CFO × Outside Director

To ensure sustainable growth, we've implemented new capital policies based on financial principles that best suit Tsumura's business.

Ryohei Yanagi
(left in photo)
Outside Director

Muneki Handa
(right in photo)
Director CFO
(Chief Financial Officer)

Looking at Tsumura's Kampo and Traditional Chinese Medicine Businesses in Terms of Financial and Management Risk

Mr. Yanagi, you joined our board in June 2023. What have you learned about Tsumura's business characteristics, particularly its financial health, compared to pharmaceutical companies focusing on new drug discovery?

Yanagi: First, Tsumura shares a common mission with pharmaceutical companies, to protect the lives and health of patients and consumers, staying close to each. Although ours is different in terms of the products and business model we've chosen to accomplish this mission, it's essentially the same, I think. As a former financial director of a pharmaceutical manufacturer producing original products, well acquainted with its profit-loss structure, I think Tsumura's profit-loss structure stands out for its relatively low ratio of R&D expenses and high costs. Cost growth is inevitable because prices for some crude drugs are rising right now on top of the weakening yen. We also have to maintain inventories at certain levels to manage the production volume of crude drugs, which fluctuate widely due to factors like weather.

Handa: You're right. For the sake of reliable supply, thinking strategically, we have to maintain our raw material inventories at certain levels. So high efficiency in our business operations and balance sheet management is a particularly important theme for Tsumura. While our ratio of R&D expenses is far lower than typical manufacturers of original pharmaceuticals, it's also true that we've been making solid investments in basic and clinical research, mainly on high-priority themes, to help build scientific evidence, and that is generating new cash flow.

