CROOZ

Q1 FY03/22

Message from Koji Obuchi, President and CEO of CROOZ Group

(August 11, 2021)

I am Koji Obuchi, president and CEO of the CROOZ Group. Earlier today, on August 11, 2021, we announced our financial results for Q1 FY03/22. Now, I would like to share with you my thoughts and impressions to give you a better understanding of the current situation.

First of all, Q1 sales looks substantially lower, but this is due to the impact of adopting the new accounting standard for revenue recognition, which all listed companies that use the Japanese accounting standards are required to adopt. As a result, we are disclosing sales net of purchase costs from Q1 FY03/22 onward. This is only a change in reporting and does not have any impact on profit. In the past, I did not specifically mention transaction value because we referred to it as sales. However, it is safe to assume that transaction values disclosed from Q1 FY03/22 onward are equivalent to what we disclosed as sales until FY03/21, so please keep that in mind when making YoY comparisons[1].

Turning to overall consolidated group results, Q1 transaction value came to JPY8,342mn (-4.1% YoY) and consolidated operating profit was JPY431mn (-31.0% YoY).

I will explain in greater detail later, but the main reasons for the YoY drop in consolidated operating profit were lower operating profit in the mainstay SHOPLIST business and development costs for new games at Studio Z.

Next, I would like to explain the details of the results for each segment. In our full-year FY03/21 results announcement, I stated that the CROOZ Group will further focus on the e-commerce field as an e-commerce solution company going forward. Accordingly, we reorganized our segment classification in Q1 FY03/22, which now consists of E-commerce, Game, Online Advertising and Media, and Investment segments.

First, let me go over the E-commerce business, which consists of the SHOPLIST business as well as e-commerce related businesses such as undertaking of e-commerce developments and operations which were previously under the Other segment. I will still focus mainly on the SHOPLIST business, as the e-commerce related businesses are still small compared to it. In Q1 FY03/22, the SHOPLIST business reported transaction value of about JPY6,139 million (-6.6% YoY) and operating profit of about JPY365 million (-37.7% YoY). To be frank, these are not the results we were striving for. It has been about a year since I came back to the company as president in July 2020 to focus on rebuilding the SHOPLIST business by reforming the business and organization through the Critical Project Program[2] and other measures. As a result of these reforms, which include streamlining logistics costs and advertising promotions, we achieved double-digit growth in sales for the first time in eight quarters last quarter along with an operating profit of nearly JPY2bn, proof that things are steadily improving. On the other hand, there are some deep-rooted issues that have accumulated over the years, and I feel that it will take some time to resolve all of them and achieve a full-scale comeback.

I will now talk about the transaction value. The main reasons behind the 6.6% YoY drop in transaction value include: (1) the tapering of one-time COVID-19 demand brought on by the state of emergency declaration in Q1 FY03/21; (2) a drop in average shipping price; and (3) fewer visitors from SEO and apps.

The average shipping price in Q1 was JPY5,912 (-5.4% YoY), and there are several reasons behind this drop, but the biggest reason is the drop in average product selling price. The average product selling price came in at JPY1,668 (-6.4% YoY), and this was mainly due to the fact that we have not yet been able to fully achieve the improvements from our merchandising measures that we have previously mentioned. One of the key focal points was on appropriately controlling prices, and we have not been able to select appropriate products for sales promotions, which led to the drop in average product selling price.

Next, I will explain the drop in the number of visitors. In a critical project aimed at SEO improvements, which had produced significant results through FY03/21, we discovered a bug in our program that diminished the results we had achieved to date. In addition, the number of visitors via apps fell about 7% YoY. I believe this was due to the lack of promotions. As a result of the drop in visitors from SEO and apps, our transaction value fell YoY.

The drop in average shipping prices and number of visitors is something we need to address as soon as possible, and we have already created and started working on a critical project for it. With regard to the drop in average product selling price, which caused the drop in average shipping price, we will improve the accuracy of our analysis of top-selling products and implement appropriate price controls, including strict inventory control and the elimination of inefficient sales promotions. We have already completed analysis using past sales data, and we know which products were sold inefficiently, so we are already seeing improvements in this area. In addition, we launched full-scale promotions of outlet products on June 15, 2021, which is part of our Sustainability Project. The average price of outlet products is about 30% higher than that of regular products, and by further strengthening sales of these products, we will be able to increase the overall average product selling price.

