

# Past, Present, and Future of Olympus

## Conversation with Analysts



### Hidekatsu Watanabe

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#### Profile

Mr. Watanabe joined Nomura Research Institute, Ltd., after graduating from the Faculty of Economics of Keio University in 1990. Positioned in the Corporate Research Department, he was placed in charge of the healthcare sector in 1995. He entered Mizuho Securities in 2000. Today, he covers a wide range of fields in the healthcare sector, including medical equipment.



### Yukihiro Koike

Vice President  
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Morgan Stanley MUFG Securities Co., Ltd.

#### Profile

Mr. Koike joined Goldman Sachs Group, Inc., in 2008, where he conducted corporate research on the automotive sector. In 2010, he joined Morgan Stanley MUFG Securities, where he has focused on the healthcare sector, specifically medical equipment and specialty pharmaceuticals. He received a B.S. from Kyoto University (in Pharmacy) and received an MSc in neurology from the University of Southern California. Mr. Koike also holds a pharmacist license.



Yukihiro Koike  
Morgan Stanley MUFG Securities Co., Ltd.

Hiroyuki Sasa  
President and Representative Director

It has been two years since the Company instituted its new management team, and Olympus has implemented several monumental strategies during that time. How has Olympus changed? How should it target future growth? President Hiroyuki Sasa conversed with analysts with regard to their evaluation of the Company over the past two years, the challenges Olympus faces, and their hopes for the Company's future, receiving their earnest opinions and advice.

(Conversation held on June 17, 2014, in a meeting room of the Company's head office)

## Current State of Corporate Governance and the Board of Directors and Changes over the Past Two Years

**Sasa** After the Company's scandal came to light, Olympus replaced all members of its Board of Directors. At the time, I suspect the outside directors that we appointed were dubious of how far Olympus could be trusted; indeed, taking up a position on the board required a significant degree of conviction as they certainly did not understand the Company. In fact, most members of the Board of Directors were in this position, and I remember feeling very tense not knowing how the board should function under these circumstances. As a representative from the business execution side, I thought exhaustively about how I could help the outside directors understand Olympus. By conducting briefings prior to meetings of the Board of Directors, I believe I was able to communicate the characteristics of our business as well as its strengths and weaknesses to the outside directors. Over the past two years, this new Board of Directors

made numerous important decisions and set several initiatives into motion. Examples include selling ITX Corporation, which operated the non-core Information & Communication Business, entering into a business and capital alliance with Sony Corporation, and cutting staff size as part of restructuring measures. Also, we saw the removal of the Security on Alert designation placed on the Company's stock by the Tokyo Stock Exchange, and subsequently we increased capital by approximately ¥110 billion. The Board of Directors discussed these and other undertakings from various perspectives. These experiences cultivated mutual understanding among the members of the board, and I believe that its proceedings now transpire more smoothly. Today, discussions at meetings of the Board of Directors are lively and forward-looking, and we find ourselves debating a variety of topics.



Hidekatsu Watanabe  
Mizuho Securities Co., Ltd.

Masahiro Shibano  
Citigroup Global Markets Japan Inc.



### Masahiro Shibano

Director  
Capital Markets Origination Department  
Citigroup Global Markets Japan Inc.

#### Profile

Mr. Shibano received a master's degree in economics from the Graduate School of Economics in the Faculty of Economics of the University of Tokyo. He joined Nikko Citigroup Limited (currently Citigroup Global Markets Japan) in 2005. After being placed in charge of several sectors, he reached his current position of covering the precision instruments and semiconductor equipment sectors in 2009.

**Watanabe** I understand that you were an executive officer when the scandal surfaced. I assume that a number of thoughts crossed your mind as an executive officer, but you probably never imagined you would be placed in the position of leading Olympus. Rebuilding the Company's corporate governance systems was an unprecedented endeavor. Over these past two years, how did you drive Olympus forward to fortify the areas in which it was lacking and make it into the revitalized company it is today?

