1. Supplemental explanation of FY2014 Q1 financial results

[Overall view]

The first quarter (Q1) of fiscal year 2014 (ending March 31, 2015) started with a downturn compared to the initial outlook announced on April 30, 2014. This was caused primarily by lower dry bulker market than the outlook and a slight delay in our plan to reduce unit cost (reduction of vessel costs and fuel cost per unit), which is the key to improving profitability in the containership business. On the other hand, the decrease in a year-on-year comparison was caused by lower profit from car carriers in the process of adjusting services to cope with the shift of automobile production areas, and a decline in containerships freight rates. These factors were within the scope of the initial outlook. Therefore, we projected a decrease in profits for Q1 at the initial outlook, but the margin of the decrease was higher than in that outlook.

[By segment: Bulkships]

<Dry bulkers>

The supply/demand balance for large-size Capesize vessels remains on an improving trend from the previous year, but that for mid- and small-size vessels, particularly Panamax vessels, has remained on a deteriorating trend up until this year. The Capesize market did not move upward in Q1, because spot contracts for transport of iron ore outbound from Brazil did not increase from April to May as expected, and mid- and small-size vessel markets dipped to a level lower than the previous year. While we have continually earned stable profits with long-term contracts, the division’s profit in Q1 showed a slight downturn from the initial outlook due to the impact of these moves on its market exposure, even though profit increased in a year-on-year comparison.

<Tankers>

The very large crude oil carrier (VLCC) market was weak due to periodic repairs at oil refineries in Asia as usual. However, the number of free VLCCs decreased from 16 at the end of June last year to 11 at the end of June this year thanks to reduced market exposure, which we have pushed forward since last year. These efforts to enhance market tolerability have had a positive impact, improving income.

Speaking of other ship types, the product tanker market deteriorated in a year-on-year comparison and in a comparison with the initial outlook, although the LPG carrier market showed robust growth.

Overall, the tanker division showed a year-on-year increase as forecast in our initial outlook, making a good start toward turning to profitability for the full year.

<LNG Carriers/offshore business>

Normally, this division records stable profits from long-term contracts. But in Q1, ordinary income declined, resulting in a slight deficit because high expenditures for dry-docking and off-hire during this period in addition to increased outlays for seafarer training.

However, these were within in the scope of the initial outlook, and the segment will swing back to a normal profit structure after Q2.

<Car Carriers>

We assumed in the initial outlook that, while we started new services to meet automakers' moves to disperse their production plants worldwide and are forging ahead to improve operational efficiency, ordinary income will decrease significantly from FY2013, which was the most favorable year in recent history, until these efforts get on track.

The Q1 profit in this division decreased in a year-on-year comparison, and the margin of the decrease was higher than our initial outlook because of a delay in customers' shipments on new services such as Mexico-North America and intra-South America routes, and delays in improving route efficiency on some trades.

[By segment: Containerships]

We assumed that deficits would continue even in our initial outlook for Q1, but ordinary income deteriorated even more significantly than our forecast.

The Q1 average freight index of our all routes was 79, a decline of six points from 85 in FY2013 Q1. It was also two points lower than our assumption of 81. The Asia-South America East Coast trade showed the largest decline, because the general spot rate fell by 32% in a year-on-year comparison. However, the rate has been rising to a level surpassing April-June or July of last year.

In terms of lifting, the average utilization rate for all outbound/inbound routes during Q1 was 78%, nearly the same as in FY2013 Q1, despite an 8% increase in capacity. However, it was a one point downturn from our outlook. While Asia-North America and Europe trades were very strong, services for South America East Coast and Intra Asia showed a downturn. Nevertheless, the South America East Coast trade, which experienced hardships, is now at full cargo capacity.

