

Analysts' Meeting Q&A

Business Results for the First Nine Months of Fiscal 2017 (September 2016 to May 2017)

The following are questions from analysts about our latest business results. The answers have been edited for clarity.

Q1: You have changed your capital expenditure figures for FY2017. Is this due to any change in store opening plans? Also, what can you tell us more about your store plans for FY2018?

A1: Takeshi Okazaki, Group Executive Vice President & CFO – The new capital expenditure figures reflect a slight delay in store openings in Asia. This doesn't represent a change in our store-opening policy, merely a slight adjustment in the timing of the new store openings, as we continue to expand our store network. As far as our store-opening plans for FY2018 are concerned, we are planning to open a large proportion of new stores in Mainland China, at a similar pace to the current business year. Given the strong growth that we have been experiencing in Southeast Asia, we would like to accelerate new stores openings in that region going forward.

Q2: What progress have you made with your digitalization plans over the third quarter? How is the transformation of your distribution systems progressing?

A2: CFO Okazaki – In terms of progress on digitalization, we renewed our e-commerce business at the end of March and expanded our range of online services. While we did experience some hiccups with our e-commerce distribution in the first half from September 2016 through February 2017, and this did disrupt services to some customers to some extent, our logistics system has been operating more smoothly since March. E-commerce sales have picked up steadily since we renewed our online website in March and enriched our e-commerce product range by offering special online sizes and exclusive online products. Over the three months from March to May, e-commerce sales expanded by 17% year on year and that rate rose to well over 20% from April onwards. The development of our online sales operation is lagging our internal planning, so we are still not satisfied, but it is extremely good to see the operation getting established and starting to grow.

One clear issue to be addressed at this stage is the fact that UNIQLO customers are still not sufficiently aware of our online sales operation. Only a very small percentage of the many customers who visit real UNIQLO stores use our online sales service. Our ultimate aim is to increase the overall frequency of purchases and the number of items purchased by encouraging customers to shop at whichever place is most convenient for them, be it instore or online. With a wider size range and exclusive online items, our online product range is designed to meet a broad range of customer needs. We plan to expand these additional products going forward. I also want to ensure we have sufficient stock of strong-selling online items to avoid product shortages.

One other important tool in this equation is digital marketing. Our digital marketing should not focus purely on boosting online sales. Instead, part of the motivation for improving the appeal of our e-commerce site should be to motivate customers to visit our physical stores as well.

Q3: UNIQLO Japan cost of sales and distribution outsourcing costs are both expected to rise in FY2018. Can you explain your product pricing strategy, and how you plan to maintain UNIQLO Japan profitability heading into FY2018?

A3: CFO Okazaki – UNIQLO Japan uses three-year forward contracts to hedge against foreign exchange fluctuations, but right now we are feeling the effects of a gentle weakening in the yen in the form of a rising cost of sales ratio. That said, I want to maintain current price levels at UNIQLO Japan until the upward pressure on the ratio starts to ease, something we forecast could take over 12 months. To absorb this upward pressure, the challenge will be to improve the gross profit margin by controlling product markdowns. Our easily recognizable everyday set-price strategy, which we introduced in the second half of fiscal 2016, has been extremely successful in helping us control discounting rates more consistently and effectively, and build sales in a more controlled discounting environment. I intend to maintain firm control over discounting going forward.

It is also important to reduce business expense ratios. Distribution outsourcing costs have been rising persistently over the past one to two years. There are two factors at play here. First, the unit cost of distribution outsourcing has been increasing. Second, we decided to transform our distribution framework precisely because we expected distribution outsourcing costs would rise. That transformation has resulted in temporary cost increases, such as the cost of maintaining duplicate warehousing, and the cost of dealing with inevitable confusions that occur as we build up our in-house distribution operation. I believe the second factor will resolve itself broadly by the end of the current financial year, but the first factor will depend very much on what happens in the broader market. Looking ahead, we need to improve efficiencies as we develop our in-house distribution operation, and do everything we can to control the rise in distribution costs in the broader market. We are working actively to achieve this.

We are experiencing similar challenges with store personnel costs. The basic hourly rate for temporary employees has been rising, and it can be difficult to hire temporary staff in some areas. We foresaw this situation well in advance, so we worked hard to stabilize our workforce by encouraging temporary staff to become local-store employees. We will continue to look at ways of improving individual hourly rates and staff treatment. Going forward, UNIQLO Japan will focus boosting efficiencies to help successfully absorb the broader increase in both personnel and distribution costs.

