DAIDO STEEL CO., LTD. (5471 JP)

FY24~FY26: TRANSFORMATION OF THE BUSINESS MODEL FOCUSED ON PROFITABILITY

Daido Steel [DS] announced its new medium-term management plan covering the three-year period between FY24 and FY26 on 6 June 2024. The firm designates the three-year period as a transition period towards becoming the company it aims to be in 2030. Over the next three years, DS aims to work on 1) transforming the business portfolio, 2) enhancing management resilience, and 3) advancing ESG management.

MEDIUM-TERM MANAGEMENT PLAN 23 REVIEW

DS's previous medium-term plan, “2023 Mid-Term Management Plan” lasted between FY21 and FY23. Following is the firm’s assessment of Plan achievements.

Earnings

The Plan’s OP target of over ¥40,000mil was achieved in FY22. Although the level of OP declined YoY in FY23, it still overshot the medium-term plan target. During the tenure of the Plan, the firm focused in particular on the product portfolio as opposed to sales volume. Although steel product sales volume fell short of the Plan by approx. 10% (1.072mil tonnes vs 1.2mil target) and the High-performance and Magnetic Materials [HP&MM] segment saw underperformance on the back of weak demand from the SPE segment, DS was nonetheless able to secure higher than target OP due to the following efforts:

- Improved gross profit margin [GPM] in the legacy Specialty Steel segment. Despite a shortfall in steel sales volume, price hikes introduced from FY22 onwards to reflect higher energy costs (previously not subject to surcharges) contributed.
- Development of a higher margin product portfolio. Examples include open die forging, stainless steel for SPEs and titanium products. The PA&IE segment, which includes open die forging saw segment OP improve from a loss of -¥2,109mil in FY20 to ¥7,539mil in FY23 while sales grew approx. 30% over the three years from ¥80,750mil to ¥105,633mil.
- Cultivation of the Engineering business such as electric furnaces and heat-treatment furnaces that contributes to carbon neutrality.

Growth in DS’s strategic products, such as high-performance stainless steel and open die forging, has led to a marked improvement in sales mix.

Balance Sheet and capital efficiency

The 2023 Mid-term Management Plan also included initiatives relating to measures to improve the balance sheet. Achievements were as follows.

- Owing to improved cash flow, the D/E ratio came in at 0.41x, better than the firm’s target of 0.5x.
- Optimisation of inventory controls.
- Reduction of strategically held shares. DS has sought to reduce strategically held shares to below 20% of net assets via sale of such

EXECUTIVE SUMMARY

- Upon successful achievement of the previous Mid-Term Management Plan ended in FY23, Daido Steel (DS) saw 1) improved GPM, 2) an improved product portfolio such as open die forging, stainless steel for SPEs and Titanium, 3) cultivation of the Engineering products such as heat-treatment furnace.
- On the BS side, DS achieved a better D/E ratio (0.41x) versus target of 0.5x, and steadily reduced strategically held shares contributing to an ROE of above 10% and higher than 8% target.
- The key message of the new Mid-term Plan is transformation of the existing business model. While the existing three core businesses, namely Specialty Steel, High Performance & Magnetic Materials [HP&MM], and Parts for Automobiles & Industrial Equipment [PA&IE], will continue to see steady growth, the firm aims to accelerate growth in fast-growing products. Such products, which generated 10% of FY23 sales is expected to increase to 15% of total sales in FY26, and then to 25% in FY30.
- DS plans to allocate total of ¥190,000mil+ to 1) CAPEX and growth investment, and 2) shareholders’ return.
- One of the core investment topics is Superalloy Manufacturing Process Transformation, to which the firm plans to allocate approx. ¥30,000mil investment, and boost OP by approx. ¥5,000mil, realising ROIC of 8% in after completion of the investment in FY27. This is part of total of ¥64,000mil investment during the Plan to boost OP by ¥16,000mil.
- Although the firm’s principal shareholders’ return policy is dividend payout of more than 30%, it might consider allocating more on shareholders return depending on progress in investment.

assets and reduction of shares owned by the retirement benefit trust. During the Plan (FY21~FY23), DS continued to unwind strategically held shares and sold a total of ¥44,800mil worth of holdings over the three years. In FY23, DS accelerated the sale of investment securities and sold four holdings (approx ¥35,800mil) and reported an extraordinary profit of +¥26,696mil. Due to stock market strength, however, the total value of shares held on the balance sheet has not declined. DS reduced 40% of its stock holdings. As of FY23, DS's strategic holdings declined to 23.4% of net asset as of FY23 (¥467,687mil).

