

Q&A Summary of the Online Explanatory Session for Analysts and Institutional Investors for the Second Quarter of the Fiscal Year Ending March 31, 2023

Ferrotec Holdings Corporation (6890)

☆Date: Friday, December 2, 2022, 16:00-16:45

Q1: While the performance of semiconductor equipment manufacturers is projected to be sluggish next year, I would like to know the factors that enable your company to maintain growth while other companies are having a difficult time, based on your president's view.

A1: Our semiconductor-related business includes quartz, ceramics, silicon parts, CVD-SiC, parts cleaning, and commissioned metal processing. According to our customer's situation, the quartz market will be unchanged from the current term, and the market in China has been growing. Although the overseas sales of ceramics, especially to the U.S. market, are shrinking, the Chinese market is still expanding. As for silicon parts, the sales of silicon boats and focus rings for Chinese and overseas device manufacturers, which are not OEM products, are expanding rapidly. CVD-SiC sales are expected to expand to about 4 billion yen this fiscal year, and with the addition of three furnaces, we hope to nearly double sales in the next fiscal year. The commissioned metal processing business for equipment manufacturers in China has grown to a considerable scale, and we are now able to produce legacy-level products (although they are not the most advanced ones), and we expect a 20% increase from the current term. As for parts cleaning, device manufacturers have been increasing the number of 12-inch wafers, and we hope to increase this by about 15% from this year.

As for electronic devices, the growth of power semiconductor substrates is remarkable. The amount of finished products is not enough at all. The sales of not only DCB substrates, but also AMB substrates have been increasing. New DPC substrates, too, have attracted customers. We are in the process of building a new factory in Neijiang, Sichuan, which will be completed around the end of May next year, and when that is completed, the production output of DCB and AMB will increase by 500,000 wafers and 400,000 wafers, respectively. As for AMB substrates, we acquired a company to which we outsourced the soldering process, enabling us to increase production by conducting the process in house. In addition, we have developed a silicon nitride material for substrates and are now able to manufacture it. However, as we have explained to our current suppliers, our own supply is not enough, and we are willing to buy all of the supply from suppliers or conclude LTAs (long-term agreements). Also, thermo-electric modules can now be used to build cooling systems. Once this is done, the business will expand to various industries. Also, thermo-electric modules are being used in a variety of electric vehicles (EVs).

As for the two companies acquired through TOB, Ohizumi Mfg is promoting its temperature sensors in China, and we have already gone so far as to provide samples to about three client companies. Toyo Knife is also moving forward to enter the Chinese market, both of which are positive factors for our company.

In the next year, we believe that the decline in sales of semiconductor-related products to major U.S. manufacturing equipment makers (although Japanese manufacturing equipment makers do not seem to be affected to that extent) will be offset by the expansion of the Chinese market and the development of the markets in Southeast Asia and Europe.

Q2: Please tell us about the future development of your manufacturing bases outside of China.

A2: In Japan, we will invest in the production increase of the third factory in Ishikawa and CVD-SiC in Okayama, and start the operation of the Kumamoto Factory. We expect the new factory to be completed by 2024. Also, in Japan, we would like to increase the commissioned metal processing business.

A major European company has asked us to manufacture power semiconductor substrates outside of China. We would like to establish a manufacturing base as early as next year or the year after, and our current idea is to establish one in Malaysia.

Q3: Regarding profit margin improvement, you are working on cost reduction and automation, but at what level are you aiming?

A3: While profit margin varies from business to business, we have set a target profit margin and are improving it.

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Q4: Regarding shareholder returns, you have raised the dividend amount to 100 yen/share this time, but will you continue to do so based on the dividend payout ratio, what about fundraising, and what about capital and dividend policies?

A4: The dividend amount has increased from 70 yen/share to 100 yen/share, and the dividend payout ratio is now 19.2%, but we keep pursuing a dividend payout ratio of 20%. Regarding fundraising, we have been diversifying our fundraising methods. Last year, we raised equity in Japan and China, and we are also using borrowings, but we are managing our interest-bearing debt quite well and do not want to increase the amount too much. We will continue to diversify our fundraising. In terms of our own funds, we are increasing profit in our business, and depreciation is also increasing.

Q5: Regarding the regulatory risk, for example, is there any risk that the products you manufacture in China at your factories in Dongtai and Changshan, which are used to supply products to U.S. customers, will be regulated?

A5: We do not believe that any of Dongtai's or Changshan's products are currently subject to the regulation. Dongtai manufactures power semiconductor substrates and has the world's second largest supply capacity, but there is still a shortage of products, so we would be asked to manufacture them rather than being subject to regulations. Even if they were to be subject to sanctions, I believe that growth can continue because our company can manufacture and sell in China.

The factories in Dongtai and Changshan handle quartz, but I think that pyro-processed quartz products will increase in the future. There is also a shortage of pyro-processed quartz products. We are trying to establish a system of 500 pyro-processing workers at three bases by the first quarter of the next fiscal year, and I do not think this will be subject to the regulations. Also, the Changshan Factory is engaged in commissioned metal processing and we have invested in a large automated line. At present, we expect an increase in the volume of vacuum chambers for semiconductor equipment, vacuum spare parts, and assembly unit-related products. In the future, we will build a factory to produce ceramics and CVD-SiC in Changshan, and we believe that this will lead to an increase in domestic sales in China.

Q6: When will the second-phase factory in Changshan be in full operation? What will the production capacity be compared to the current level?