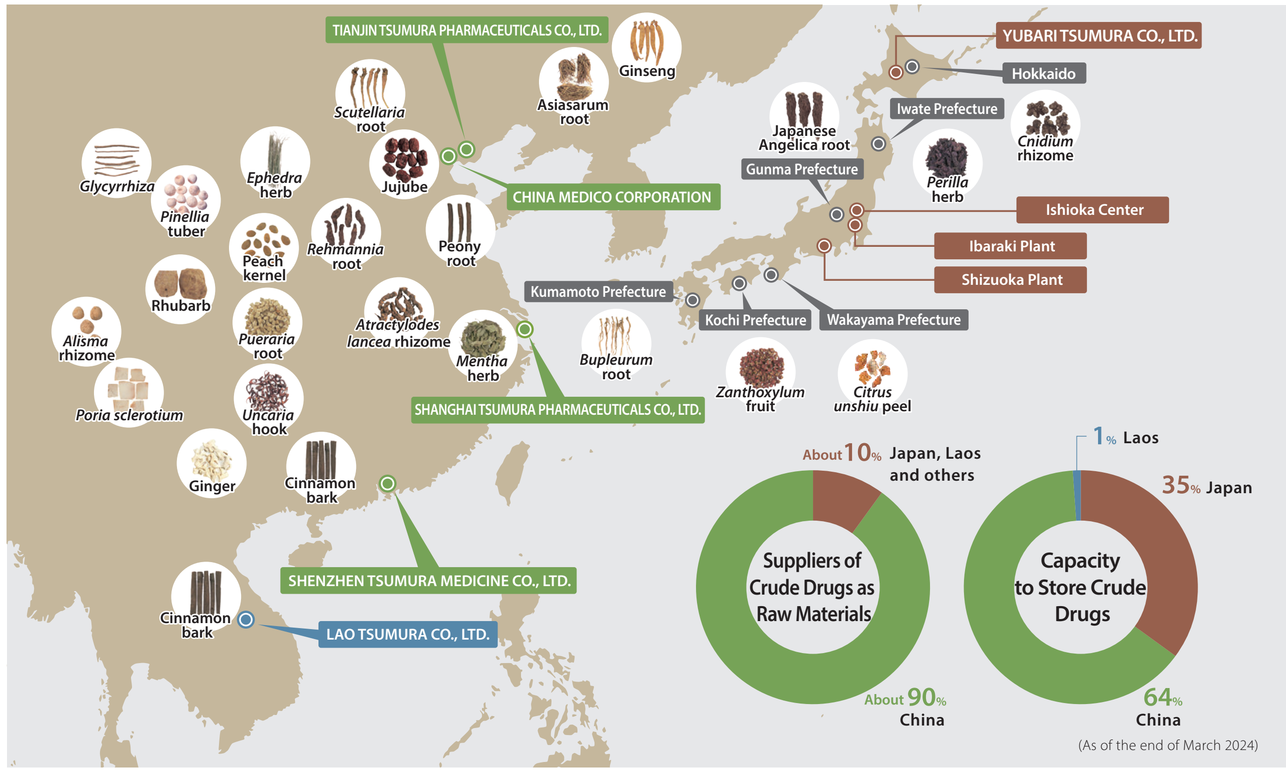
Yanagi: I work as a deputy president for the Japanese subsidiary of a British investment firm while teaching financial theory in a graduate school. This allows me to wear the hat of a foreign institutional investor. Looking at Tsumura's balance sheet from that perspective, inventories, capital and cash seem somewhat excessive. It makes me wonder why Tsumura doesn't reduce its equity ratio more with stronger leverage, because it doesn't have R&D risk and enjoys over 80% of the domestic market for prescription Kampo medicines. With a clearer picture of exactly what Tsumura does, it may be easier to understand why high levels of inventory and cash and a steep equity ratio are necessary as well as robust financial health. There are two background risk factors. One is an earnings structure that depends on the domestic market, under the strong influence of the NHI drug price controls. The other is high dependence on China for raw materials. I used to imagine that Tsumura could plant and harvest in countries and regions that are climatically similar to China to hedge risk. Since I became an outside director and came to understand the volume of crude drugs that Tsumura procures and the prices it pays, and that some medicinal plants only grow in specific climates and soil types, however, it hit home for me that procuring crude drugs from China is the core of Tsumura's business. Recently, many Japanese firms are reconsidering their Chinese operations, mainly due to rising geopolitical risk. Tsumura, on the other hand, has chosen to embrace the challenge of turning risk into opportunity, without fear.