- Capitalisation of other assets such as real estate assets. DS reported an extraordinary profit of +¥7,047mil from the sale of fixed assets in FY23, of which +¥6,900mil was from sale of a leasing property owned by a subsidiary, currently leased to Aeon Mall Atsuta.

Thanks to improvements in the earnings structure and capital efficiency, ROE reached 10.4% in FY22, surpassing the medium-term target of 8%. In FY23, although high-performance stainless steel products were affected by weak demand, ROE reached 12.5% on the back of sale of assets boosting extraordinary profits.

The 2023 Mid-Term Management Plan Achievement

	Results of the fiscal year ending March 31, 2021 (FY2020) (Japanese GAAP)	2023 mid-term plan targets (Japanese GAAP)	Results of the fiscal year ending March 31, 2022 (FY2021) (Japanese GAAP)	Results of the fiscal year ending March 31, 2023 (FY2022) (Japanese GAAP)	Results of the fiscal year ending March 31, 2024 (FY2023) (Japanese GAAP)
Specialty steel sales volume (non-consolidated)	978 thousand tons	1,200 thousand tons	1,253 thousand tons	1,085 thousand tons	1,072 thousand tons
Operating income	10.1 billion JPY	40 billion JPY or more	37 billion JPY	47 billion JPY Achieved	42.1 billion JPY Achieved
Return on equity (ROE)	1.6%	8.0%	8.5% (Excl. extraordinary income/loss: 8.3%) Achieved	10.4% (Excl. extraordinary income/loss: 10.2%) Achieved	12.5% (Excl. extraordinary income/loss: 7.8%) Achieved
D/E ratio	0.66	0.5	0.69	0.64	0.41 Achieved
Investment amount (3-year total on an approval basis)	–	85 billion JPY	–	–	94.7 billion JPY Executed
Dividend payout ratio * Excluding one-time effects	Dividend payout ratio: 22.1%	Dividend payout ratio: about 30%	Dividend payout ratio: 29.3% Executed	Dividend payout ratio: 29.5% Executed	Dividend payout ratio: 31.6% Executed

Source: Daido Steel Co., Ltd. FY24-26 Mid-Term Management Plan – Transition Management – released on 6 June 2024

BUSINESS MODEL RECAP

DS has five businesses of which three, 1) Specialty Steel,2) High Performance Materials and Magnetic Materials [HP&MM], and 3) Parts for Automobile and Industrial Equipment [PA&IE] (includes open die forging), generated approx. 91% of sales and 87% of operating profit [OP] in FY23. The proportion OP represented by the three segments was lower in FY23, however, due primarily to underperformance of the HP& MM segment. The segment suffered from a decline in orders from the SPE sector as well as continued weakness in demand from the industrial machinery sector. DS also sees the Engineering segment as an emerging business segment given its focus on the engineering technology such as electric furnace and heat resistant furnace, which supports customers achieve carbon neutrality.

1. Specialty Steel
   DS sees the Specialty Steel business as its base line business. The segment generated 37.7% of sales and 35.1% of OP in FY23. Every specialty steel maker is unique in how they combine steel and alloys – to create properties such as heat, abrasions, and corrosion resistance. They each develop tailored products to meet the needs of its customers.

   Segment sales are primarily derived from the auto and industrial machinery sectors. Due to high exposure to the auto and industrial machinery sectors, auto production volumes, especially by Japanese manufacturers, are an important bellwether for DS'S earnings. A portion of specialty steel manufactured in this segment is used internally. In FY23, 22.7% of segment sales was for internal use (inter-segment trades).

