J. Front Retailing
Summary of Q&A session at
results presentation for the first six months of the fiscal year ending February 29, 2024
Date and time: 16:30 – 17:45 on Tuesday, October 10, 2023

<Q&A session>

Q. You mentioned that the middle class has returned to Daimaru Matsuzakaya Department Stores to a large extent, and what kind of response do you feel? On the other hand, compared to before the COVID-19 pandemic, not all stores have returned to normal, with the Daimaru Umeda store showing weak return, perhaps due to the competitive environment. What do you think needs to be done in order to further increase sales in the future?

(Sawada)
A. As I have already reported, we have made considerable investments over the past three years to strengthen the three categories of luxury items, watches, and art, and to capture the top market share in the department store industry, and we are seeing reasonable results.

Other than them, for example, for fashion, we can categorize brands into those that exceeded their 2019 results around the end of the first quarter and those that did not, and when we look at all stores, the good brands are doing well in all stores, and sales of the bad brands, or the brands whose sales are not back, are not back in any stores.

The analysis, including interviews, on what each brand is doing and how customers are returning, shows that sales of the brands that have switched their touch points to online are returning faster. The brands that are devising ways to control inventory and strengthen design capabilities upstream in the supply chain also perform well. Among the various initiatives, we are beginning to see some winning strategies. We are trying to raise the overall level while talking about such things with the brands that are relatively behind.

The most positive response we are seeing is the significant progress in the digitalization of the touch points using the “app.” We have seen a considerable increase in the average spend per customer in this first half, and we intend to use this as one of our weapons.

On a store-by-store basis, sales of some stores have already exceeded the fiscal 2019 levels, but what I can say for sure is that the stores that have made strategic investments over the past three years have become extremely strong. Sales of the stores that are taking a wait-and-see attitude are returning slowly. In other words, I feel that the proper actions taken lead to solid results.

Q. PARCO is doing very well in Shibuya and Shinsaibashi. I think that some rural stores are also doing well, but in general, the figures show that sales of the rural stores are a little weak. Please explain the differences between stores.

(Kawase)
A. Transaction volume has increased significantly by 50% and 60% from the previous year amid the COVID-19 pandemic, mainly at Shibuya PARCO and Shinsaibashi PARCO. For example, PARCO

stores such as Sapporo PARCO and Fukuoka PARCO in the cities where inbound tourists are returning, although a little later than in the Tokyo area, have good results.

What they all have in common is the experience value of culture, art, and entertainment that is unique to PARCO, which we have prepared amid the COVID-19 pandemic. We have been able to achieve good results in the stores where we have already put in place mechanisms that allow not only inbound tourists but also local customers to choose PARCO when considering how to spend their days off.

The Group's policy is to "make strong stores even stronger," so we would like to further strengthen our urban stores, which have continued to perform well. We would like to further emphasize the characteristics of entertainment and culture.

On the other hand, as shown in the results by store in the first half on page 15 of the results presentation material, we consider Nagoya PARCO, Sendai PARCO, and Hiroshima PARCO to be stores with a slightly weaker recovery from the previous year. These stores mainly sold a large proportion of clothing, and are designed to attract a large number of customers from a wide area in search of clothing.

Under the influence of COVID-19, the habit of buying personal items through e-commerce has spread, and the trend of shopping at the nearest commercial facility instead of going out to PARCO has also taken root. In such a situation, I am aware that Nagoya PARCO, Sendai PARCO, and Hiroshima PARCO have been a little slow in recovering from COVID-19. We are also planning to renovate these stores to incorporate art and entertainment that will enhance the experience value.

Not all floor concept reforms can be completed in one year, and some may take a little longer, but we would like to encourage customers to visit our stores through these efforts.

Q. You explained the results earlier in your review of the current medium-term plan, but what are the challenges? I think the most important pillar for the next medium-term plan will be how much stronger the retail business will become. In your explanation earlier, including the renovation of the Matsuzakaya Nagoya store, you dared to refer to "retail" rather than department stores, but how do you define this? Could you explain a little more about how the retail business will be positioned in the next medium-term plan?

(Yoshimoto)

A. Personally, I think there are too many issues, but ultimately, we have a pretty aggressive direction in sight, and the big challenge is "to develop human resources" in that direction.

As I mentioned in my explanation, people are important in everything we do in the future, but I think that the issue of what to do with an organization to nurture those people or what to do with an organization to operate it is also very important.

