Business Model ▶ Top Interview

Now Is the Time to Change. Break This Impasse with Diversity as a Driver.

YOSHIMOTO Tatsuya
Director, President and Representative Executive Officer

Awareness that the world will not return to normal

It has been more than one year since the COVID-19 pandemic started. My thought about the "worst" has changed fundamentally over the past year. For example, manufacturers have to write down their newly built plants, or in some cases, close them if strong competitors emerge or alternatives emerge suddenly. In our case, in terms of sales, I think the worst was an approximately 10% decrease after the collapse of Lehman Brothers. As retail is a stable business model in a way, we were in a "boiling frog" situation. On the other hand, manufacturers may achieve a V-shaped recovery when they make new products that their competitors do not make. But it is difficult for retailers.

The department store market had been shrinking after peaking in 1991, but recently, it was coming back to life mainly in urban stores because the inbound market expanded rapidly. Taking our company as an example, our inbound sales in fiscal 2019 were ¥60.1 billion, which grew to almost 10% of our department store sales. In the previous fiscal year 2020, however, people were globally restricted from traveling and the inbound market almost evaporarated due to COVID-19. Though it was often pointed out that we depended too much on inbound sales, I think no one expected we would have almost zero inbound sales.

Meanwhile, looking at Japan, spending by affluent people, mainly *gaisho* sales activities based on strong relations with customers, has been robust but crowd restrictions have an immense impact. Customer traffic to Daimaru Matsuzakaya Department Stores decreased by 47.9%, almost half, in fiscal 2020. It is true that this is largely due to temporary closures and business hours reduction at the request of the national and local governments and our efforts to strengthen our safety and security measures "not to create close contact between people" to the greatest extent possible to prevent infection from spreading. However, we have to pay more attention to the fact that consumption structure is greatly changing with changes in customer values and behaviors triggered by COVID-19.

The world will return to normal in time — I never think so. The Group has overcome a number of crises over its 300 and 400 year history. But in order to respond to unprecedented changes facing us currently, to what extent will we become serious after awakening from the boiling frog situation? I think our readiness for change on a level different from the past is called into question.

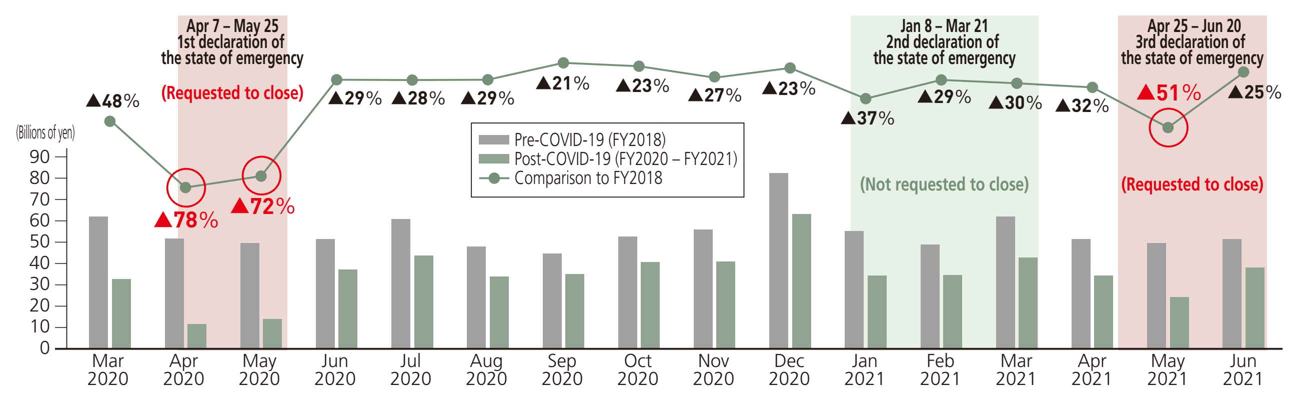
COVID-19 is not the main reason

The Group fell into the red for the first time in 19 years. It is true that it was greatly affected by a dramatic decrease in foot traffic and the evaporation of inbound sales due to the COVID-19 pandemic spreading around the world. More importantly, however, I think the underlying cause is that the core department store business has not reached a solution of the conventional problem of the obsolescence of its business model. That is to say, its ability to respond to changes is weakened due to over-dependence on apparel, over-dependence on elder people and over-dependence on physical stores. The COVID-19 pandemic has only exacerbated and exposed these problems at a stretch.