   Cost factors affecting segment margins are steel scrap and alloy prices. Steel scrap and core alloy materials are subject to surcharges. Energy and graphite electrode prices also affect the operating cost of an electric furnace. During the 2023 Mid-term Management Plan, DS aimed to adjust prices to meet a rapid surge in graphite electrode and energy which were not part of the surcharge pricing mechanism applied to raw materials (such as metal alloys). The firm introduced a surcharge system to the costs of energy on the back of a rapid surge in energy prices. As a result, the segment became more resilient to swings in auto production which plummeted during the COVID pandemic and post-COVID fraud issues at some OEM makers.

2. High Performance Materials and Magnetic Materials [HP&MM]
   Management sees this segment as the core of DS's future growth. The segment generated 34.9% of FY23 total sales and 34.3% of total OP. Back in FY21, the first year of the previous Mid-term Plan, this segment earned 72.0% of total OP and OPM of 13.5%, thanks to strong demand from the SPE segment. Key products include stainless steel products, rare earth magnets, high alloys, titanium products, and powder metal products. Main applications are for automotive motors, semiconductor production equipment [SPE], mobile phones and consumer electronics. The segment's higher margins reflect 1) a larger number of high value-added products, 2) increasing proportion of high performance of specification products, and 3) a larger number of niche products.

3. Parts for Auto and Industrial Equipment
   The segment's primary business is to process in-house manufactured specialty steel materials for auto and industrial equipment parts manufacturers that includes Tier 1 makers. There are two sub-segments: (1) die forging, engine valves, and precision castings for automobiles, and (2) open die forging, which enjoys higher margin than die forging and includes non-automotive uses such as aviation, space, energy, and oil/gas applications.

   DS commands high market share in numerous product categories in this segment. Examples include aircraft jet engine shafts, automobile engine valves and turbine wheels. The segment earned 18.2% of sales and 17.9% of total OP in FY23. Despite the fact that some materials (e.g. specialty steel), are supplied in-house, segment OPM remains in the region of 5~8% range. This is explained by 1) the existence of the lower margin die forging business in the same, 2) fixed costs are relatively high, and 3) fierce pricing competition in the mature auto parts business (e.g., precision casting for turbo engines).

Daido Steel (5471JP): Sales, OP and OPM by Segment (Cumulative)

(¥mil)		FY20	FY21	FY22	FY23	FY24*
		FY	FY	FY	FY	FYCE
Specialty Steel	Sales	145,842	197,803	214,770	219,021	225,000
	OP	-2,632	3,827	9,771	14,797	13,500
	OPM (%)	n/a	1.9	4.5	6.8	6.0
High Performance Materials & Magnetic Materials	Sales	149,420	197,604	219,724	202,832	210,000
	OP	12,172	26,650	24,286	14,432	21,000
	OPM (%)	8.1	13.5	11.1	7.1	10.0
Parts for Automobile and Industrial Equipment	Sales	80,750	92,504	101,232	105,633	115,000
	OP	-2,109	4,979	8,217	7,539	11,500
	OPM (%)	n/a	5.4	8.1	7.1	10.0
Engineering	Sales	20,205	18,214	18,956	23,117	20,000
	OP	858	-1,277	1,425	2,424	1,500
	OPM (%)	4.2	N/A	7.5	10.5	7.5
Trading & Service	Sales	16,504	23,540	23,881	30,681	30,000
	OP	1,786	2,834	3,293	2,900	2,500
	OPM (%)	10.8	12.0	13.8	9.5	8.3
Total	Sales	412,722	529,667	578,564	581,287	600,000
	OP	10,070	36,982	46,986	42,113	50,000
	OPM (%)	2.4	7.0	8.1	7.2	8.3

Source: Nippon-IBR based on FY23 Earnings Results Materials published by Daido Steel
Total numbers are after adjusted for inter-segment trades.
* FY24 numbers are adjusted for the Japanese GAAP

MEDIUM-TERM MANAGEMENT PLAN 26 – KEY FOCUS

DS designates the new Mid-term Management Plan as transitional management, based on the firm's focus on how to transform the current business portfolio into one with sustainable growth by 2030. Thus, the next three-year period represents the transition period of DS's business model. There are two core strategies: 1) growing sales of existing businesses in an environment where domestic demand for specialty steel is seeing a long-term decline, and 2) investing profits earned from aforementioned existing businesses into growth opportunities. DS aims to increase sales of growth businesses to 25% of total sales by FY2030.

