial indicator , with a focus on ROIC, and create specific action plans for achievement
Action 3	Create new value through internal company synergies generated by our conglomerate advantage
Action 4	Define scale-down or withdrawal strategies broken down to each Sub-BU and product
Action 5	Create a portfolio focusing on profitability, stability and growth



【Examples of progress】

Action 1: New production facility for the Boeing 787-10 and increasing production completed (March 2015) Relocation to Kobe Works of all of engineering departments in Plant & Infrastructure segment, which were at Tokyo Head Office and Kobe Works (April 2015)
Action 1・2・5: Established and disclosed Group Management Model 2018 (October 2014)
Action 3: Developed and delivered efWING® (Rolling Stock, Aerospace) Applied CFRP(carbon-fiber-reinforced plastic) technologies used for aircraft to rolling stock bogie Developed and sales started of Ninja H2R/H2 (Motorcycle & Engine, Aerospace, Gas Turbine & Machinery) Applied the flow analysis technology used in aircraft design and design technology used in gas turbines to high-performance motorcycle Development of the technology and products of hydrogen infrastructure Development of the hydrogen liquefaction system Obtained approval in principle for our new tank for ships that carry liquefied hydrogen in bulk
Action 4・5: The assignment to Hitachi Construction Machinery Co., Ltd. of all of shares of KCM Corporation as of October 1, 2015 (scheduled).

Targets for Group Management Model 2018

	FY2013 Actual	FY2014 Actual	FY2015 Forecast	Group Management Model 2018
Before-tax ROIC	8.1%	10.4%	11.8%	12% or higher
ROE	11.0%	12.9%	15.0%	14% or higher
Operating income margin	5.2%	5.8%	6.1%	6% or higher
Operating cash flows	¥151.7 billion	¥127.6 billion	¥110.0 billion or higher	¥110.0 billion or higher
Net debt-to-equity ratio	109.3%	83.9%	80%-90%	70%-80%
Total asset turnover	0.89 times	0.89 times	1.00 times	1.00 times or more
(Reference: Net sales)	(¥1,385.4 billion)	(¥1,486.1 billion)	(¥1,650.0 billion)	(¥1,800.0 billion)
Exchange Rates (actual & assumed)	¥99.63/\$	¥109.51/\$	¥118/\$	¥100/\$