The direction is to increase synergy like Daimaru and PARCO in Shinsaibashi, switch to a younger target like GINZA SIX, or have a global focus like Shibuya PARCO. And finally, as I mentioned AnotherADdress as an example, I believe that the success of AnotherADdress is due to the fact that the people who took on this new business with an entrepreneurial mindset have been able to manage it by establishing detailed KPIs for the processes at their own risk.

And, as I mentioned in the section on human capital management on slide 41, I dare to provide numbers for the CVC fund and digital human resources.

In terms of the CVC fund, it has contact with 4,800 employees and produces 200 employees who will lead the transformation. The CVC has contacts with startups and hopes to make a significant contribution in revitalizing companies as a strategic return. The person in charge of business strategy travels to sites all over the country and works closely to connect the sites and startups. Connecting these things together and taking on new initiatives will likely produce many members like those who were involved in launching AnotherADdress.

Also, as for digital human resources, we are planning to train 100 digital human resources, analysts and designers by fiscal 2024 and 1,000 by fiscal 2030 under our own system. Our management team recently received a portion of this training. Through these initiatives, I believe that creating an organization where every workplace has at least one digital expert will lead to success in the core part of the next medium-term plan.

There is no doubt that retail is our core business. However, rather than staying within the existing areas of Daimaru Matsuzakaya Department Stores or Parco, I would like to explore new areas and measures by combining the different aspects of the people who grew up in these two companies. As I mentioned earlier about what is happening in Shinsaibashi, I have heard of cases where only young people from both stores came up with various projects in August, and mutual customer referrals between the two stores improved considerably. If such things start to emerge spontaneously in the area, I think that the initiatives in the area will probably be positive exponentially, and I would like to think about the mechanism for that by combining the Department Store and Parco everywhere.

I believe that this will lead to a new vision for retail, and it would be best if it can be understood as the vision for retail we are aiming for in the next medium-term plan.

Q. With regard to the assumptions for gross sales in the second half at Daimaru Matsuzakaya Department Stores, I would like to know the absolute amounts, year-on-year comparison, and comparison to 2018 or 2019 before COVID-19 separately for duty-free sales and sales to domestic customers. I would like to understand the "degree of acceleration" mentioned in your comment that inbound sales accelerated, so I think it would be easier to understand if you could show the percentage changes separately for the first half and the second half. In addition, looking at the monthly trends in September and the sales trends during the travel season in China, I think that there will be no impact, such as the impact of treated water and consumption in China, but I would like to ask if you could add a little more to your comments on that as well.

(Sawada)

A. First, duty-free sales were approximately 25.0 billion yen in the first half and are expected to be 29.5 billion yen in the second half. I think it is the most accurate to look at the numbers obtained by dividing them by the numbers of business days, and the actual results in the first half are about 126.00 million yen on a daily sales basis, and sales of 29.5 billion yen forecast for the second half will be about 163.00 million yen on a daily sales basis.

In September, daily sales were approximately 183.00 million yen, and although there were Chinese National Day holidays at the beginning of October, they exceeded 200 million yen even yesterday after the holidays were over. The daily sales forecast of 163.00 million yen for the second half may be considered conservative, but we believe that there will probably be room for revenue growth here.

Cash sales excluding duty-free sales are currently projected at just over 210.0 billion yen in the second half, a 2.7% increase over the previous year. In the first half, cash sales excluding duty-free sales increased by 7.8% compared to the previous year, so this is a slightly more toned-down and conservative outlook than the first half.

Similarly, the growth rate of gaisho sales for the second half is expected to be slightly lower than that of the first half, with an actual increase of 8.4% in the first half and an increase of 6.7% forecast for the second half.

In terms of actual value, gaisho sales are expected to be around 105.0 billion yen in the second half, and they were around 95.0 billion yen in the first half. If this is the case, annual gaisho sales of Daimaru Matsuzakaya Department Stores will be approximately 200.0 billion yen, and those of the Department Store Business, including Hakata and Kochi, will probably exceed 210.0 billion yen.

At the beginning of the fiscal year, I believe I mentioned that we would like to exceed 210.0 billion yen in gaisho sales, and we expect to almost achieve that figure.

Q. Regarding the product gross profit margin of Daimaru Matsuzakaya Department Stores, I think that in the second half of the previous fiscal year and this first quarter, it was down quite a bit by 0.4 percentage points YoY, but in the second quarter, although it is still decreasing, I think the rate of decline has become smaller. Given that inbound sales are expected to accelerate from here on out, how do you see the gross profit margin for the second half? Looking at the plans for gross sales and gross profit, I think it is assumed that they will increase YoY in the second half. Even if sales of luxury items are strong, gross profit margin has largely stopped declining. Or looking at the monthly figures for the second quarter, the rate of decline in gross profit margin is actually shrinking. I would like to know such facts so that I can raise my convictions.