The 2026 Mid-term Plan [the Plan] Target and Core KPIs

Under the Plan, DS aims to achieve OP of ¥60,000mil (12.5% CAGR for FY24~FY26) and ROE of 9% or more by FY26 under the Plan (note the CAGR figure is for reference only as whilst the firm introduced IFRS accounting standard from FY24, the CAGR figure was calculated using FY23 OP under Japanese GAAP. Although the firm does not set a topline target for the Plan, given an ROS [operating profit margin / OPM] target of 10% or more in FY26, it is estimated the final year sales target will likely be ¥600,000mil (CAGR of 1.1% for FY24~FY26) or more. DS is aiming to achieve the numerical targets by the following initiatives:

<u>Changing Business Portfolio</u>

As aforementioned, DS currently has three core businesses, 1) Specialty Steel, 2) High Performance and Magnetic Materials [HP&MM], and 3) Parts for Automobile and Industrial Equipment [PA&IE]. Segment OP forecast for the duration of the Plan is shown in the table below. Despite a gradual decline in demand for speciality steel products for automotive use due to the shift to BEVs, DS assumes that sales of existing products to continue to increase until FY26, based on the assumption that global automobile production will continue to increase. During the three years to FY26, the company will take the following measures:

1. Expand HP&MM businesses and open die forging businesses. Improve PA&IE segment OP to the level above that of the Specialty Steel segment. DS estimates that the specialty steel segment is able to produce OP of at least ¥12,500mil per year.
2. Realise sales growth of existing businesses irrespective of the medium to long-term downward trend in domestic specialty steel demand.

3. Invest profit from existing businesses into fast growing markets and increase sales of such products from 10% currently to 25% of total sales by FY2030. Along with growth in fast growing products sales, DS aims to improve the overseas sales ratio from 28% in FY23 to 30% in FY26, then to 35% in FY30.

Ⅲ-1) | Main strategic KPIs

Strategy category	Strategic KPI	FY2023 results (Japanese GAAP)	2026 Mid-term management plan for FY2026 (IFRS)	"Vision for 2030"
Business Strategy	**ROS (Return on sales)**	7.2%	10% or more	12% level
	Percent of products sold in fast-growing markets	9.6%	15% or more	25% or more
Financial Strategy	**ROE**	12.5% (excl. extraordinary income/loss)	9% or more	10% or more
	D/E ratio (Balance between maintaining financial soundness and improving capital efficiency)	0.41	about 0.5	about 0.5
	Equity ratio (Balance between maintaining financial soundness and improving capital efficiency)	54.4%	50-55%	50% or more
ESG Strategy	**E: CO2 emissions** (Daido Steel Group's CO2 emissions reduction target (compared with 2013)	20% reduction (Expected achievement)	35% reduction	50% reduction
	S: Improvement in labor productivity (non-consolidated)	Standard	+20%	+30%
	S: Improvement in employee engagement score (non-consolidated) (Improvement in willingness to contribute among employees who share our Mission)	–	The target value to be set during FY2024	A revised target value to be set during FY2024
	G: Ratio of cross-shareholdings to net assets	23.4%	Target: 15%	Target: 10%

Source: "Fiscal Years 2024-2026 Mid-Term Management Plan – Transition Management –" Daido Steel Co., Ltd. 6 June 2024

