Q2 FY03/22

Message from Koji Obuchi, President and CEO of CROOZ Group

(November 11, 2021)

I am Koji Obuchi, president and CEO of the CROOZ Group. Earlier today, on November 11, 2021, we announced our financial results for Q2 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, the financial results for this term seem to show a large decrease in sales—more than half year on year—but this is due to the impact of applying the 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 FY03/22. This is a change in the method of reporting and has no 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, 1H FY03/22 transaction value was JPY16,344mn (-7.4% YoY) and consolidated operating profit was JPY537mn (-53.8% YoY). Consolidated transaction value for Q2 FY03/22 was JPY8,002mn (-10.6% YoY), and consolidated operating profit was JPY106mn (-80.3% YoY).

The main reasons for the YoY decrease in consolidated operating profit were lower operating profit in the mainstay SHOPLIST business and development and advance promotion costs for new games at Studio Z.

Next, allow me to explain in detail the business results for each business segment.

First, let me go over the E-commerce business, which consists of the SHOPLIST business as well as e-commerce related businesses such as the 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. The total transaction value of the SHOPLIST business in 1H FY03/22 was JPY11,608mn (-13.1% YoY), and operating profit was JPY400mn (-61.3% YoY). In Q2 FY03/22, transaction value was JPY5,469mn (-19.4% YoY), and operating profit was JPY34mn (-92.2% YoY). To be frank, these are not the results we were striving for. It has been over a year since I came back to the company in July 2020 as president to focus on rebuilding the SHOPLIST business by reforming the business and organization through the Critical Project Program[2] and other measures. By reforming our business structure, including streamlining logistics costs and advertising promotions, we achieved double-digit growth in sales for the first time in eight quarters in the previous fiscal year and generated operating income of nearly JPY2bn for the year, proving that things were steadily improving. On the other hand, some deep-rooted issues have accumulated over the years, and I feel that it will take some time to resolve them and achieve a full-scale comeback.

I will now talk about the transaction value. The main reasons for the 19.4% YoY decline in transaction value include: 1) the tapering of one-time COVID-19 demand, 2) fewer visitors from SEO, and 3) fewer visitors from advertisements, especially via apps, due to a lower purchase rate. As for the decline in the average price of shipments—one of the factors behind the decline in transaction value in Q1 FY03/22—there was an improvement to JPY5,691 (+0.4% YoY) in Q2 FY03/22. This was attributable to implementing appropriate price control measures such as eliminating inefficient sales through more accurate analysis of hot-selling products.

Next, I will explain the drop in the number of visitors. First of all, we have yet to fully recover from the impact of the program bug that occurred in the SEO project in Q1 FY03/22, which caused a decrease in the results we had accumulated to date. Overall, the number of visitors via advertisements is declining, and within that, the impact of the decline in the number of visitors from apps is significant. As a result of this decrease in the number of visitors via SEO and advertising, the transaction value also decreased compared with Q2 FY03/21.

As for the drop in the number of visitors from SEO, 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. As a result of this, the number of visitors via SEO had dropped to 68% compared to the peak, but it has now recovered to 84%. Initially, we had expected it to return to the previous level in October. However, since it is out of our realm of control, we cannot accurately predict when it will fully recover, but improvement is underway. In addition, to address the drop in the number of visitors via advertisements, we have been eliminating unnecessary advertising promotions since FY03/21 and had successfully streamlined our advertising investment. However, we have not been able to take on measures to boost traffic. Moreover, we are a bit behind in our merchandising measures such as improving the stock-out rate of products that users want to buy, which has resulted in a decline in the purchase rate. This in turn deteriorated the advertising efficiency, and the overall number of visitors via advertising declined. Also, the number of visitors via apps, which have a high purchase rate, is declining. This further is increasing the drop in the purchase rate. In response to this decrease in the number of visitors from advertisements—particularly via apps—from Q2 FY03/22, as previously reported, we reviewed our existing promotion methods and implemented new measures such as YouTube advertisements, live YouTube streaming through influencer casting, and a point-back campaign only available to buyers via apps. As such, we have invested more aggressively in advertising, but we have yet to achieve the results we initially expected. We will continue to implement the PDCA cycle to put into practice more effective measures for advertising. From Q3 FY03/22, we will resume TV commercials to expand mass recognition and will continue to use YouTube and other social media advertisements, while also implementing campaign measures to increase the inflow of customers from apps. We will further boost our appeal to young people centered on the F1 demographic—which is a strong area for SHOPLIST—to continue attracting new young users, thereby driving visitors to our website not only from advertisements but via apps as well.

