Financial Results for the Third Quarter of Fiscal 2021

Summary of Questions and Answers

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Speakers:

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[Overseas Business]

Q: Is DI's creative businesses expected to recover in the fourth quarter or next year?

A: Organic growth in the creative business in Q3 was +7.3%, showing a recovery. In the first half of the year, the events business was sluggish, and MKTG, which was obviously significantly impacted last year, but is showing signs of recovering. Virtual events were held, and progress was made in both real and virtual events, leading to the results for the third quarter. In particular, the Americas and EMEA are growing at double-digit rates, and we see this outcome very positively. We are seeing client's confidence now back. This trend was noticeably apparent in the media business, and behind that, a similar trend has been observed in creative as well. Also, it should be worth noting that Fred Levron started as a new Global Chief Creative Officer on November 1st. He now is on board, very rapidly integrating into our business with our people and with our clients already having client meetings and engagement. So, we feel very positively about where creative is heading from here starting with this performance in Q3.

Q: Comparing International's organic growth rate with peers, it seems that Americas is currently winning, but in Asia or in Europe, it seems somewhat behind. Is this due to client reasons? Or is it because of Merkle capability? And because of Merkle capability strength in the United States, is that why growth is higher in Americas? If the latter is the case, then can these capabilities be deployed in Europe and Asia more effectively? Are there specific measures you have in mind to achieve this?

A: We had a very strong performance in the Americas with growth across all service lines. Merkle is, of course, robust, but the media is also growing. Creativity is also growing, and the win rate is rising. We've seen wins and expansion with Walgreens, J&J and Altria with CXM. We've seen wins on Hilton, Cracker Barrel and Cox on Media. And in Creative, we've seen wins and expansions with existing clients, such as American Express, 7-Eleven, Mondelez and GM. In Asia, China has been weak, and some projects have been delayed or cancelled. In particular, that has impacted the performance our automotive sector which we have high exposure. By service line, media and CXM are performing well, and creativity is in a challenge. We also have limited exposure to local clients in China which we are also focusing on. I would like to comment that we have now seen a standout performance from Australia. After many quarters of challenged performance, we are now seeing Australia restores performance, showing 20% growth in the quarter. We feel strongly that that market is going to continue to contribute to our performance.

[Progress against Transformation Program]

Q:What is the progress and latest status of the transformation program in Q3? Also, as a short-term outlook, will this transformation accelerate further?

A: I think our program is ambitious, we continue to make really good progress on our transformation. We are deduplicating the business, simplifying the business, making it easier for clients to navigate our services, and for us to drive growth in the medium to long term. We are also centralizing our back-office functions. We have made good progress, aligning all of our businesses onto the same common systems and platforms, pursuing an offshoring office to drive efficiency, but also competitiveness when we are pitching for the new business. We are delivering returns in line with our business case, and we are doing this for a lower cost to achieve, which is very positive. As a result of these measures, there was a significant improvement in margins this year, resulting in profit growth of more than 20% compared to 2019. With regard to the outlook for the future, we are still implementing a number of measures, and I think that the medium-term margin outlook will also be extremely strong. Progress is therefore viewed positively. There are still many things to do, but we will undertake that with a continued vigor and rigor.

[Forecast for the fourth quarter]

Q: If I look at your guidance for the full year organic of 12% for the Group and 17% for Japan, you can work out that International is 8% to 9%, about 8.5%. And based on the performance over the first 9 months, it shows about 8.5% in Q4. 8.5% in Q4 is a 3-point slowdown versus Q3 if you look at the 2-year basis, which is kind of similar guidance to Publicis, Omnicom and WPP. Are you actually seeing a slowdown? Or are you just being conservative because you want to account for potential supply chain disruption or budget adjustment in December?

A: In Q4, we have prepared the plan based on what we are seeing from clients. I would like to emphasize that clients have a mindset for growth toward the fourth quarter, and talking with top clients, we hear continued mindset of seeking incremental growth. Our guidance is maintained. You see us coming in 8.6% right now, and we will be holding this for the remainder of the year. So, there is no conservatism in this. It is more of a reflection of our plans and understanding with our clients.