A6: In the second phase, the Changshan Factory will manufacture thermo-electric modules and silicon parts, and undertake commissioned metal processing. We believe that we can manufacture these products on a full scale once undelivered machines are installed. Based on the production capacity in the first phase in Changshan and Hangzhou, we should be able to produce the same amount in the second phase in Changshan.

Q7: Regarding power semiconductor substrates, you said that the factory in Neijiang, Sichuan is scheduled to begin production in May. How much will the production capacity increase once it is fully operated?

A7: To put a concrete figure on it, DCB substrates will be produced at a rate of 500,000 wafers/month, and AMB substrates will be produced at the same rate as the current Dongtai Factory, that is, 400,000 wafers/month. Also, we will use materials in house when it becomes possible to produce them. By the way, the current production capacity is 1.1 million wafers/month for DCB substrates and 450,000 wafers/month for AMB substrates.

Q8: I recently read an article in the Financial Times that you are going to invest outside of China. How much of the 180 billion yen investment over 3 years do you want to invest outside of China? Have you disclosed that amount?

A8: We have already decided to invest in Japan and Malaysia, but we have not disclosed the breakdown. We are considering building factories overseas (other than China) for power semiconductor substrates, but this is not included in the 180 billion yen investment amount presented in the Mid-Term Management Plan.

Q9: How much will the friction between the U.S. and China affect your business?

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A9: There will be an impact on the receipt of orders from overseas equipment manufacturers, but we expect it to be limited. Conversely, we expect subsidies and other support from the Chinese government and others, and the contribution of this support will be significant, and as far as I can see, the positive effect from the support will be greater than the negative effect. Frankly speaking, this subsidy is considerably larger than that of Japan or the U.S.

Q9-2: To what extent is the assistance provided? And in what manner will it be provided?

A9-2: The subsidy is about 20-25% of the factory investment, and we receive payment in cash after confirming all the invested amount.

Q9-3: Then, in the case of your company, in free cash flow, there is a subsidy from the Chinese government in terms of financing, so is it correct to view this as an investment that appears excessive in terms of periodic profit, but is not unreasonable in terms of the subsidy?

A9-3: Your understanding is correct. In China, subsidies are quite generous, especially in the semiconductor industry. In addition to direct subsidies, there are government subsidies for interest rate on borrowings. For the record, the prevailing interest rate in China is about 4%.

Q10: When you aim for further growth in the fiscal year ending March 31, 2024, I hear that you are considering investments in China, Japan, and Malaysia, as well as in the U.S. What do you think about this? Also, is there a possibility of exceeding 180 billion yen in terms of future growth?

A10: There is a possibility of investment in the United States. At present, we do not expect our investment to exceed 180 billion yen over the three years of the Mid-Term Management Plan.

Q11: Regarding the results for the next fiscal year, you said that even with the impact of friction between the U.S. and China, you expect to maintain an increased profit and achieve a high level of profit margin, but what is the probability that you will achieve an operating income of 40 billion yen in the Mid-Term Management Plan?

A11: Of course, we cannot make a 100% promise because we do not know what will happen in the future, but at this point, we believe that we can achieve both sales and operating income as currently planned.

Q12: With regard to the IPO in China, the parts cleaning subsidiary (FTSVA) will be listed, but in what way will these be reflected in your company's earnings per share and net assets per share in the future? For example, the stock price of the subsidiary will fluctuate. In what way will the profit from such fluctuations be recognized, for example, on a quarterly basis? Would unrealized gains be recorded as extraordinary income?

A12: With regard to stock price fluctuations, we do not reassess them every quarter. For consolidated businesses, a loss is recognized only when there is a significant decline in price. In addition, when an equity-method affiliate increases its capital through a third-party allotment, for example, when the wafer business (CCMC) increases its capital, a gain or loss on change in equity will be recorded.

(Note: This explanation is based on the currently assumed accounting.)

Q12-2: Then, is it correct to understand that when the IPO is realized in January 2023, even if share price of the consolidated subsidiary increases tenfold, you will not see an increase in extraordinary income, but only an increase in the unrealized gain of the shares of affiliated companies it holds?

A12-2: Your understanding is correct. Since there is no institutional plan to sell the shares held, it is our understanding that if consolidation is to be maintained, there will be no impact on the periodic profit and loss.

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Q13: To reconfirm, when you say that the friction between the U.S. and China has an impact on overseas equipment manufacturers, are you referring to the impact of customers' reduced exports to China and reduced sales of parts used in that equipment, or are some of your company's products subject to restrictions? Also, how much are you prepared for a decrease of orders from major U.S. equipment manufacturers in the next fiscal year?

A13: Mostly the former, and since the OEM spare parts that we make in China are not so cutting-edge, I think the impact will be limited. We expect orders from major U.S. manufacturers to decrease by up to 20%, but we believe that the decrease will be offset by an increase of orders for new equipment from Chinese equipment manufacturers.

Q14: Looking at the securities reports, we see that President's remuneration is around 900 million yen, which is quite high among Japanese listed companies, so I recommend stock-based compensation. Wouldn't it be better to reduce the proportion of cash compensation and increase the proportion of stock-based compensation, which would not only improve the profitability of your company, but also make shareholders aware that your company is managing its business with an awareness of stock prices?

A14: The amount of compensation is determined based on business performance, but there is a certain thought about increasing the percentage of stock-based compensation.

*This document was produced by the IR/Publicity Department in the IR Office from the viewpoint of fair disclosure in accordance with our "Disclosure Policy."

*Please note that due to the poor communication conditions on the day of the web conference, similar questions were asked by several attendees, but we have not summarized them here. Thank you for your understanding.