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Olympus Corporation

4Q FY2024 Earnings Conference Q&A (Summary)

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For your reference, please find an English translation of the question and answer session at the conference for financial results for the fourth quarter of the fiscal year ended March 31, 2024 below.
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[Q&A (Summary)]

Q: Regarding the slide 42 "Fiscal 2025 Forecast Factors that Affect Consolidated Operating Profit", I would like to ask about the probability that JPY 88 billion of other expenses will decrease. Given that one-time expenses have increased over the past several years and the actual results deviated from the February forecasts, what is the background behind your assumption that other expenses will decrease in FY2025? For example, does this mean that you now have a better system in place to control one-off expenses? I would like to hear your thoughts on the feasibility.

A: It is understandable that there are concerns as there have been many downward revisions in the past. Our current view is based on the fact that, when reviewing the current situation, assets, and business, there are no assets at this time that would cause a significant loss. Last year was the CEO's first year in office, and as we have dealt with assets of concern as much as possible, there are currently no assets to be concerned about. Additionally, as CFO, I am being asked to strengthen budget control, and I am already feeling that we can improve. It's difficult to commit to this, but I believe it will definitely be better than before.

Q: What have been the problems so far, and what changes do you think will improve the discrepancy in one-time expenses?

A: I can't say for sure at this point, but there are two things. One is governance for M&A and investment projects. We are creating a committee and trying to strengthen it as a company. There is already such a team under the CSO (Chief Strategy Officer). The other is information coordination within the company. Although we have talented people in each function, I feel that there are issues with communication among functions I believe that by eliminating these silos, past problems can be improved.

Q: How much do you expect to spend on Project Elevate this year? Also, how does it differ from previous assumptions?

A: We started the remediation and quality transformation program, and announced in May 2023 that the total cost over three years would be approximately JPY 60 billion. When I received the same question at the financial results conference for FY2024 Q2, I answered that it would be within the range of ±10%. Now, due to the impact of exchange rates, the recent depreciation of the JPY has led to higher costs, which is also affecting Elevate. Therefore, the final cost is expected to be around JPY 70 billion. Remediation activities will be concentrated on FY2024 and FY2025. From FY2025 onwards, we will focus more on quality transformation activities and increase our competitiveness by prioritizing quality and patients. In FY2024, the total cost was approximately JPY 31.5 billion. It is expected to be approximately JPY 32 billion in FY2025.

Q: How would it look if you divide it between SG&A and other expenses?

A: As a rough guide, about 1/3 is SG&A expenses, and about 2/3 is other expenses. Other expenses, which are recorded as one-time expenses, will be eliminated in the future. Also, note that SG&A expenses are included in the Elevate cost because those expenses cover the cost of optimizing the organization and systems.

Q: Is it correct to understand that one-time expenses will eventually be gone, while the impact to SG&A will remain?

A: Over the past year and a half, we have concentrated on remediation activities and have made great progress. Additionally, the system has been improved, optimized, and made more efficient in multiple areas. For the next year and a half to two years, we will firstly maintain the level we have achieved now. This will be the future cost of QARA. Looking to the future, we would like to aim to achieve best-in-class performance compared to peers in our industry by making many growth investments, including in technology. However, we cannot answer specific costs for FY2026 at this time.

Q: The breakdown of Elevate expenses for FY2024 was JPY 8.5 billion for SG&A and JPY 23.0 billion for other expenses. Would you give us the same breakdown for FY2025? Also, if I look at the slide 42, other expenses are expected to make a significant improvement. Given the Elevate cost will remain largely unchanged, I think impairment losses are expected to decrease considerably. As the slide 40 shows that there were many last-minute unexpected expenses incurred in the fourth quarter of FY2024, I just wonder whether no additional impairment losses will really occur in FY2025.

A: Regarding the Elevate cost for this fiscal year, SG&A expenses are expected to be approximately JPY 12.4 billion, and other expenses are expected to be approximately JPY 19.3 billion. As for whether impairment losses will be eliminated, we do not expect any impairment losses at this time. As the business environment changes, it is difficult to say that there will be no impairment loss at all in the future, but there is nothing that needs to be factored into the guidance at this point.

Q: A lot of impairment losses were recorded in FY2024. Can it be said that potential risks have been fully recorded? Also, why did they come out together in FY2024?

A: I think our policy for FY2024 was to deal with concerns as much as possible. I think the idea was that by doing so, we would enter FY2025 with a clean balance sheet and get on a growth trajectory. I also believe that this is a result of our efforts to proceed with safety first, based on our core value of “PATIENT FOCUS.”