(Sawada)

A. As you said, we have compiled the numbers based on the expectation that the gross profit margin for the second half will improve by about 0.3 percentage points compared to the first half results. As for the rationale for the 0.3 point improvement from the first half, we had expected that cosmetics purchased on a no return basis would grow along with the resurgence of inbound sales, but as of September, of course, there was an improvement, but not as much as we had expected.

Regarding the problem with treated water, we have received various information from each store, but so far there has been no major impact.

As a side note, the inbound tourist traffic to the Kyoto store is now second only to the Shinsaibashi store in the company. As you can see if you go to Kyoto, it has a large number of foreign tourists, and the number of hotels has increased considerably, with a considerable number of stay-over foreigners.

Q. You mentioned that Parco offset the shortfall in commission income with cost reductions, but I would like to confirm the background behind this shortfall in commission income and what kind of room there is for cost reductions. Parco is a low-cost business to begin with, so I wonder if SGA will be able to make up for it when income weakens. The costs may include SGA and cost of sales, but I would appreciate comments on areas such as room for improvement and control in the costs.

(Kawase)

A. I believe there are three main reasons behind the shortfall in commission income. First, as you know, Parco has fixed-rent tenants and commission-based tenants. Of these, fixed-rent tenant transaction volume including services, such as travel and tickets, for example, has increased significantly this year. On the other hand, although not all commission income, the growth of commission-based tenants is still smaller than that of fixed-rent tenants, so there is a slight discrepancy between transaction volume and real estate commission income.

Second, regarding whether rental income will increase in parallel to the growth in transaction volume, there are tenants whose contracts do not necessarily allow for a parallel increase in rental income to the growth in transaction volume at the shop. These tenants are also experiencing significant sales growth, partly due to increased inbound demand, which does not parallel our rental income, but this is where the discrepancy between transaction volume and commission income comes from.

And finally, there is an increase in the number of event operation areas. This is not a formal contract to rent the floor, but a contract to rent the floor under an event contract, and these contracts have a lower profit margin for Parco than formal contracts.

The number of these event areas is increasing compared to the end of fiscal 2019 before COVID-19. There are two reasons for this. One is the deliberate increase in the number of event operation areas in order to secure a certain amount of space for floor concept reforms. Another reason is that market conditions have worsened, and the number of event operation areas is increasing where tenants have withdrawn.

As for the room for cost control, as you mentioned, Parco is not a very cost-intensive business. The first reason why we were able to control costs in the first half was in advertising expenses. Normally, advertising expenses are used to plan large-scale projects that attract many customers, but Parco has taken the risk of strengthening its efforts to ensure that this will lead to income. This results in a net decrease in advertising expenses we are spending. Another reason is that in this first half, after much scrutiny, we were able to find areas where we did not have to spend outsourcing expenses, so we were able to keep costs down.

For the future, I do not think there is much room for cost control, so we would like to focus on increasing the top line to improve our performance.

(Yoshimoto)

A. As a supplemental explanation of how the Department Store sales are today compared to before COVID-19, the gross sales forecast for the Department Store segment for fiscal 2023 is a 2.6% increase over fiscal 2019. Gaisho sales will be up 19% compared to 2019. Domestic cash sales will decrease by 5.2% and duty-free sales will decrease by 10.7%. You might think that domestic cash sales are declining even more, but since the majority of sales of luxury brands and watches are domestic cash sales, this is what happens when looking at them from three perspectives.

Q. We would like to hear your thoughts on the Department Store's top line looking a little further into the future. Inbound sales have returned considerably, and domestic sales, mainly luxury goods, have been strong. What are your current thoughts on further building up the top line over the next fiscal year and the year after?

Also, how do you plan to manage cost control in the future, including from a slightly longer-term perspective?

(Yoshimoto)

A. In my explanation, I used examples such as Shinsaibashi because I could see a direction that would last for a certain period of time. The synergy between Parco and Daimaru Matsuzakaya Department Stores, or the new affluent class I mentioned in the section on GINZA SIX, I believe these are the seeds of our growth that will continue for some time to come.

The Department Store has been in a rather difficult top-line situation, but now, especially when it comes to urban stores, we are beginning to see a certain direction of attack, and if the direction of our strategy can be matched with that direction, particularly if we can create a new retail business by combining the know-how of Parco, the know-how of the real estate business, and the know-how of the card business with the growth we have achieved so far in the Department Store alone, I personally believe that we will be able to continue to increase our top line for quite a long time, and I would like to steer the Group in that direction.

