

Olympus Corporation
1Q FY2022 Earnings Conference Call Q&A (Summary)

(Disclaimer)

For your reference, please find an English translation of the question and answer session at the conference call for financial results for the first quarter of the fiscal year ending March 31, 2022 below.

This transcript has been edited/modified from the original Q&A conversations for the sake of clarity.

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[Q&A (Summary)]

Q: Can you provide more details on the background of the full-year forecasts revision in ESD and TSD? In ESD, the growth in OP appears to be small, compared with the extent of upward revision in revenue. Do you anticipate any one-off expense ahead?

A: This time we revised the outlook upward mainly in the GI endoscope segment in ESD. At the previous briefing meeting, we were asked why the outlook on Japan looks more conservative than on other regions. We said we have a cautious stance. Now three months later, we confirmed that the same momentum as last year continues. Similar trends were observed in other countries. That led to our upward revision. OP in ESD was affected by the impairment loss associated with an equity-method investment that was recorded in 1Q, but there is nothing else to be noted.

Q: You said that you resumed the shipment of EDOF scopes from July as originally planned. You had a cautious outlook at the beginning of this fiscal year because of uncertainties surrounding the EDOF scopes issue, didn't you?

A: We identified the cause of the EDOF scopes issue from an early stage, modified and tested the programs, and organized documentation. Therefore, although there might have been miscommunication, we did not have an uncertain outlook. Due to the various steps involved in resuming shipment, we refrained from disclosing the specific timing of resumption. We were able to resume in July. This was almost the same timing as projected in the original full-year forecasts presented at the beginning of this fiscal year, so it did not trigger the upward revision of the full-year forecasts.

Q: Can you tell us more details on an increase in SG&A expenses in 1Q (around ¥15 billion)?

A: Overall, costs increased YoY due to relaxation of restrictions on sales activities. Among SG&A items, sales promotion and T&E expenses did not increase so much. Attributable to the increase are: approx. ¥4 billion for forex impact, approx. ¥4-5 billion for investments for IT and strengthening of our operational infrastructure for the future. In addition, there was an increase in R&D expenses.

Q: Starting from this fiscal year, the bronchoscope business, which was classified in ESD, has been transferred into TSD. What are your growth projections for this fiscal year, compared to two years ago (FY2020) after the reclassification adjustment?

A: Although there are no official figures after the reclassification for FY2020, we have managerial based figures. +5.8% for ESD and +9.3% for TSD.

Q: If we compare FY2022 1Q with FY2020 1Q, why is ESD's growth (+9%) higher than that of TSD (+8%)? Can you share regional color with us? Can you explain the factors behind the lower growth of TSD, which tends to be more proportional to the number of procedures than ESD, which focuses on capital products?

A: +9% growth in ESD vs FY2020 was driven by North America, Europe and China. Although these are managerial based figures, North America grew approx. +14%, Europe approx. +9%, and China approx. +8%. GI endoscope and Medical service segments performed well, led by new products effects in North America and Europe. For example, strong momentum in TJF-Q190V duodenoscope and OER-ELITE reprocessor in North America, and EVIS X1 system and GIF-1100 gastroscope and CF-HQ1100DL/I colonoscope in Europe. Sales in China increased due mainly to market growth. In the meantime, TSD, with mostly disposable products, tends to have a higher correlation with the number of procedures than ESD. However, each business performance is also affected by various factors such as new products like those described above. So it is difficult to compare the two divisions and analyze which growth rate is better in a short-term frame.

Q: Can you explain the background of a decline in the number of employees in TSD (about 200 people overseas), which is disclosed in Financial Data?

A: The main reasons were the reallocation of the human resources in the medical business and a restraint of new hire to cover the decline of the number of employees due to voluntary retirement in North America in consideration of the prolonged pandemic. The restraint of hiring in North America will be eased during FY2022.

Q: Both ESD and TSD had great performance in 1Q. Do you think this momentum will continue in 2Q and onward?

A: As shown in the new forecasts, we expect 1Q trend to continue throughout the year. With the recovery from the impact of COVID-19, the number of procedures has increased and the budget execution has improved. As a result, we are seeing YoY growth continues from the second half of last year. New products are contributing to sales increase. We expect this momentum to continue to some extent and that we will be able to achieve the forecasts announced today.