The reason why impairment losses were high in FY2024 and are expected to decrease in FY2025 is that FY2024 was the first year of Elevate and patient safety was not necessarily ensured in all areas. We started to work on products and assets that have such concerns. We also wanted to avoid any surprises in FY2025. Although the business environment remains volatile and remediation activities are underway, we believe that FY2025 guidance is more accurate than FY2024 as business risks are better controlled.

Q: Regarding the anti-corruption campaign in China, can you tell us to what extent there is momentum for improvement from the second half of FY2024 to FY2025? If possible, I would also like to hear about any changes in the status of tenders and the competitive environment.

A: Our stance on China remains unchanged. Since there is a huge unmet need, we think there is great growth potential in the medium term. We have a large installed base and strong relationships with customers. FY2024 was difficult due to Buy China, VBP (Volume Based Procurement), the anti-corruption campaign, etc. We expect these effects to continue in the first few months of FY2025 as well. However, we expect a return to growth in FY2025 as a whole.

To add a little more about the competition, Buy China has put us in a difficult position in some tenders. As a countermeasure, we are currently working to increase our competitiveness by building up our production capacity in China. The impact of the anti-corruption campaign on sales is difficult to predict. Customers were hesitant to make purchases at times, but the impact has been diminishing since the beginning of FY2025, and we believe it will become even smaller in the second half of FY2025. Although we recognize concerns about China's economic and geopolitical risks, demand for endoscopes has been expanding throughout China. So, we believe that growth will return to high single digits in the second half of FY2025.

Q: Can you tell us about your forecast for ESD in the U.S. for FY2025? The U.S. grew 2% YoY (after adjusting forex). How much growth do you expect for FY2025?

A: Our U.S. team has a very positive outlook. EVIS X1 was affected by the Noto Peninsula Earthquake, so we have to keep an eye on the impact, but a new scope is scheduled to be launched, and we expect the U.S. to grow about 7% YoY. U.S. is the largest market, accounting for approximately 35% of our total ESD sales, so we want to make good progress.

Q: The slide 42 "Fiscal 2025 Forecast Factors that Affect Consolidated Operating Profit" shows a decrease of JPY 12.7 billion in SG&A. Is there any possibility that this figure will change? Also, is there any buffer included intentionally in the SG&A forecast? You mentioned earlier that there are no impairment losses included at this time, but I remember that control on SG&A has also been an issue in the past. I would like to hear what thoughts and details you included in the plan.

A: The guidance for FY2025 does not include any buffer, and the figures are realistic. Both opportunities and risks are included in the top and bottom lines. Regarding the bottom line, SG&A expenses include Elevate and the strengthening of QARA functions, but at the same time, we are also considering cost control measures. In addition, we plan to introduce the "career support for external opportunity" program not only in Japan but also in other regions, which will increase costs. However, we would like to improve the SG&A ratio compared to FY2024. SG&A expenses for FY2025 are based on realistic views, but we still need to make efforts.

I feel that we have strengthened our control over SG&A expenses, so we can continue to control them.

Q: Regarding budget control that you just mentioned having a positive feeling about, what specific improvement measures have you found? I would like to hear more details, for example, the way you communicate with business lines, organizational changes, etc. What are you planning to implement this year?

A: Not only those under CFO, but all employees in all organizations are aware of the necessity of improving budget control. I have positive feeling about it. In addition, the deputy CFO has been assigned the role of overseeing collaboration with business lines. As he works closely with each function, I believe that the accuracy of budget and forecast will improve.

In FY2025, we are working to strengthen the responsibility and accountability of budgeting. We have strengthened the system more than before, and I think you will see changes in the future, including cost management.

Q: I would like to ask about the outlook for the Elevate cost. You mentioned earlier that the total amount would be around JPY 70 billion, but given the actual cost in the previous fiscal year and the forecast for this fiscal year, is it correct to understand that it will be significantly lower in FY2026? Also, is it correct to understand that Project Elevate will be completed in the next fiscal year?

A: To your first question, the answer is yes. The Elevate expenses in FY2026 will be smaller than in FY2024 and FY2025. Regarding the second question, Project Elevate is divided into two major parts. One is the remediation part. This is to resolve the problems identified in the three Warning Letters as soon as possible. If we can resolve those issues, we will be ready for inspections. But this does not mean the end of reform activities. Quality transformation activities are broader than remediation. It is not enough to simply comply with regulations. It is important to ensure that we are properly compliant, prioritize quality, and put patients first. Transformation activities will continue beyond FY2026 and will never end. But that doesn't mean there will be additional costs. We will implement this as part of the regular business improvement process.

Q: I would like to hear about the current progress in responding to FDA's Warning Letters and the timing of inspections.

A: We communicate with the FDA on a monthly basis and monitor progress. We are also exchanging opinions regarding changes to the quality system. I believe that the FDA will come for an inspection as soon as our remediation activities are completed. If the improvements are found to be effective, we can move forward, but there is no specific timeline at this stage.

