WATTS (TSE Prime, 2735) FY8/23 Q2 Operating Results

Sales generally progressed as planned.
Despite the relentless rise in costs, improving profitability through cost control measures.

<Brief summary>

<Overview of FY8/23 Q2 results>

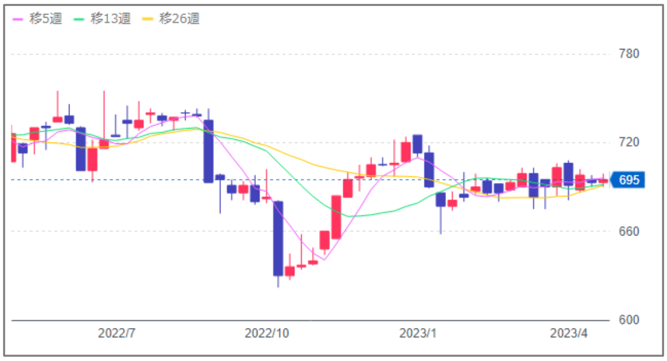
- Sales were generally in line with the plan at 29,550 million yen (+3.7% YoY, -0.3% to the plan), and operating profit was 271 million yen (-57.3% YoY, -28.4% to the plan). Sales at existing shops were affected by bad weathers and a pause in the COVID-related demand, while new shop openings were solid. Profits fell sharply YoY due to the higher-than-expected costs caused by the sharp depreciation of the yen and the soaring utilities costs; this led to revisions to the Q2 business forecasts.
- In 1H, sales at 100-Yen shops were 104.2% at all shops and 99.0% at existing shops YoY. New shop openings progressed almost as planned, contributing to all-store sales. Same-store sales were affected by bad weathers, such as snowfalls, and a decrease in special demand for stay-at-home products during pandemic after the slowing down of the COVID-19's spread. Although the same-store sales declined slightly to 99.0% YoY, average spend per customer improved to 101.2% through the introduction of higher-priced products, and the number of customers also recovered to 97.8% from 95.5% in the same period in the previous fiscal year.
- The gross margin was 37.8% for 1H, down 0.5ppt YoY. This decline was due to the sharp rise in the procurement cost reflecting the sharp depreciation of the yen last year. On the other hand, it was 37.6% for Q1 alone and was 38.0% for Q2 alone, showing a slight but steady improvement. The Company's efforts to control costs are beginning to show results, and if external conditions such as foreign exchange rates are assumed to maintain the current level, the gross margin may improve from the bottom in Q1.
- SG&A expenses and its ratio both deteriorated YoY due to higher expenses resulting from the M&A and new shop openings, as well as higher personnel expenses. The increase was generally in line with the plan, but utility costs rose more than expected.
- In response to the sudden change in the external environment, the Company is taking measures to control costs in all its businesses. It is on track to improve profitability, mainly by changing its product mix through the introduction of new and higher-priced products, which are profitable even at current exchange rates. Further, the Company is now seeing the possibility of new types of shops that other companies cannot realize. It is currently developing a multi-purpose shop model that combines 100-Yen shops with other lifestyle product shops.
- The Company is also trying to improve the efficiency of its management system. In September 2022, after dividing the acquired Ontsu F・RETAIL co.,ltd shops into east and west, their businesses were integrated into Watts East Japan Sales Co., Ltd. and Watts West Japan Sales Co., Ltd. In the same month, Watts Connection, which run the Buona Vita shops, was merged into Watts East Japan Sales to enhance linkages with the 100-Yen shops.

FY8/23 full-year forecasts

- The Company forecasts sales of 60,500 million yen (+3.7% YoY), operating profit of 920 million yen (-7.9% YoY), recurring profit of 850 million yen (-26.0% YoY), and net income of 530 million yen (-32.2% YoY). Although the effects of cost control measures have been seen, the Company has left its full-year forecasts unchanged as it needs to make cautious judgments amid the still uncertain external environment.

