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Financial Strategies of 16CSP Targeting Future Growth

—Discussion between the Chief Financial Officer and Analysts

At the end of March 2016, Olympus unveiled its new medium-term management plan, 2016 Corporate Strategic Plan (16CSP). As directives for financial strategies, 16CSP puts forth the policies of secure financial soundness and improve capital efficiency, which are to be accomplished through efficient cash flow allocation. Chief Financial Officer (CFO) Yasuo Takeuchi talked with analysts about Olympus, which has escaped its state of crisis and is now transitioning to a stage of more aggressive development, and its financial strategies and listened to their earnest opinions and advice.

(Conversation held on July 5, 2016, in a meeting room of the Company's head office)

Hidekatsu Watanabe

Senior Analyst
Equity Research Department
Mizuho Securities Co., Ltd.

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.

Junya Ayada

Senior Analyst
Equity Research Department
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Profile

In 2003, Mr. Ayada graduated from the First Department of Literature at Waseda University and joined Daiwa Institute of Research Ltd. (currently Daiwa Securities Co., Ltd.). Over the years, he conducted studies of small and medium-sized enterprises and was stationed in London before being placed in charge of the electrical machinery industry in 2011. Today, Mr. Ayada primarily covers the consumer electronics sector.

Financial and Capital Strategies of 16CSP

Takeuchi

Over the past four years, our primary focus has been reconstructing management, and we have been successful in raising equity capital and substantially improving return on equity, or ROE, through this process.

In 16CSP, we define four important management indicators based on which quantitative performance is to be evaluated. These indicators are ROE; the operating margin; the growth rate of earnings before interest, taxes, depreciation, and amortization, or EBITDA; and the equity ratio. The underlying principle behind our decision to set these indicators is for us to maintain ROE of 15% over the long term through earnest business reforms to improve profitability and asset efficiency, even as our financial leverage decreases due to efforts to ensure financial soundness. The target figure of 15% for ROE represents a level that will exceed our capital costs after financial soundness has been achieved through an appropriate capital structure. In addition, this is the level that will be necessary for Olympus to stand shoulder-to-shoulder with other global medical equipment manufacturers and continue growing indefinitely.

Moreover, we believe that responding to the needs of our shareholders and other stakeholders, and pursuing a balanced increase in the differing types of value sought by shareholders, customers, employees, and business partners, will in turn lead to improved corporate value. Sustained improvements in corporate value will require that we continue to generate returns that meet the expectations of our stakeholders while maintaining financial soundness, thereby ensuring that Olympus is a company that can grow its business in an ongoing manner over the medium-to-long term. Based on this premise, we will practice management that emphasizes the four management indicators I just mentioned, the perspectives they represent, and the balance among them with the aim of improving corporate value.

Management Emphasizing ROE

ROE 15% = $\frac{\text{Net income}}{\text{Equity capital}}$

- Achieve ROE level necessary to compete with global companies and realize ongoing growth
- Improve profitability and capital efficiency (growth potential) to maintain ROE of 15% over long term

		FY2016 (Results)	FY2021 (Targets)	
Profitability	Ratio of net income to net sales = Net income / Net sales	7.8%	Approx. 10%	■ Increase operating margin ■ Improve balance of other income and expenses
×				
Asset efficiency	Total asset turnover = Net sales / Total assets	0.8 times	Approx. 0.9 times	■ Increase net sales ■ Improve business asset efficiency ■ Improve corporate asset efficiency
×				
Financial leverage	Total assets / Equity capital	2.6 times	Approx. 2.0 times	■ Manage financial leverage ■ Conduct BS-based management

Watanabe

Let me begin by saying that I honestly think that Olympus has set forth a very good balance among the management indicators established in 16CSP. Over the past few years, Olympus has accomplished a startling improvement in its balance sheet, a feat that I believe warrants praise. Probably anyone looking at the approach toward capital policies announced in the new corporate strategic plan would feel the same. I can get behind the aim of substantially expanding surgical device operations, as contained in the Company's growth strategies, but it cannot be denied that many investors find objection with the reiteration of this goal given past failures to achieve targets set in this regard. The target of a compound annual growth rate of slightly more than 10% for sales in the surgical business, including energy devices, is a target that Olympus has pursued previously. While holding doubts in relation to this target, investors will certainly check to see if sales growth is achieved and the Company's share of the surgical device market does indeed increase. I have covered Olympus for 17 years now, and I can therefore explain to investors that raising market share is not easy and that such growth must come gradually. However, it seems to me that the time frame investors adopt to view such progress is a bit different to the unique time frame that is taken by medical equipment manufacturers.