**Sasa** The business foundations of Olympus themselves were solid, particularly with regard to the Medical Business. While the Imaging Business continued to record losses and performance in the Scientific Solutions Business could not be seen as impressive, the Company's frameworks and the systems that drove the businesses were functioning soundly. The group presidents were advancing their respective businesses while looking toward the future and addressing the challenges faced. This situation continues today. And I believe that, even at the time of the scandal, Olympus had solid business foundations. For the non-business elements, it was necessary to address issues one at a time, looking at corporate governance and other management systems and determining what needed to be fixed and how. For issues of exceptional importance, we often devoted a great deal of time to discussions, which sometimes became very heated. For example, we extensively discussed what we should do about the potential business and capital alliance with Sony, and we examined exhaustively the necessity of the increase in capital.

**Koike** I would think that the Company had options, other than Sony, for an alliance partner. Why did you choose Sony, and how has the alliance proceeded in comparison to your expectations?

**Sasa** Olympus holds a share of approximately 20% of the global surgical endoscope market. Sony possesses 3D and 4K imaging technologies. These technologies have the potential to strengthen our surgical endoscopes, and this field is one that we needed to expand. Our initial plan for this alliance called for us to expand operations using these technologies through our own sales channels, and this is actually how matters are progressing. In participating in this alliance, we came to be surprised by Sony. The ingenuity and speed of this company as well as the breadth and depth of its technological capabilities were much greater than we had expected. This fact was something we could not have known before commencing our alliance.

**Shibano** With the majority of the Board of Directors consisting of outside directors, I assume that a significant amount of time is being devoted to decision making. In terms of organization, Olympus has already approved plans to revise business units, and I believe that the Company has established governance systems that are sufficient for the time being. What are your plans for the long term? Do you think that the current systems represent the ideal form for Olympus, or do you feel that there is room for improvement?

**Sasa** At the moment, I believe that our Board of Directors and its 13 members are ideal. I mean this in terms



of the number of members as well as the ratio of internal and outside directors and the ratio of independent directors and non-independent directors. Nonetheless, circumstances will change in the future, and it will be necessary to rethink our systems based on those changes. I believe that the ideal governance systems and membership ratios differ based on the operating environment, and that there are optimal systems for any circumstance we may face.

**Watanabe** At the moment, what issues do you expect to face in further evolving governance systems?

**Sasa** The biggest issue Olympus faces at the moment is the need to flexibly allocate management resources in a volatile market environment. The integration of business units was one measure to address this issue. We must also ascertain the business opportunities created by this situation and evaluate these opportunities while readying our next move. This approach will require us to create a system that enables us to accurately evaluate each milestone we pass and ensure the decisions we make are appropriate. Our ability to realize such a system will have a large impact on the future of Olympus. Of course, we will require a plan to build this system, and our people will not be able to act without a plan. I believe it is impossible to optimally allocate our management resources without clearly identifying what activities we will stop and what new initiatives we will undertake.

**Watanabe** It is rare for a company to be able to effectively reevaluate itself. I spoke with many endoscopic physicians immediately after the Olympus scandal, and even then they were not particularly upset. To physicians, it was almost as if the scandal did not matter at all.

**Sasa** I was the division manager in charge of the Marketing Division at the time of the scandal. After the news broke, I received words of encouragement from countless physicians, not only those in Japan but also physicians from around the world.