Q4: Looking at your GU operation in FY2018, there have been reports that you are intending to shift the focus of GU advertising campaigns from appealing individual items to promoting coordinated outfits. Is that right and, if so, can you explain this strategy in more detail?

A4: CFO Okazaki – Our low-priced GU casual fashion brand has performed extremely strongly over the past few years, largely because of the brand's hit products. However, on reflection, it is probably fair to say that we focused our business model too strongly on winning home runs by developing hit products within the product mix. This season, our campaign items did not miss the

mark in terms of popular fashion trends, but they didn't become the home-run hit products we anticipated. Consequently, lower-than-expected sales resulted in inventory rundowns and a contraction in gross profit margin. Shortages in strong-selling items also resulted in lost sales opportunities. Under these circumstances, it is taking us longer to generate an improvement in GU performance.

GU is a fashion brand, and that is why I think we should change our focus and our strategy. Rather than compete on individual products, we should be working more on styling, design and providing highly finished items that offer customers the chance to have real fun with fashion. Getting the fashion trends right is not necessarily the hardest part, and it is important, from a business perspective, to ensure we have sufficient volumes of trendy items that are the most popular with customers at the height of the season. We are looking to generate more stable growth for GU by changing course and starting to propose styling options that enable customers to enjoy fashion.

Q5: The GU stores that you opened in Hong Kong have proved a huge success. What are your future store plans for GU in Hong Kong? At the same time, GU stores in Shanghai do not appear to be generating solid results. Is that an accurate interpretation?

A5: CFO Okazaki – In terms of GU's international development, we are delighted to say that the first GU stores to be opened in Hong Kong earlier this year were highly praised by local customers, and have since generated higher-than-expected sales. In view of that strong welcome, we would like to open more GU stores in Hong Kong with the aim of actively growing GU's presence in that market. GU stores in Shanghai and Taiwan are now starting to carve themselves a solid presence, so we would like to steadily expand the GU brand in those markets as well over time. Having said that, now is not the time to rapidly expand store numbers. Instead, it is important to consolidate GU's existing operations, and to carefully nurture and train personnel in the interests of future growth. We want to accelerate GU store openings, but only after we have a solid and satisfactory operational framework in place. There are some GU Stores in Shanghai that are struggling right now, but that is not to say that the overall operation is struggling. In fact, the overall Shanghai operation is on its way to becoming a profitable business.

Q6: Can you tell us more about your decision to provision ¥6.5 billion in future tax expenses to cover changes in your policy on receiving dividends from overseas subsidiaries?

A6: CFO Okazaki – We are provisioning against potential future dividends, but it does not mean that we intend to allocate dividends worth that amount. To date, none of our fully owned subsidiaries have paid dividends, but, to reflect changes made to our dividend strategy, including the possibility that a portion of fully owned subsidiaries may start paying dividends, we decided to provision the maximum potential tax expenses as required under basic accounting rules. We plan to make flexible and agile judgements on potential dividend payments after scrutinizing each subsidiary's level of funds and capital investment, etc.

Q7: This is a question on cost of sales at UNIQLO Japan. Is the impact of the weakening trend in internal yen exchange rates on the cost of sales ratio likely to be more severe in the second half of FY2017 compared to the first half, and is it likely to worsen even further in the first half of FY2018? We understand you have been working to reduce the cost of sales ratio by intensifying raw materials procurement. Is that proving effective?

A7: CFO Okazaki – We have always conducted rolling hedges on our settlement rates. So, if you study our past exchange rate trends, you will see that we have managed to successfully moderate sharp fluctuations. You would note however that yen exchange rates have been gradually weakening and we expect this trend will continue for another year at least. Cost of sales is not determined by exchange rates alone but is a mixture of factors, including raw material procurement costs. Having said that, while the cost of sales ratio won't necessarily rise exactly in line with the weaker yen trend, we have decided to assume a firm upward trend in the ratio.

Q8: In terms of the Ariake Project, you have pursued some radical organizational changes since moving part of your operations to the new Ariake Office. These efforts seem to have helped achieve more appropriate product mixes and control losses on product markdowns, but will you be actively seeking to contain markdown losses in FY2018, and possibly beyond?

A8: CFO Okazaki – The launch of the Ariake Project has contributed considerably to our organizational transformation, but we still have some way to go to reach our ideal goal. We intend to intensify improvement efforts going forward to help realize the full benefits of the Ariake Project over the coming two financial years.