Annual Report 2014: Interview with the President

Q. Companies need more than a quick response to today's volatile markets. They need an overarching vision that matches their core competencies. Tosoh is the largest fully integrated manufacturer of its class of commodities in Asia and has experienced the market volatility of recent years. What are the Tosoh Group's mission, strengths, and strategic goals going forward?

A. Our mission remains to maintain or grow our market share as a comprehensive materials supplier serving manufacturers worldwide. We pride ourselves on a tradition of craftsmanship, quality, and innovation. And we further that tradition by bolstering our manufacturing hubs; investing in R&D; building regional sales networks; and looking out for M&A opportunities that can generate synergies, augment our portfolio, and extend our reach.

Our strategic goals are supported by our core strength, which, as you've noted, is the largest fully integrated manufacturing operations in our commodities class in Asia. The vinyl isocyanate chain as we call it supplies much of the raw materials, utilities, and infrastructure for the Tosoh Group's commodity and specialty products. We manage input and output along the chain to optimize cost competitiveness and quality.

Tosoh has designed a strategy to counteract the cyclicality of its chemicals business. By developing specialty products for niche markets, we provide ourselves with a buffer against downturns in the markets for our core commodities. The niche markets for our specialty products offer us the advantages of competitive superiority and of substantially higher profit margins. Commodities provide most of our cash flow, while specialties supply most of our profit.

The result is a dynamically balanced commodities and specialties strategy that positions us for stable profitability and growth. And I'm pleased to report that the strategy is working. We achieved an average 6.4% return on ordinary income across the board for the year under review. Although that represents growth, we have our sights set much higher.

Q. Your mission requires that the Tosoh Group stay in step with or abreast of the industries it serves. How are your strategies playing out at the group level? What initiatives or actions are under way?

A. **Specialty Group**
Specialty markets are fast growing and profitable, and we are targeting a 20% return on ordinary income. Tosoh keeps pace with capital investments to match surging demand. We go where the growth is, and our strategies are taking us deeper into China and Southeast Asia, the Middle East, India, and South America. We are also pushing our established networks in North America and Europe for more growth. And we are keeping our options and eyes open for M&A deals and opportunities to build plants overseas.

The Tosoh Group has built its specialty businesses through practical R&D that has served evolving markets for the mega industries of electronics, automobiles, energy, bioscience, pharmaceuticals, and chemicals. Because we often work with our customers to customize materials and products and provide technical support for their specific needs, we also have developed marketing and sales bases worldwide for many of our specialty businesses.

Some of our activities in fiscal 2014 include approving a major capital investment by Tosoh SMD, Inc., in the 450-millimeter wafer semiconductor market and a decision to expand our high-silica zeolite (HSZ) production capacity. We also began constructing a plant to produce Rzeta, our unique, proprietary, emission-free reactive amine catalyst for polyurethane foam; announced the successful development of an ultra-degradation-resistant zirconia capable of withstanding extreme conditions; and launched a game-breaking high capacity Protein A-affinity separation media.

Chlor-alkali Group

Our strategies for the Chlor-alkali Group are geared toward commodity markets. Competitiveness and profitability amid expanding global production capacity and fluctuating costs and prices are the chief priorities. And although our goal is a lower 5% return on ordinary income, the Chlor-alkali Group's large sales volume can be extremely profitable in favorable markets.

Our fully integrated vinyl isocyanate chain's principal products, moreover, serve as feedstock for the numerous commodity products of the Chlor-alkali Group. Operations in Japan supply raw materials to the Tosoh Group's PVC manufacturers throughout Asia. Optimizing our upstream processes, therefore, improves the chain, as do cost reductions to offset rising raw material prices. These are clearly important and ongoing strategies.

Constant reengineering and innovation are essential, and so, too, are the resulting synergies. Our move into the methylene diphenyl diisocyanate (MDI) business, for example, has provided wide-ranging production and marketing synergies. But in MDI and other of the Chlor-alkali Group's businesses, we must decide whether to expand production capacity for economies of scale or remain the same size and move upmarket with value-added or quality products.

Carefully managing such considerations has given us a highly competitive chlor-alkali infrastructure, including independent electric power generation. And our geographical location grants us logistical advantages that position us to benefit from Asia's growing markets.

Activities in fiscal 2014 included clearing a bottleneck in vinyl chloride monomer (VCM) production at our Nanyo Complex that adds 200,000 metric tons of annual VCM production capacity. And we decided, significantly, to merge with another of our subsidiaries, our MDI production and sales subsidiary Nippon Polyurethane Industry Co., Ltd. (NPU).