Stock price data (April 28, 2023 closing price)

Stock price	701 yen
Shares issued	13,898,800 shares
Market cap	9,743 million yen
PER (est.)	17.96 times
PBR (actual)	0.79 times
Dividend yield forecast %	2.14%



Performance (Figures for FY8/23 are the Company's estimates)

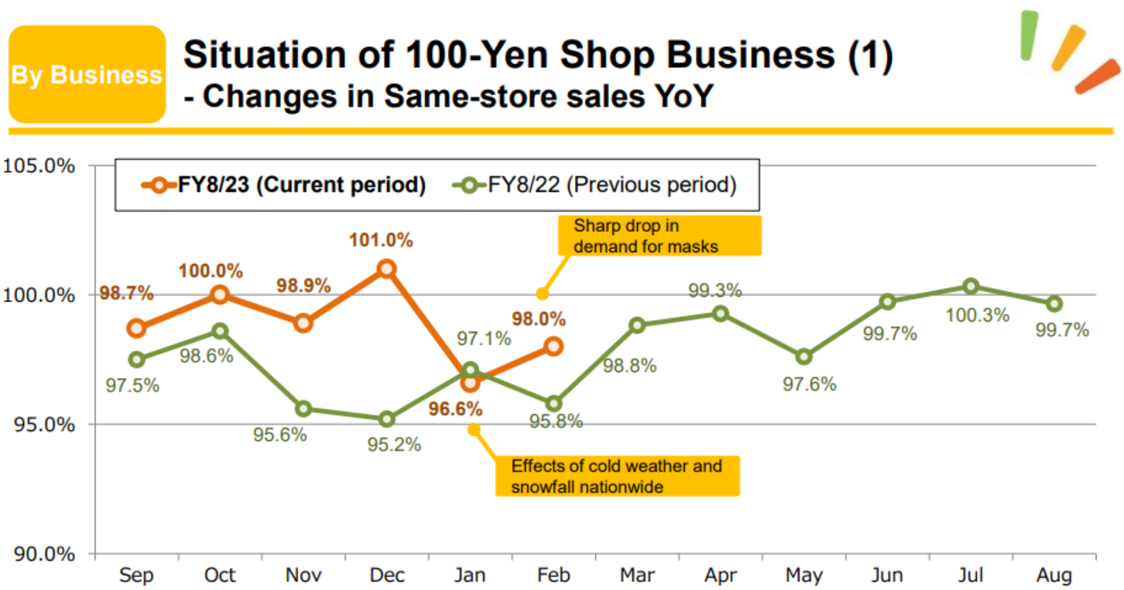
(Million yen)	Operating profit	YoY (%)	Operating profit	YoY (%)	Recurring profit	YoY (%)	Net income	YoY (%)	EPS (Yen)	Dividend (Yen)	ROE (%)
FY8/22	58,347	15.1	998	-40.2	1,148	-27.6	781	-19.1	57.83	15.0	6.7
FY8/23(E)	60,500	3.7	920	-7.9	850	-26.0	530	-32.2	39.04	15.0	4.4
FY8/22(Q2)	28,506	11.3	637	-41.3	678	-36.4	361	-54.8	26.89	-	-
FY8/23(Q2)	**29,550**	**3.7**	**271**	**-57.3**	**270**	**-60.1**	**292**	**-19.1**	**21.53**	**-**	**-**

<Overview of FY8/23 Q2 results>

- Sales were 29,550 million yen (+3.7% YoY, -0.3% to the plan), and operating profit was 271 million yen (-57.3% YoY, -28.4% to the plan). Sales at existing shops were affected by bad weathers and a pause in the COVID-related demand, while new shop openings were solid. The profits fell sharply YoY due to the higher-than-expected costs caused by the sharp depreciation of the yen and the soaring utilities costs; this led to revisions to the Q2 business forecasts. Net income attributable to owners of parents exceeded the plan to 292 million yen, but the was mainly due to the impact of income tax adjustments associated with reorganization.

<Overview of the 100-Yen shop Business (1) -Strongly affected by external environment, but Q1 results may be the bottom>

- In the 100-Yen shop business, the Company opened 104 shops, compared with the plan of 107 shops, and closed 53 shops, compared with the plan of 62 shops. New shop openings were close to the plan, while closures were slightly lower, resulting in a net increase of 51 shops over the plan. Along with the increase in shop openings, all-store sales were 104.2% in 1H.
- Same-store sales were 99.0% in 1H, down slightly YoY. Abnormal weather, such as snowfalls, and a decrease in special demand for stay-at-home products reflecting the slowing down of COVID-19's spread, caused a significant drop in January and February figures. Another factor is that it was unable to allocate sufficient staff to the maintenance of existing shops. This was because in the current fiscal year, the Company promoted the streamlining and renovation of shops under the FLET'S and Hyakuen Ryojikan brands acquired through M&A, and priority was given to strengthening the workforce for this renovation and new shop openings. In addition, local factories in China were closed due to the strong countermeasure against COVID-19, which led to a slowdown in shipments of some products and made product shortages. Currently, it is reviewing the allocation of personnel to each shop and promoting measures.
- The introduction of higher-priced products is progressing steadily, with 9% of total sales and 2,169 items as of 1H. The Company increased selling prices of products that are no longer profitable at 100 yen due to the steep rise in procurement costs, and this measure contributes to increasing customer spending and product mix. In 1H, the average spend per customer rose to 101.2%, and the number of customers also improved to 97.8% (95.5% in the same period of the previous fiscal year).



