

Q&A at the Conference Call for Analysts and Institutional Investors for the Third Quarter of
the Fiscal Year Ending December 31, 2018 (Summary)

【Attending】 Norio Tadakawa, Corporate Executive Officer, CFO

【Third Quarter Results】

Q) Why did year on year operating income slowdown in the third quarter compared to the first half?

A) Broadly speaking, this was down to three factors. First, in the third quarter of 2017, operating income doubled year on year and so the hurdle was set very high. Second, sales did not grow as much as anticipated mainly due to natural disasters and supply shortages, and we were not able to achieve large enough profit margins to absorb increased marketing investments. Third, we increased marketing investments aiming for sustainable growth from the fourth quarter or later.

Q) What caused the improvement in the gross profit margin in the first nine months? Why was the improvement in the gross profit margin in the third quarter smaller than in the first half? Is this because inbound demand in Japan slowed down?

A) The improvement in the gross profit margin to date can largely be attributed to three factors. First, the review of our business and brand portfolio in 2017, including business with a comparatively high COGs ratio such as Zotos and Burberry, contributed to the improvement. Second, the sales ratio of prestige brands such as SHISEIDO and Clé de Peau Beauté increased. Finally, in terms of product mix, economies of scale emerged due to sales expansion of individual items. The improvement in the gross margin was smaller in the third quarter than in the first half because, in certain areas, higher inventory write-off was recorded than a year ago. This is because there was a problem with the accuracy of sales and demand-supply forecasts which led to a buildup of inventories.

【Japan】

Q) Give approximate sales ratios for individual tourists and buyers. Give details of recent year-on-year growth and ratio trends.

A) Sales to individual tourists account for around 75% of inbound sales whilst sales to buyers account for around 25%. In the first half, sales to individual tourists grew 50% year on year compared to high-teens growth in sales to buyers. In the third quarter, growth in sales to individual tourists was in the mid-teens, whilst sales to buyers fell by almost 20%. These ratios do not change significantly from quarter to quarter. Year-on-year growth in sales to buyers slowed in the third quarter mainly due to supply shortages.

Q) Which brands were affected by supply shortages?

A) The products that were most affected were certain popular products of the *Clé de Peau Beauté* brand. In 2017, we did not experience any supply shortages for these products because sales were not as strong, but since the beginning of this year they have suddenly grown in popularity. We had not fully grasped this demand trend. In October, we have been increasing these products and from late October, when the products hit the shelves, sales more than tripled. For some products sales recover rapidly as soon as they hit the shelves. Also, certain products such as *SHISEIDO ULTIMUNE* and *ELIXIR* brands have been very popular, and supply could not keep up with the sudden growth in sales.

【China】

Q) Is there a sense that sales in China are slowing down?

A) Judging from the third quarter and recent conditions, the market does not seem to be slowing down.

Q) Explain the impact of China's new e-commerce law due to come into effect next year.

A) We do not expect the new law to have such a great impact on individual tourists. Even if the new law affects our inbound sales to buyers, we can offset this impact with sales through our cross-border marketing in mainland China and Travel Retail business. Cross-border e-commerce sales have also grown considerably. We will be fine as long as there is no decline in demand among Chinese consumers.

【Travel Retail】

Q) The third quarter sales remained strong, with organic year-on-year growth of 42%, but how did operating income compared with last year?

A) The OPM was 17.7% in the third quarter. While this may seem lower than the OPM a year ago (23.3%), this fall reflects a change in prices of internal transactions. Excluding the impact of this change, the OPM is around 5% higher. The Travel Retail business also posted sales growth and is performing well.

【Supply Chain】

Q) Give details of sales opportunity loss as a result of product shortages. Which regions were impacted?

A) We estimated that sales opportunity loss amounted to around ¥40 billion over a 12-month period. The regions affected were mainly Japan and Travel Retail. Since the popular products are the same across all regions, we have been allocating the key products based on an assessment of sales and inventories in each region.

Q) What improvements have been made to the supply chain to date?

A) To address the supply shortages of packages which ran out last year, we had our suppliers strengthen their production facilities and this year there is now an abundant supply of these packages and the supply of products using these packages have improved. In volume terms, production capacity also improved almost 8% from 2017. We have also begun managing production in value terms, for clarifying an order of priority. In value terms, production increased 20%. However, in this latest third quarter, we failed to identify products which might run out in the future, and inventory gradually ran out, leading to shortages. The prioritization of products manufactured in our factories did not go far enough and we were unable to procure the necessary packages.

Q) What is important to increase the accuracy of sales and production forecasts in the future?

A) To link production plans to the latest store sales data in a timely manner. We carry out distribution and negotiations based on new product sales plans, but the key question is whether we can reflect plan fluctuations in production at that time. In the case of existing products, it is the most important to strictly prioritize the SKUs. With sufficient product packages, flexible production supply has become possible.

【2018 Forecast】

Q) At the time of the first-half financial results, you commented that full-year operating income may be ¥10 -15 billion higher than forecast. Is your forecast still the same?

A) At the time of the first-half financial results announcement, we had not anticipated the natural disasters and supply shortages in Japan. In the third quarter, the China and Travel Retail businesses made up for the slowdown in growth in the Japan business, but in our forecast, we are being slightly cautious. However, there is no change in our basic stance and we will carry out inspections of products whose supply shortages are likely, to minimize supply issues and we will do our utmost to respond flexibly to market fluctuations.