Q:Based on the full-year forecast, in Q4 it appears that you are planning a very large 23% year-on-year increase in cost recorded in the accounts between revenue less cost of sales and underlying operating profit. For international, you have been focusing on cost actions toward the end of last year, so I can understand that it will increase to some extent, but it seems that the cost will also increase substantially in Japan. How do you plan to spend the money? And how will that be reflected in the growth from next year and onwards.

A: The third quarter in a positive way was an exceptional quarter. Revenue less cost of sales increased substantially, and cost in comparison to last year did not grow as much. In February, when we announced the MTMP, we made a very strong commitment to margin, and we put in place a very stringent control of costs. Therefore, even though there were investment requirements these were not made in Q3 and investment is now needed , particularly in hiring new talent. As for operating expenses, we announced the consolidation of Septeni and we are preparing for the integration of group companies in Japan, and there will be expenses for the reorganization. I am not able to show a breakdown, but investment into talent and technology or IT accounts for the majority. We are committed to CT&T transformation in our MTMP. And this investment in CT&T is necessary. In any event, we will make sure that there will be appropriate growth in the top line and ensure a margin that is satisfactory to our stakeholders and we will dynamically use costs flexibly.

Margins were very strong in the third quarter and improved significantly in the nine-month results as well. This is the result of the transformation and the cost initiatives implemented last year by all employees' contribution. As a result, we raised our full-year guidance and set the margin at 18%. However, we must recognize here that the impact of timing and phasing will have a significant impact on Q4 results in that we must continuously invest in the business. Talent costs such as incentive bonuses which were not recorded last year, IT investment, and restructuring costs, have impacted results in the fourth quarter more significantly, and we believe we also need to invest in automation. We also need to invest in overseas offshore and near-shore locations, which will reduce the cost of providing services over the long term and lead to investments that will ensure competitiveness and sustainable growth. Given the need to balance investment in growth with sustained margin improvement over the long term, we believe margin improvement can be strongly improved over the medium term, although margin improvement will slow temporarily in 2022.

[Outlook for Fiscal 2022]

Q: I think this year's organic growth is higher than usual because of the recovery. Shall it return to normal levels next year and achieve an organic growth rate of 3% to 4% on a consolidated basis? Or is there any factor for the growth rate expected to be different than normal in 2022?

A: We expect to achieve very high growth rates this year, thanks to the success of our business recovery from 2020. Within the goal of achieving a 3% to 4% CAGR during the term of the medium-term management plan, the hurdles in the first year will be high, but we expect it to grow from next year onwards. Guidance for 2022 and subsequent years will be provided when we report our full-year results in February of next year.

Q: Looking at the extremely high domestic organic growth rate in the third quarter, I think the effect of the Tokyo Olympic Games was a certain degree. In establishing the outlook for the next fiscal year, I would like to know whether the impact of the Tokyo Olympic Games will affect growth as a reaction.

A: In the third quarter of Japan's business, the advertising industry as a whole believes it has recovered significantly from the COVID-19 crisis. Advertising companies such as ours, followed by television and other mass media, internet media, and other companies made a significant recovery in performance. In addition to the great demand for advertising by our clients in anticipation of recovery from the COVID-19 disaster, as you pointed out, I believe that the content of the Olympic and Paralympic Games has helped to utilize the mass media and the Internet media. Looking only at the third quarter, since we achieved an extremely high growth rate in the current fiscal year, I think that growth in the third quarter may be negative. However, for the full year of next year, we expect growth based on the level that recovered from COVID-19 in this fiscal year.

[Margin]

Q: Japan's margins this year are much higher than in the past few years. Is this a sustainable level?

A: Margin in the third quarter was very high, which allowed us to provide guidance for the full year of 18%. The recovery of the industry as a whole in the third quarter is expected to be the starting point for 2022. From now on, I think it will be the stage where we can expand our top line by pushing forward with structural reforms and business reforms. Accordingly, we certainly hope that this margin level will be sustainable throughout the year, although it has been helped by the results in the third quarter. Out medium-term management plan also commits to continuously the improve margin. However, I think the pace of this improvement will be slower vs this year.

