

Analysts' Meeting Q&A

Business Results for Fiscal 2019 First Quarter (September to November 2018)

Below are questions from our analysts' meeting concerning business results for the first quarter of FY2019, or the three months through November 30, 2018. The answers have been edited for clarity.

Q1: You have explained how the warm winter resulted in sluggish sales and increased inventory in the first quarter, but, now that your transformative Ariake Project is fully underway, were you able to change your inventory or discounting control strategy to better respond to those immediate conditions?

A1: Takeshi Okazaki, Board Member, Group Executive Vice President & CFO – Our performance was so strong in the first half of last year that we had run out of stock of some thermal clothing items by the end of the season, causing inconvenience for our customers. That experience sparked the decision to include a larger amount of warm clothing in our product mix this year. Only, the strategy backfired when we experienced a warm winter this year. Thanks to progress made on our transformative Ariake Project and our ability to better visualize production, retail and distribution, we were able to get a better grasp of inventory and warehouse conditions once sales started to slump. That meant we suffered much less than the last time warm winter weather affected performance three years ago. There was no confusion over distribution, and we were able to control costs. I see this as proof that we are able to respond much better to unexpected events such as warm winter weather.

However, there were also lots of lessons to be learned. First, we know there is always a possibility of a warm winter, so we should have developed and included some new items that customers would find attractive in the fall season when the weather was still warm. We should have produced more of the products that did sell well this year. We could also have made better business decisions on winter clothing by operating to a shorter lead time and not increasing production until we had a better grasp of the overall trend. These are issues that can be improved to create better business practices for the future.

Q2: You explained that UNIQLO Greater China (Mainland China, Hong Kong, Taiwan) sales came in slightly below forecast in Q1 due to the warm winter effect but that operating profit increased more than expected. We hear many different reports about consumption in China, but what is your view?

A2: CFO Okazaki – The Chinese economy and consumption are probably slowing down as

reported, but, at this point in time, we have not felt any adverse impact on our own business. Customer demand is firm. The fact that sales came in slightly lower than expected was due more to the warm winter effect than sluggish economic conditions. Inspired by our LifeWear concept of providing ultimate everyday comfort, UNIQLO is attentive to its regular customers and the brand is becoming an increasingly integral part of customers' everyday lives in China. That seems to give us a stronger tolerance or resistance against less favorable economic conditions. However, we must always be on guard because we don't know how far the Chinese economy might slow.

Q3: UNIQLO International reported a strong overall performance. However, while Mainland China generated strong results, Hong Kong and Taiwan were weaker. Are you noticing a growing divergence in national and regional sales trends within UNIQLO International?

A3: CFO Okazaki – While same-store sales declined in Hong Kong and Taiwan, overall revenue in Hong Kong actually rose. I think the performance from Taiwan was notably poor, but this was due more to one-off factors such warm weather and the general election, rather than any significant structural business issues. Having said that, demand is considerably weaker in Hong Kong and Taiwan compared to Mainland China, so we continue to monitor closely any future impact that might have. Elsewhere, business in Southeast Asia is strong, with that operation generating consistent growth in same-store sales across the board, and higher overall revenue and profit.

Q4: You explained that you expected procurement rates would remain high in the first half, and then start to decline from the second half of the financial year. What do you think will happen after that, and will you apply the benefits from lower cost of sales to improving price or quality for instance?

A4: CFO Okazaki – Procurement rates will improve from the second half as our forward foreign exchange contracts swing sharply to a stronger yen position. There will be some slight variations depending to the season, but we expect procurement rates will continue on a gradual yen strengthening trend. The first priority is to secure an appropriate cost of sales level. Given our intention to keep prices as they are, as you say, once we have secured a cost of sales level that enables us to generate sufficient gross profit for the business, I would like to channel any benefits from this exchange rate environment into improving products.

Q5: UNIQLO Europe and UNIQLO USA generated a large profit gain in the first quarter. Was this due to the fact that the UNIQLO brand is becoming increasingly well recognized,

enabling those operations to move into a new phase? Are you expecting to see a go-sign for accelerating new store openings anytime soon?

A5: CFO Okazaki – Our businesses in the United States and Europe are different. UNIQLO USA is improving primarily because we are finally managing to do the required fundamental things. We have worked hard to resolve former confusion over creating regionally tailored product mixes, smooth store operations and distribution operations, and now each store is able to operate properly. We have also closed structurally unprofitable stores. All these factors have greatly helped improve our business in the United States.

However, I believe that UNIQLO brand visibility remains lower in the United States and Europe compared to Asia. We have put so much effort into the United States market because we want the US operation to become a key pillar of the Fast Retailing Group in the future, but we need to do more to build the UNIQLO brand in that market. In that sense, we still have plenty to do and must work to increase brand awareness further in the United States.