Ayada

In my daily conversations with investors, I feel that they understand the Company's market and have praise for the position

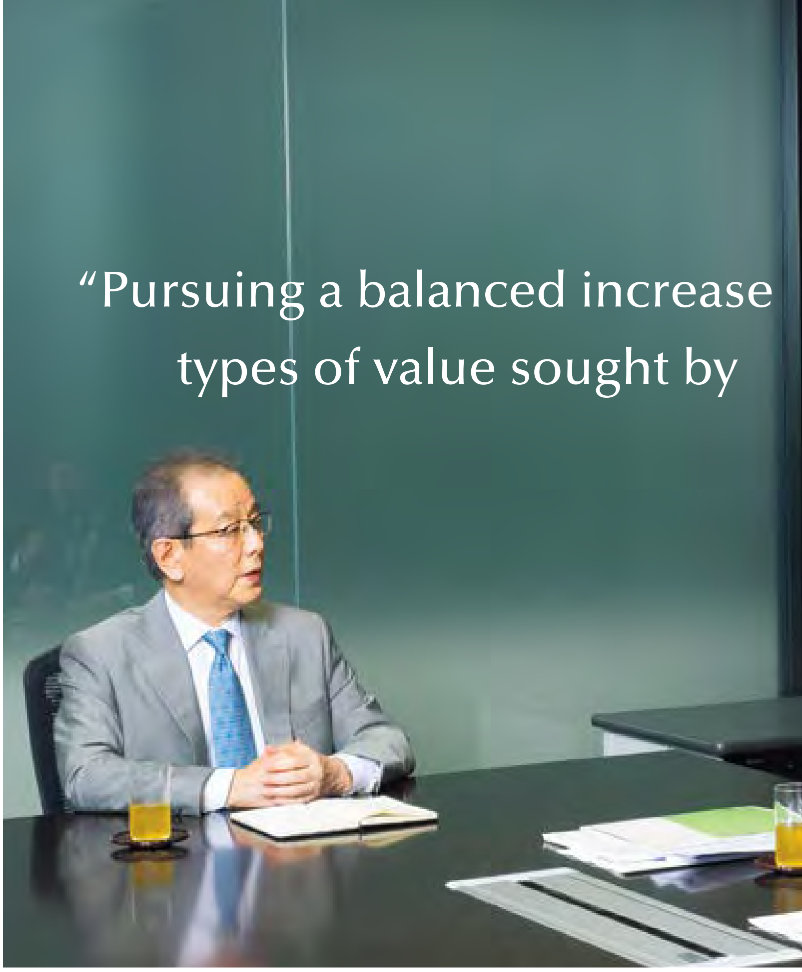
Olympus commands within this market. In other words, they realize how solid the Company's 70% share of the gastrointestinal endoscope market is. Previously, Olympus has grown on the back of this strong position. In 16CSP, however, Olympus has displayed its intent to grow of its own accord, striving to outperform the market and laying down very ambitious target figures. As Mr. Watanabe hinted at, the market has a very favorable opinion of 16CSP. At the same time, however, there is some doubt with regard to the ability of Olympus to topple its rivals in the surgical device and endotherapy device fields, especially when considering their strong business models.

I mainly cover the electrical machinery industry. One clear difference between gastrointestinal endoscopes and standard electronics products is the extent to which they incorporate customer needs. Gastrointestinal endoscopes are developed through a market-oriented approach, by maintaining close coordination with physicians, which allows manufacturers of these products to create strong business models. Electronics products, on the other hand, are sometimes developed by focusing too much on the products themselves, and this approach can lead to divergence between products and the needs of consumers. From this perspective, I cannot help but feel that the market-oriented product development practices and approach toward understanding customer needs that Olympus uses for gastrointestinal endoscopes will also prove successful for surgical devices and endotherapy devices.