Looking at our efforts to enhance cost competitiveness, the key to recovering containership business performance from this fiscal term, the results for Q1 fell below our initial outlook. But there is an explanation to this. We plan to enhance cost competitiveness, in particular by reducing unit costs by launching newbuilding large-size vessels, disposing of mid-size vessels with lower fuel efficiency, and improving operational efficiency through expansion of alliance operations. During Q1, disposal of mid-size vessels lagged behind schedule, though the last of five 14,000 TEU large-size vessels was delivered as scheduled. In addition, we were unable to fully achieve our projected cost reductions through slow steaming, as vessels had to steam faster because reduced efficiency at some ports and harbors forced them to stay in port longer.

In conclusion, progress toward three elements in our containership business targets — enhancement of freight rates, cargo volume, and cost competitiveness — fell below our outlook. At the same time, ordinary income decreased in a year-on-year comparison, due mainly to low freight rates.

[By segment: others]

Ordinary income in the ferry and domestic transport segment increased by 600 million yen in a year-on-year comparison due to increasing cargo and passenger transport volume in the ferry segment and improved operational efficiency in the domestic transport segment. Looking at associated business, the real estate business generated stable profits and the margin of losses decreased in the cruise ship business. As a result, ordinary income increased by ¥300 million in a year-on-year comparison.

[Enhancement of cost competitiveness]

We achieved cost reductions of ¥5.6 billion in Q1, representing 19% of our full-year target of ¥30 billion. This was about ¥2 billion short of our goal of ¥7.5 billion, or one-fourth of the full-year target, mainly because we missed our unit cost reduction target in the containership business, as mentioned earlier.

We have taken immediate countermeasures for recovery in that segment.

2. Supplemental explanation of FY2014 Full-year Forecast

[Overall view]

We truly regret to report that we made a downward revision from the full-year forecast announced in April: from ¥70 billion to ¥50 billion in ordinary income and ¥60 billion to ¥40 billion in net income. This was due to a slowdown in the dry bulker market, a delay in recovery of the tanker market, degradation of operational efficiency on outbound trades, slower growth in cargo volume on inbound and cross trades in the car carrier division, and lower-than-forecast freight rates and lifting in the containership segment.

In the dry bulker and tanker divisions, many of our free vessels, which are susceptible to fluctuating profits as markets change, are operated by subsidiaries in Singapore (the financial results are closed in December). Their business performance from April to June, when the spot market stagnated, will be reflected in our Q2 results (July-September). Those stagnated results will be offset by the containership business, as we project ¥7.5 billion in ordinary income for Q1, and ¥7.5 billion for Q2. Stagnation during Q2 in the dry bulker and tanker divisions was already reflected by the market from April to June, so we have mostly seen the results. On the other hand, we anticipate improvement in the containership segment in July-September depends on the coming market conditions, but based on the current environment, we expect to be able to improve and achieve the target in Q2.

[By segment: Bulkships]

<Dry bulkers>

Under normal circumstances, we would expect a much higher freight rate market considering Brazilian iron ore exports and the tonnage of newbuilding vessels delivered from April through June. However, the market actually stagnated. China’s accumulated iron ore inventory topped 100 million tons. The ore price temporarily dipped below US$90/MT. We think those factors had a negative psychological impact on players involved in the iron ore trade. But still, in a year-on-year comparison, the Capesize market from January through June has shown a slight improvement as trade increases. We expect the market to turn over in line with increasing trade from Brazil this year, as we saw during the second half of the previous year.

Speaking of grain trade, we expected trade from South America to drive the market upward, but this was not the case, so a market upturn will have to wait until grain shipments from the U.S. begin this autumn. While forecasts call for a bumper crop of grain in the U.S., caution is in order regarding the future, as California and some other western states are suffering through a drought of historic proportions, which may be affected by an El Nino event.

<Tankers>

Periodic maintenance season at oil refineries in Asia has come to an end, and we observed a recovery in trade from the Middle East and West Africa, while China restarted its strategic reserves. Thus, the very large crude carrier (VLCC) market is back on course for recovery. We expect the cargo movement to slacken as usual starting in August, with the market showing a slight downward trend. But, as forecast in an International Energy Agency (IEA) announcement, demand for crude oil will increase from October through December, and the supply of newbuilding vessels is very limited. So we anticipate that the market will remain brisk.