> To fulfill for shareholders our fiduciary responsibilities as a trustee, I promote discussions that will contribute to value creation based on strong financial principles. — Yanagi

Handa: Chinese producers are essential Tsumura partners, and together we have been mutually improving by learning from one another for over 40 years. In 2017, Tsumura committed fully to business that will contribute to public health in China. Our motivation is to apply our original technologies and expertise to create a second core business and enhance our capacity to procure crude drugs overall.

Yanagi: That move may seem risky to the equity market, but that is outweighed by the positives of contributing to society and patients in China, which is huge in both market scale and growth potential. Tsumura's China business currently accounts for a little over 10% of total sales. By gradually increasing this and becoming less dependent on the Japanese domestic market, and subsequently less vulnerable to NHI drug price controls, Tsumura can hedge risk.

Primary Raw Material Procurement Areas



Commitment to Objective, Reasonable Board Discussions with Figures and Explanations

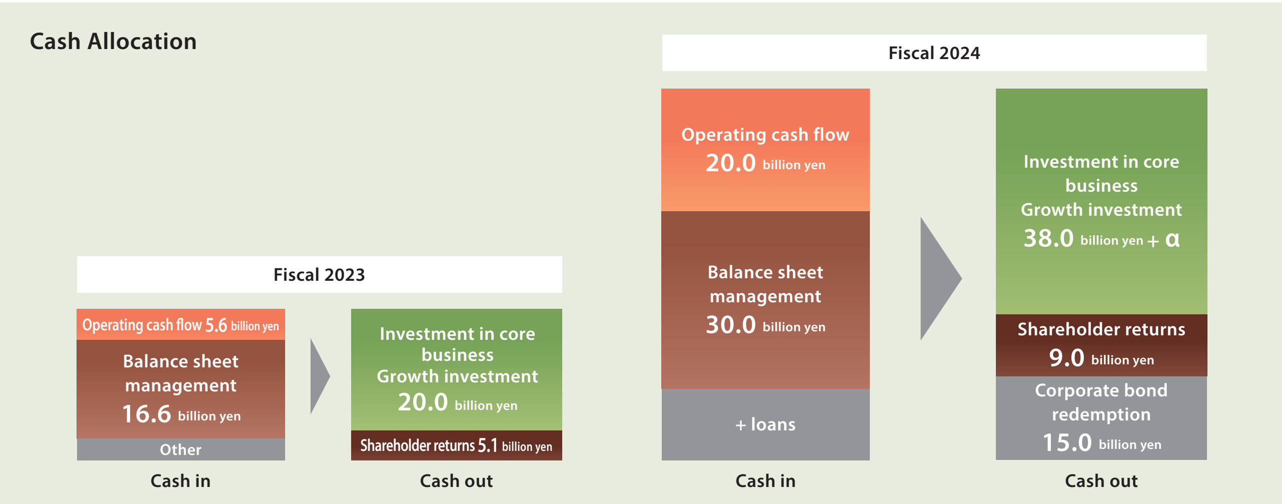
Capital policy was a priority theme in board meetings in fiscal 2023. What did you discuss?

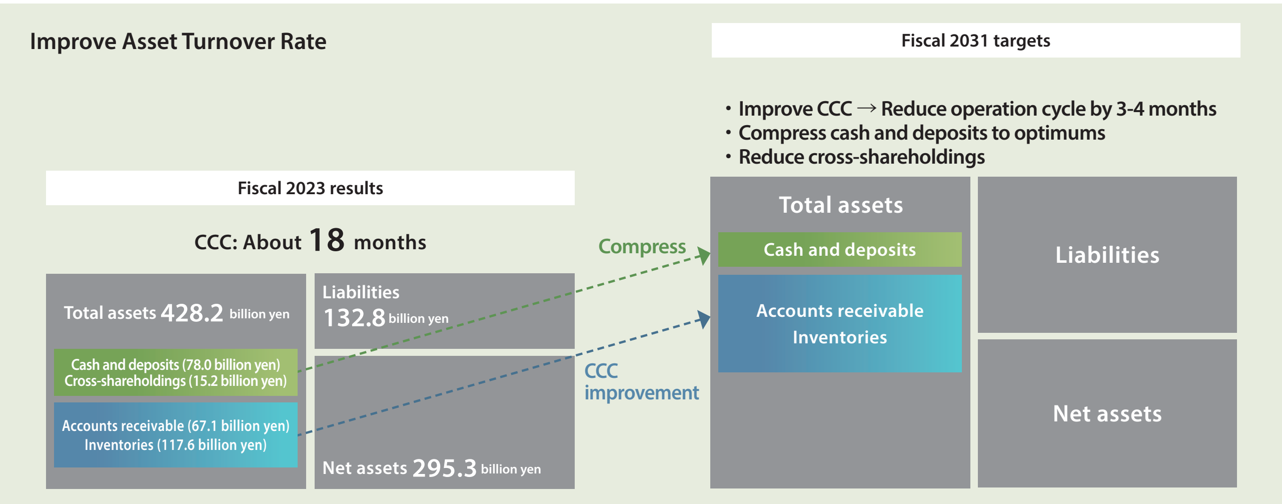
Handa: We discussed capital efficiency and optimizing our capital portfolio. I've been aware of the issue of cost effectiveness, thinking we have to scrutinize it to maximize effect relative to cost. Mr. Yanagi has strongly advised that board discussions be based in reasonable explanations compatible with financial rules rather than settling abstractions like "Kampo is special" or "this is for the sake of reliable supply." Taking this shift toward more grounded discussions as an opportunity, we are reviewing our investment criteria. Over the year, I think we've held some very high-quality discussions.