Now, I will talk about operating profit. Operating income for Q2 FY03/22 was down YoY to JPY34mn (-92.2% YoY). The main reason for this is a drop in transaction value. First of all, logistics-costs-to-transaction-value rose 0.5% YoY to 15.0% in Q2 FY03/22, owing to fixed costs such as warehouse rent accounting for a larger percentage of the total costs due to the large decrease in the transaction value. Neither our average shipping price nor our cost structure has deteriorated.

In addition, our promotion cost-to-transaction value increased by 1.2% from 10.3% in Q2 FY03/21 to 11.5% in Q2 FY03/22. And, due to a change in the accounting method for point reserves caused by the Accounting Standard for Revenue Recognition that was applied from FY03/22, what used to be recorded as SG&A expenses is now subtracted from sales. Excluding this change, our promotion cost-to-transaction value would have increased by 2.5%. This is partly due to the drop in transaction value, but also because we are actively investing in the aforementioned measures such as YouTube advertising and live streaming through influencer casting. From Q2 FY03/22, we will aggressively invest in measures to restore and further boost transaction value. While this means that the level of promotional expenses will remain high for the time being, we will identify and adopt more efficient advertising and promotional measures while implementing the PDCA cycle to avoid wasteful investments.

Next, our outsourcing costs-to-transaction value came to 2.7% in Q2, up 1.3% from 1.4% in Q2 FY03/21. This was in part attributable to the drop in transaction value, but also because some of our key projects continued to require major system upgrades and new development in Q2, such as for strengthening sales of outlet products. In line with this, our engineering outsourcing costs also increased. Our outsourcing costs-to-transaction value may remain high from Q3 onward as we will need to newly develop and upgrade systems as we continue to address issues through respective critical projects. This is also, however, a temporary cost increase for future growth, and I expect development work to settle down from Q4 onward.

This concludes my explanation of Q2 results for the SHOPLIST business. As I have already mentioned, we must get transaction value once again trending toward growth, and this is our top priority. We have already been able to improve the decline in the average shipping price that occurred in Q1, but we have yet to recover from the drop in the number of visitors. As I previously stated, we have completed the analysis of the causes and the formulation of countermeasures, and we will recover the business from Q3 onward to put it back on track for growth.

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. Q2 sales came to about JPY592mn (+6.6% YoY), with an operating loss of about JPY215mn (compared with an operating profit of JPY67mn in Q2 FY03/21). Development and advance promotion costs for the recently announced new game *SHAMAN KING Funbari Chronicle* were JPY290mn in Q2 FY03/22, resulting in a loss for the segment on a non-consolidated basis. Excluding the development and advance promotion costs for this title, the segment produced stable earnings and would have reported an operating profit.

Development is at its final stage and on track for release by the end of this year, but we expect to continue incurring development and promotion costs in Q3. As for the current status, pre-registration has started, and as of November 8, 2021, the number of registered users is over 280,000. And the number of followers of the official Twitter account has steadily increased, surpassing 170,000. We feel that this is promising, given the results of our competitors who showed strong first-month sales and had 100,000—200,000 Twitter followers at the time of game release. We will continue to disclose information such as the game's full release date via press release as necessary.

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 and manage them as one business segment as both businesses were closely related in many areas.

Q2 transaction value came to about JPY931mn (-12.2% YoY), and operating profit increased significantly to JPY162mn (+43.7% 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, mainly in the financial sector. As the business has only been up and running for about three years, there may be some volatility in performance in the short term. The profit margin is high, however, and the business is expected to grow substantially going forward, so we will continue to focus on boosting results.