1H	Sales	Number of customers	Spending per customer
Previous period	96.6%	95.5%	100.1%
Current period	**99.0%**	**97.8%**	**101.2%**

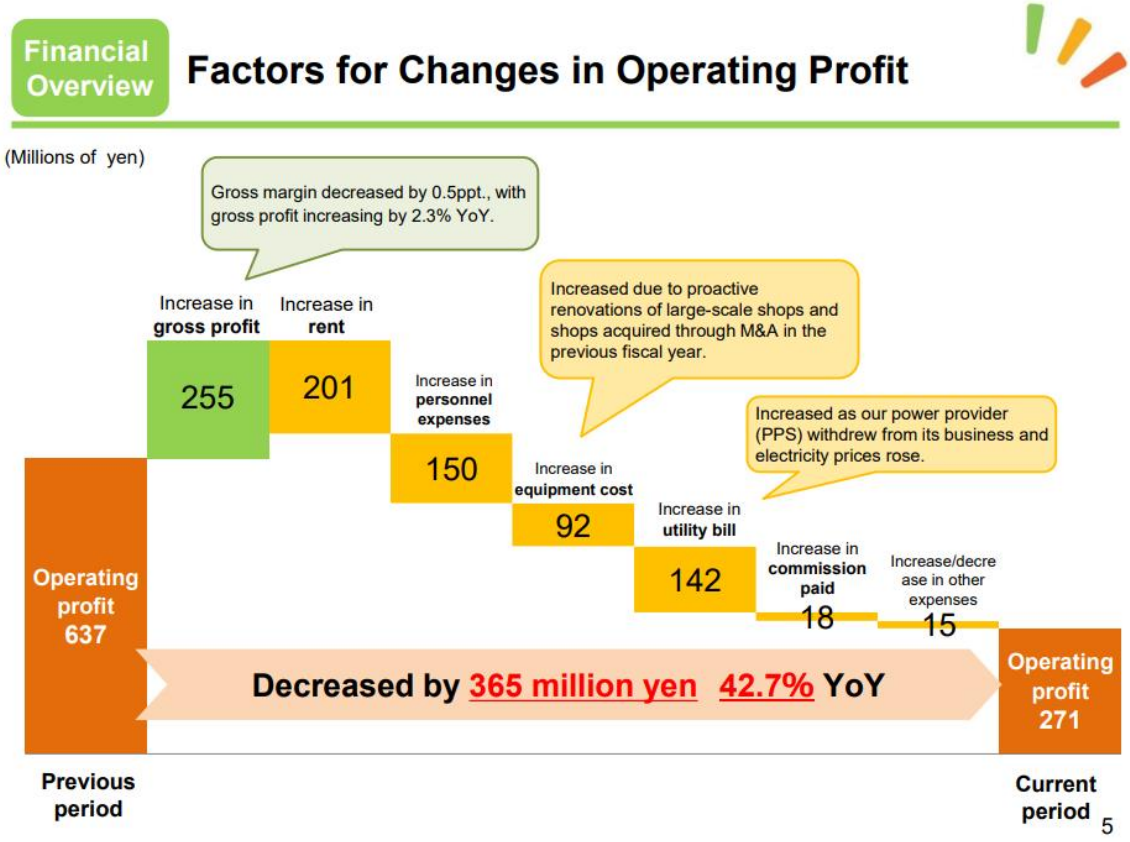
✓ Same-store sales was 99.0% YoY, despite our efforts to improve customers' in-store experience with new products and renovation of some existing shops.
✓ On the other hand, sales of Watts brand shops were 100.7% YoY.