Yanagi: That kind of appreciation is very gratifying to me as an outside director. To fulfill our fiduciary responsibilities to our shareholders, I think it's essential to keep our discussions objective, backed by sound financial principles and figures, even though that can be annoying to some. I was asked to prove with figures the worth of value creation based on investment criteria such as NPV[*1] and IRR[*2], which demand capital cost consciousness. As a result, Tsumura now takes the step of checking the numbers that I've provided to help determine whether to go ahead with a given investment over a certain amount. I've been amazed at Mr. Handa's quick action and leadership in sticking with the investment criteria. Thank you very much.

Handa: We asked Mr. Yanagi to attend board meeting follow-ups that mostly involve people from the Corporate Planning Department discussing capital policy. In those, you've not only led the discussions, but have also given the attendees homework, for example, "show me your projections for the coming decade," which highlighted the commitment of executives to an earnings structure shift. This became a good opportunity to simulate the Company's future, bringing several risk factors into consideration. Our best takeaway from these projections has been a range of capital policies to support our future vision.

Yanagi: We've had numerous serious talks, and I asked the executive team to run dozens of simulations.





I follow through on measures to improve capital efficiency, optimizing the allocation of management resources and building a framework for assessment. — Handa

Handa: Through in-depth board discussions focusing on the standpoint of long-term stakeholders, we decided on ROE of 10%, equity ratio of 50% or higher and DOE[*3] of 5% as new financial KPIs to achieve by fiscal 2031, and integrated the results of those discussions with our internal rules and action plans. Going forward, we will focus on incrementally executing what we decided, including improvement in our CCC[*4] and reducing cross-shareholdings. As a pharmaceutical manufacturer, we have a strong commitment to quality and reliable supply, and I think we should enhance our meetings of executive officers as an organization to enable comprehensive discussion of cost effectiveness, for example.

*1 Net present value: Difference between the values of cash inflows and outflows over a period of time; this assessment index reveals the profitability of a given investment to guide decisions on investments and M&A actions.
*2 Internal rate of return: Discount rate balancing future cash flow generated from an investment, converted to current value, against current value of the investment. "Discount rate" means the rate applied when converting future value of a currency to current value. When the IRR is above capital cost, we proceed with the investment; when it's lower, we discard it.
*3 Dividend on equity
*4 Cash conversion cycle: Number of days needed to collect sales proceeds after paying down accounts payable

Improving Our Initiatives by Visualizing the Relationship between Pre-Financial Capital and Corporate Value Growth

Tsumura's current[*5] price-to-book ratio has increased to nearly 1.2, but remains below the prime market average of 1.4. What prospects do you see for effort to build corporate value?

Yanagi: Our corporate value has been increasing due to the effects of rising earning power and new capital policies—our permanent growth rate[*6] as indicated by PER is 0 or slightly negative. This means that many institutional investors are still unconvinced about the potential of Kampo and traditional Chinese medicines and Tsumura's growth scenario. Conversely, however, Tsumura is a corporation with ample potential for growth. Our businesses are going well, with operating profit above 10% and ROE is projected at 10% for fiscal 2024. When hope grows for higher longer-term growth, our PBR should surpass 1.4, and could even approach 2. The key to winning the trust of institutional investors is steadfastly showing good results and convincing them of Tsumura's potential for corporate value growth.

Handa: In fiscal 2023, we began a project[*7] to visualize our pre-financial capital. Behind this is our resolve to explain clearly that pre-financial capital can convert to future financial capital. We made our entire ESG effort a subject for analysis using the Yanagi model[*8].

Yanagi: The Yanagi model is based on the hypothesis that ESG value will be factored into a PBR above 1. In the investor survey I conducted, I found that about 70% of investors worldwide supported the idea that ESG value should be included in PBR over the long term, which agrees with the hypothesis. To show the degree of potential a given corporation has to increase its value, it will be ever more important to visualize pre-financial capital as numbers and explain them.