Petrochemical Group

Our Petrochemical Group manufactures commodity and specialty products. It therefore requires diverse strategies, including cost-cutting innovations, product moves upstream, product mix management, and product line diversification.

This group produces roughly half of the ethylene required by our vinyl isocyanate chain and polyethylene operations and purchases the rest. As Tosoh's ethylene supplier, it has a major role in maintaining the cost competitiveness of many of our operations through flexible feedstock strategies that ensure the lowest raw material costs for the Tosoh Group.

Climbing naphtha prices have made diversifying the feedstock used in our cracking operations as important a cost-cutting strategy as managing the cracker output mix to maximize profitability. In the wake of the shale gas revolution and the availability of cheap liquefied petroleum gas and natural gas liquids feedstock, we also are developing added-value grades of ethylene to better compete with the many gas crackers coming onstream. We need as well to explore ways to benefit from the greater production of propylene and C4 fractions by naphtha crackers than by gas crackers.

We took numerous strategic actions in fiscal 2014, particularly to boost the value-added product lineups of the Petrochemical Group. Our R&D programs for special grades of polyphenylene sulfide (PPS) resins yielded Susteel-brand PPS, which boasts superior metal bonding for automotive applications and has attracted the attention of a major smartphone manufacturer. We are one of Japan's top manufacturers of ethylene vinyl acetate (EVA) for the solar cell market and continued our efforts to develop increasingly high-performance EVA products.

In addition, we took the next step in expanding the use of our new optical polymer in displays for smartphones, cell phones, and tablets. And we developed Tosoh HMS, a functional polymer that is a high-performance display substrate. We also developed two grades of high melt strength polyethylene (HMS-PE) suitable for medical-grade bottles.

Among established product lines, we focused on developing superior grades of chloroprene rubber (CR), such as sulfur-modified and latex chloroprene rubber grades. We likewise continued our chlorosulphonated polyethylene (CSM) product development program, which should expand production capacity. Tosoh is the world's major supplier of CSM to the high-end market, where it holds an approximately 70% share.

Engineering Group

Recent events involving Tosoh subsidiary Organo Corporation are notable. This specialist in water treatment and pure water generation technologies and systems is central to the Engineering Group, and its water treatment systems and soil remediation technologies are prized worldwide. Effective April 1, 2014, however, Organo restructured to upgrade its management and operations to deal with globalization and to emphasize the undeveloped medium-sized enterprises market domestically.

Q. Tosoh had an excellent year in fiscal 2014. Consolidated net sales grew ¥103.8 billion, or 15.5%, to ¥772.3 billion, and net income climbed ¥12.7 billion, or 75.3%, to ¥29.6 billion. How would you assess Tosoh's performance?

A. We seek a strategy that assures profitability under the severest conditions, but we know well, post-Lehman, that the global economy is a formidable foe. In fiscal 2014, though, Tosoh has benefited from many of the recent economic trends in Japan and globally. A weak yen has helped us with our exports more than it has hurt us with rising raw material and energy costs. And the benefits have combined with growing demand driven by upswings in the US, European, and Asian economies. China's economic growth has been disappointing, but China remains a substantial market.

Tosoh capitalizes on opportunities because of continued efforts to improve its cost competitiveness and because it has made the capital investments to position itself in strategic markets worldwide.

I can report that our commodity operations recovered profitability in fiscal 2014. The caustic soda market was again weak globally, so strategic adjustments are needed. But the weakness was more than offset by recovery in our VCM production volume and our VCM operations' capitalization of the weak yen and strengthened global demand. Our MDI and other urethane raw material operations, too, were much improved and enjoyed shipment growth in Japan and the benefits of foreign exchange related gains in export prices.

Sales of the Petrochemical Group's commodity products, such as ethylene and propylene, were generally brisk.

Group profitability, though, improved significantly on the strength of price increases to cover the rising costs of naphtha and other raw materials.

Our Specialty Group again proved the wisdom of our dual commodities and specialties strategy with strong growth in sales and profits. Its performance came largely through the expansion of its main growth drivers: electrolytic manganese dioxide (EMD); zeolites; zirconia; and most of its bioscience products, such as separation media, high-performance liquid chromatography (HPLC) columns, and automated immunoassay (AIA) instruments.

I've touched only on the highlights. But it was a satisfying year that allows us to refocus on our core strategies.

Q. Despite Nippon Polyurethane Industry Co., Ltd. (NPU)'s challenges with its MDI operations, Tosoh has steadily increased its stake in NPU and is poised for a merger in mid-fiscal 2015. What are the objectives of that merger and its potential for contributing to profitability?