Q: I would like to ask about ESD sales forecasts by region for FY2025. The total ESD growth forecast is 6%. I would like to know about the regional breakdown.

A: As a general answer, we expect growth to be around 9 to 10% in all regions.

Q: I would like to ask about the growth on a local currency basis by region.

A: We don't disclose at the regional level.

Q: You told us earlier that China would return to high-single-digit growth in the second half of this fiscal year. However, considering the pent-up demand from the anti-corruption campaign and the policies that have recently emerged in China to promote the purchase of medical devices, I wonder if you can expect a little higher growth rate in the second half. What are your thoughts?

A: Unfortunately, the policy to promote the purchase of medical devices does not apply to our company. However, for China in FY2025, we expect ESD to grow at a high-single-digit and TSD to grow at a mid-single-digit.

Q: Regarding China, at the last financial results conference or before, you mentioned that the impact of the suspension of bank lending due to the real estate recession was surprisingly large. Do you think this will continue for a long time? Is it affecting your business? Do you think the impact is being reduced?

A: We are not aware of any bank lending-related impacts in China.

Q: I think I heard that explanation before. I have an impression that a prolonged bank lending issue caused by the real estate recession is a risk. Has this affected your business?

A: We have never explained anything like that. If we were to provide such finance-related explanations, we have explained about the policy of promoting the renewal of equipment at low interest rates to some medical institutions. We recognize that the lending attitude of financial institutions has never influenced our business.

Q: So, no need to take the real estate recession seriously?

A: Our business is a different story.

Q: Regarding the outlook for gross margin, it is 68.5% in FY2025, which is higher than in the past three years. What are the factors behind the improvement? Is this due to a temporary factor, or is it possible to aim even higher? I would like to know what assumptions are used to estimate the gross margin compared to the past.

A: In the previous fiscal year, there were many one-time costs such as recall costs. The elimination of those costs led to an improvement in gross profit in forecast.

Q: For the past three years, it has been around 67%. Do you mean that the forecast for FY2025 is based on the assumption that there will be no decrease in GM and no impairment loss?

A: We think that there will be no major difference in gross margin between this and previous years, excluding the one-time costs and the impact of exchange rates.

Q: I would like to ask about your sales plan for this fiscal year. I understand that supply constraints caused by parts shortages and QARA compliance are not yet over. To what extent are sales likely to fluctuate in this fiscal year? If you have formulated a plan with a range, please tell us. Also, to what extent do you expect the supply constraints to affect this fiscal year's performance at this point?

A: There are two major reasons for back orders. One is the issue of parts supply from vendors. The other is the suspension of shipments related to remediation activities. In the last fiscal year, TSD was greatly affected by those factors. In terms of weighting, the impact of the parts supply shortages was greater, but it has improved by about 30% since its peak. In addition to being able to maintain this improving trend in this fiscal year, we also expect an additional 15% improvement over the next three months. Thus, we are forecasting growth, taking into account improvements in backorders due to vendor dependence.

Q: I understand that your share buyback policy remains unchanged. With the premise that you carry out share buybacks when there are surplus funds after securing sufficient liquidity on hand for working capital and future investments, a new share buyback of JPY 100 billion was announced. What is sufficient liquidity on hand? I would also like to know the background behind the decision to make the size of this share buyback JPY 100 billion.

A: Liquidity on hand refers to how much cash we have on hand in relation to our monthly sales. We are considering how many times the monthly sales should be secured based on the investments and operating cash flow planned for this fiscal year.

Q: Adjusted operating margin for this fiscal year is expected to be close to 20%. As a new CFO, do you feel that even higher than a previous target of 20% can be achievable? If you have any thoughts, I would like to hear them along with a timeline.

A: I think the key is to increase gross profit and to control SG&A expenses. We will implement those initiatives in FY2025. It is too early to say whether we can achieve higher than 20%. I think it is important to show a return to 20% in FY2026 as the first step.

Q: While there are costs that cannot be anticipated at the beginning of the period, one idea is to formulate a best case of, say, 23% with a buffer, so the final OPM can be around 21%. Regarding future plans, I think it is necessary to include a buffer to some extent, given the past. If you have any ideas, I'd like to hear them.

A: I understand that the method of creating a buffer in formulating a plan is not unusual in other industries, but I have not yet determined whether this method is suitable for our company. We will consider the best approach while listening to the thoughts of analysts.

There is room for margin improvement. However, the top priority is to get back on a growth track this year and next. It is important to deliver products reliably to customers and contribute to society. Over the next two to three years, we will grow at the same level as the market and improve our margins.

(End)