In the Investment business, Q2 sales came to about JPY347mn (+457.1% YoY), and operating profit was JPY167mn (compared with an operating loss of JPY30mn in Q2 FY03/21). The main reason for the profit in Q2 was the recording of a gain on the sale of some of our stock holdings. 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. In addition, as disclosed today, based on our policy of focusing on the e-commerce domain as an e-commerce solutions company in the announcement of the full-year results for FY03/21, we have reviewed our strategy for the Investment business and decided to convert a portion of the fund equity managed by our consolidated subsidiary Sevenwoods Investment, Inc to cash. As a result, the company's stake in the fund will decrease and the fund will no longer be a consolidated subsidiary. This means that the Investment business will no longer be a reportable segment. Going forward, it will continue to be a net investment, and the profit and loss resulting from the investment will not affect the company's operating profit and loss. We will allocate the funds obtained from this project to the enhancement of our corporate value by investing in domains most likely to contribute to the growth of the group, including e-commerce.

This concludes my explanation of the results for each segment. In the SHOPLIST business, transaction value continues to decline and it will take some time to improve, but the decrease in the average shipping price has improved and some measures can be implemented to deal with the decline in the number of visitors. Furthermore, the Games business itself is performing well if we exclude the development cost for new games and advertising expenses, and the Online Advertising and Media business is generating profits and remains stable. Overall, on a consolidated group-wide basis, there is no cause for concern.

The SHOPLIST business is now in a position to generate stable profits, but as I have been saying, 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 as we have been doing from Q2. 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.

As of Q2, however, the transaction value growth rate was still lower than in Q2 FY03/21, and we have fallen far behind on our goal of achieving a transaction value CAGR of 30% or more. We therefore have to change the targets we announced at the end of FY03/21, which include achieving a transaction value CAGR of 30% in an year or so and an operating profit-to-transaction value ratio of at least 8% (on a non-consolidated basis for SHOPLIST[3]). First of all, we would like to restore transaction value to Q2 FY03/21 levels by end-FY03/22, and achieve a transaction value CAGR of 30% or more in FY03/23 and beyond. It has taken much longer than we had originally anticipated, which is disappointing, but we will work hard to achieve these goals. Our measures to achieve these targets remain centered on our critical projects. Priority matters for improvement are 1) a decrease in the number of visitors, and 2) a decline in the purchase rate. In response to the decrease in the number of visitors, we will expand the number of visitors by focusing on critical projects related to the aforementioned resumption of TV commercials and the strengthening of advertising promotions centered on social media. To combat the decline in the purchase rate, we will bolster the number of visitors via apps by strengthening advertising promotions. We further intend to decrease the stock-out rate through a project to build a system that predicts orders based on past sales data and manages inventory appropriately to enrich products users are interested in purchasing. This will standardize the inventory management methods for all merchandisers and optimize the stock-out rate through more efficient, more effective inventory management. 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. 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. The project on this evaluation logic is now well underway and could potentially improve transaction value by 10% or more compared with the previous project.

In addition, in November, we opened three new brands (CosmeLand, AXES, and 6ixty8ight) that are well-known among users and have the potential to contribute to increased transaction value. CosmeLand is a popular cosmetics store that carries 250 brands of famous cosmetics, including brands from abroad such as SK-II, Lancôme, and

Clinique, and domestic brands like Shiseido, Kanebo, and KOSE. AXES is a popular brand store that carries more than 7,000 items from over 70 foreign brands, including Louis Vuitton, Gucci, Prada, and Balenciaga. 6ixty8ight is a global lingerie brand with annual sales of JPY100bn and 327 stores around the world, in countries including China, Hong Kong, Taiwan, Korea, Japan, Singapore, and Malaysia. Going forward, we intend to expand brands and products like these that appeal to users and strive to increase the transaction value.

Until FY03/21, we prioritized critical projects aimed at solidifying our foundation, focusing on cost reductions, streamlining operations, and improving the organizational structure. Beginning in FY03/22, we have been devoting the majority of our resources to critical projects aimed at substantially boosting transaction value. I have also been devoting over 90% of my attention on growing our transaction value and been doing more than my best. However, it is not proceeding like we had originally expected. Numerous issues remain that have not been afforded due attention, and it is taking time to resolve these problems and completely rebuild the business. We do believe, however, that we will be able to recover and grow again, and we are prepared for the challenge that this fiscal year holds. We are gradually making progress on critical projects and will work at full speed to achieve results in the shortest amount of time possible.

November 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.