A. Let's start with a little history. We recognized MDI's growth potential and fit with our commodity and specialty operations in the mid-2000s. MDI is a raw material for polyurethane and a fine chemical with many uses in organic synthesis. It also has synergies with our diverse product lines, including organic synthesis compounds, polyurethane catalysts, and specialty polymers.

So we entered the MDI market with a stake in NPU and began integrating NPU's production into our operations by adding production facilities for NPU's raw materials. We then gradually increased our stake in NPU, making it a wholly owned subsidiary in July 2012, with the result that our vinyl chain became a vinyl isocyanate chain. NPU, however, fell on hard times starting in 2008 and amassed considerable red ink because of the strong yen, rising global MDI production, and a downturn in the global economy. The fight back to profitability has been challenging but not without value. NPU's cost cutting and move toward more value-added and profitable products, the yen's recent depreciation, and recoveries in Asian markets enabled NPU to return to profitability in fiscal 2014. MDI's improved cost competitiveness will render it potentially a major source of earnings for Tosoh.

The implications of the merger are obvious. We will have a larger, more flexible range and mix of products and greater opportunities to capitalize on synergies and cost reductions with an integrated vinyl isocyanate chain. We also, moreover, are well positioned in the polyurethane market. Polyurethane is a building block used throughout the manufacturing and construction industries. As such, polyurethane has potential, particularly in developing countries and specifically as a potential source of growth for Tosoh.

We feel that NPU is ready to take on a greater role within the Tosoh Group. It will consolidate our respective synergies under a single management for better, more flexible responses to fluctuating exchange rates, expanding global production capacity, and growing overseas manufacturing competition. Our shareholders have given the green light to the merger plan, and the merger will be effective on October 1, 2014.

Q. Let's look at Tosoh's core values. You have a well-structured corporate responsibility organization. What were your Responsible Care (RC) milestones in fiscal 2014, and where are you headed? What is Tosoh's policy for rewarding providers of financial capital? And what is Tosoh's stance on governance?

A. We are a member of the global RC initiative to improve chemical companies' performance environmentally and in safety and health. Tosoh annually sets policies and objectives that involve qualitative and quantitative targets. And we use the plan-do-check-act (PDCA) cycle to pursue improvement in our efficiency and effectiveness.

I wouldn't call them milestones, but we did reach our hard targets in fiscal 2014. We met myriad standards for controlled and registered substances in many countries. We lowered our energy consumption to 75% of our fiscal 1991 level. And we again exceeded our intermediate target for reducing emissions of registered substances in Japan, as we have for several years.

Safety is where we have experienced setbacks. We are nevertheless determined to make progress. I believe that our goal of achieving zero accidents, including at Tosoh Group companies, is achievable and obligatory. Safety comes first.

The direction of our RC program, meanwhile, is guided by our commitment to social responsibility in fulfilling our corporate credo of "supplying essentials for daily life." We recognize that Tosoh has to help solve emerging issues, such as those relating to the environment, energy conservation, and the depletion of natural resources.

To reward providers of corporate capital, we employ a policy of maintaining stable dividends while ensuring the internal reserves to move into the future and realize sustained growth. We try to accommodate the investment objectives of our shareholders. Most are long-term investors, particularly financial institutions, with few individual investors. Our emphasis, therefore, is establishing corporate value.

Our stance on corporate governance is simple: thorough, long-term corporate governance enhances corporate value and growth. Robust corporate governance at Tosoh optimizes transparency, compliance, business performance, and operational efficiency. We have a solid system of oversight and of checks and balances to ensure that the system works.

Q. What is your view of Tosoh's business environment, strategies, and prospects?

A. We anticipate Japan's economy to weaken in early fiscal 2015 in reaction to a spike in demand ahead of the April 2014 hike in Japan's consumption tax. Yet there are expectations that corporate earnings, employment opportunities, and personal incomes will improve courtesy of the Japanese government's "Abenomics" policies and the recovery in the global economy.

Amid dynamic changes in global markets, I believe that we have the tools to manage a normal range of fluctuations and are well positioned for growth in strategic markets. The Tosoh Group is, therefore, making every effort to boost profitability by expanding its sales volume, maintaining an optimum pricing structure, and reducing costs.

By building on our dynamically balanced dual specialties and commodities strategy, I feel confident that we will achieve our goals for fiscal 2015, ending March 31, 2015. Tosoh's financial projections on a consolidated basis call for net sales of ¥810 billion, operating income of ¥46 billion, ordinary income of ¥45 billion, and net income of ¥52 billion.

I am optimistic that despite global political and market upheaval the world holds opportunities. Tosoh intends to support and indeed lead industrial progress. We are ideally positioned to capitalize on opportunities. And we are committed to delivering on our promise of profitability and investor value through Tosoh quality and the chemistry of innovation.