**Watanabe** It must be quite reassuring to know that the Company has the support of the end users of its products.

## Evaluation of Business Performance and Initiatives over the Past Two Years

**Watanabe** When the Tokyo Stock Exchange designated the Company's stock as Security on Alert, Mizuho Securities revoked its rating. As a result, I temporarily stopped reporting on Olympus. Over the period of approximately two years before I resumed reporting, I did not revise the forecasts for Olympus. In my first report after I restarted coverage, I was expected to include both the previous forecasts and the Company's new forecasts, but both sets of figures were almost exactly the same. In other words, even amid the turmoil that followed the scandal, business at Olympus was proceeding generally according to plan. I believe that the stability of the Medical Business was a major factor behind this smooth progress. The ongoing losses in the Imaging Business are, of course, a problem. However, faced with today's exceptionally harsh market, I think that losses of merely a few billion yen are the best the Company's management could have done. Personally, I choose to focus on the degree to which a company can grow stably over a period of three to five years, rather than

looking primarily at its ability to maximize earnings in the short term. From this perspective, I have a very high opinion of Olympus.

**Koike** I started covering Olympus in January 2013. The precision machinery industry team at Morgan Stanley MUFG Securities had been following the Company before the scandal, but I was new to Olympus, covering the Company as the first representative from our healthcare industry team. A year ago, there were not many brokers that had resumed coverage of Olympus, and we were the only one to send someone from their healthcare team. As such, there was a large backlash from investors with regard to our coverage. This backlash was particularly intense from overseas investors. It was not as if investors overseas were constantly monitoring the situation in Japan, and much of their information regarding the scandal came from media sources like newspapers. For this reason, we received many comments stating no improvement had been seen in governance at Olympus. Later, the Security on

Alert designation was lifted from the Company's stock and you began visiting institutional investors around the world to explain the situation at Olympus in conjunction with the capital increase. After this, we stopped hearing complaints about the Company's governance systems. The focus of institutional investors is always changing, and I am sure that they are now turning their critical eye to another aspect of Olympus. However, I believe that resolving the governance issues was a large step forward for the Company.

**Shibano** I mainly cover the precision instruments industry, and I began reporting on Olympus roughly one month before the scandal. I was quite shocked with the incidents that unfolded. Looking back at the two years that followed, I find myself concurring with the other gentlemen here today; there has been almost no change in Olympus with regard to the strength of its Medical Business, its operating environment, or its position in the industry. After the scandal, product development moved forward in the Medical Business, despite all the issues that needed to be addressed both inside and outside the Company. Today, Olympus is reaping the benefits of the new products it developed during this period. I believe the ability to bring these products to launch even faced with such adversity is truly symbolic of the strength of Olympus. With regard to the digital camera business, however, I cannot be so positive, even considering the increasingly harsh operating environment. Looking at the results of the Company's restructuring of this business, I am forced to say that other companies are making better progress than Olympus. There are still numerous issues that need to be addressed in this business in terms of sales, marketing, and the precision of business plans, and I do not think that this situation is something that began when the scandal was exposed. I expect that the stock market is hoping for some clarification with regard to this business. Olympus needs to clearly explain its plans for the digital camera business, describing how it is positioned within the Company's business portfolio and stating whether this business will be continued or exited.

**Sasa** Gentlemen, I believe that everything you have said today is accurate. Reflecting on the past two years, we accomplished some of our initial goals, but we also failed to accomplish others. The market is always changing, and each change requires us to alter our plans in response. In terms of businesses, the Medical Business has proceeded as planned, while the Imaging Business has not. In regard to the Medical Business as well, we were not able to achieve certain targets because of the various measures we instituted, such as those related to foreign exchange. We were able to meet numeric targets, but there are still issues that need to be addressed. For example, our targets were unmet in the energy device field, and it was the strong performance of other areas that allowed us to achieve overall targets. If everything had progressed as planned, performance in the Medical Business would have been even more impressive.