Handa: At Tsumura, we've conducted a value relevance analysis, limiting the focus to organizational and personnel capital this time. Some ESG items showed striking correlation with value, and others didn't as much. In fiscal 2022, we began using ROIC as an index for internal management, believing that we can uncover the meaning and results of a given job and raise employee morale if we successfully identify KPIs that will help improve ROIC and explain balance sheet management step by step. We will continue improving our rules and assessment framework for resource allocation to help institutional investors understand and more accurately assess the value of the Tsumura Group.

*5 As of June 27, 2024
*6 A way to calculate continuous value, assuming that free cash flow will grow at a specific rate after the business plan period
*7 See page 37 for details.
*8 A model developed by Ryohei Yanagi, introduced in his book *CFO Policy* (Chuo Keizaisha, 2020)

Focus Initiatives to Visualize Pre-Financial Capital

In relation to the value creation cycle*[1] based on seven capitals, the Tsumura Group undertakes initiatives for "pre-financial capital" to obtain understanding from investors by visualizing its connection to future financial value, and to clarify the challenges for each initiative and work to improve them. In fiscal 2023, we started a cross-divisional project for quantitative analysis of pre-financial capital, focused on visualizing the value of pharmaceuticals derived from natural substances, the value created by the Kampo value chain, and the value of organization and human capital.

*1 Please refer to page 22 "Value Creation Cycle" for details.

Visualization Analysis of ESG Activities

First, we used the non-financial capital and equity spread synchronization model (Yanagi Model), and conducted a landscape analysis*[2] of our overall ESG activities. Next, we conducted a value relevance analysis*[2] to take an objective view of our overall ESG activities based on the correlation between our ESG indicators and price-to-book ratio (PBR) and explore our organization and human capital policies. In this analysis, we established a hypothesis about the process in which the value created by our organization and human capital policy leads to financial value, and verified the direct connection between ESG indicators and financial indicators.

Looking ahead, we will use the optimal analysis method to examine the value of pharmaceuticals derived from natural substances, such as the multi-component nature of Kampo medicines and their applicability to integrative medicine, as well as the value created by the Company's unique Kampo value chain, starting from crude drug cultivation, and clarify their correlation with financial value, using our findings to strengthen our strategies and initiatives.

*2 Analysis using the Digital ESG Platform of ABeam Consulting Ltd.

Results of the Landscape Analysis Process

A landscape analysis takes into consideration fluctuations in ROE, which have a powerful impact on the Company's PBR, and examines the increase or decline in PBR due to progress in ESG activities, looking at aspects such as how many years later and with how much sensitivity. The target period for this analysis was the 24-year period from fiscal 2000 to fiscal 2023, and we used analysis data for an average period of 7.3 years. Among all our ESG activities, we extracted a total of 502 indicators after eliminating overlaps from the indicators for which data was available. From among these, we eliminated indicators that did not satisfy criteria for indicators worth analyzing, leaving 373 indicators for our landscape analysis.

As a result, we identified 36 indicators that have a desirable correlation*[3] with increasing corporate value. We will objectively examine our ESG activities based on these analysis results and use it to strengthen our measures for increasing corporate value. Going forward, we will continue to revise the processes for our initiatives and our calculation methods, and conduct repeated analyses to visualize our social impact and develop the Company's own unique story for increasing corporate value.

*3 Indicators for which the positive or negative correlation result aligned with the envisaged desirable relationship

Main Indicators for Which a Desirable Correlation Was Detected and Their Impact on PBR

Organization and human capital

- An improvement in work style and leave style contributes to increase in corporate value
  [1 ppt increase in percentage of paid annual leave taken → 7.37 ppt increase in PBR two years later]
- A longer number of days of childcare leave taken by female employees contributes to an increase in corporate value
  [1 ppt increase in average number of days of childcare leave taken → 1.25 ppt increase in PBR one year later]
- An increase in women newly appointed to managerial roles contributes to an increase in corporate value
  [1 ppt increase in percentage of women promoted → 0.27 ppt increase in PBR two years later]
- An increase in the percentage of employees receiving health examinations contributes to an increase in corporate value
  [1 ppt increase in percentage of employees receiving health examinations → 12.72 ppt increase in PBR three years later]

These results show that supporting rapid career development and formation for women yields positive results. Measures such as encouraging the use of paid leave and childcare leave lead to retention and attraction of talented human resources, with a resulting impact on increasing corporate value.