Daido Steel (5471JP): Sales, OP and OPM by Segment (Cumulative)						
(¥mil)		FY23 FY	FY24 FYCE	FY25 Target	FY26 Target	3-year CAGR (%)
Specialty Steel	Sales	219,021	225,000	N/A	N/A	N/A
	OP	14,797	12,500	12,500	12,500	-5.5%
	OPM (%)	6.8	5.6	N/A	N/A	N/A
High Performance Materials & Magnetic Materials	Sales	202,832	210,000	N/A	N/A	N/A
	OP	14,432	20,500	25,000	28,000	24.7%
	OPM (%)	7.1	9.8	N/A	N/A	N/A
Parts for Automobile and Industrial Equipment	Sales	105,633	115,000	N/A	N/A	N/A
	OP	7,539	11,000	13,000	14,500	24.4%
	OPM (%)	7.1	9.6	N/A	N/A	N/A
Engineering	Sales	23,117	20,000	N/A	N/A	N/A
	OP	2,424	1,500	2,000	2,500	1.0%
	OPM (%)	10.5	7.5	N/A	N/A	N/A
Trading & Service	Sales	30,681	30,000	N/A	N/A	N/A
	OP	2,900	2,500	2,500	2,500	-4.8%
	OPM (%)	9.5	8.3	N/A	N/A	N/A
Total	Sales	581,287	600,000	N/A	600,000	1.1%
	OP	42,113	48,000	55,000	60,000	12.5%
	OPM (%)	7.2	8.0	N/A	10.0	N/A

Source: Nippon-IBR based on FY21, FY22 & FY23 Q3 Earnings Results Materials published by Daido Steel

NB: Figures for FY24 onwards are on IFRS basis, therefore, CAGR numbers compared to FY23 are for reference only.

By Segment

- Specialty Steel

  DS forecasts segment OP of ¥12,500mil per year for the next three years. The firm assumes steel products sales volume of between 1.08mil~1.16mil tonne or slightly above the 1.072mil tonnes in FY23. During the previous mid-term plan, DS shifted its strategy from pursuing sales volume to one focused on securing optimal margins/segment OP by improving the sales mix. DS's segment OP forecast for the next three years is likely to be the minimum of what the firm may achieve even with little growth in sales volume. The firm aims to lower the segment's break-even point by improving productivity and production yields at factories. Furthermore, DS also plans to obtain third-party certification by calculating the precise CO^2 emissions of each product for the segment. The aim is to quantify the superiority of electric furnace steel in reducing CO^2 emissions and ultimately to increase market share through precise carbon footprint [CFP] calculations.

- HP&MM

  Although the segment saw negative OP growth in FY23 reflecting weak demand from the SPE sector, DS assumes segment earnings growth will be highest among all the segments. Until FY26, the driver of segment growth will likely be stainless steel for SPEs. Out of four VARs (vacuum arc melting) of which two will be invested under the Superalloy Manufacturing Process Transformation Project, two will be invested into the HP&MM segment so as to be able to promptly respond to unexpected surges in demand. The firm also aims to promote the HP&MM products to overseas clients. Whilst segment sales estimates are not disclosed, DS expects segment OPM will improve significantly. As a reference, FY23 segment OPM was 7.1% compared to a recent peak of 14.9% in FY21 Q1 (peak of the previous silicon cycle). The firm anticipates that fast-growing products in this segment, such as LiB anode materials, will start contributing to earnings after the current mid-term management plan.

- PA&IE
  The segment includes one of the main strategic products, namely open die forging. DS estimates FY26 segment OP of ¥14,500mil or more. DS has been steadily increasing production capacity for open die forging. During the Plan, the firm plans to invest in large-sized radial forging machines and vacuum induced machinery [VIM] that will improve throughput. DS estimates segment OPM will gradually improve as the effects of the Superalloy Manufacturing Process Transformation Project are realised and two VARs (vacuum arc melting) invested in the PA&IE segment start to feed into segment earnings.

Fast-Growing Products

One of the mid-term growth drivers for DS is fast-growing products. As of FY23, such products only represented approx. 10% of total sales. The firm aims to grow the fast-growing product ratio to 15% in FY26 and 25% in FY30. Management believes that as the fast-growing product ratio grows, the overseas sales ratio will also increase. In FY23, 28% of sales came from overseas. This is expected to grow to 30% in FY26 and 35% in FY30.

DS identifies five segments as fast-growing markets as per below:

1. Connected, Automated / Autonomous, Shared, Electric [CASE]
   Under the Plan, the fastest growing - products area is likely to be CASE for DS. In particular, the firm believes demand for steel materials used in e-Axles will lead growth. The firm reckons that increasing use of sensors will boost demand for stainless steel. Any contribution from CASE related products will be reflected in the Specialty Steel segment as well as the HP&MM segment.