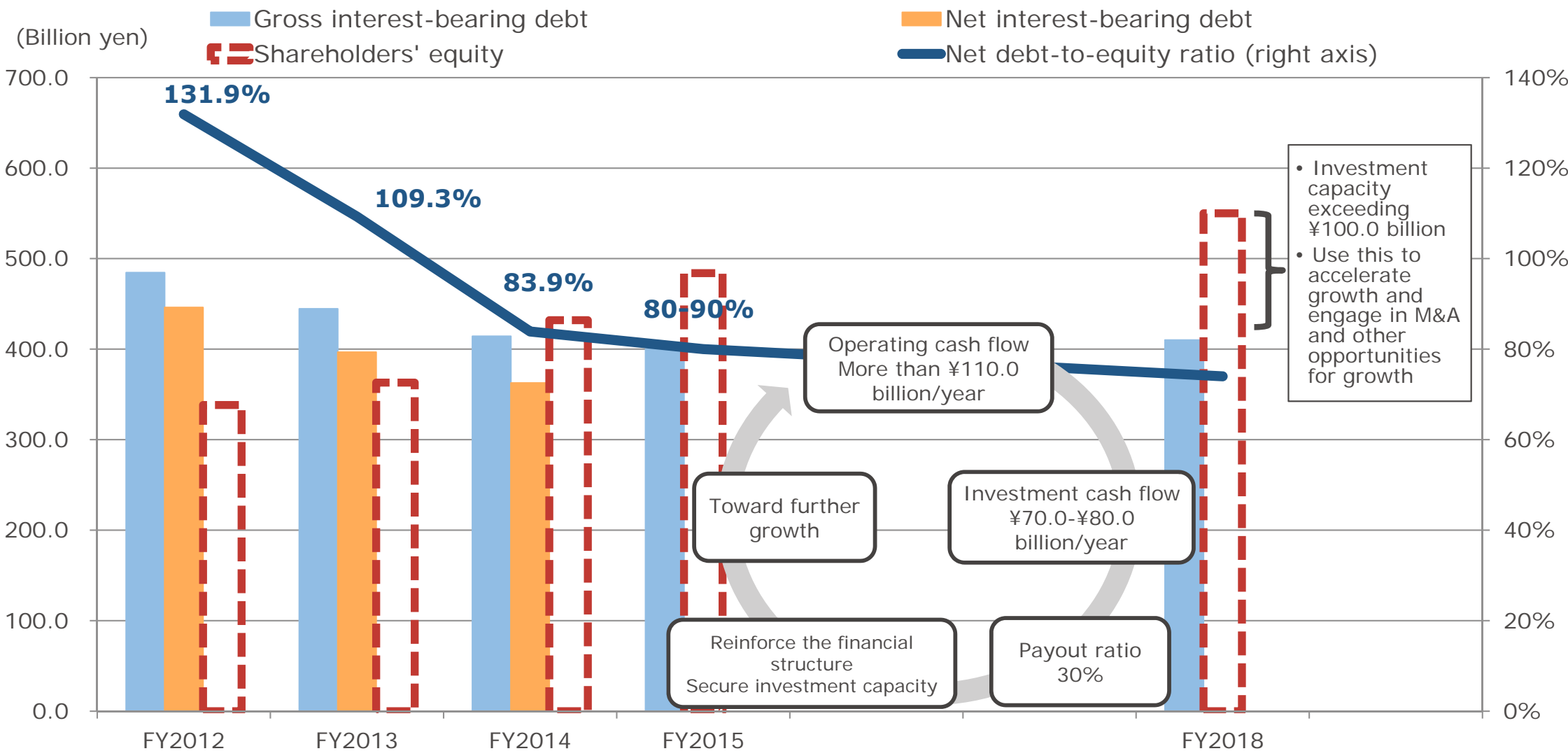
Notes:

- ROE = Net income / {(Shareholders' equity at previous year-end + Shareholders' equity at this year-end)/2}
- Before-tax ROIC = EBIT (income before income taxes + interest expense) / Invested capital at year-end (interest-bearing debt + shareholders' equity)
- Total asset turnover = Net sales / Total assets at year-end

Cash Flow Management

KHI achieved net debt-to equity ratio target (100%) in FY2014 one year earlier, which is originally planned to achieve in FY2015. We set the target for this ratio of 80%-90% in FY2015.

KHI will utilize capital for investment for future growth and ensure return to shareholders, while allocating cash for further investment and using it to accelerate growth and engage in M&A and other opportunities.



Change of ROIC Rating

ROIC rating of each BU, classified in February 2014, has changed as follows. ROIC rating of each BU is based on 5 years average ROIC in "Year covered".

ROIC rating		Set in February 2014 ^(*)	As of April 2015
A	Market leader	11	11
B	Stable contributor	6	8
C	Contributor (unstable)	7	4
D	Improved investment efficiency required	6	8
E	Restructuring required	2	1
Year covered		Actual :FY2011-2012 Assumed:FY2013-2015	Actual :FY2013-2014 Assumed:FY2015-2017
Actual & assumed exchange rate (¥/\$)		FY2011 :¥79/\$ FY2012 :¥82/\$ FY2013-2015:¥95/\$	FY2013 :¥99/\$ FY2014 :¥109/\$ FY2015-2017:¥113/\$

(*)We excluded some BUs which were not comply with ROIC rating from "The Purpose and Characteristics of Kawasaki-ROIC Management" (Released July 30, 2014).

Examples of “α+” and “f”

Regarding ROIC rating, in addition to A to E, **[α+]** (alpha plus) rank had been set to set apart products and businesses deemed to contribute to value creation in the future. Furthermore, we had set **[f]** (small f) rank for BU, which are subject to scale-downs, withdrawals, and spinouts/spinoffs when necessary. Current examples are as follows

《Current Ongoing Projects》

Hydrogen Business (manufacturing, transport, storage, usage, etc.)