As for the drop in the number of visitors from SEO activities, we have already fixed the bugs in the program and are on track to recover, but since SEO is evaluated and reflected by external search engines, it generally takes some time before we can see any results. Currently, we are expecting the number of visitors to return to previous levels by October. In addition, to address the drop in the number of visitors from apps, we will aggressively invest in advertising from Q2 onward. We eliminated unnecessary advertising promotions from FY03/21 and successfully streamlined our advertising investment, but the number of visitors from apps fell as we were not able to take on measures to boost traffic. From Q2 onward, we will conduct a drastic review of our existing promotion methods, not only to streamline promotions, but also to shift to a more aggressive approach by strengthening promotions centered on advertising on social networking sites. In particular, we will further boost our appeal to young people centered on the F1 demographic, which is a strong area for SHOPLIST, to attract existing and new young users, thereby driving visitors from apps to our website.

Now, I will talk about operating profit. As I have previously mentioned, we have been focusing most on improving operating profit in the SHOPLIST business, but Q1 operating profit fell 37.7% YoY to JPY365mn. The main reason for this is a drop in transaction value. Logistics costs-to-transaction-value rose by 0.5% YoY to 14.8% in Q1, owing to an increase in logistics cost per shipment resulting from a drop in average shipping price ultimately driven by lower average product selling price as I mentioned earlier. However, since there is no change in our logistics cost structure itself, we will focus on increasing our average shipping price.

In addition, our promotion cost-to-transaction value came to 7.3% in Q1, a 0.8% drop from Q1 FY03/21. This is attributable to a change in accounting method for point reserves as a result of adopting the new accounting standard for revenue recognition in Q1 FY03/22. Previously, we recorded point reserves as part of SG&A expenses, but now we subtract it from sales. Excluding this change, our promotion cost-to-transaction value increased 0.4% YoY, but this was driven by a drop in transaction value. In terms of advertising promotion, as mentioned earlier, we have not yet been able to invest aggressively, so from Q2 onward, we will strengthen investment, including for advertising on social networking sites.

Next, our subcontracting costs-to-transaction value came to 2.3% in Q1, up 0.8% from 1.5% in Q1 FY03/21. This was because some of our critical projects required major system upgrades and new development, such as for strengthening sales of outlet products, and our engineering outsourcing costs increased in line with this. Our subcontracting costs-to-transaction value may remain high from Q2 onward as we will need to newly develop and upgrade systems as we continue to address issues through respective critical projects, but I expect development work to settle down from Q4 on.

This concludes my explanation of Q1 results for the SHOPLIST business, but going forward, our top priority will be to boost transaction value. We must urgently address the issues that became apparent in Q1 FY03/22, such as the drop in average shipping price and the number of visitors. However, as I mentioned earlier, we have already analyzed the causes and formulated countermeasures, and we will put the business back on track for growth by Q3 FY03/22.

Now I would like to talk about the Games business. We called this segment the Internet Content Business until FY03/21, but decided to rename the segment to better reflect the actual business. Q1 sales came to about JPY482mn (-17.6% YoY), with an operating loss of about

JPY99mn (vs. an operating profit of JPY99mn in Q1 FY03/21). We reported a loss in the segment as results were weighed down by development costs for our new game SHAMAN KING Funbari Chronicle (about JPY170mn) which we announced recently. Excluding the development cost for this title, the segment produced stable earnings and would have reported an operating profit. We are in the final stages of development and making steady progress toward releasing the title by the end of this year, but we expect to continue incurring development costs in Q2. We will issue a press release on the game's full release date and other additional information as appropriate.

Next, I will talk about our Online Advertising and Media business. This is a combination of the Advertising Agency and Media businesses, which were separate reportable segments until FY03/21. We decided to combine them and manage it as one business segment as both businesses were closely related in many areas.

Q1 transaction value came to about JPY922mn (-9.7% YoY), and operating profit grew substantially to JPY174mn (+111.0% YoY). This was attributed not only to Rank King, which we have been disclosing results for, but also to the strong performance of other new media and advertising agency businesses. As the business has only been up and running for about three years, there may be some volatility in performance in the short term, but we will continue to focus on boosting results as we expect this business to grow substantially going forward.

In the Investment business, Q1 sales came to about JPY57mn (+11.7% YoY) with an operating loss of about JPY32mn (loss of JPY30mn in Q1 FY03/21). The main reason for the operating loss was that there were no sales transactions that outweighed the management costs of the fund. However, as I have explained in the past, it normally takes five to seven years to start seeing results in the Investment business. We may incur upfront costs, including impairment charges and management costs, but the Investment business is still in the early stages, just three years since inception, and there are no particular issues with its progress. Several of the investees are preparing to list on the stock market, and we hope that this will generate substantial profit within a few years.

This concludes my explanation of results for each segment. In the SHOPLIST business, we have already started implementing concrete measures to address the drop in transaction value as we already completed a root cause analysis and identified areas for improvement. Meanwhile, the Games business itself is doing well if we exclude the development cost for new games, and the Online Advertising and Media business is generating profits and remains stable. The Investment business has not yet produced tangible results, but business progress is steady. Overall, on a consolidated groupwide basis, there is no cause for concern.

