◆ Cosmo Energy Holdings (5021)

Financial Results for Second Quarter of FY 2019

- Financial Results Explanatory Meeting for Analysts and Investors – Summary of Q&A

―This material contains descriptions regarding future prospects. Notes are provided at the end of this material ―

1. Date and time : November 8, 2019 (Fri) 10:00 a.m. - 11:00 a.m.
2. Attendees : 67 persons
3. Main questions and answers

Q1: Describe why the full-year forecast is unchanged.

A1: It has become realistic for the Oil E&P Business to achieve better results for the full year than previously expected. We expect that the full-year results for the Petrochemical Business will fall short of the plan due to the deteriorating market conditions for petrochemical products. In the Petroleum Business, there was a discrepancy between actual profit and initial forecast for the first half of around ¥10.0 billion, which was primarily attributable to a negative time-lag effect impacting the margins for four products, including gasoline, kerosene, diesel fuel and heavy fuel oil A, along with the declining naphtha prices. We expect that there will not be a time-lag if crude oil prices remain stable in the coming months, which will prevent profit from plunging by ¥4.0 billion or ¥5.0 billion in the second half. Currently, naphtha prices are almost back to the initially expected level in the budget.

The IMO regulation will be a positive factor in the second half. Currently, there is a significant gap between LSC heavy fuel and HSC heavy fuel in the market, which is far beyond our initial expectations. While it is difficult to make a forecast, we expect that there will be a positive effect worth about ¥5.0 billion. We predict that the average crude oil price will be $65 per barrel. Assuming that the second half will start with the current price level of $60 per barrel, we expect that there will be a positive time-lag without having to change the full-year results forecast.

Q2: Elaborate on the positive effect worth ¥5.0 billion associated with the IMO regulation.

A2: It is difficult to describe simply, but I would like to point out that we will benefit in terms of revenue and profit from the comprehensive gaps between heavy and light crude oil, distillate and heavy fuel oil as well as LSC and HSC heavy fuel oil. For example, LSC heavy fuel oil is currently traded at prices close to those of diesel fuel on the market. We operate the fuel oil hydrodesulfurization unit, a system to remove sulfur from heavy fuel oil products. What this system does is similar to the process of making diesel fuel out of HSC fuel oil in the current market. It appears that the benefits being offered by the system are far more significant than our initial expectations, and we anticipate that its impact will be worth about ¥5.0 billion in profit.

Q3: What will be your primary metrics when determining shareholder returns? Are there any specific targets in mind?

A3: We aim to further enhance net DER and net worth value. Specifically, our medium-term management plan calls for net DER between 1 and 1.5. Initiatives aiming to improve the financial structure have been progressing much faster than originally scheduled, which resulted in higher dividend payments per share last year. We will make decisions based on comprehensive analysis of revenue, profit and other factors, while aiming to achieve the goals.

Q4: What has made it possible for you to improve domestic margins, net of a time-lag?

A4: Taking advantage of the benefit of being in a certain position as a market follower, we have made it possible to improve the domestic margins. I believe that the normalized supply and demand situation has aided our success.

Q5: During the first half, you achieved growth in sales volume centering on gasoline, kerosene, diesel and heavy fuel oil A. Have you purchased the petroleum products in short supply to Kygnus Sekiyu K.K.? Describe the relationship between sales volume and profit.

A5: We rely primarily on imports for those products sold incrementally. Given a widening gap in margins of gasoline products in Japan and overseas, we continue to operate in a business environment where it is possible to generate profit from the sale of imported products. Imported products are usually less lucrative than those produced domestically, but we can make a decent profit by selling imported products in a certain market.

Q6: How is the supply situation on conforming heavy fuel for vessels in relation to the IMO regulation?

A6: Currently, we receive orders for conforming heavy fuel primarily from ocean liner operators, who possibly need to replace fuel tanks for new sea routes. The regulation will go into effect in January, but orders are already coming in and we have started product shipments accordingly.

At the moment, the Chiba Refinery is in the process of undergoing a regular operating inspection, which will be finished soon, of one fuel oil hydrodesulfurization unit. The Sakai Refinery recently finished undergoing a regular inspection and started shipping products partially mixed with middle distillates, because it has not reached an optimal production capacity. With a fuel oil hydrodesulfurization unit back in place at the Sakai Refinery, we will launch a range of new processes.

We expect that it will take some time for us to see a shift in demand from coastal vessel operators towards conventional fuel products for short transport distances.

Q7: Describe the pricing for conforming fuel in view of the IMO regulation and its impact on your revenue and profit.

A7: There is a clear distinction in pricing for conforming fuel between ocean liners and coastal ships. Fuel for ocean liners is traded at prices that are generally higher than our estimates on the Bunker Wire Link operated by Platts, positively impacting our revenue and profit in a significantly favorable manner. Shipments to coastal ship operators are yet to start in full scale, which is likely to make a significantly favorable contribution to revenue and profit.

Q8: What is the latest situation in the wind power generation business?