I do not think our awareness of issues and the direction we took were wrong. But I regret that there was a lack of speed in addressing these problems. In addition, since new variables including changes in customer values and behaviors were added, as a matter of course, I think we will be forced into a quite insufficient situation if we only continue in the same direction as in the past.

As for the direction of our business model reform, based on the major premise of creating a more lean

Daimaru Matsuzakaya Department Stores sales and comparison to pre-COVID-19



business structure, we need to change the look of physical stores and boost digitalization with stores as its starting point to capture new customer segments. The creation of synergy with Parco such as content development and the mutual transfer of customers will be a big point.

I have no intention of blaming COVID-19 for current poor department store performance. Instead, I think we should take this opportunity to face anew the essential issues of department stores. On the other hand, in fact, department stores are said to be an "industry in structural recession." However, I feel uncomfortable about summing up all in this single phrase. I believe we will be able to change such perception depending on our ability to respond to the situation.

As sort of 10 years of changes have come all at once, we are expected to respond to changes more quickly than ever. I would like to clearly show that department stores are never "outdated" by accelerating business model reform that meets changes in the times and changes in customers appropriately without misjudging the true nature of the problem.

Management based on sustainability

We could obtain a lot of awareness from the current COVID-19 pandemic. The vulnerability of the business overly dependent on physical stores was exposed. Concerns arose about the advantage of urban locations which we had considered as our strength. In this way, the problems with the business model, which we have had since before the COVID-19 pandemic, became more conspicuous. In the meantime, precisely because we are in such a situation, I am sure we were given an opportunity to strongly realize again how important it is to have person-to-person relationship and communication and real face-to-face meetings, how important it is to give first priority to the safety and security of customers and employees, and that we are with all stakeholders including customers, shareholders, business partners and local communities.

The Group has identified the materiality issues considered to have a significant impact on the Group and its stakeholders from issues related to environmental, social and economic sustainability to promote sustainability management. The Group identified five materiality issues including "contribution to a low-carbon society," "management of the entire supply chain," "coexistence with local communities," "promotion of diversity" and "realization of work-life balance." However, considering that environmental problems are rapidly becoming serious and that the current COVID-19 pandemic is changing values and establishing new lifestyles, we have decided to newly add two items including "promotion of circular economy" and "realization of customers' healthy/safe/secure life."

At the same time, concerning "contribution to a low-carbon society," we went a step further and revised it to "realization of decarbonized society." And in light of changes in society, we renewed "promotion of diversity" and "realization of work-life balance" with "promotion of diversity and inclusion" and "realization of work-life integration," respectively. With regard to these materiality issues, while identifying both risks and opportunities, we will create business opportunities to achieve both social value and economic value.

The Group has a long history of 300 and 400 years. I am proud that we are a corporate group that continues to represent sustainability. The Corporate Credo "Service before Profit" underlies that. Those who give priority to service over profit will prosper. I think it suggests that it is important to solve social issues through business activities by offering support to customers and society. Our idea of achieving both social value and economic value is not something new. What is really important? When we face a difficult situation, we return to this Corporate Credo.