(Source: The Company's results briefing material)

<Overview of the 100-Yen shop Business (2) -Implementing various cost control measures>

- The gross margin was 37.8% for 1H, down 0.5ppt. YoY. The major factors behind this were the rapid depreciation of the yen last year and the steep rise in the procurement costs reflecting the rise in raw material prices. On the other hand, the gross margin on the quarterly basis showed an improvement, with 37.6% for Q1 alone and 38.0% for Q2 alone (the same figure as in the same period of the previous fiscal year). The decline in the gross margin was partly attributable to the fact that the proportion of low-margin foods was higher at shops of Ontsu F･RETAIL co.,ltd (hereinafter referred to as "OFR"), which became a subsidiary in the previous fiscal year. The Company is taking steps to address these issues by increasing the proportion of non-food products in these shops, and the measures are beginning to show steady results, with sales in these shops growing significantly. The initial assumption was that the increase in such product sales would positively impact profitability. However, the actual rise in costs surpassed expectations, and it was not possible to absorb all of the cost increases. In this regard, if the external environment stabilizes, it can be expected that the effects of the measures will be apparent in the future.

- In SG&A expenses, expenses such as rent, personnel, and utilities rose mainly, and both the amount and the ratio of SG&A expenses to sales increased. The majority of the increase in rents is due to the addition of subsidiary shops and new shops, with very little increase in existing shops. Personnel expenses were mainly due to wage increases associated with the rise in minimum wages. Both rent and personnel expenses rose within expectations, but utilities costs, mainly in electricity costs, rose more than expected.
- In response to a sudden rise in various costs, the Company is working to improve the cost-of-sales ratio through the following measures: 1) launching new products that can secure profits even at the current exchange rate, 2) promoting the introduction of higher-priced products, and 3) reviewing the selling prices of 100-yen product groups for which it is no longer able to secure profits. As noted above, profitability is gradually improving, partly due to the effects of measures at subsidiary shops, which account for a large proportion of food products. However, as of 1H, it was not enough to cover all cost-increases, while gross profit improved in Q2 alone. In the future, if the April-May exchange rate levels continue, the effects of cost control measures may gradually become visible for 2H of the year.



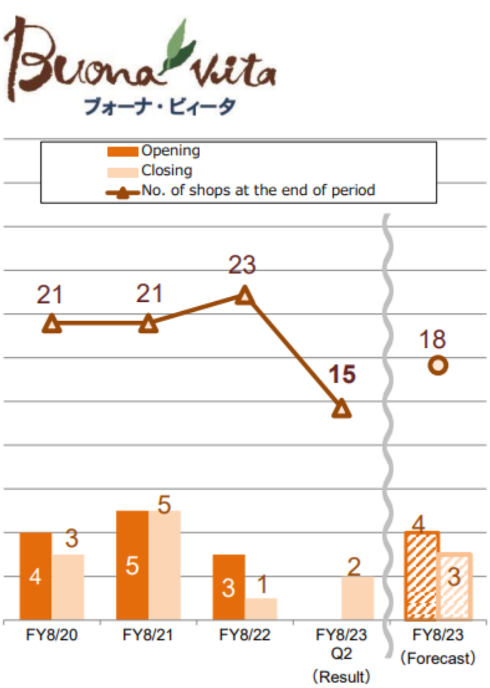
(Source: The Company's results briefing material)

<Other Domestic Lifestyle Product Business: Opening of shops in collaboration with 100-Yen shops>

- In the lifestyle product shop Buona Vita, same-store sales were robust at 110.4% YoY, and the number of customers is also returning to the pre-COVID level. There were no new shop openings as of 1H. The number of shops was 15. At first glance, this appears to be a large decline, with 8 shops decreasing from 23 at the end of August 2022, but only 2 of these shops were actually closed. This was because part of this business was integrated into the 100-Yen shop operating subsidiary, and the 6 shops (consignment-type shops in the Company's 100-Yen shops) were excluded from the shop count. Buona Vita will continue to promote shop openings and sales strategies in collaboration with 100-Yen shops.
- Tokino:ne, a new type of household goods shop launched in March 2021 in Kobe City, has a unique business model. The layout is divided into zones for morning, noon, evening, and night, offering a collection of products necessary for each time zone. In March 2022, the Company opened the second shop in Aeon Kaihin Makuhari. The number of shops remained unchanged at 2 as of 1H. Tokino:ne also started selling its items at the Company's 100-Yen shops, and 200 of its 100-Yen shops already have the Tokino:ne item section.
- As for the discount shop Real, they are being asked to increase prices by their suppliers, like the 100-Yen shops. However, unlike 100-Yen shops, Real is able to control selling prices more easily, so they are able to pass on a certain level of price increases and maintain a sales growth while securing gross margins. The number of shops was 5 as of the end of February 2023.
- As for the online shops, the Company is searching for an optimal form of operation. With a fixed selling price of 100 yen, the shipping costs tended to be inevitably high for customers. In response, the Company has taken the following several measures to enhance its operations: 1) lowering the free shipping threshold with in-store pick-up service, 2) implementing centralized management of online product inventory, utilizing the same warehouse utilized by physical shops, and 3) introducing higher-priced products above 100 yen, such as Buona Vita and Tokino:ne items.