The large-size LPG carrier market is strong, with a current rate of US97,000/day (freight rate per ton: US$122/MT). Though demand usually declines after October, we think it will remain at US$70-80/MT because the supply of newbuilding vessels is limited for the time being, new LPG trade from the U.S. shows steady growth, and exports from West Africa, including Angola, are expected to grow. We may even see skyrocketing prices if customers in East Asia increase their purchases, so we don’t see the risk of a significant drop at this point.

In the product tanker sector, trade for products such as kerosene will start in the second half of this fiscal year, and we expect growth in the naphtha trade as new production facilities in South Korea come online. Looking to the west, we forecast that the shale oil-derived product trade from the U.S. to Europe and South America will expand, while increased trade of U.S.-made condensate will improve the market.

<Car Carriers>

Outbound trade and Atlantic Ocean trade are lower than our estimate, and completed car transport did not grow as expected on the Intra NAFTA service from Mexico, which launched this year, and the Mercosur shuttle service. This led to sluggish growth in profit. We do not expect a change in the trend of trade outbound from Japan from Q2 — exports of 3.9 million units per year — but trade inbound for North America, the Red Sea, and the Middle East are expected to grow. However, we must improve profitability by more efficiently operating vessels on inbound and cross trade routes. This is a time that requires patience until our cross trade service gets up to full operation and becomes an axis for growth.

[By segment: Containerships]

Q1 showed a significant downturn from the outlook, but we are seeing progress in the recovery of freight rates, which are central to our assumptions for Q2 and later, including those on the South-North route. We are now near full cargo capacity, and expect to achieve the utilization target in initial full-year outlook. Disposal of mid-size vessels, which is the key to this plan, is progressing as expected, so we will push ahead to resolve excessive costs. In addition, full-scale automated operation of the U.S. West Coast terminal (TraPac) has been postponed about a half year, but we expect significant improvements in cost control after that. Comparing H1 and H2, ordinary income in the containership segment is expected to increase by ¥8.5 billion. This includes improvement of freight rates (+ ¥2.0 billion), reduction in vessel expenditures and cargo handling costs (+¥3.5 billion), and increase in terminal and logistics related profits and increase in profits on sales of containers (+¥3.0 billion).

[Dividends, other]

Looking at dividends, we will maintain the previously forecasted payment unchanged, planning an interim payment of ¥3, and ¥3 at year end, for a total of ¥6 for the full year. The dividend payout ratio is 30% for the interim and 18% for the full year on our projected profits

We should have no problems securing funding, even though we made a downward revision of profits. We will not need to raise funds, for example, for an increase in capital, and have no plans to do so.

3. Questions and Answers

[Bulkships]

Q1) The dry bulker market assumptions for Q3 (October-December) are Capesize, US$35,000/day; and Panamax, US$10,000/day. Generally, the Capsize market is said to be roughly double the Panamax market, so are these Capesize assumptions reasonable? And if the Capesize market were to end up at US$20,000/day, how much would profits decline?

A1) The Capesize fleet supply and demand environment is different from that of Panamax vessels. In Capesize, the launch of newbuilding vessels has halved since last year and scrapping went ahead as planned, which means the supply/demand environment has improved. On the other hand, with Panamax, launching of newbuilding vessels still weighs heavily on the market, so the supply and demand environment has not yet begun to improve. That said, the difference between the Capesize market and the Panamax market has continued to increase compared to the past. Looking at the seasonal fluctuation and last year’s performance in the Capesize market, we must say that our assumptions are not too high in the least. On the other hand, we see we cannot expect an increase in the Panamax market as in the Capesize market because of the heavy pressure of the Panamax fleet supply.