First, achieve "full recovery" in three years

Recently, the Group has prepared the FY2021 to FY2023 Medium-term Business Plan to integrate its corporate strategy and business strategy based on such sustainability management. It aims to achieve "full recovery" by recovering both PL and BS back to fiscal 2019 levels in the three years through fiscal 2023 after bottoming out in fiscal 2020. The numerical plan for fiscal 2023, the final year of the Medium-term Business Plan, which symbolizes full recovery, is operating profit of ¥40.3 billion, ROE of 7% and interest-bearing liabilities of ¥260.0 billion. In fiscal 2019, operating profit was ¥40.2 billion. So it shows our determination to definitely go beyond it. We will also decrease interest-bearing liabilities, which ballooned because we gave priority to securing liquidity on hand to prepare for "emergencies," back to normal levels. However, we do not assume that the top line will recover to the previous level in these three years. We assume it is inevitable that the markets for both domestic consumption and inbound consumption will shrink if we continue to do the same things as we do now. Therefore, I think we will not be able to achieve full recovery without transforming our business structure to a leaner one through structural reform.

What we should do first is to lower the break-even point by reducing fixed costs. There is no doubt that the Group's cost reduction efforts were much ahead of its peers. In that situation, I am often asked, "Can you reduce costs more?" I think there is still ample room for cost reduction as long as we have an intention of changing business structures and operation systems instead of simply cutting costs. We would like to cut fixed costs by ¥10.0 billion or more in these three years by reforming our human resource structure through business model transformation, reviewing the right size of offices because remote working has become established to a certain degree, and promoting the digitalization of advertising.

The Group will also reorganize its businesses and narrow down its business foundation. As part of these efforts, we sold J. Front Foods, which operated restaurants, at the end of the previous fiscal year and decided to close Tsudanuma PARCO and Shintokorozawa PARCO. After fiscal 2021 began, we decided to absorb and merge Daimaru Matsuzakaya Sales Associates, which is commissioned mainly to operate the sales floors of Daimaru Matsuzakaya Department Stores, into the company and to sell Neuve A to select and concentrate the Group's businesses. Going forward, we would like to assess our businesses and stores with an eye to the future as quickly as possible.

Three strategies drawn from strengths

Meanwhile, concerning how we will restore the top line, which was extremely damaged due to the COVID-19 pandemic, we have decided to clarify anew what the Group's strengths are and put them into practice as growth strategy.

The Group's strengths include "commercial production capability," "good customer base," "partners including suppliers and creators" and "real estate assets in major cities." Based on these strengths and medium- to long-term environmental changes, we have decided to focus our growth initiatives on "three major strategies" in the new Medium-term Business Plan. The first of the three strategies is the Real × Digital Strategy, the second is the Prime Life Strategy, and the third is the Developer Strategy.

Needless to say, digitalization is a must for retailers. The greatest theme that the COVID-19 pandemic made us aware of is that Parco and the Department Store, which are the core businesses of the Group, conduct their businesses within "time and place constraints." Digital or OMO (Online Merges with Offline) is one of the solutions for that. We would like to aim to create added value using customer service and counseling expertise through "people" in real places such as stores, which are our intangible assets, instead of expanding e-commerce, which mainly deals in products. That is to say, I think the digital that the Group should handle cannot exert a presence without synergy with physical stores.

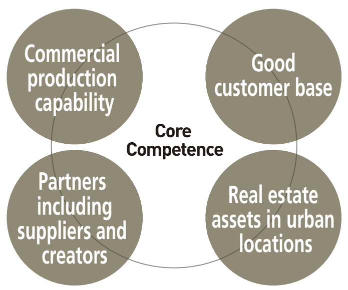
Therefore, in promoting digitalization, I think it is more important to improve physical stores and content. During this three-year period, however, from the standpoint of fully restoring financial health as well, we have no choice but to limit investment to some extent. For the Department Store, we will focus investment on Nagoya, Sapporo and Kobe stores to expand luxury items, which are its strength, and strengthen watches and art. And for Parco, while developing new content, we will renovate flagship stores including Nagoya, Hiroshima, Sendai, Urawa and Ikebukuro stores to increase their appeal so that they will become the stores of choice in their local areas.