Hydrogen liquefaction system



Liquefied hydrogen carriers



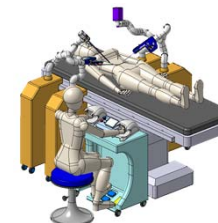
Liquefied hydrogen storage systems



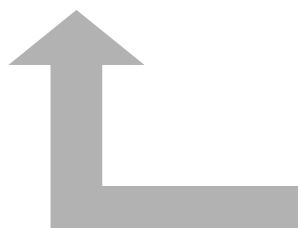
Hydrogen-fueled gas turbines

《Future Projects》

Development of medical robots (including applied robots and surgical support robots)



[α+]



- New products and businesses deemed to contribute to value creation in the future
- Technological synergies that cross over the border of segments or BUs

A

Market leader

B

Stable contributor

C

Contributor (unstable)

D

Improved investment efficiency required

E

Restructuring required

With thorough consideration to factors such as ROIC rating, core competence and future market trends, scale-downs and withdrawals will be considered for BUs that do not contribute to the improvement of enterprise value. (Sub-BUs, products included)

[f]



Shift business resources to area of growth

Strengthening the competitiveness and creating synergies through collaboration with other companies

《Previous Withdrawals》

Bridge Construction, Floodgates, Multilevel Parking Structures, etc.

《Previous Spinouts》

Safety Equipment Business, Steel Manufacturing Plants, etc.

《Scheduled Spinout》

Wheel Roder Business (Scheduled October 2015)

Kawasaki-ROIC Management as a Companywide Endeavor

For the Kawasaki-ROIC management, people at all levels and in all divisions as well as board members will understand the proper ROIC mechanism and go about their daily duties, to connect the improvement of the enterprise value. Therefore, we work on the following in-house education and enlightenment.

The KHI Group targets an increase in its corporate value by increasing profit and improving investment efficiency.

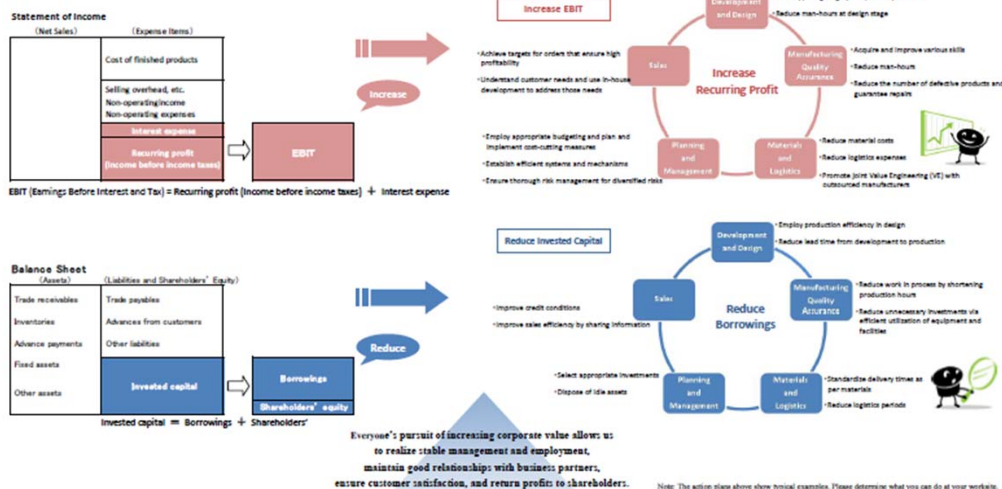


The KHI Group adopts the ROIC concept as a management indicator to improve its investment efficiency.

What is "ROIC"? Taking the acronym "ROIC" (Return On Invested Capital), this financial indicator measures a company's profit against total money invested (invested capital), not quantitatively in terms of profit value, but qualitatively, that is, how efficiently the company earned its profit. To improve ROIC, it is necessary to **increase recurring profit and reduce borrowings**. In other words, earning increased profits with less capital improves the ROIC value. Please consider what each person should do specifically in the form of action plans at his/her workplace.

