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Olympus Corporation

3Q FY2025 Earnings Conference Q&A (Summary)

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For your reference, please find an English translation of the question and answer session at the conference for financial results for the third quarter of the fiscal year ending March 31, 2025 below.
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Q&A (Summary)

Q: I would like to ask about your current earnings power. After this downward revision, the adjusted operating margin for this fiscal year is expected to be 17.5%, which is short of the target of about 20% in the medium-term company strategy announced in 2023. While I expect that the organizational structure change will accelerate growth and improve efficiency, what level of margin do you aim for the next fiscal year, which is the final year of the medium-term plan? Also, please tell us how you plan to increase profitability beyond that point.

A: Unfortunately, this fiscal year is expected to end with an adjusted operating margin of below 20%, but we have not changed our adjusted operating margin target since we announced it in 2019. Various issues have arisen over the past few years, but we see this as a time to transition to a global medtech company. Project Elevate is not just an effort for compliance, but also an effort to strengthen our foundation as a global medtech company. In addition to speeding up time for getting approvals for new products, we will raise safety levels in many aspects and make it sustainable in the long term. Currently, we have to invest lots of areas, but we believe profits will follow in the future. Since the next year's guidance is currently being formulated, it is difficult to indicate a specific profit level, but we would like to get as close as possible to the target of an adjusted operating margin of about 20%. In the meantime, we need to take into account the uncertainties that currently lie. When will various investments take effect? Will the Chinese business really recover? We believe that these may have a significant impact on our profitability in the next fiscal year.

Q: Is there any room to further increase the margin after the next fiscal year?

A: The long-term baseline is an adjusted operating margin of >20%, but we hope to improve it gradually in the future.

Q: I have a question about expenses. Regarding R&D expenses in 3Q, there appears to be a large increase in ESD. Since the capitalization of R&D expenses does not appear to have changed, I believe that R&D expenses recorded in the P/L (as SG&A) increased. Also, in the full-year forecasts, since the capitalization of R&D expenses decreased, I believe that the SG&A part increased. What is the background?

A: The increase in R&D expenses is due mainly to the development for the next-generation GI endoscope system and our digital business. The timing of capitalization of R&D expenses is the decision making timing at the product planning meeting for product commercialization, so capitalization is still far in the future.

Q: Is that also the reason for increasing R&D expenses on the full-year forecast basis?

A: Exactly.

Q: The cost for Project Elevate was previously projected at 31.7 billion yen for the full year. How was that changed this time?

A: Originally, Project Elevate's costs for this fiscal year were estimated at 31.7 billion yen, but as a result of efficiency improvements, it is now estimated at 30.5 billion yen for the full year, of which 12.2 billion yen will be for SG&A expenses and 18.3 billion yen will be for Other expenses.

Q: I would like to ask about the trend in gross margin. While revenue has progressed steadily from 2Q to 3Q, gross margin had declined significantly. What is the reason for this? Were there any special factors? Or was it due to a change in regional sales mix on the backdrop of the struggles in China?

A: Although our efforts to reduce manufacturing costs are progressing smoothly, the decline in sales in China had an impact. China is a high-margin market, and the impact of the product mix was the biggest factor. In addition, the elimination of unrealized gains due to exchange rates has caused misleading results. In 2Q, the elimination of unrealized gains had a large impact due to the movements in exchange rates compared to 2Q of the previous year, lowering COGS and increasing gross profit. This was leveled off in 3Q.

Q: Is it correct to understand that due to the leveling out, the impact of the elimination of unrealized gains in 3Q was not particularly large?

A: You understand correctly.

Q: Regarding the business in China, what are your assumptions for 4Q and the future? Given the anti-corruption campaign, VBP (Volume Based Procurement), and intensifying competition in the local market, what is your current outlook?

A: It has been about two years since the major impact in China began. We did not expect such a situation to continue. With the Chinese government's promotions for capital renewal (Trade-In program), we hoped for a recovery in the second half of this fiscal year, but this is not the current situation. It is very difficult to predict the future. From a long-term perspective, there are a lot of unmet needs and actual demand, so we hope that local production, which is scheduled to start by the end of the next fiscal year, will be a catalyst for recovery. It is difficult to give specific figures or growth rates. Regarding ESD, looking at the tender data in China for December and January, there is a recovery, but it is not enough to make up for the large slump this fiscal year. Due to the large unmet needs, we are making mid- to long-term infrastructure investments and are accelerating investments for the training centers and toward the start of local production. Once regulatory approval for local production in China is granted, we will be able to produce major GI endoscope products locally by the end of the next fiscal year. We will also make improvements for timing of the new product launch and corporate structure to ensure that we can maintain sales on a sustainable basis. At present, sales in China for this fiscal year are expected to fall by around 15% to 20% compared to the previous fiscal year, but we intend to continue investing from a medium- to long-term perspective.