Value of pharmaceuticals derived from natural substances

- An increase in the number of briefings for physicians contributes to an increase in corporate value
  [1 ppt increase in the number of briefings held → 0.59 ppt increase in PBR one year later]

This result shows that increasing the quantity and quality of information provided to medical professionals contributes to an increase in corporate value. We see this as the result of strengthening e-promotions and working through a cycle from analysis of information requested by individual physicians to improvement of MR activities.

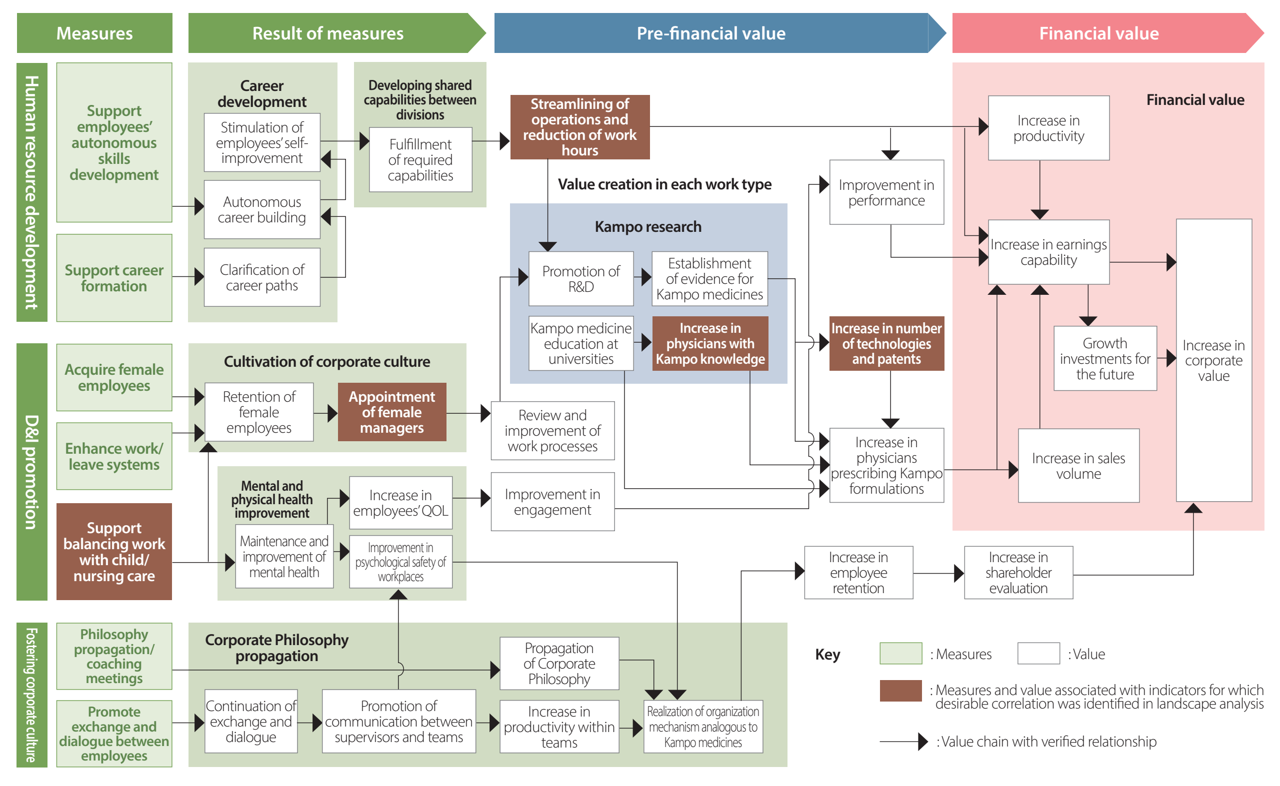
Value in the Kampo value chain

- Decrease in industrial waste discharge contributes to increase in corporate value
  [1 ppt decrease in per-unit industrial waste discharge → 1.48 ppt increase in PBR two years later]