In Europe, our new urban flagship-class stores opened in new markets such as Sweden, Spain and the Netherlands have been well received across the board, and this strategy for launching the UNIQLO brand is proving sufficient to create a good brand image and encourage a solid awareness of the UNIQLO LifeWear concept. However, while we have had some success at establishing a reputation in urban areas, we still have a long way to go to extend this reputation across the whole of Europe.

As for accelerating new store openings, we will probably wait until we have established a clearly profitable business in the United States. Even when that profit is confirmed however, one thing you should bear in mind is that online sales constitute a considerable portion of our business in the United States and Europe, and so any strategy to expand our business will probably involve focusing on a combination of increasing the number of large-format stores and developing our e-commerce operation. Of course, store numbers will increase, but we will probably not opt for sudden mass store expansions as we have in the past.

Q6: You explained that UNIQLO Japan's gross profit margin declined 3.2 points in the first quarter and that this was slightly below target, but was this due primarily to the impact of internal exchange rates?

A6: CFO Okazaki – Stronger discounting also dampened the gross profit margin. This year, we decided to hold a large stock of warm clothing, and we ended up having to discount that stock more than initially expected when we were hit by the warm winter. We already incorporated higher

procurement prices and a consequent rise in cost of sales, so the slightly lower-than-expected gross profit margin was primarily the result of more aggressive discounting.

Q7: UNIQLO Japan inventory assets increased considerably. Could any future discounting of excess inventory significantly impact overall corporate results?

A7: CFO Okazaki – We did experience a large increase in UNIQLO Japan inventory at the end of November. However, sales of warm clothing have proved extremely strong since the weather turned cold in December and overall sales have exceeded forecasts, so we have already been able to run down a considerable amount of winter clothing inventory. The second-quarter gross profit margin will come in lower than forecast due to stronger discounting from December, but second-quarter sales are likely to be on target or higher than initially expected. Against that backdrop, I believe we can bring inventory back down to reasonable levels. However, that will mean a considerable drop in first-half profit for UNIQLO Japan, which we have already incorporated into our full-year business estimates.

Q8: While UNIQLO Japan store sales were sluggish, online sales increased approximately 30% year on year. Online sales would also have been affected by the warm winter, so how did they manage to generate such strong growth?

A8: CFO Okazaki – Our efforts to encourage customers to join our online shopping app are paying off, and members are steadily increasing. That is one reason for the strong increase in online sales. Second, last year our system failed during peak sales and we also experienced some delays with deliveries, but we learned from that and this year were able to operate smoothly. Third, customers worldwide are becoming more familiar with online shopping. Considering those factors, 30% year-on-year growth is not unusual or particularly strong. In fact, I would expect to see that pace of growth continue. Furthermore, over the past three months, we have seen a sharp increase in the number of people using our click and collect service, which enables customers to pick up their online purchases from their local UNIQLO store free of charge. In fact, on a per-order basis, instore pickup of online purchase accounted for one third of all online sales. Our store network is one of our key strengths, and we are seeing that being utilized effectively to promote further growth.

Q9: Do you think overall profitability will rise as the proportion of online sales continues to increase?

A9: CFO Okazaki – The profitability of physical stores and online sales is roughly the same. If

anything, profitability for online sales will likely be lower for the time being as we are currently investing in expanding and improving the functionality of future online sales.

Q10: Store sales and profitability appear to be deteriorating in Japan, but, rather than consider store and online sales separately, are you seeking to unify the business and merge real and virtual operations with your click and collect service for instore pickup of online purchases?

A10: CFO Okazaki – Right now, we look at physical store and e-commerce profitability separately, but as we continue to merge our physical and online store operations, it will become increasingly important to consider stores and e-commerce as a whole, rather than considering what is happening to stores and to e-commerce in isolation. I don't expect store profitability will be an issue over the medium-term as the introduction of RFID and better point of sales (POS) processes make personnel expenses more efficient.

Q11: Inventory assets increased considerably in the first quarter, but is this more of a UNIQLO Japan issue rather than a worldwide problem?

A11: CFO Okazaki – Yes, our international inventory is growing in line with expanding operations. International inventory was slightly high at the end of November, but domestic inventory was clearly higher than we would like.

Q12: Would you be prepared to carry over a certain proportion of your basic core ranges, rather than sell down all excess inventory at UNIQLO Japan?

A12: CFO Okazaki – We will probably carry over some items, and that has been considered in our full-year consolidated business estimates. While consolidated profit is likely to struggle in the first half on the back of declining profits at UNIQLO Japan, we do expect to be able to achieve our full-year business estimates.