Takeuchi

One major difference between making medical equipment and making consumer electronics is that, in the case of medical equipment, we do not directly interact with the patients; physicians handle all such interactions. For this reason, we have to base our products on the needs of physicians, and those are needs that also extend to economic benefits in the medical field. The result of this approach is that products come to be matched to the needs of patients, who are our end customers. However, as patients are not our direct target, we cannot perform direct marketing. We are also unable to approach every individual physician. Accordingly, we are focused on raising the recognition of Olympus among medical societies, striving to have our products become acknowledged as the de facto standard. These efforts, I feel, have given shape to the gastrointestinal endoscopes we deal in today.

Looking at another product, we introduced the THUNDERBEAT energy device four years ago. While this product was incredibly well received by physicians, this strong evaluation was only held by those physicians that we were able to approach directly. We have not yet been able to achieve the type of recognition that would garner the unanimous support of a certain medical society or of practitioners in a certain treatment field. Of course, the reverse is true of our gastrointestinal endoscopes, which do indeed boast this type of support. It will likely require a great deal of time for THUNDERBEAT to earn such recognition. Looking ahead, we aim to compete in the surgical device field as we have previously done in the gastrointestinal endoscope field, seeking to inspire customers to choose Olympus for products that meet their medical and overall needs. A central theme of 16CSP is to ensure that we can accomplish this goal to the greatest extent possible over the next five years.



Watanabe

Many investors still question the decision to continue the Imaging Business, and a number of investors fear that the basis for this decision is the qualitative evaluation of management alone.

Ayada

If asked whether or not investors truly trust the management of Olympus, I would have to say that they do not yet. One reason for this lack of trust is the camera business. I personally think that there is merit in Olympus continuing in the camera business. However, this continuation must be prefaced on a reason that seems rational to the stock market. In other words, this business needs to generate a profit. Moreover, this profit needs to exceed capital costs. I understand that Olympus is greatly reducing its number of models and shifting toward high-value-added products. If it continues on this course, while effectively maintaining fixed costs within a range that matches sales, I believe that the Company should be able to create a business model with high

in the differing
various stakeholders"

levels of capital efficiency, perhaps by increasing earnings through lenses. One good year will not be enough to change opinions, but if Olympus is able to continue operating the camera business in this manner over several fiscal years, the view that these operations are unprofitable will gradually fade away. If accomplished, investors will begin to see the Imaging Business as meaningful in its entirety, not just with regard to its synergies with the Medical Business in terms of optical technologies. This situation would also serve to improve management's reputation in the stock market.

Takeuchi

Quite frankly, I think there are risks associated with Olympus withdrawing from the Imaging Business. It is not that we do not want to quit this business, but rather that we believe that we should not quit this business. To validate this belief, it is vital that the Imaging Business becomes able to generate a profit on an individual business basis. However, given our corporate constitution and scale as well as the uncertain nature of market changes, stably generating earnings will not be easy. It was for this reason that we moved away from the prior in-house company system to adopt a matrix style of business operation. Under this structure, we have established new divisions for new businesses, subsequently creating new business models, which will be utilized to grow the lens business by taking advantage of our imaging technologies. This approach will require us to use all of our assets, including our human resources, in a more effective manner. I believe it is crucial for us to demonstrate the value of these operations through this approach, and this endeavor will take time. As the CFO of Olympus, I feel that improving asset efficiency and linking this efficiency to our business activities will be a matter of utmost importance.

Ayada

Looking at the targets for the five years of 16CSP, it is my opinion that the targets for the latter half of the plan are of the most importance. The first half of the plan, I believe, is somewhat of a preparation phase in which higher levels of capital will be invested. With regard to the second half, however, there is still much that is unknown, such as what type of results will be generated and on what schedule these results will appear. For this reason, if you have defined key performance indicators, such as those for determining if asset efficiency in each field of the Medical Business is being properly controlled, it will be easier for management to converse with the stock market. That in turn will ease investors and analysts, such as us, into understanding that the Company's initiatives are heading in the appropriate direction during the first half of the plan, even when we are still unable to see the top line and income growth that these initiatives will create. You mentioned that, from your perspective as CFO, asset efficiency will be a matter of utmost importance. However, with the matrix style of business operation, it might not be clear what to think of the asset efficiency levels of each individual business. The Companywide target for ROE has been defined as 15%, and I believe that this target should be focused on. With regard to whether or not individual businesses have sufficient asset efficiency or if this efficiency is increasing, perhaps it would be enough to know the level of asset efficiency for the Medical Business as a whole.