Q: As hospitals are becoming better funded, do you think the need for high-value-added products is increasing?

A: We have introduced differentiated products with high added value to other companies' products, and I think it is possible to have such a view because there is strong demand for such products.

Q: I was impressed that TSD's OPM in 1Q was very high. Can you tell us the main factors?

A: As an extraordinary factor, there was a gain of approx. ¥2.8 billion associated with the acquisition of Medi-Tate. Prior to this deal, we had owned approx. 18-19% of its shares, and the gain from revaluation of those shares to the appraised value at the time of acquiring the remainder was treated as other income in accounting. But, even after deducting this amount, the margin was higher than in the past. I would say sales increase and strict cost control are attributable to it.

Q: Are there any possible risks to profit margins from 2Q onward?

A: The new forecasts do not include any one-off factors such as gain on phased acquisition. Expenses tend to increase toward the end of the fiscal year. Other than that, we assume that operations will be carried out on a quarterly basis toward achieving the full-year forecasts.

Q: Looking at the constant currency based growth rates on P5 of Financial Data, China's growth rates in both ESD and TSD were only single digits. What is the reason?

A: Last year, the impact of COVID-19 and the recovery in China came out ahead of other regions. Therefore, China's growth in 1Q appeared to be relatively low due to comparison effect, but we recognized that there was some growth. Although the Chinese market has not slowed significantly, the recent budget execution was slowing down, as the Chinese central government announced so-called "Buy China" guidelines in May. We expect China to return to double-digit growth if budget execution returns. In TSD, highly profitable bronchoscope business started to be affected by the policy. In addition, please note that we enjoyed special demand in the respiratory area last year due to COVID-19. And COVID-19 was spread in some areas of China again. We think those factors are affected to single-digit growth.

Q: Have you heard that you are losing market share to local manufacturers due to the “Buy China” policy? Did you also revise the sales outlook in China upward?

A: Even if the central government issues guidelines for domestic preference, the response will vary from province to province. There are domestic endoscope manufacturers in China, but Chinese doctors prefer Japanese-made endoscopes, so we don't think it will have a big impact. On the other hand, surgical imaging products are competing with local manufacturers, and the situation varies from province to province. So we have been considering how to deal with it case by case. Sales forecasts in China have been revised upward as well.

Q: You have great momentum in Urology. By product, what is growing most among cystoscopes, resection electrodes for BPH, and "SOLTIVE SuperPulsed Laser System" lithotripsy device for urinary stones? Can you also tell us the factors behind the strong performance of SOLTIVE?

A: Main growth driver is resection electrodes for BPH. As background, there are an increasing number of deferred procedures for benign cases coming back from the decline by COVID-19, and we see large growth potential. In addition, SOLTIVE SuperPulsed Laser System (lithotripsy device for urinary stones) has earned great evaluations from doctors because it crushes stones into small pieces, and therefore it does not hinder a doctor's vision and is effective in shortening the treatment time. The sales are gradually growing. There is one other company in Europe that is developing thulium laser, but we are the only company in North America that has introduced it. Both products - resection electrodes for BPH and lithotripsy device for urinary stones – have high margins in consumable parts, and we have high expectations for future growth.

Q: Excluding one-off factors, TSD's operating margin has been around 18% since 3Q last year. Do you think this is a sustainable level? Can you explain the background behind an improvement of 5-6 points in OPM compared to 2-3 years ago?

A: As indicated in the full-year forecasts, we consider it to be a sustainable level. Starting from this fiscal year, we have transferred the bronchoscope business from ESD. That has contributed to some extent to improve the profitability of TSD. Going back in time, the amortization of Gyrus' intangible assets was a factor pushing down operating margin. Other than that, we believe that a combination of multiple factors such as sales increase, an improvement in gross margin, and a strengthening of cost management, has led to an improvement in operating margin.

Q: In your thinking of operating margin in the full-year forecasts, do you expect that profit margin will rise quickly in some quarter going forward? Also, do you anticipate any factors in other income and expenses that will boost operating margin in 2Q and onward?

