October 10, 2019

Shiseido Co., Ltd.

Q&A at the Conference Call for Analysts and Institutional Investors Concerning the Acquisition of Drunk Elephant Holdings, LLC (Summary)

Attending: Masahiko Uotani, President and CEO
Michael Coombs, Corporate Officer, CFO

Q） The acquisition price appears quite high. When will ROIC exceed capital costs? What effect do you expect *Drunk Elephant*'s leveraging of Shiseido's platform to have on its future sales growth?

A） We used various valuation methods to verify the acquisition price ahead of acquisition. We also made comparisons with other transactions as well as our own DCF calculations. We are satisfied with the price that was ultimately agreed upon and IRR is in the mid 10% range. We always aim for ROIC exceeding our WACC estimate and this case is no different. We believe that *Drunk Elephant* can maintain high growth in the future, and the brand still has growth potential, especially in the Americas market. Given the prospects for full-scale expansion in the European market as well, we are confident of sufficient returns on our investment. We prefer not to overestimate synergies in areas such as procurement and the supply chain, and we will consider a plan for them assuming these are additional effects in the future. The management team in the Americas business is also committed to the targets. *Drunk Elephant* already has a double-digit EBITDA margin and we believe that it can further increase profitability through initiatives with us.

Q） Surely it would be difficult to market *Drunk Elephant* in China due to the issue of animal testing. What is your strategy in China?

A） Shiseido committed to stopping animal testing in 2013. *Drunk Elephant* has begun using cross-border e-commerce to sell to Chinese consumers and employs local talent to roll out its products in China. In China, we will maintain the online channel as our main marketing channel and will also consider expanding the brand's presence though sales in physical stores. However, the brand is currently still building a base in China, conducting consumer surveys We will monitor developments in regulatory affairs. We are also considering the possibility of expansion of the brand in our travel retail business.

Q） Will you have to pay a success fee or other fee besides the acquisition price in the future? What impact will these fees have on Shiseido's P&L?

A） There is a retention program in place, but it is of utmost importance in this acquisition to capitalize on *Drunk Elephant*'s unique value. *Drunk Elephant* has around 100 employees, and it is such a creative organization with extremely high levels of employee commitment. I (Uotani) myself have visited the company in Texas to discuss how we can protect and preserve this culture. We will of course integrate operations such as governance, finance, and IT infrastructure, but we do not intend to make any changes in areas such as product development, marketing, and HR and will encourage individuals to show off their abilities more than ever.

Q） How will this acquisition affect Shiseido's P&L?

A） （Before the acquisition）The Americas business posted figures in the red in its report, but has single-digit profit margin on a commercial basis, and next year we are aiming for a double-digit profit margin in that sense. Our profit base in the Americas has improved. *Drunk Elephant*'s EBITDA margin has been historically 20 to 30% and, while amortization of goodwill, etc. is still under examination, based on *Drunk Elephant*'s EBITDA, the acquisition will have a positive impact on Shiseido's P&L. Also, in 2020, amortization of goodwill associated with the acquisition of *Drunk Elephant* will be partially offset by the fact that we will no longer be amortization of customer-related intangible assets associated with the acquisition of *bareMinerals.*

Q） Why did *Drunk Elephant* choose Shiseido? Did the startup feel that there were limitations to continuing alone?

A） One reason is likely satisfaction with the acquisition price. We reached an agreement at a price similar to our initial valuation—it is not that the price went up in the process of agreeing on the final price. Second, I believe that founder, Tiffany Masterson's concerns about a capital takeover of the brand she had carefully nurtured were allayed upon recognition of Shiseido's culture, management style of delegating authority locally, and history and proven track record with brands we have acquired in the past. Third, "clean" brands have a strong connection with sustainability and are motivated by value to society. I explained that Shiseido is a company that has supported cultural activities and that Japanese companies operate on the principle of *sanpo yoshi* (good for three sides: seller, customer and society). Tiffany also commented that she empathized with Shiseido's values in terms of consumer-oriented culture and heritage. Another likely factor is that it would take time for *Drunk Elephant*, as a US startup, to make inroads into Asian markets alone.

Q） The definition of the “clean” market is ambiguous. What is your view of the prospects for the clean market in Japan?

A） From a broad perspective, the lifestyle values of younger generations are changing. In the cosmetics industry, the “clean” market, in which *Drunk Elephant* got its start is growing on the back of this wider trend. *Drunk Elephant* uses highly effective, high quality skincare ingredients, omitting any ingredients that they deem unnecessary or might adversely affect the skin. In Japan, cosmetics are rarely discussed in the context of the clean market. Consumer interest in Japan may be relatively low but we expect it will certainly become a global trend in the future.

Q） What are the grounds for believing that there is room for growth of *Drunk Elephant* in the Americas market? Give details of the room for expansion in terms of stores and SKUs.

A） The penetration rate among consumers is still low and we believe there is potential for expansion both via physical retail and e-commerce routes. Also, *Drunk Elephant* is a skincare brand with a very high repeat rate. We believe the brand can grow more provided it attracts new consumers in the future. We expect effective utilization of this brand value and collaboration with Shiseido to result in the creation of something new. I believe that *Drunk Elephant* and Shiseido can also complement each other in marketing and sales initiatives. Although a sudden increase in the number of physical stores is not necessarily the answer, in my view, the number of stores is by no means high. The fact that the brand has only around 30 SKUs is one of its attractions in terms of repeat rate and profitability, but further expansion is also planned.

＜Comments by President Uotani＞

There are three major differences between this acquisition and the acquisition of *bareMinerals* in 2010.

First, our organization is completely different from our organization at the time of acquisition of *bareMinerals*. We now have a regional headquarters organization and have attracted talented human resources, including senior managements, who have experience working for global companies. Also, in the case of this latest transaction, we had been constantly watching the Americas market and gathering information and, therefore, had studied *Drunk Elephant* with interest for a long time before acquisition. Also, in an acquisition, it is not just the price that is important to the acquired party but also the selection of a partner, and, this time, we have succeeded in building a solid relationship of trust.

The second difference is the process. In recent decision-making, our Japanese headquarters have exercised effective governance, holding extensive internal discussions on aspects such as R&D, management strategy, and brand, and asking the Americas team many questions. It was a process in which the Americas team was responsible for operations in the US while headquarters ensured checks and balances and held discussions and obtained approval at board meetings. Moving forward, PMI will be important and will be undertaken by a team of professionals with experience working in the US. In the acquisition of *bareMinerals,* Shiseido's Japanese headquarters were responsible for decision-making and PMI but there were limitations to what could be done from Japan.

Third, the timing of the acquisition is different from that of *bareMinerals*. *Drunk Elephant* is a relatively young brand and can be expected to grow moving forward, whereas *bareMinerals* was already a large-scale operation at the time of acquisition.