2. Clean Energy
   Growing demand for solutions that address environmental issues will be reflected mainly in the Engineering segment which earned OP of ¥2,424mil (+70.1% YoY) on sales of ¥23,117mil (+21.9% YoY) in FY23. As DS has expertise in electric furnace engineering, the firm aims to capitalize on the growing demand for carbon neutrality solutions, especially within the steel sector, by providing engineering solutions in electric furnaces, heat treatment furnaces, and ultra-high temperature carbonisation furnaces.

3. Medical
   DS expects solid demand for titanium from the medical sector which is included in the HP&MM segment.

4. Aerospace
   DS has been cultivating demand for open die forging within the Aerospace sector (PA&IE segment) where the firm expects to see stable demand. Open die forging is utilised in core components such as engine shafts.

5. Semiconductors
   Solid stainless steel demand from the semiconductor sector is expected during the Plan. Beyond FY26, the firm aims to capture growth by increasing production volume of LiB anodes. Currently, the main material for LiB anodes is carbon. However, to increase battery capacity, other materials such as silicon-based metal compounds become necessary, presenting high growth potential as the next generation material.

CAPITAL ALLOCATION

DS aims to generate operating cash flow [CFO] of approx. ¥140,000mil over the three years (FY24~FY26) of the Plan. This is more than double the previous plan's CFO. DS's allocatable capital totals ¥190,000mil (including loans) which is made up of the CFO of ¥140,000mil plus ¥50,000mil of cash generated from sale of assets. The capital is allocated to 1) investment of approx. ¥150,000mil including ¥64,000mil of strategic growth investments, and 2) shareholders' return totalling ¥40,000mil.

CAPEX

DS plans to invest a total of ¥150,000mil during the Plan, of which ¥64,000mil will be invested in strategic growth areas related to the aforementioned fast-growing products. During the Plan, the ¥64,000mil strategic investment is expected to generate an estimated return of ¥16,000mil in FY26 OP and a top up of ¥26,000mil to FY30 OP. Strategic investment projects are as follows:

- The Superalloy Manufacturing Process Transformation Project.
  The firm plans to invest approx. ¥30,000mil in the project, which will generate OP growth of ¥5,000mil or more and achieve ROIC of 8% in FY26 and 9% after completion of the project in FY28. The firm aims to transform the manufacturing processes of superalloy products by transferring heat treatment, machining, and inspection processes at the Shibukawa Plant to the Chita Second Plant. DS also plans to upgrade open die forming melting through process at the Shibukawa Plant. Furthermore, the firm plans to transform the Shibukawa Plant to an integrated manufacturing plant for aerospace related products and forged parts. Thanks to surging demand from the aerospace applications, DS estimates that superalloy bar demand will grow at CAGR of 5% to CY30. As of CY22, DS's market share in superalloy was 4%. By investing in the project, the firm aims to grow its market share to 10%.

- Increasing production capacity of stainless steel for SPEs.
  DS expects a surge in demand for VIM-VAR melted stainless steel used in SPEs. Volatility of SPE related demand is similar to that of the silicon cycle. DS recognizes that its production system should be structured so as not to be affected by the cyclicality of the SPE sector, but at the same time prevent opportunity losses when demand suddenly surges. SPE related strategic investments should be complete by the middle of FY25. The firm has not disclosed project specific ROIC regarding this investment.

Shareholder Return

DS plans to allocate ¥40,000mil for shareholder returns during the three years of the Plan, compared to dividends of ¥27,000mil during the previous plan (FY21~FY23). Whilst the principal policy is to pay out more than 30% of net profit per year, depending on progress of investments, the Co may consider allocating more to shareholder returns.

Other Areas of Capital Allocation

DS also allocates resources to 1) enhancement of management resilience via human capital investments and digital transformation (Daido DX), and 2) carbon neutral initiatives. For details, please refer to DS's presentation material "Fiscal Year 2024 – 2026 Mid-term Management Plan – Transition Management - (https://www.daido.co.jp/en/common/pdf/pages/ir/library/presentation/2026mid.pdf)".

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