**Watanabe** When discussing the possibility of investing in a medical equipment manufacturer with global institutional investors, people generally fall into one of two groups. One group asserts that if a company makes quality products, then it should see improvements in earnings and the operating margin in the short term. The other group believes that maintaining a consistent speed is important for medical equipment manufacturers, and that if such a company disrupts its own rhythm it will feel the negative impacts of this action 10 or so years down the line. I think most of the global investors who invest in medical equipment manufacturers fall into the latter group. These people tend to specialize in medical companies and hold on to their investments for incredibly long periods of time. It is therefore important for companies in the medical field to consciously issue information targeting these investors. In the case of Olympus, I believe you could achieve better results from disclosures if you communicated facts about the Medical Business, such as what you view as the appropriate business speed and operating margin. Particularly with regard to the surgical device field, investors need information about how much growth potential exists in the market and how much time will be needed for this potential to come to fruition. Explanations of such factors would paint a better picture of what Olympus is trying to achieve.



**Shibano** Just as Mr. Watanabe stated, I believe that a lot of investors are trying to comprehend the medical equipment industry from a medium-to-long-term perspective. However, the medical equipment industry is not one that can be understood intuitively. An understanding of this industry requires a great deal of knowledge regarding the medical systems of countries around the world, how widespread certain devices are, and the nature of technological evolution. From this perspective, I believe that it would be incredibly beneficial for you to continue activities like the investor relations explanatory meeting on the surgical device field that was held in spring 2014.

**Koike** Olympus has a dominating share of the market for gastrointestinal endoscopes, and it is easy to imagine that sales would increase if the Company introduced a new product in this area. In surgical devices, meanwhile, Olympus is currently expanding its sales force. I imagine this being an area of uncertainty for investors, who may be unsure as to whether or not the market for these products is one in which increasing sales personnel will have a significant benefit. With regard to future product strategies as well, I believe you could better communicate the Company's growth path by disclosing information about what products will be introduced into what regions and when.

**Sasa** While I cannot disclose specific details, I can give a general overview of our plans. Take for example, THUNDERBEAT, an energy device. As a future step in the development of this product, we are considering applying its technology to the field of open surgery. We also realize the necessity of expanding the range of THUNDERBEAT probes to make this device applicable to a wider range of surgeries. This step will be important in increasing the presence of THUNDERBEAT in operating rooms. At the same time, we will need to develop techniques for utilizing these devices and train physicians in

their usage. Our surgical device sales force will also require training, as we will not be able to compete with other manufacturers if sales personnel do not possess a deep understanding of these techniques.

**Watanabe** It is hard to grasp the whole of the Company's business by looking at it as merely a minimally invasive treatment company. This is particularly true for surgical endoscopes, partially because the appropriate level of market penetration for these devices varies by component. Even gaining this basic understanding is difficult for investors, and looking at Olympus at this level alone will not grant a clear picture. Even if you are unable to disclose specific details, it would be most helpful to investors if you could give some concrete idea of what type of demand is present in what parts of medical institutions.

**Sasa** The general surgery field is very broad. We aim to expand the usage of THUNDERBEAT in areas of this field in which its strengths will be a true asset. For example, THUNDERBEAT boasts exceptional performance in terms of stopping bleeding and the speed at which it makes incisions. Operations on certain organs present immense difficulty in simultaneously preventing blood loss while making incisions. We hope to spread minimally invasive procedures for such operations by promoting the use of THUNDERBEAT. In addition, we are advancing the GI in the OR surgical device strategy, which entails encouraging physicians to use gastrointestinal endoscopy in the operating room. Our gastrointestinal endoscopy systems developed for Europe and the United States are configured for connecting to a surgical endoscope, giving them a significant advantage. A survey conducted by Olympus showed that roughly 30% of hospitals routinely use gastrointestinal endoscopes in the operating room. These devices are used for such applications as confirming whether or not stitching conducted during surgeries has created a sufficient seal.

**Watanabe** That is remarkable. So you mean to say that gastrointestinal endoscopes are used for diagnosis, treatment, and even confirmation.