Most of the industrial waste generated by the Tsumura Group is residue left over from extract produced during the Kampo formulation manufacturing process. We have been working for many years to make effective use of this crude drug residue. A reduction in the volume of industrial waste discharge due to using the residue for biomass fuel and other applications appears to result in a correlated increase in corporate value.

Results of Value Relevance Analysis

Looking at human resource development, the analysis results showed that the development of careers through measures to support skills development leads to operational efficiency and performance gains, and contributes to the increase in productivity and earnings capability. With regard to promoting diversity and inclusion (D&I), the analysis results showed that measures to support employees balancing work with childcare or nursing care lead to retention of female employees and the appointment of female managers, and the increase in employees' quality of life. This in turn drives increases in engagement and performance that are related to increased earnings capability. Measures to cultivate a corporate culture had a demonstrable relationship to contributing to increased corporate value through the propagation of the Corporate Philosophy and promotion of communication between supervisors and their teams. This analysis verified the value chain in part, but it also revealed issues to be addressed including the appropriateness of measures and KPIs set to evaluate them, as well as related data collection. We will continue conducting analyses going forward.



Bolstering Balance Sheet Management

The Tsumura Group is seeking to bolster balance sheet management based on a fundamental direction for capital policies that deepens discussion of financial strategy for achieving the Group's long-term management vision.

With respect to financial strategy, we are acting to enhance medium- to long-term corporate value, powered by improvements in capital efficiency and the pursuit of both capital efficiency and an optimal capital composition. In executing strategy, the generation of operating cash flow from scale expansion domestically and in our China business, as well as improved profit margins, is a key assumption. Additionally, via CCC improvements, compression of cash reserves, the sale of cross-shareholdings and other steps, we look to generate cash from balance sheet management to invest in support of sustainable business development and growth.

Target levels for fiscal 2031 | ROE 10% | Equity ratio 50% or more | DOE 5%

Note: Cost of shareholders' equity: approx. 7%
CAPM-calculated risk-free rate: 2%; Risk premium: 6%; Beta (β): approx. 0.8
Equity spread = ROE − cost of shareholders' equity

Improvements in Capital Efficiency

ROE = **Earning power** × **Total asset turnover rate** × **Financial leverage**

Earning power
- Net sales growth
- Reduce cost of goods sold
- Curb the SG&A ratio
- Aim to secure a profit margin for the China business equivalent to or higher than the profit margin in the domestic business

Total asset turnover rate
- CCC improvement
- Appropriate level of cash reserves
- Sale of cross-shareholdings
- Improving capital investment efficiency, etc.

Financial leverage
- Secure financial soundness and pursue an optimal capital composition
- Leverage interest-bearing debt
- Equity ratio of 50% or more

To improve capital efficiency, our aim is to achieve a positive equity spread, with ROE above the Company's calculated cost of shareholders' equity of 7%. To this end, we view ROE as an important management indicator, breaking it down into three elements—"earning power," "total asset turnover rate" and "financial leverage"—and accelerating initiatives to spur improvement.

Earning Power

We are working to boost the operating profit margin by expanding sales with respect to scale, and through reductions in the cost of goods sold and the SG&A ratio. As specific measures, along with expanding the cultivation of naturally grown crude drugs, we are advancing automation of "cultivation, primary processing, and the sorting process." At each plant, we are taking phased steps to realize low-cost operations through automation by fiscal 2031, with a goal of more than doubling our labor productivity compared to fiscal 2021. Similarly, in SG&A expenses, we intend to maintain R&D expenses that contribute to the scientific study of pre-symptomatic diseases at the level of 5% or more of consolidated net sales. Moreover, thanks to benefits from improved productivity through DX, our aim is to hold the SG&A ratio to the low 20% range by more than doubling net sales per employee compared to fiscal 2021.