<Overseas Business: Break-even sales even under the continued harsh environment>

- In the overseas business, due in part to sudden fluctuations in exchange rates, sales remained stagnant at 647 million yen, down 0.5% YoY. Although the impact of COVID-19 has subsided, the business environment in Peru remains challenging due to political instability. For the time being, the Company will work to improve profitability by, for example, liquidating shops in Thailand, where there are still unprofitable shops. In addition, it intends to maintain profitability for the full year by focusing on the relatively low-risk wholesale business.



(Source: The Company's results briefing materials)

"Tokino:ne" Aeon Kaihin Makuhari Shop

December 2020 San Felipe Shop (Peru)

Close-up: Develop a new shop model unique to the multi-brand company
Large-scale shop openings through the collaboration of multiple businesses

- In addition to its mainstay 100-Yen shops, the Company also operates general merchandise shops such as the lifestyle product shop Buona Vita and the household goods shop Tokino:ne. Leveraging its multi-brand operation, it is working to develop a collaborative shop model; it is based on the existing 100-Yen shop but combines sections of other general merchandise shop brands. In such collaborative shops, it is possible to sell products in the price range above 100 yen on the same floor, so it is expected that the unit price and gross profit will be improved. In addition, this kind of "100 yen shop + α" format makes it more attractive as a tenant to owners of shopping malls, etc. than other competitors, and gives it an advantage in seeking new locations. In terms of size, it is possible to open ultra-large shops with 300-1,000 tsubo, which other competitors would not open because they would not be profitable enough for a 100-Yen shop alone, and this can lead to differentiation.
- As a realization of this model, the Company opened a large shop with 650 tsubo in Mita City, Hyogo last year (picture below). This shop combines the Buona Vita and Tokino:ne sections in a 100-Yen shop. By combining the 3 formats, it became possible to open large-scale shops that would be difficult to realize with only a 100-Yen shop alone. This format is well-received from customers. It is assumed that after the Company steadily introduced products priced above 100 yen, consumers began to get used to the mix of higher-priced products at 100-Yen shops, and it was possible to open this kind of collaborative shops.
- It will be necessary to closely monitor whether the expansion of this model can be achieved while ensuring profitability. However, if it can be successfully established as a shop model, it is expected to thrive as a unique differentiating factor that competitors cannot replicate. Initially, the Company's strength lay in its ability to achieve profitability through a consignment-type shop model, wherein it operated small 100-Yen shops as tenants in supermarkets and similar locations. However, due to the limited shop size, this model had a restricted impact on overall profits. If this large-scale shop model can be established, the smallest-sized shops would operate under a consignment model, while the largest-sized shops would operate under the collaborative shop model. This would create an opportunity to expand the target areas where other companies find it difficult to enter, leading to a distinct shop expansion strategy different from other companies. It is worth keeping an eye on future developments.

Photos provided by the Company.
The Buona Vita sign can be seen on the right side of the overall shop photo on the left. The Tokino:ne section can be seen behind.
Each shop is as shown in the picture on the right.

<Full-year Business Forecasts/Shareholder Returns>

FY8/23 full-year forecasts

- The Company forecasts sales of 60,500 million yen (+3.7% YoY), operating profit of 920 million yen (-7.9% YoY), recurring profit of 850 million yen (-26.0% YoY), and net income of 530 million yen (-32.2% YoY), expecting increases sales and decreases in profits. In a tough external environment, it seems that the Company has no choice but to make a conservative outlook. Although the Company had initially expected the external environment to be difficult, higher-than-expected utility costs, particularly electricity costs, put pressure on profits, forcing it to revise the Q2 forecasts.
- As of Q2, progress against full-year forecasts was 48.8% for sales, 29.6% for operating profit and 55.2% for net income attributable to owners of parent, facing a challenging situation. Despite the visible impact of cost control measures implemented by the Company in Q2, the full-year forecasts remain unchanged, reflecting the need for prudence in a still uncertain external environment.

