(Translation)

May 24, 2023
West Japan Railway Company

May 2023 Small Meeting, Summary of Questions and Answers

1. Overview

(1) Date May 24, 2023 (Wednesday)

(2) Participants President and Representative Director
Kazuaki Hasegawa

Director and Senior Executive Officer,
Senior General Manager of Corporate Strategy Headquarters
Eiji Tsubone

Administrative Officer, General Manager,
Corporate Strategy Division, Corporate Strategy Headquarters
Hiroo Oda

(3) Content Questions and answers

2. Principal Questions and Answers (Summary)

Q1

The current mid-term plan appears to prioritize growth investments and also reveals a conservative approach to revenues and costs. JR-West is taking various measures to rejuvenate its railway business, addressing unprofitable lines unlike in the past, and contemplating fare price adjustments that were previously considered impracticable. However, it is disappointing that JR-West is targeting an operating income of ¥80-90 billion in the railway business in 3-5 years, not the previous level of ¥120-130 billion. I feel there is room for improvement here. Could you explain the concept of "challenging targets" and what thought process went into shaping the mid-term management plan?

A1

The term "challenging" means two things here. Firstly, it means reviving the railway business, which has suffered during the three years of the pandemic. It is a challenge to create and cater to new demand while seeing some customers leave. Secondly, it means making our business foundation stronger and more adaptable by transforming our business portfolio and expanding into the life design sector. As a part of the challenge of taking on new businesses, we are venturing into the social infrastructure management business, one where we can leverage our assets, expertise, and experience. It is a challenge to prioritize such new fields as our investments increase and as we seek solid returns. If energy costs had not increased so much, profit would have already surpassed pre-pandemic levels, but soaring energy costs have offset our structural cost reductions. Unfortunately, profit is unlikely to exceed pre-pandemic levels due to inevitable increases in costs related to DX, investments in human capital, and compliance with internal environmental rules. Particularly, from the standpoint of having raised capital, it is vital that we address the issue of how to create demand and meet shareholder expectations by bringing profits back above pre-pandemic levels.

Q2

Where will additional returns come from, using the funds raised in the capital increase? The norm is to fund real estate projects through debt, but JR-West intends to use equity financing in its aim for higher returns. Comments were also made about synergistic effects with the railway business, but where can we expect to see additional returns commensurate with the capital increase?

A2

Our intention when raising funds through the capital increase was to ensure the steady execution of our originally planned growth investments, even in a challenging situation where our financial health was hurting and cash flow was tight. Due in part to opening-related expenses, real estate projects will start to fully contribute to profits after the current medium-term management plan's timeframe. For these development projects, however, we aim to expand returns while stimulating urban development in neighboring areas. Furthermore, one reason we could draw up this medium-term management plan is because we reinforced our financial health through the capital increase. At the time of the capital increase, we stated that as our financial health improves along with the use of these funds, we would also obtain the leeway to raise additional debt financing for growth investments. Consequently, in the current medium-term management plan, we are planning our largest-ever capital investment of about ¥1.4 trillion over five years, and we are prepared to earn solid total returns.

Q3

For investors, improving earnings per share (EPS) and dividends per share are important financial targets for JR-West. During the recovery phase from the pandemic, I would like to know how JR-West plans to restore EPS, even though operating income and cash flow depends somewhat on external factors.

A3

We are at the starting line for the next three years in our current medium-term management plan, a challenging period for swiftly recovering from the damage caused by the pandemic, as we aim for higher levels than before. We are working to reduce structural costs, but realistically, we face a challenging situation where these cost reductions are being offset by rising energy costs. Even under these circumstances, it is vital that we quickly return to past profit levels and meet shareholder expectations in light of the additional weight of our capital increase via public offering. On the other hand, financial stability is essential to running the railway business, and while maintaining financial discipline, we recognize the importance of enhancing shareholder returns, including through share buybacks, and making additional growth investments when cash flow exceeds expectations.

Q4

Regarding leverage, what are management's thoughts on the balance sheet?