Looking at the impact on profits, in light of market exposure in Q3, we foresee a downward of some ¥1 billion. Nevertheless, please understand that difference between the actual movement of the market and the market assumption is not always reflected precisely in profits.

Q2) In the car carrier business, the cargo volume in Q1 increased in a year-on-year comparison, so can you tell us why you show a reduction in profit for that business?

A2) The total number of vehicles increased, but cars transported outbound from the Far East and Southeast Asia declined. In particular, the reduction in vehicles outbound from Japan was especially detrimental. This is a result of automakers' policies of "local production for local consumption," which is the main factor in the movement toward reduction in transport of completed cars outbound from Japan. Trade decreased for our highly profitable shuttle service outbound from Japan using large-size car carriers, which had a corresponding negative impact on our profitability. Further, we used to load from one port and unloaded at one port under automakers' shipment patterns, but the trend is now to load at several ports and unload at several ports, which reduces vessel operation efficiency and in turn deteriorates profitability.

Q3) Apparently the LPG carrier market is above the outlook, so by how much you exceed your profit forecast?

A3) The LPG carrier market began its surge in April. LPG carriers are operated by our Singapore subsidiary, and its first half fiscal semester runs from January to June. The profit increased by about ¥1 billion for the first half.

[Containerships]

Q4) Can you tell us what factors will lead to improving containership profits by some ¥7.5 billion over Q1 and Q2?

A4) There are four main factors. First, increased freight rates. The average freight rate (index) in Q1 was 79 and is currently increasing to 81. We expect the rates to decline a little bit in September, but fully expect the Q2 average to be 81. That means an improvement of more than ¥3 billion. Second, cost reductions. In Q1, due to a delay in the disposal of medium-size vessels, we did not see full progress on cost reduction. But we will see the impact in Q2, when we expect to reduce costs by nearly ¥2 billion compared to Q1. Third, reduced cargo handling costs. In Q1, there was some holdover from the previous quarter's cargo costs, but that did not carry over to Q2, so costs should show an improvement to that degree. Fourth, increased profit on the sale of containerships, which means an increase of about ¥1 billion over Q1.

Among the above, the effects of numbers 2) through 4) were settled, and the remaining point is whether or not freight rates will move. We believe there should be no problem in July and August because we can expect high utilization. Looking ahead to trends in September, we think at the moment that our assumptions are on conservative side.

Q5) Why do you post deficits even though your vessels are at full cargo capacity? Did you lower rates to increase utilization? Is that the problem?

A5) We did not set pricing down just to increase utilization. Even compared with the same period of the previous year, East-West trade shows no great rate reductions. The rates went down on the South America and Intra Asia trades.

Intra-Asia trade showed very small reductions in rates, and because cargo trade volumes were large, there was much adverse effect on profits. The South America East Coast trade saw rates increase in April and then drop in May and June, so they put downward pressure on Q1 profits. That said, the rates in July show an underlying upward trend.

[Other]

Q6) With the reduction in cash flow from operating activities this time, do you think you may have to review the plan to hold down the cash flow for investing activities?

A6) As set out in the midterm management plan we announced at the end of March, we will prioritize our investment in LNG carriers and offshore businesses, which are expected to generate stable, long-term profits. When written down in numbers, it looks like a huge amount of money, but it is necessary to secure future returns, so we will execute the investment as planned; that is our basic policy. As the investments are very sure to result in good returns, we should have no trouble going to financial institutions to borrow funds.

Q7) You announced a new midterm management plan in March, so in the face of the downward revision you have made in forecasts, will you need to re-examine some of that business plan in the midterm management plan?

A7) At the moment, we are not considering re-examination of the plan we announced in March.

The basic policies of that midterm plan are to take a proactive stance in securing mid- to long-term contracts that will be the core of our stable profitability. On the other hand, with dry bulkers and tankers, which are part of the reason for the current downward revision of forecasts, there is no change in the policy to downsize our market exposure in those fields. In the containership business, another reason for the downward revision, we think recovery is possible, as we explained previously.