Under the Prime Life Strategy, we will strengthen proposals for "consumers who value culture and art and enjoy fulfilling and sustainable lifestyles." Main initiatives include the development and provision of solution services for loyal customers, the acquisition of new loyal customers and the improvement of *gaisho* online communication. In order to advance these initiatives, we will improve our

digital infrastructure, for example, by equipping "connaissligne," a closed website for its members who are *gaisho* customers, with payment function, and at the same time, we will actively consider collaboration and alliance with companies outside the Group.

The Developer Strategy is a long-term business. So it will not significantly contribute to profit over these three years. But we will steadily proceed with the preparation for growth in 2024 and beyond including the investment of ¥30.0 billion. In September last year, the Real Estate Business of Daimaru Matsuzakaya Department Stores was centralized into Parco and 47 properties held by Daimaru Matsuzakaya Department Stores were transferred. We will strive to monetize these assets mainly by effectively using them. In the past, real estate development was conducted mainly for commercial purposes. But going forward, we will promote multiple initiatives without being limited to commercial use.

Strengths of the Group



Create new value through synergy

Though Shinsaibashi PARCO opened last November when we started to see the signs that a third wave of COVID-19 was starting, it has performed better than our internal plan since opening. Particularly, luxury items, art and culture enjoy strong sales. In March, a restaurant mall, which is unique to Parco, opened on the second basement floor. The essences, which led Shibuya PARCO to success, were incorporated throughout the store and I feel it is building a strong presence as a new popular site in Shinsaibashi mainly among tuned-in young people.

Shinsaibashi PARCO is almost integrated with the adjacent Daimaru Shinsaibashi store across a road. Combined, they are a large commercial complex with a floor space of more than 80,000 square meters. We could choose to further expand the department store but we decided to open a Parco store because we wanted to provide new value to the area. I can say confidently that only the Group could develop this large commercial complex. It also serves as a touchstone for what synergy will be created by the Department Store and Parco whose main customer bases are different from each other.

We are already seeing the results in various forms. I said before that luxury items enjoy strong sales. Actually, the customers of the Daimaru Shinsaibashi store, particularly *gaisho* customers, shop feeling that the assortment of luxury items was significantly expanded because Shinsaibashi PARCO opened next to the store. After a modern art event in Shinsaibashi PARCO was closed, we offered a special sale of art works to *gaisho* customers at the closed website and they were sold out immediately.

Customers and content mingle between the Department Store and Parco — It is one form of synergy creation we have aimed for. I am quite sure that enhancing customer experience value makes greater chances. I think it will lead to the medium- to long-term value creation of the Group.

Create a portfolio 10 years from now

In our business portfolio based on operating profit in fiscal 2019 before the COVID-19 pandemic, the Department Store and Parco accounted for about 80% of the total. The current COVID-19 pandemic greatly damaged these two businesses and renewed our awareness that the unbalanced business portfolio increases risk. Above all, the Department Store generates the greatest sales and profits but it is most severely damaged in this unexpected situation. I think COVID-19 is steadily receding with accelerated vaccination rollout. However, there is no doubt that another pandemic will happen in the future. Increased globalization gave us a good opportunity to generate inbound sales. On the other hand, the pandemic increased risk.

Then, what is the optimum balance of portfolio? Looking ahead to 2030, 10 years from now, the declining birthrate and aging population, depopulation, technological advancement and the maturation of consumption will continue. At the same time, the new normal created by COVID-19 will become established. In the meantime, I think the ideas that the Group has valued, including "respect for human thoughts and individuality," "coexistence with local communities," and "inheriting traditional culture and communicating cutting-edge culture," will become even more important.

One of the directions in which we will spread our wings based on the above is shift to the Developer Business. Around our department stores, we have many properties that are not fully used in terms of profit generation. Particularly, in the Shinsaibashi area, Osaka, and the Sakae area, Nagoya, I think there is room for large-scale development in the medium- to long-term term. We will create new value in these areas by developing not only commercial facilities but also residences and offices with the aim of coexisting with local communities.