A: Expenses will vary from quarter to quarter, and that is included in the forecasts for the next three quarters. We don't anticipate any factors in other income and expenses that will boost operating margin. For the remaining nine months, we would like to raise operating margin by improving the lines from revenue to SG&A expenses.

Q: I think you didn't see North American growth so strong at the beginning of this fiscal year. Have your views changed?

A: Since there are no new events, both our assumptions and market conditions have not been changed. This year is a challenging year as we are not able to launch the new GI endoscope system (EVIS X1) in North America. However, we are aiming to achieve the sales target with a contribution from some new scopes.

Q: Can you tell us which sub-segments of ESD and TSD had pent-up demand? Also, what are your views on pent-up demand in 2Q and onward?

A: ESD is basically a capital products business, so a change in the number of procedures is not necessarily linked to its business performance. Of course, if the number of procedures declines, the income of hospitals is negatively impacted, so we are carefully monitoring how budget execution is progressing. Although the overall number of procedures has not yet returned to the pre-COVID level, some countries/regions have returned to 90%. We expect it to take another several months to a year to return to the pre-COVID level. In the meantime, in TSD, there are various treatment areas that are associated with its endotherapy devices, such as gastrointestinal, urology and respiratory, and the situation varies from country to country, like in ESD. Most recently, the Delta variant has been rampant around the world, and the outlook remains uncertain.

- Q: Is there any pent-up demand in the surgical endoscope segment, too? I heard that there are some medical facilities buying capital products in advance in anticipation of the end of the pandemic. Also, can you tell us your assumptions in the forecasts on how COVID-19 will end in each region?
- A: Surgical endoscope system is also capital products, so if the number of procedures increases, hospital revenue will be improved and budget execution will proceed. In some hospitals, purchases are made ahead of schedule, but it is common for hospitals not to spend on capital products unless their incomes increase. While it is difficult to predict the impact of COVID-19 throughout the year and we have no specific assumptions, we expect the business environment to improve. In the revised forecasts, we have set the most challenging figures that we think we could achieve at this point.
- Q: Can you tell us qualitatively about the outlook for the market conditions in ESD in 2Q and onward? In particular, on new product effects, and how much the old GI system will sell in North America.
- A: EVIS X1 has already been launched in Europe, Japan and some parts of Asia. With Australia and Southeast Asia added soon, we will be able to sell the product in about 75% of the APAC region. Now the EDOF scopes issue has been resolved and shipments have resumed, we believe the product will be the driver of ESD in those regions. In North America, EVIS X1 is scheduled to be launched in FY2023, but because doctors in the region know that it is already on sale in other regions, there is a risk of holding out for the new model, which is a difficult situation. We would like to cover this by selling new products in colonoscope and duodenoscope. OER ELITE, reprocessor for endoscopes, has also been on sale since last year, and we would like to achieve the sales target with these new products. In China, we are aiming to continue double-digit growth by selling EVIS LUCERA series (predecessor model of EVIS X1).
- Q: What is the status of semiconductor procurement at Olympus?
- A: Semiconductor shortage has become a global issue, and our procurement department is making the best efforts to procure what we need. While we recognize it as a risk, at this moment we don't see a supply shortage that will affect this fiscal year's sales.
- Q: Both ESD and TSD have a co-head system. How do you divide roles between Japanese and non-Japanese leaders? Also, in TSD, is the business development led by the US side?
- A: (ESD, Mr. Hironobu Kawano) ESD is run by two people - Mr. Frank Drewalowski, a German, and me. I have been working closely with him for more than 20 years, and I think that we can naturally divide roles while making use of each other's strengths.
(TSD, Mr. Seiji Kuramoto) TSD is run by two people - Ms. Gabriela Kaynor, who is based in the US, and me. Since I have experience to work in the US for a long time, I understand the dynamics of the North American market and the therapeutic device business. So I don't feel much gap. I am in charge of communicating with Japanese manufacturing bases in Aomori and Aizu, taking advantage of my local connections in Japan. North America is a dynamic region with rapid technological innovation, so the US side is leading the way in business development.

(End)