The definition of ROIC depends on how each company adopts this concept. The KHI Group's ROIC is defined as follows:

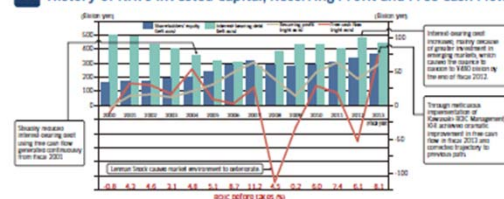
$$\text{ROIC (\%)} = \frac{\text{EBIT (Recurring profit [income before income taxes])} - \text{Interest expense}}{\text{Invested capital}} \times 100$$



Part 2 Definitions to Deepen Understanding of Kawasaki-ROIC Management

Did the interview with Mr. Matsubara give you a good understanding of the ideas that have shaped Kawasaki-ROIC Management? Part 2 offers a detailed description of terms and concepts mentioned in the interview to enhance your understanding of the interview content.

01 History of KHI's Invested Capital, Recurring Profit and Free Cash Flow



02 Enterprise Value

Enterprise value is the sum total of capital invested in a business and the present economic value added, which that business generates into the future. Therefore, the improvement of enterprise value rests on the ability to achieve higher economic value added.

Traditionally, economic value added is the difference between aggregate market value of stock and shareholders' equity (book value).

Enterprise value = Aggregate market value of stock + Economic value added

Enterprise value = Book value of stock + Economic value added

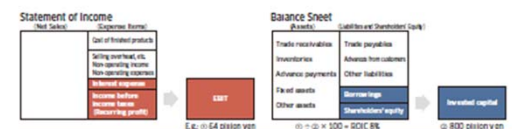
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03 What is "ROIC"?

ROIC (Return on invested capital)

This financial indicator measures a company's profit versus total amount invested (borrowings + shareholders' equity) in its business activities, not quantitatively in terms of profit value, but rather qualitatively, that is, how efficiently the company earned its profit. It is consistent with the management principle of "improving quality over quantity." The definition of ROIC differs from company to company, but for the KHI Group, the formula used is: $\text{ROIC} = \frac{\text{EBIT} - \text{Interest expense}}{\text{Invested capital}} \times 100$



Note: ROIC (Return on invested capital)
EBIT (Earnings before interest and tax)

KHI has announced the following figure as a target for Medium-term Business Plan 2013.

FY2015 Before-tax ROIC 11%

04 Reason for ROIC Above 8% — Generate Value

To improve enterprise value, the value generated by business activities must be greater than the cost of capital associated with the invested capital. For the value generated by business activities to exceed the cost of capital, the minimum ROIC that KHI must achieve must be at least 8%.

Cost of capital comprises not only the cost of borrowing from banks or other sources of capital (cost of borrowed capital) but also the cost of capital raised through the issuance of stock (cost of equity), and the amount is calculated using weighted average cost of capital (WACC) from the sources shown in the formula below.

Cost of borrowed capital (%) = $\frac{\text{Borrowings}}{\text{Invested capital}} \times \text{Cost of borrowed capital (\%)}$

Cost of equity (%) = $\frac{\text{Shareholders' equity (market value)}}{\text{Invested capital}} \times \text{Cost of equity (\%)}$

WACC (%) = $\frac{\text{Shareholders' equity (market value)}}{\text{Invested capital}} \times \text{Cost of equity (\%)} + \frac{\text{Borrowings}}{\text{Invested capital}} \times \text{Cost of borrowed capital (\%)}$

Cost of capital = $\text{Invested capital} \times \text{WACC (\%)}$

WACC is not necessarily a cost but rather indicates profits in the stock market and other factors will cause the rate to fluctuate. But in theory, for KHI, the rate is determined at about 8%.

For easy monitoring, KHI estimates ROIC before taxes. WACC is an after-tax amount, so a before-tax ROIC of 8% is equivalent to WACC of 8%.

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Hand out the pamphlet to all employees

Feature "Kawasaki-ROIC Management" in the in-house newsletters

Kawasaki, Working as one for the good of the planet

Figures recorded in the business forecasts are forecasts that reflect the judgment of the Company based on the information available at the time of release and include risks and uncertainties. Accordingly, the Company cautions investors not to make investment decisions solely on the basis of these forecasts.

Actual business results may differ materially from these business forecasts due to various important factors resulting from changes in the external environment and internal environment. Important factors that may affect actual business results include, but are not limited to, economic conditions, the yen exchange rate against the U.S. dollar and other currencies, the tax system, and laws and regulations.