Rendering of redevelopment of Nagoya Nishiki 3-chome District 25 (planned to be completed in 2026)   Provided by Mitsubishi Estate

Another direction is the growth of the Payment and Finance Business using the expansion of customer touchpoints in the Department Store, Parco and Developer Businesses. It has just made a fresh start by renewing cards in January 2021. Absolutely, it has a great potential in terms of compatibility with the core businesses of the Group. On top of it, we also consider M&A and alliance to spread our wings.

We need to further improve business management so that the Developer Business and the Payment and Finance Business will become growth drivers. To this end, the Group has decided to officially adopt ROIC as a key performance indicator. We set hurdle rates above the cost of capital for each business segment and aim for ROIC above them to enhance corporate value.

Through these efforts, in 2030, 10 years from now, we would like to increase the operating profit share of the Developer Business, the Payment and Finance Business and Other and decrease the share of the Department Store and Parco to around 60% from the current share of about 80%. By doing so, we would like to change our portfolio to strongly balanced one and develop ourselves to the "corporate group that produces fulfilling lifestyles and develops local areas in a unique way that coexists with local communities," which is what we aim to be.

Diversity and resilience

There are two major differences between the new Medium-term Business Plan and the previous plan that started in fiscal 2017.

One is to clarify non-financial indicators as well as financial indicators as quantitative targets. We set specific numerical targets for fiscal 2023, which is the final year of the current Medium-term Business Plan, for operating profit as a business growth indicator, ROE as a capital efficiency indicator, interest-bearing liabilities as a financial health indicator, and others. In addition, as sustainability indicators, we have committed to 40% reduction of greenhouse gas (GHG) emissions (compared to fiscal 2017) and the ratio of women in management positions of 26%. Among them, operating profit, ROE and two sustainability indicators are linked to stock-based remuneration to be provided when the Medium-term Business Plan is completed. Especially, the evaluation weight of sustainability indicators is 20%. I think our commitment to solving social and environmental issues is becoming stronger.

The other is to use human resources diversity in the process of formulating the Medium-term Business Plan. The holding company's team that played a central role in formulating the plan comprised a mixed group of people from the Department Store, Parco and companies outside the Group. As seen from this, fusion with Parco, which became a wholly owned subsidiary last year, is steadily progressing.

A person who is responsible for the digital development of the Department Store, which is one of the points of the current medium-term plan, is an employee in his 40s who had made a career move from Daimaru Matsuzakaya Department Srores to a leading IT company once. The Group employed him again because he was considered as the right person to strengthen digital in the Department Store's distinctive way. Concerning the newly launched subscription business, a young employee in his early 30s formulated a business plan and is responsible for the business.

In terms of the oversight of execution, one of six Outside Directors was a woman when the Medium-term Business Plan was formulated. Currently we have two female Outside Directors. The Board of Directors has a total of three female Directors and their percentage increased to 25%. We support Keidanren's Challenge Initiatives for 30% of Executives to be Women by 2030. We started to disclose a skill matrix this fiscal year. I feel the skills held by Directors have become more diverse.

The Group's ratio of women in management positions (manager and above positions) increased to 19.9%, almost 20%, in fiscal 2020. Some mid-career female workers employed under our unique Mother Recruitment program are working as key persons. The Women's School for female employees who are working for shorter hours while raising children has become established. I would like to develop more and more female employees who serve as leaders. To this end, it is more important to change our awareness and develop talents than simply to select.

It is true that experience is more important when confronted with crisis. Currently, however, changes are increasing in speed and complexity to the extent we cannot solve only with experience. Respond to changes and create new value by going beyond boundaries such as culture, gender and age and crossing, accepting and gathering different views. Increase resilience to overcome the current difficulties — I think it is the greatest driving force.

"Create and Bring to Life 'New Happiness.'" I think this Group Vision deeply and clearly shows what direction we should take in the current era. With the aim of realizing this Vision, first, we will strive to achieve "full recovery," and then, gear up to "regrowth" to achieve sustainable growth and enhance corporate value.