Dividend policy

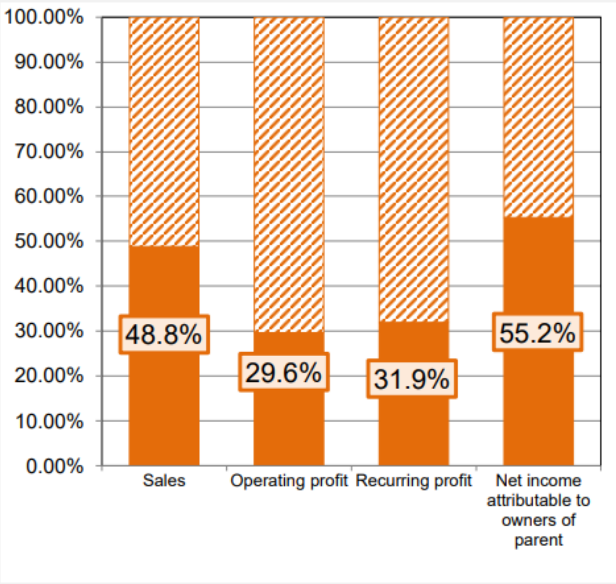
- The Company's basic policy is to pay a stable dividend. The Company says "We consider 20-30% of payout ratio."

  In FY8/21, the Company raised its dividend by 7 yen to 22 yen per share from the initial forecast of 15 yen per share, in line with the revision of its business forecasts during the period (increase in profits), resulting in a payout ratio of 30.5%. For FY8/22, the Company paid a dividend of 15 yen per share, the same as in the previous year and as the initial forecast, with thw payout ratio of 25.9%.
  Dividend for FY8/23 is forecast to be 15 yen per share, the same as in the previous fiscal year, with the payout ratio of 38.4%. The dividend yield at the closing price of 701 yen on April 28, 2023, is 2.14%.

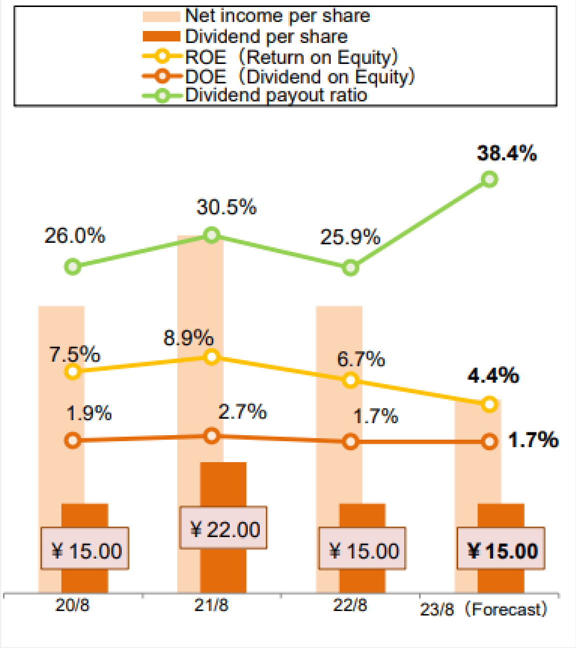
Shareholder Benefit Program

- The Company offers a shareholder benefit program. Shareholders holding 200 or more shares will receive a coupon of 2,200 yen (including tax), which is available at the Company's online shop. The number of items eligible for the benefit program has been greatly improved from the end of August 2022; coupons can now be used for all products listed on the online shop. This benefit program reflects the Company's desire to "make our shareholders online shop users." When estimated at the closing price of 701 yen on April 28, 2023, the benefit yield is about 1.5%. When the above yields on benefits are combined with the dividend yield, the overall yield for a holding of 200 shares or more is 3.64%.

Progress rate of full-year business forecasts as of 1H



Dividend results and forecasts



(Source: The Company's results briefing material)

<Satisfaction of the Continued Listing Criteria for the Prime Market>

Situation regarding efforts to satisfy the Continued Listing Criteria

- At the end of the previous fiscal year (end of August 2022), the Company had not satisfied a criterion (tradeable share market capitalization) under the Prime Market's listing maintenance standards (against the standard of 10.0 billion yen in total market value, the Company's total market value as of the end of August 2022 was 5.27 billion yen). The Company will implement various measures to meet the standard by FY8/24. As one of these, the Company has put forth the Medium-Term Business Plan described below.