A8: Our offshore wind power generation business has seen consistent progress. In July, the Ministry of Economy, Trade and Industry announced 11 sea areas that are considered to have progressed to a certain level of preparations for the start of projects for promoting the utilization of maritime renewable energy resources. The selected 11 areas include all three of our facilities. Four of the selected 11 sea areas are designated as promising areas, which include one of our facilities. It appears that the government will introduce further legislation towards the renewable energy initiatives. We are more focused on the designated areas than others and are making consistent progress.

Q9: Describe the reason for the robust performance of the existing oil fields and its sustainability in the Oil E&P Business.

A9: There was a setback in production at the existing oil fields last year. We determined a certain system failure rate based on our past experience with the oil pumping system, and this rate has been considered statistically in the budget. The system actually failed more often than expected in the budget last year. Based on the lessons learned from this experience, we have introduced improved pumping systems. We adopted conservative estimates for the pumping system failure rate in the budget for this year. Fortunately, we have enjoyed stable oil production with only a limited number of system failures so far this year.

When it comes to crude oil production, we need to explore and develop new wells to maintain the current production rate. We have actually seen higher-than-expected production at a newly developed oil field.

Things remain uncertain in terms of sustainability for the future. Currently, however, our business remains excellent.

Q10: What market conditions do you assume when you expect an impact of profit totaling around ¥5.0 billion associated with the IMO regulation?

A10: Picture it as the current market condition. However, it is very complex because it involves multiple issues, including crude oil selection. The ¥5.0 billion impact on profit is simply an estimate based on a certain assumption. Things will continue to develop in practice, but I believe we will be successful no matter what because of our strong flexibility and adaptability to the IMO regulation, in which we take great pride.

Q11: In the wake of the Saudi facility attack that occurred in the middle of September, have you seen any impact on your refinery operations there?

A11: No, there has been no impact on our facilities. We are ready to take a flexible approach using the delayed coker unit in the Sakai Refinery and the hydrodesulfurization unit in the Chiba Refinery, regardless of a change in the API gap for crude oil.

Q12: Describe your capital spending plan over the medium to long-term.

A12: Since the announcement of the mid-term management plan, there has been an increase in investments for enhanced recovery at the Hail Oil Field. The relevant investments are under close examination at the moment, but the value is not yet available in detail. Other expected investments remain generally consistent with the mid-term management plan, and I expect the amount of capital spending to decrease in the second half.

Q13: Do you predict that the Petrochemical Business segment will run a deficit in the second half?

A13: No, we do not predict that will happen. We expect the Petrochemical Business segment to keep from falling into an operating deficit on the whole, aided by certain amounts of products being sold at production cost. We anticipate that the segment will be able to avoid running a deficit as long as market conditions remain unchanged, unless the market changes significantly.

Q14: I understand that you will have more interest payments on the hybrid loans, beginning in the next fiscal year. What is your repayment plan?

A14: We are currently holding discussions with the credit rating institution regarding the repayment plan for the subordinated loans. I decline to comment further, because it is subject to timely disclosure rules.

Q15: There has been a surge in VLCC and Aframax tanker rates following the announcement of sanctions against the COSCO Shipping Tanker. What sort of impact will it have on the crude oil purchase cost and exports/imports in the short and long run?

A15: If there is any impact, we expect that it will be limited to the level of our competitors because we have long-term contracts to use crude oil tankers that span a certain period of months. With the impact being limited to the level of our competitors, we will pass the higher charges on to our product prices. This way, there will be no significant impact on revenue and profit. We also expect that there will be no significant impact on exports/imports of our petrochemical products.

Q16: I understand that you expect an increase in product imports associated with the supply of petroleum products to Kygnus Sekiyu K.K. Do you also expect that the CDU operating ratio will rise? Describe your perspective on the operating ratio.

A16: We understand that the operating ratio tends to decline with frequent regular inspections in the first half. Without an effect from regular inspections, the operating ratio stands at 96%, a level close to full operation. We will rely on imports to cover some of the customer demand that we are unable to accommodate with our own production.

We have experienced operating deficits in the past with imported products being priced in favor of wholesale suppliers. With stable market conditions in place at home, we have maintained certain price bargaining power against wholesale suppliers. We expect to secure a certain level of profit without regard to some fluctuations in the margins. Initially, we expected to be able to take advantage of the full operating ratio for the refineries despite the shrinking demand on the domestic front. We generate profit on imports, which is positive.

Q17: Do you plan to have any large capital spending in the Petrochemical Business segment at this point in time?

A17: We do not expect to undertake large capital spending at the moment. Having said that, we position the Petrochemical Business as our priority for future growth. We aim to embark on new business in the area of high-performance products, following the success of Chiba Arkon Production Limited.

Q18: What are your plans for the overseas business, excluding the Oil E&P Business?

A18: We do not intend to build a refinery plant overseas. We will operate as a late comer in the lubricant market and do not think that the lubricant market justifies heavy investment. We will focus on the domestic market first, and explore business opportunities overseas related to wind-power generation and others.

End