Watanabe

With regard to the numeric side of 16CSP, I would have liked a little more information on R&D expenditures and capital expenditures. Five-year aggregate figures have been provided, but I feel that the Company could have stood to offer some sort of breakdown in relation to these figures. The R&D activities of manufacturers in the medical equipment industry are difficult to understand, but I think this is actually becoming an area that investors need to consider. Pharmaceutical companies disclose their pipelines, making research progress readily apparent. The underlying research efforts of medical equipment manufacturers, however, can be difficult to see. As such, we often do not know whether the benefits of R&D activities are increasing or decreasing in comparison to expenditures. The lack of applicability of such indicators as the ratio of new product sales to total sales can be frustrating to investors. For this reason, I think it might have been a good idea to explain this matter in greater depth. Perhaps you can discuss this topic a little more in the future.

Takeuchi

Knowing that investors perceive our R&D activities in this manner does provide some hints about how we should proceed. For the meantime, we are projecting R&D expenditures that are equivalent to approximately 10% of net sales. With regard to capital expenditures, we have completed almost all of the large-scale expenditures anticipated, and future expenditures will likely be limited to ongoing investment in sales-use demo products. Accordingly, the level of investment at Olympus will be lower than at other global medical equipment manufacturers over the foreseeable future.

Watanabe

When explaining to overseas investors that, compared with other Japanese medical equipment manufacturers, the valuation of Olympus is low in comparison to its profit growth, these investors have stated that, on the contrary, they view the Company's stock price as high. My theory about this discrepancy in opinion is that, in the eyes of overseas investors, other Japanese medical equipment manufacturers are a type of "Far East niche company." For this reason, the level of their valuation is not seen as an important factor for consideration. Olympus, meanwhile, is competing with the titans of the United States in a massive and completely new market. For this reason, overseas investors compare it to Johnson & Johnson, Medtronic, and other such rivals. That might explain why the Company's stock price is seen as high. In other words, this discrepancy could be seen as proof that Olympus is viewed as a peer to these companies, a situation that raises the bar to which Olympus is held.

Takeuchi

I am happy to hear that. Over the past four years, we have continued to advance IR activities overseas. At first, Olympus was primarily viewed as just a Japanese company. Today, however, I feel that we are increasingly being seen as a global company.

Ayada

If there is one indicator that would be most effective in communicating the Company's value to global investors, who see Olympus as only one potential investment target from among candidates in all other industries, I believe this indicator would be free cash flow yield. If, for example, the Company generates free cash flow of ¥60 billion to ¥70 billion a year and has a market capitalization of roughly ¥1,300 billion, then free cash flow yield will be about 5%. I do not think that such a yield is particularly low in comparison with companies in other industries. Looking at cash usage, I understand that 16CSP is projecting a five-year aggregate free cash flow of more than ¥250 billion. When the measures instituted during the first half of the plan begin contributing to enhanced cash-generation capacity in the second half of the plan, what will this cash be used for? I suspect that this question is on the minds of many participants in the stock market. Olympus has a profit model based on the large size of its market share and the consistency of its business, a sort of recurring profit model. I therefore feel that the Company's ability to generate cash flows is highly evaluated. The question that remains then is how this cash will be used and how improved asset efficiency will be achieved. If this cash is effectively utilized to fuel the future growth of the Company, investors will naturally come to hold higher expectations for the Olympus of tomorrow. In regard to shareholder returns, I do not think it is enough to simply use cash to make returns by issuing dividends and acquiring treasury stock. Rather, the Company should purchase treasury stock when its stock price is low and use the funds created in this manner to conduct M&A activities, for example. I hope to see Olympus taking advantage of its cash in such ways over the medium-to-long term.