A4

The railway business is inherently a long-term business. In this context, we believe it is necessary to operate the business stably from a healthy financial position. However, we are also using leverage and making aggressive growth investments, a dual approach that should ultimately lead to a stronger business foundation and sustainable growth. Our ultimate financial targets might change depending on the business portfolio. For instance, we target a net interest-bearing debt/EBITDA ratio of 4x by the fiscal year ending March 31, 2028. The railway business requires a financial base of a certain size, and as non-railway businesses expand, we must control the level of returns and capital costs that correspond to each business. Considering both these aspects and the outlook for our business portfolio for the fiscal year ending March 31, 2028, we believe we are taking a balanced approach to financial discipline in the medium-term management plan. Please note that if the business portfolio changes in the future, the appropriate level of capital costs may also change, which might lead to changes in our approach to financial discipline. As we take on various challenges, we are not firmly committed to taking a singular approach, but this how we are currently approaching the balance sheet.

Q5

The next three years seem to be heavy on investments, with free cash flow likely to start being generated from year four onwards. What are management's thoughts on generating free cash flow, including real estate securitization?

A5

Over the next three years, we expect profit growth to be driven by mobility services, followed by growth in the life design sector. Since we must commit resources to the business first, however, please understand that the life design sector will start generating cash several fiscal years later. Regardless, we aim to enhance our ability to generate cash flow for further investments in growth and more returns for shareholders.

Q6

What kind of a margin does JR-West consider sustainable for the railway business? Assuming ridership will decline over the long term as the population shrinks, an 8-9% margin does not seem sustainable. From the perspective of the sustainability of the railway business, how is management setting goals?

A6

Railways must be sustainable as a business and for society. Instead of maintaining current conditions on all railway lines, we believe it is important to reach out to communities and rethink the state of transportation systems based on regional characteristics. Otherwise, we might not be able to maintain the desired level of services on the Kyoto, Osaka and Kobe area lines, as well as on Shinkansen lines. On that point, it is important to address issues on local lines, and we are prepared to deal with these issues through the relevant new legal system. With the population on the decline in the foreseeable future, however, JR-West also needs to raise fares in order to secure overall revenue.. Under the current system, it is difficult to revise fares, and even if fares are changed, the returns that can be approved are not that large. For these reasons, we believe fare deregulation is necessary, and ideally, revisions to the fare system should be made while there is still a surplus, before deficits are incurred. Under the current system, however, this is problematic, so we are monitoring debates on this issue at the national level.

Q7

What kind of discussions were held with outside directors when formulating the medium-term management plan? Was there anything that changed in the plan based on those discussions?

A7

Given demographic forecasts, the long-term outlook for the railway business is a challenging one. We had lengthy discussions with our outside directors, and concluded that management cannot be based solely on forecasts. This has led to changes in our business portfolio. Some outside directors raised issues about how to invigorate the railway business itself because mobility services still account for 60% of overall profits even if the life design sector expands in the long term. The outside directors also voiced various opinions about our initiatives related to the global environment and human capital, and reminded us of the importance of diversity in strengthening and growing the business foundation.

Q8

I understand the direction the company is moving in terms of human capital management, but what initiatives are being undertaken to realize this? I have heard about the side job system and the innovation creation program, as well as the current expansion of the Digital Solutions Headquarters, I think JR-West needs to take steps to identify and utilize hidden talents across the group, not just at the parent. How does management plan to accomplish this?

A8

Human resource development and translating this into organizational capabilities are the basis for achieving our medium-term management plan. One of the challenges is creating opportunities for our employees to thrive, and we view the success or failure of human resource development as one of the risk factors. Our work system is based on the railway business, which lacks flexibility in some respects. We believe it is important to create as flexible a work system as possible, recognize diverse work styles, and diversify our human resources by expanding our recruitment of mid-career professionals. In addition, last fiscal year, we launched a training program to improve IT literacy among all employees. We believe it is important to draw out the best traits of each person through various initiatives.

Q9

As providers of high-risk capital, investors expect shareholder returns to increase to over 35% as a return on the portion of profits that exceed forecasts. Does this align with management's thinking to some extent? Management has also mentioned the possibility of share buybacks, so under what circumstances would buybacks be carried out? If this fiscal year's earnings beat expectations, will JR-West buy back its shares? I would also like to know the timing and conditions for returning the funds raised through the capital increase.

A9

We have set out a long-term vision for the next decade, and we have clearly defined our goals for the next three years as milestones along the way. We aim to balance financial discipline with effective growth investments, but if we have surplus funds while achieving this balance, we intend to carry out further growth investments and return value to shareholders through share buybacks. We will monitor our overall cash situation for the next three years.