Q: Could you elaborate on the reasons for ESD's profit decline in 3Q?

A: The biggest factor is the decline in sales in China. China is the highest margin region for ESD, so the decline in sales there led to a decline in profit margins. Furthermore, sales also declined in other major countries, such as the U.K., South Korea, and Australia, and the decline in these regions also had an impact. In addition, the decline in sales in Russia has had an impact in recent months. Most recently, export restrictions on GI endoscopy products from Germany were lifted, making it possible to export from Europe to Russia, but this was a bit too late for us to see a recovery for this fiscal year. Moreover, as the business performance in China has been worse than initially expected, we have been working to reduce costs since September. For example, we have frozen hiring and imposed restrictions on business trips. But from a medium- to long-term perspective, we are trying to accelerate R&D for next generation GI endoscopy system and local production in China.

Q: In ESD, full-year revenue and operating profit have been revised down by 11 billion yen and 24.5 billion yen, respectively. You have mentioned about China and R&D. To what extent has each factor affected the figures? I would appreciate it if you could explain by sales region or by expense.

A: The main reason for the downward revision is GI. The largest factor was China, where profit margins are the highest. So lower sales there lead to a decline in profit margins. Originally, a slight decrease in sales was expected for China for the full year, but we now expect its full-year sales to fall 15% to 20%, leading to a worsening COGS ratio due to a change in sales and product mix. In addition, we originally expected sales in Japan, Europe, and APAC to increase, but we now see these regions flat. Similar to China, these regions have high margins for ESD, so lowering the outlook for these regions is also a factor behind the downward revisions in profits.

Q: I have a question about the Chinese market. I understood that China had a large impact on margins. Is there a risk that sales will not come back until local production begins? Also, I think in China Olympus sells at premium prices relative to competitors, despite that Chinese hospitals are not being able to obtain budgets. If the economic downturn in China is prolonged, will the price premium be acceptable?

A: EVIS X1 has been very well received in China and North America. We believe that we can supply EVIS X1 from China once local production begins. It is still successful in China third-class (top tier) hospitals. Therefore, we do not plan to reassess the price of EVIS X1 at this time. For second class and lower hospitals, there are two major challenges. One is that our Japanese competitor is offering products at low prices. The other is that local Chinese competitors are being given a boost by the Buy China policy. We are working with our China team for future recovery. We think that the recovery will be a gradual U-shape rather than a V-shape. TSD includes both capital business and consumables business. We are seeing the same trend as ESD for the capital (budget purchase type) business. In the capital business in China, the bronchoscope business accounts for a relatively large weight. We believe that we can maintain our premium position because we hold a strong position in the lung cancer staging diagnosis using ultrasound scopes. On the other hand, consumables are being affected by VBP. This is a program by the Chinese government to hold down the price of consumables in order to promote healthcare cost containment, and therefore we think that commodity products will be affected. Having said that, we believe some products, such as ERCP products, provide unique solutions, and we can maintain relatively high prices in such areas.

Q: If you continue to be in a position where you do not need to lower prices, can we assume that your profitability will not decline from the current level? For example, even if we assume that sales in China do not recover in the first half of the next fiscal year, can you maintain your current profitability? Is there a risk that it will fall further?

A: For TSD, we believe that it can maintain profitability as long as overall sales do not decline. However, especially for capital products, we think that the situation will remain tough. Although the trade-in program is ongoing, it is unclear how much recovery will occur. ESD is in a similar situation. We think that the recovery will continue, not just over the past two months, and we expect growth in China. There have been some difficult periods up until now, but we believe that we can recover from this, and that profitability will also improve as sales grow.

Q: TSD's sales in China on a local currency basis have been declining for a long time. Is this due to the impact of VBP? Also, I would like to know if it is affecting the capital business You mentioned bronchoscopes, but the respiratory sales are not that large within TSD, so I am curious on what is causing the negative impact.

A: The biggest factor is the impact to the GI-Endotherapy business. VBP is being implemented sooner than expected, and this is having the biggest impact.