The SHOPLIST business is now in a position to generate stable profits, but as I have mentioned in the past, it is important to reinvest the profits to expand transaction value, and the problem is that we have not carried out this investment. We may see lower profits YoY in the near term as we push forward with investments to boost transaction value, such as for strengthening advertising promotions, from Q2 onward. However, there is no change in our aim to boost both sales and profits by expanding transaction value, although the timeline for achieving this may vary to an extent.

We've fallen behind on our goal of achieving a transaction value CAGR of 30% as our transaction value fell YoY in Q1 FY03/22. However, we will continue working to achieve the targets we announced at the end of FY03/21, which include achieving a transaction value CAGR of 30% and an operating profit-to-transaction value ratio of at least 8% for SHOPLIST on a stand-alone basis over a period of one year or so[3]. Our measures to achieve these targets remain centered on our critical projects. First, we will expand the number of visitors by focusing on our critical project aimed at boosting advertising promotion as mentioned earlier. We will also improve the purchase rate through a critical project aimed at changing the logic behind the display priority of current products on the SHOPLIST site. While the logic for display priority has mostly remained the same, the number of brands and products we handle has increased considerably over the past few years, and the products that would normally sell have not been getting proper exposure. As an extreme example, monthly traffic resources were being sent to products with low sales volume or extremely low purchase rates. We believe that by properly revising the display logic of the website, we will be able to capture more orders with the same number of visitors. In addition, we will continue to work on critical projects related to merchandising, such as strengthening sales of outlet products, to improve the average product selling price and ultimately the average shipping price. As we fully expect to achieve strong results through our critical projects, we will continue to aim for a transaction value CAGR of over 30% and an operating profit-to-transaction value ratio of at least 8%.

Until FY03/21, we prioritized critical projects aimed at solidifying our foundation, focusing on cost reductions, streamlining operations, and improving organizational structure. As a result, we were only able to carry out some of the critical projects aimed at restoring transaction value growth, such as those focused on SEO improvements. We were able to stop the losses and start generating stable profits, but we were not able to solve all of our issues and fully recover in one year. However, since reinvesting necessitates turning a profit, I am glad that we are now profitable. As a result, from FY03/22 onward, we will be able to devote most of our resources to critical projects aimed at substantially boosting transaction value. In particular, I will devote over 90% of my attention on growing our transaction value. It will take time to completely rebuild our business, as new issues emerge as soon as other issues are solved, but I believe FY03/22 is a critical year for us. Our critical projects are steadily producing results, and when we are done working through the challenges of all the projects, I believe our achievements will be beyond expectation based on our current level of transaction value and operating profit. We will work at full speed to achieve results in the shortest amount of time possible.

August 11, 2021
Koji Obuchi

*1 All listed companies that use Japanese accounting standards will be required to adopt the Accounting Standard for Revenue Recognition from fiscal years beginning on or after April 1, 2021. As a result, SHOPLIST and some other businesses are required to disclose sales net of purchase costs from April 2021 onward. Therefore, sales in FY03/22 will appear lower, but this is only a change in reporting and will not have any impact on profit. In the past, I did not specifically mention transaction value because we referred to it as sales, but starting in FY03/22, we will start referring to sales, sales growth rate, and operating profit margin as transaction value, transaction value growth rate, and operating profit-to-transaction value ratio in our disclosures. It is safe to assume that transaction values disclosed from FY03/22 onward is equivalent to what we disclosed as sales until FY03/21.

*2 Critical Project Programs are those that are directly under the supervision of the president, and the project owners are given the same authority as the president to dig deeper into the background and reasons of issues, use various data to come up with solutions, and rebuild SHOPLIST.

*3 Currently, SHOPLIST's marginal profit ratio (the ratio of profit to transaction value calculated by subtracting variable costs from transaction value, or in other words, the ratio of incremental profit to transaction value) is about 20%, taking into account the main variable costs such as purchasing costs (about 60%), logistics costs (14%), and payment processing fees. Roughly speaking, FY03/21 transaction value were JPY27.1bn, marginal profit was 20% of that, or about JPY5.4bn, and operating profit was JPY1.9bn, with the difference being our fixed costs at about JPY3.5bn. If increased by 30%, transaction value would be about JPY35.2bn, and marginal profit would come out to roughly JPY7bn, so if fixed costs remained the same, operating profit would be about JPY3.5bn, bringing the operating profit margin to around 10%. In reality, we will be making investments to strengthen our workforce, so it will not be as simple as this calculation, but the business is structured in a way where profit margins rise in line with transaction value growth. Therefore, even if we reinvest from our current profits, I believe we can still achieve an operating profit margin of over 8% through transaction value expansion.