Q10

JR-West plans to cut dividends for this fiscal year. If a stable dividend is truly a priority, a minimum dividend of ¥125 per share is desirable for this fiscal year. What are your thoughts on the plan to reduce dividends?

A10

Profit in the previous fiscal year includes some extraordinary accounting-related gains. We are therefore considering a one-time increase in dividends. In our various discussions, we had some disagreement about whether to increase dividends based on these extraordinary gains, but in the end, we concluded that it would be appropriate to pay a dividend in line with a payout ratio of 35% based on realized profits. For this fiscal year, based on a payout ratio of 35%, dividends per share would be less than ¥100. Given that JR-West has paid a dividend of ¥100 per share even during years of losses, we distributed a dividend of ¥100 per share in line with shareholder expectations.

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Q11

This question is for the president. Why should investors buy JR-West's stock, and not that of other railway companies?

A11

Our business area covers regions that have rich nature, culture and histories, such as the Kansai region, Hiroshima, and prosperous rural cities like Matsue in the Sanin region. One attractive aspect of JR-West is that we are committed to invigorating these areas along with regions, while increasing regional exchanges and the local population. As we carry out the comprehensive infrastructure management business, it is crucial that we have the trust of the region. This is why the main focus of management is on synchronizing the development of the region with that of the Company. We hope investors resonate with us on these points and choose to invest in JR-West.

Q12

Regarding changes to the fare system, what do the regulatory authorities think about how the railway business should be run? While fare hikes would be viewed in a positive light by shareholders, in the long run, fare hikes alone are not enough for railway companies to maintain infrastructure amid a declining population.

A12

In the railway business, JR-West has responsibilities to fulfill as a private entity listed on the stock market and also a public role to serve as social infrastructure, and there are limits to what can be accomplished with private capital. We have made our best effort to maintain this vital national social infrastructure JR-West inherited from Japan National Railways, but there are limits to what we can do. The national government presumably views railways as a public transportation service that is privately operated. As it becomes evident that the efforts of each JR company are untenable, we will have to hold discussions on the financial involvement of the national and local governments to support the direct costs of operations and capital investments. How the public and private sides will share this burden is a thorny issue, but our common goal should be how to sustain this public transportation network across Japan. We have laid the groundwork for such discussions about local lines from a rational, not emotional, perspective. For various scenarios in the future, we believe discussions will be held about the division of roles between the public and private sectors.

Q13

Can JR-West expand measures for tapping into foreign tourism? Apart from raising the price of the Japan Rail Pass, there should be a lot more that JR-West can do on its own accord, including in the lifestyle design sector, such as increasing the value added of experiences in coordination with hotels.

A13

We recognize the need to take steps to increase unit prices and enhance value added in other areas, and we plan to revise services and prices for the Japan Rail Pass. Beyond foreign tourists, we would like to raise fares for express trains, among other initiatives, in order to expand revenues. We are also working to increase the average daily rate (ADR) at our hotels, focusing efforts on not just improving occupancy rates, but also on providing high-level services at commensurate prices. We are aware that the perceptions of customers have changed, including in Japan, and we are keen to offer our services at a reasonable price.

Q14

With the Osaka-Kansai Expo and integrated resort (IR) project on the horizon, how is JR-West responding? What kind of returns can we expect in the end?

A14

It is hard to estimate how much additional revenue the Expo will bring in, so our medium-term management plan does not reflect any boost to revenue from the Expo. Although the Expo is a one-time event, we aim to use it as an opportunity to energize inbound tourism and have more people visit the Western Japan area. We anticipate great opportunities from the Expo and IR project in terms of increasing the usage of our services outside the railway business, as these events will elevate the status of Kansai cities and attract attention to them as urban tourism destinations.

Q15

Should the comprehensive infrastructure management business be viewed as more of a downstream business, with more of a hands-on approach, or an upstream operation more akin to management? What kind of social needs are there potentially, and how will JR-West satisfy these needs?

A15

When entering this field, we will probably take on specific projects, but our goal is to play a supervisory role in upstream administrative tasks, such as maintenance planning, replacement planning and construction management, while working together with various partner companies. It is conceivable that some local governments will find it difficult to manage infrastructure on their own, so our goal is to cover a broader area across municipal boundaries as comprehensively and efficiently as possible, while leveraging Group strengths in operations that are broad in scope and cover wide areas.

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