Takeuchi

You mentioned M&A activities. Let me say that we are not considering the possibility of M&A activities purely for the purpose of increasing the scale of our business. Olympus does not view M&A activities in terms of purchasing entire companies. Rather, we see these activities as a means of purchasing technologies. As stated, we are projecting a five-year aggregate free cash flow of more than ¥250 billion under 16CSP, part of which is earmarked for R&D expenditures. Our quantitative targets are primarily based on the assumption of organic growth. However, we are considering, of course, the possibility of using cash for M&A transactions that are not excessively large.

Ayada

Would you help me understand this policy of viewing M&A activities through the lens of research and development? Does this mean that Olympus aims to purchase lacking technologies, or does this imply that the Company's target will be the acquisition of people? Some also speak of buying time. In the case of Olympus, which of these do you believe to be lacking?

Takeuchi

M&A activities conducted without a clear post-acquisition integration plan will not be effective, and that is true whether the target of the acquisition is technologies or people. There are several cases of acquisitions not providing their anticipated benefits in the medical equipment industry. I suspect that, in these cases, sufficient post-acquisition plans were not established. As for Olympus, we will be concentrating investments on the surgical device field going forward.

Watanabe

The Company has stated its intent to target a total return ratio of 30%. Given the circumstances surrounding the resumption of dividends, this seems like an incredibly orthodox decision. However, as investors traditionally anticipate high growth rates from medical equipment manufacturers, they will not expect a higher payout ratio than your target. I therefore think that the policy of focusing on purchasing technologies is a prudent decision. The Company's gastrointestinal endoscope operations will no doubt continue to grow non-stop over the next 10-to-15 years, and this growth will be seen in both examination-use and treatment-use endoscopes. It can also be expected that the fundamental form of endoscopes will be very different 15 years from now. For this reason, the policy of using funds to acquire technologies could be seen as one facet of R&D activities, from a broad definition. In the future, when Olympus is debt-free, there will be a need to determine how cash generated thereafter will be used. I do not suspect that investors will expect this cash to be used to increase the total return ratio.

Opinions, Advice, and Hope for Olympus

Watanabe

Of the listed medical equipment manufacturers in Japan, the only manufacturer that can be called a first-mover is Olympus. The Company did not gain its position by simply mimicking its U.S. rivals. Quite the contrary, Olympus earned its position by promoting the spread of gastrointestinal endoscopes on its own. It is true that Olympus is a latecomer in the surgical device and energy device fields. However, the current trend in these fields is toward both North American and Japanese companies simultaneously striving to develop new therapeutic devices and thereby mold the markets. You would be surprised to see how many investors do not realize this fact. At the same time, the landscape of the medical equipment field in Japan is also changing. In the current environment, it is crucial to consider the potential of such trends as the aging of the population. For this reason, it seems only natural for the valuation of companies that primarily compete in Japan, where the population aging trend is more pronounced than in other nations, to be higher in this country than companies based out of North America, where medical equipment is treated as a full-fledged industry. I believe that there is room to continue the discussion of whether or not some sectors are more viable in Japan and if it is important to hold stocks in sectors other than the medical equipment sector.

Ayada

I believe that Olympus currently holds a very beneficial position. There is some discussion regarding the possibility of designating Olympus stock as one of the core stocks among those of the Japanese stock market. For this reason, I believe that Olympus is the target of both high anticipation of the future and high expectations for its actions. The stock market currently has its eyes on Olympus, intent to see if it can steadily advance the recently announced 16CSP and thereby live up to the expectations of investors. I touched on this point at the beginning of the discussion, but I would like to reiterate that the Company's ability to achieve the goals of 16CSP will likely hinge on whether or not Olympus is able to increase its share in the surgical device and endotherapy device markets. Accordingly, I hope that Olympus will not become overly preoccupied by short-term fluctuations in the macroeconomic environment or foreign exchange rates. Rather, I feel it is important for the Company to strengthen its business portfolio from a medium-to-long-term perspective, looking 5-to-10 years in the future.

Takeuchi

In formulating 16CSP, we engaged in countless discussions, forging the plan and the logic contained therein, over a period of more than a year. We have utter confidence in this plan, and therefore we are convinced that our odds of success are high. Foreign exchange rates will change, and it would be difficult for us to hedge against all the factors that could impact us in the short term. Accordingly, we do not intend to devote an excessive amount of effort to combating these potential impacts. Rather, we are committed to moving forward with 16CSP and ensuring its success.