Total Asset Turnover Rate

We aim to improve the total asset turnover rate via CCC improvements, rightsizing the balance of cash reserves, the sale of cross-shareholdings, improved capital investment efficiency and other means.

For CCC improvement, which is also a medium- to long-term issue, we are acting while considering balance and risks throughout the entire supply chain. Anchored by the planning system for compounding crude drugs adopted in 2023, we aim to shorten the operation cycle by around 3 to 4 months by optimizing the entire Kampo value chain, beginning with crude drug cultivation. Additionally, we are moving toward the swift collection of accounts receivable by promoting the roughly 20% reduction in credit periods in negotiations with pharmaceutical agents and wholesalers.

Our ratio of cash reserves to monthly sales is high, reflecting a decision to move ahead with fund procurement given interest rate trends. Going forward, we intend to conduct planned growth investments to shrink this down to an appropriate level. Where cross-shareholdings are concerned, we are making progress in gradually reducing these through negotiations with partners. Based on a policy of zero cross-shareholdings as a rule, we embarked on a full-scale reduction effort from fiscal 2024 to cut these in half quickly.

With respect to capital investment, we have positioned the three-year period of the first medium-term management plan as time to conduct focused up-front investments in growth investments for the future and to expand business scale. Through production capacity augmentation and productivity enhancement, IT infrastructure development and other means, we plan to make total investments of around 115.0 billion yen. To better ascertain the costs and benefits of investments, we are supplementing indicators such as NPV and IRR with newly adopted investment selection criteria, for management decision-making conscious of capital costs and capital efficiency. From the standpoints mainly of changes in the internal and external environments and return on investment, we are considering the cancellation or review of our investment plan, or postponed fulfillment, for an outlook of around 73.5 billion yen in total investment during the first medium-term management plan. In fiscal 2024, we took steps for second- and third-phase construction at the Tianjin Plant, a manufacturer of Kampo extract powder; in Japan, we also sought to bolster our Kampo extract powder manufacturing processes and production capacity for a downstream process—granulation packaging. Furthermore, to respond to increased production, we carried out expansion of the crude drug warehouse of YUBARI TSUMURA, with an eye to increasing our crude drug inventories in Japan.

Financial Leverage

By reviewing the ratio of net assets to interest-bearing debt, we are pursuing an optimal capital composition while ensuring financial soundness. From November 2023, we established an "equity ratio of 50% or more" as a standard for maintaining financial discipline.

Key Investments to Further Strengthen the Stable Supply System

Main investment activities	Total investment	2024 investment	Period
Tianjin Plant Phase 2, Phase 3 construction (manufacturing of Kampo powdered extracts)	25.0 billion yen	9.5 billion yen	2021- 2026
Newly establish processes for Kampo powdered extract manufacturing and granulation packaging	68.0 billion yen	10.5 billion yen	2024- 2027
Expand YUBARI TSUMURA's crude drug warehouse	2.5 billion yen	1.5 billion yen	2023- 2025

(Additional manufacturing costs)

Main activities	2024 increase in value
Boost headcount to newly establish a manufacturing line, etc.	+1.0 billion yen
Strengthen prevention and maintenance, secure warehouse, etc.	+1.5 billion yen

Dividend Policy

At Tsumura, we view the return of profit to shareholders as a vital company policy. In addition to making efforts to raise corporate value through the sustainable expansion of domestic business and growth investment and infrastructure development in the China business, shareholder returns are decided after consideration of medium- to long-term profit levels and cash flow conditions. While maintaining a sound financial footing and enhancing management efficiency, cash gained from leveraging operating cash flow and debt and optimal capital composition is allocated appropriately to additional growth investments and shareholder returns. Furthermore, shareholder returns have the dividend on equity (DOE) ratio set as an indicator, which we aim to raise to 5% by fiscal 2031 to expand dividends.

Shareholder Returns