(Sawada)

A. I also believe that the top line of the Department Store will continue to build up. Looking at each store, over the past three years, there are some that have not taken all possible measures or are not yet ready. I also believe that in the areas of art and watches, for example, we already have the leading market share in the department store industry. Taking the top share is a major strength, and since we can operate directly managed stores nationwide with that strength, it is conceivable that we can further expand our strengths. I believe that there is room for growth because some of our stores have not taken all possible measures and we have some strong categories that seem to take the top market share. In addition, I hope to increase sales of online businesses such as AnotherADdress and Raku-Rich in the future and bring them into the black as soon as possible. I believe that the top line will grow with the addition of these new initiatives.

We will clarify costs in the next medium-term plan, but the Shinsaibashi, Nagoya, Kobe, and Sapporo stores are becoming able to earn enough to generate 5.0 billion yen in business profit even after the head office expenses are allocated. With them at the top of the list, I will look at what is the most rational way to maintain the facilities over a 10-year cycle.

Therefore, instead of holding out as long as possible to use infrastructure facilities, including the electrical systems, and finally spending a large expense to repair them, I believe that spending on repairs in a planned manner over a long range will probably lower costs in the long run.

Also, as for renovation expenses, I believe that we should make major reinvestments in remodeling our stores on a 5-year or 10-year cycle. I believe that further cost reductions can be achieved through systematic investments over a 10-year span.

As for the personnel structure, the number of people has not kept up with the number of posts. Of course, there are ways to recruit and redirect people, but now that we have a clear idea of what we should do and how we can win, we will redesign the organizational structure and role design in line with that strategy, and draw up an organization and role structure that can adjust to that number of people in the next medium-term plan.

Therefore, although outsourcing expenses are increasing now, I believe that we can achieve this with no outsourcing expenses at all, and I see that it will be quite possible to lower the cost structure in that area.

Q. Mr. Yoshimoto mentioned earlier that you are “shifting your focus to growth” and “making more aggressive investments.” How do you plan to allocate cash flow as you aim for ROE of 8% first, and then 10% beyond that? Profit levels are recovering significantly, so it would be good if the recovery is even higher after investing, but I think there are some uncertainties, and I also think that retained earnings will accumulate to a certain extent with the current dividend payout ratio of 30% or more.

The “flexibility” in terms of flexible shareholder returns has not been seen recently, but will you increase the allocation to shareholders a bit more as shareholder return, or so-called cash allocation? Or even if it is not increased, free cash flow will increase significantly, so will there naturally be room for dividend increases and share buybacks?

Dividends are increasing due to a recovery in business performance that is more like a V-shaped recovery for the Department Store, but when thinking about the future, I wonder if investment will increase even more and things will go back to what they were before. I think your company is doing well, but I would like to hear your thoughts on cash flow allocation and shareholder return distribution. Will ROE be really 10% based on the 10-year vision?

(Wakabayashi)

A. Originally, the Group's capital policy has been based on the concept of determining a balance between strategic investments for growth, capital reinforcement, and shareholder returns at each stage. As you are aware, we have been focusing on strengthening our financial position and increasing capital during the COVID-19 period, but for the three years of the next medium-term plan, we would like to basically devote ourselves to strategic investments for growth. Therefore, we set ROIC for each business as a hurdle in order to increase profits.

However, based on our track record to date, unfortunately, it is the fact that investments have not been linked to profits as expected, so I would like to consider a combination of strategic investments for growth and shareholder returns in the future.

If we have planned to make a strategic investment for growth but do not expect results to be successful, we would like to take a flexible approach by directly returning the balance in the form of shareholder returns and increasing its weight a little.

Q. I think it is a prerequisite to increase profits, but when the level of profits rises considerably, with the current dividend payout ratio of 30%, retained earnings will increase considerably, so I personally think it would be good to increase DOE and dividend payout ratio for shareholder returns in consideration of capital efficiency in the future. I hope you will consider this point carefully.

(Wakabayashi)

A. I would like to properly take this viewpoint into consideration.

(Yoshimoto)

A. Investments will be always made with an eye on returns. We have included the Developer and the Payment and Finance among the four pillars of growth that will follow, and I think that there will be quite a few areas where upfront investment will be involved, so I would like to give a clear total picture and think carefully about how much we will devote to growth and how much we will return to shareholders in a way that does not waste money.

End