Medium-Term Business Plan

- The Company is part way through its Medium-Term Business Plan, with FY8/24 as the final fiscal year. For FY8/24, it has targets of sales of 70.0 billion yen, operating profit of 2.1 billion yen, and net income of 1.1 billion yen. To reach these targets, it has given the following 4 main measures: (1) early completion of PMI of OFR, which became its subsidiary; (2) increasing its openings of consignment-type 100-Yen shops, its forte; (3) improving store profitability by switching to a computer system of self-checkout machines and automated ordering; and (4) differentiation from competitors by using 100-Yen shops collaborating with other brands. By the Company's calculations, if it can reach its goal of a net income of 1.1 billion yen in FY8/24, its total market value will be 27.5 billion yen, which is net income of 1.1 billion yen x a PER of 25 if the PER is set as 25 times earnings, the retail industry's average PER. The Company says that it can exceed the criterion of 10.0 billion yen, as its tradeable shares' total market value will be about 14.2 billion yen if this net income is multiplied by the 51.8% tradable shares ratio of FY8/22. Given that Seria Co. (2782), currently the firm in the 100-yen-shop industry with the highest total market value, had a forward PER of 18 as of April 28, one is left with the impression that setting the PER at 25 is a bit high. Also, achieving a net income of 1.1 billion yen will not be an easy goal to achieve, given that the current situation for cost factors, such as a yen's depreciation, will become harsher. However, even supposing if its PER were set to 20 times earnings from 25, its tradeable share market capitalization would be 11.3 billion yen. If the PER were 20, such a setting may not be impossible to achieve, given that Watt's forward PER as of April 28 was 18.

  Also, regarding the tradable share ratio of 51.8%, the Company is attempting to make improvement through share buybacks made on the assumption of their retirement and negotiations with major shareholders to sell shares. If it can improve total market value together with tradable share ratio, albeit these are technical measures that are somewhat off the point of increasing intrinsic corporate value, it should be all the more to easier to meet the criterion amount. Also recently, the Tokyo Stock Exchange has demanded improvement from firms with a PBR of less than 1. The Company's PBR as of April 28 was less than 1, at 0.79. Whether looking at the Prime Market's continued listing criteria or improvement of PBR, the necessity to start moving on improvements is strong, so we expect the Company to strengthen its IR efforts hereafter.

Status of the 3-year Medium-term Plan

	3-year average (Result)	FY8/24 (Plan)
Sales	¥53.94 billion	¥70.0 billion
EBITDA	¥1.97 billion	¥3.10 billion
Operating profit	¥1.47 billion	¥2.10 billion
Net income	¥0.84 billion	¥1.10 billion
Ratio of 100-Yen shop sales	91.1%	86.8%

(Source: Presentation materials to explain the progress of the plan toward compliance with the listing maintenance standards issued by the Company)

Latest Press Releases

The Company's major press releases disclosed since the Q1 of FY8/23 are as follows.
It held a results briefing for institutional investors on April 14. (Click on the image below to check press releases on the IRSTREET.)

05/09/2023	Notice Regarding April 2023 Monthly YoY Change in Sales and Number of Shops
04/14/2023	Operating Results for the Six Months of the Fiscal Year Ending August 2023 and Progress of the Full-Year Plan
04/10/2023	Summary of Financial Results for the Second Quarter Ended February 28, 2023 [Japan GAAP] (Consolidated)
04/07/2023	Notice Regarding March 2023 Monthly YoY Change in Sales and Number of Shops
04/06/2023	[Delayed] Notice Concerning Revision to Business Forecasts for the First Half
03/07/2023	Notice Regarding February 2023 Monthly YoY Change in Sales and Number of Shops
02/08/2023	Notice Regarding January 2023 Monthly YoY Change in Sales and Number of Shops
01/23/2023	[IR STREET REPORT]: Sales were in line with the plan, driven by the strong new shop openings. Profit decreased due to a decline in the gross margin caused by a steep rise in the cost of purchases, a rise in the proportion of food sales and overseas wholesale sales, and an increase in SG&A expenses as planned. Initiatives for key measures are generally promoted as planned.
01/13/2023	Summary of Financial Results for the First Quarter Ended November 30, 2022 [Japan GAAP] (Consolidated)

◆ IR information page of the Company

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