Q: There is a large difference between International margins and Japan's margins, but will this difference narrow in the medium term?

A: Whereas the Japanese market is one country, the overseas market is a bundle of more than 140 countries. And the content of the business structure will change dramatically in the coming future. It is difficult to compare margins at home and abroad with Apple to Apple. It is difficult to comment on whether domestic and foreign margins will be margined because the two are completely different business structures and it is difficult to compare operating margins.

[Medium-to long-term outlook]

Q: In order to maintain medium-to long-term organic growth, I think it will be important to grow customer transformation and technology (hereinafter referred to as "CT&T"). To what extent will the expansion of this area continue to boost the organic growth of the entire consolidation?

A: Now that the group as a whole has embarked on business transformation, we have acquire LiveArea in Dentsu International and in Japan we are expanding the BX, CX, and DX businesses. It is hard to explain in a single way how CT&T's expansion affects margins and profits. Business transformation proceeds step by step, and the rate at which the benefits are generated also changes. Various costs must also be incurred to achieve transformation. In the medium-term management plan announced in February this year, we committed to gradually improve its operating margin, but I would like to secure an appropriate operating margin while watching business growth.

I would like to comment additionally on the performance of Merkle that are highly related to CT&T. Merkle achieved double-digit growth in Q3, exceeding 2019 results, partly due to the small impact of the COVID-19 crisis. Merkle's pipeline is very strong, with a win rate of 60%. We also see that investing is leading to growth, with Commerce Experience growing more than 20 percent, BtoB growing more than 30 percent, and analytics growing more than 20 percent. In light of these facts, I think you will understand our position in CT&T, but I would like to invest here in the fastest growing area of CT&T within the industry, grow further, and consolidate our foothold in the future.

[Capital Allocation]

Q: The sale of the Shiodome headquarters building will be completed, and cash will be received. I think that this cash will be allocated to investments in growth businesses, shareholder returns, and internal reserves. What is the idea of how to allocate this cash?

A: As a result of the comprehensive review of the business, we sold off non-business assets and is accumulating cash on hand following the recovery of the business. Use of funds needs to be discussed in combination with growth investment and shareholder returns. First of all, we are in a situation where we have to make structural reforms, business reforms, and then make medium-to long-term growth investments, and I think this is the most important thing. In the medium-term plan, we announced our direction of management, but plan to update the medium-term plan next year, including a specific policy on growth investment. At that time, I would also like to explain our policy on additional shareholder returns.

[Investment for Growth]

Q: Please tell us about priorities and areas of investment when investing in growth businesses. For example, are there markets that need to be prioritized when comparing overseas and domestic markets? When investing in the digital domain, does it need to invest to increase headcount or to enhance data solutions? I would like you to tell me what kind of parts you intend to obtain.

A: Business investment is not prioritized in the categories of domestic and overseas. Japan is of course an important market for the group, and North America is a very important market overseas. After clarifying the markets that should be prioritized for the group as a whole, we have adopted an idea of prioritizing investment in each market. In our medium-term management plan, we aim to transform our business to account for 50% of total revenue less cost of sales in the CT&T domain, or data and technology-based businesses. We intend to invest in priority markets toward this goal.

In the domestic business, CT&T is defined as the BX, CX, and DX areas. Among them, the CX domain, Customer Relation Experience domain, is a key focus area. In particular, the digital promotional and commerce fields are critical areas. In its domestic business, we are focusing on two areas: how to increase capabilities in this area, and how to secure human resources in the DX area.

It is good that the flexibility of the balance sheet is secured, and the pipeline has become very active. The resumption of M&A and the acquisition of LiveArea was a very good progress, positively impacting not only the CXM area, but the entire business. CXM is considering the digital transformation and e-commerce areas, where long-term and structural growth is expected, as M&A to augment CT&T's capabilities. We will also invest in areas related to alliance partners, such as Salesforce, Adobe, Google, which are key technology alliance partners, with the aim of growth over the medium to long term.

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