Q: When do you think the impact of VBP will dissipate? When could you expect a recovery?

A: We think there will continue to be an impact. However, as the number of patients in China is very high, once the decline bottoms out, we can expect a recovery.

Q: I assume that local production in China is mainly for ESD. Are you considering local production for TSD, as well? I would also like to know when production will start and what products are to be produced.

A: We are considering local production for TSD, too. ESD production will start first, after that we will consider local production of TSD's capital products. At present, we have no plan to produce consumables locally, and consumable products will continue to be supplied from Japan and other countries.

Q: I would like to ask about China. ESD's sales in North America were about 54.5 billion yen in 3Q of FY2024, while those in China were about 18.7 billion yen, a threefold difference. In 3Q of this fiscal year, ESD in North America grew 17% on a local currency basis, which is very good, while China fell 18%. Why does almost all profit disappear just because a region representing one-third of sales declined? China was doing poorly in the first half of this year, but you told us that this would be made up for by strong sales in North America. As expected, North America did well, but what was misjudged in the first half? Is something unusual happening?

A: At the time of the first half, we explained that we were not optimistic about the outlook for the full year. Our assumption at the time was that China would recover from -20% for the previous year to flat or a slight decline for this year. We also expected other major countries such as the U.K. and South Korea to recover in the second half. We had left our outlook for the full year unchanged in anticipation of these recoveries. However, looking through December, the situation in China had not recovered at all, and the situation in the U.K., South Korea, Russia, etc. remained the same. In other words, this downward revision is not due to a sudden worsening of the situation, but rather the disappearance of the expected recovery.

Q: Regarding the 18% decrease in ESD sales in China, given that the sales weighting of the surgical endoscope business in China is small and sales of medical services were almost unchanged, is it correct to consider this as a decrease in sales of GI endoscopes?

A: By segment, the main factor was a decrease in sales of GI endoscopes.

Q: I think the U.K.'s NHS budget will increase next year. Do you expect the U.K. to improve next year?

A: That's the way we see it.

Q: Can you tell us about the organizational structure change? I understand that you will separate the business divisions into GI and other areas. Can you talk more in detail on how you would like to change the existing divisions by this reorganization, using examples of products.

A: The changes are to transfer surgical products from the current ESD to the Surgical & Interventional Solutions Division (SIS), and to transfer GI Endotherapy products from the current TSD to the Gastrointestinal Solutions Division (GIS). As a result, GIS will be responsible for the whole gastrointestinal business, while SIS will be responsible for the rest as a specialized organization for surgical areas.

Q: I would like to know what issues you have been aware of up until now that have led to these organizational changes.

A: ESD and TSD are divided into capital business and consumables business. They were grouped based on our situation, which resulted in a complex structure from management to customers. This time, we changed the classification to what is normal as a global medtech company. Many global medtech companies organize their internal organizational structures according to their customer base. We believe that this will allow us to provide better solutions to our customers in the future, particularly as we move forward with OLYSENSE. Just to add a comment, every time we considered our strategy, there was always a discussion about whether it would be better to have a customer-centric organization. Traditionally, we have had an organization with a product-based and strong manufacturing-oriented perspective. This time, we decided to introduce a patient- and customer-centric organization, which is the first time in our medical business.

Q: I don't assume that this initiative will have any impact on the Project Elevate's costs from the next fiscal year onwards. But three months ago, you explained that the Elevate's costs would be higher than initially expected, so if there is anything you can say at this point about the Elevate's costs and SG&A expenses for the next fiscal year onwards, please provide us with any additional information.

A: Since the plan for the next fiscal year is currently being formulated, it is difficult to give a specific guidance. In the previous explanation, I said that the total Elevate costs would not be less than 70 billion yen over the three years, and that premise has not changed. Although I cannot give you detailed figures, I think the next year's cost will surely be lower than the amount for this fiscal year. We are currently discussing how far we can promote efficiency and reduce the cost. I think everyone has recognized Project Elevate as a compliance project, and there has been a tendency to emphasize only the monetary amount of the cost. Elevate is not just for compliance purposes but is a major initiative to change the very nature of our company, so it is not a matter of the monetary amount. Although the specific timing of the FDA reinspection is not known, the activities themselves are progressing very smoothly. It is an initiative that must be successfully completed for our future and will surely lead to future profits. We will continue our activities with a strong awareness of this in mind.

(End)