## Opinions, Advice, and Hopes for Olympus

**Shibano** Even looking at the entire world, there are very few companies whose business could be truly described as “strong.” As such, Olympus is a rarity. In emerging countries, Olympus may have to face the threat of increasingly more powerful local companies as time progresses. My greatest hope is that the Company will continue to conduct the investments necessary to grow its business and maintain its

current position of superiority over the long term. I look forward to seeing Olympus develop its businesses while leveraging its strengths, and this sentiment applies not only to the Medical Business but also to the Imaging Business and the Scientific Solutions Business. In regard to investor relations activities, the amount of information disclosed has increased substantially over the past two years. I am most satisfied with these

proactive activities, particularly such examples as the tours of the Olympus gastrointestinal endoscope plant in Aizu, Fukushima Prefecture, and the explanatory meetings and tours of the training center held in Guangzhou in China. However, there is still so much more I want to know about the Company's business. I hope that you will expand upon these activities in the future.

**Koike** Looking at the Company's investor relations activities, I am particularly impressed with the small meetings held between analysts and yourself following quarterly financial results presentations and the teleconferences conducted targeting overseas investors on the night of presentations. This sort of effort is highly appreciated and differentiates Olympus from other companies. I believe that many investors hold these activities in very high regard, and this is especially true for overseas investors, who are rarely able to receive timely information disclosure from Japanese companies. I hope these activities will continue. Looking to the future, technological innovation will become more crucial than ever, and this applies to medical equipment manufacturers worldwide. If technologies do not advance, it will be difficult to receive approval for premium pricing rates under insurance systems. Were such a situation to occur, product selling prices could drop, subsequently creating a downward spiral. Such a development is a major risk inherent in the medical equipment industry. Olympus has significant room to breed new innovation in the endoscope and surgical device fields, and there are still numerous business opportunities for the Company to exploit. Whether or not Olympus can maintain its current high growth rates over the next 10 or 20 years is a concern often held by investors. In order to dispel this concern, I think Olympus should be even more proactive in its disclosure efforts. That would be a sure way to secure the ongoing support of capital markets.

**Watanabe** Both in Japan and overseas, we see a major corporate scandal once every couple of years. While Olympus caused one such scandal, it has since managed to overcome this setback, and it has actually become stronger than other companies that have been involved in scandals as a result. This improvement in strength was not only limited to governance. I therefore hope that Olympus will serve as an example for capital markets of how a company can move past such adversity. Also, I understand that Olympus is the only Japanese medical equipment manufacturer to conduct its business through collaboration with academia. Mr. Koike hinted at the decline in new technological innovations. Hopefully, Olympus will be able to uncover innovation through its work with academia and use this innovation to drive growth over the coming decade. I believe that the medical field is a core area in which Japan can make contributions to the rest of the world. Olympus has the potential to contribute to Japan's manufacturing industry in terms of both tangible and intangible elements as well as from



other angles, such as the culture of the industry itself. I strongly hope that Olympus will actively lead the medical field, both in Japan and on the wider global scale.

**Sasa** The market is constantly changing for all fields in which we operate. As I mentioned earlier, an important point going forward will be the extent to which we utilize the Company's assets and act flexibly in response to market change. The medical equipment industry is transforming on a global scale as marked by prominent M&A activities and other developments. Some companies are growing by becoming holding companies and skillfully managing numerous companies below them. Olympus, however, is not suited to this type of structure in my opinion. As symbolized by our slogan of "Back to Basics," I believe that Olympus is a company that is most suited to focusing entirely on manufacturing, and this is where our expertise and managerial competence lies. It is vital that we accurately determine what our strengths are, and how we should respond to change, and in turn act accordingly. Recently, we approved plans to conduct upfront investment in business-to-business operations in the Imaging Business. With regard to this endeavor as well, we will need to ascertain what we can achieve with the Company's current management resources. The same must be done in the Medical Business. Looking ahead, a central concept in our management is the creation of a vision for the future Olympus by overlapping the potential accomplishments of our resources.

Thank you for joining us today. I hope to draw on your valuable input and insight in management to create an Olympus that lives up to your expectations.