Special Feature 2

Embark on structural reforms with a clear understanding of the issues

The Seven & i Group's superstore and department store operations are pursuing large-scale reforms, including a process of store-oriented selection and concentration and a significant review of the sales area configuration, based on business restructuring hammered out in 2015 to achieve sustainable growth and the Medium-Term Management Plan announced in 2016. In the fiscal year ended February 28, 2017, a more detailed course was plotted under a new management structure, and steps were taken to rebuild the businesses and establish a stronger revenue base. The fiscal year ending February 28, 2018, is the first year of the Group's Medium-Term Management Plan, and a priority will be placed on accelerating structural reforms.

Pinpoint issues through one-on-one meetings with top management

The new structure emphasizes management practices based on the PDCA cycle, and the first priority in formulating plans is to analyze current conditions. The process for obtaining a true picture of what is happening was a series of one-on-one meetings—in a company sense rather than an individual sense—whereby top management at Seven & i Holdings met repeatedly with top management at each operating company.

In the past, solutions to issues were shared among all companies under the holding company umbrella, but the sharing process was insufficient. After the new management structure was introduced, it became clear that this insufficiency required attention. It was time to look squarely at the facts, starting with an analysis of the impact that environments surrounding the Group—macro and consumer—have on sales as well as the status of investment returns to date and the success of the current product mix and marketing activities. As necessary, one-on-one meetings were attended not only by top management from operating companies but also by people responsible for activities in a product division or a planning division integral to the discussion. Seven & i Holdings could ask for opinions and get operating companies to describe operation-specific problems in the search to identify and share issues of concern from many different angles. One-on-one meetings provided a venue for meticulous discussion on approaches fine-tuned for each company to overcome respective challenges.

Through repeated one-on-one meetings, a shared awareness of the struggles faced by Ito-Yokado and Sogo & Seibu emerged. The meetings made it clear that the environment remains inhospitable for the companies to raise profits above the cost of capital through the operation of stores alone. Management also acknowledged that the situation is exacerbated by aging store buildings, which further decrease profits.

At the same time, Seven & i Holdings accepted the fact that its own efforts fell short of the level needed to improve corporate value over the medium to long term. Management saw that it had not provided operating companies the necessary level of support and monitoring that is incumbent upon a holding company and had not adequately achieved optimum allocation of resources. This realization, however, became the catalyst for strengthening corporate governance.

Key points of structural reform

Superstore Operations (Ito-Yokado)

1. Keep on track to close 40 unprofitable stores, in line with the Medium-Term Management Plan
2. Convert from general merchandise store format to *Ario* high-profit shopping center format
3. Review sales floor space and product lineups of directly operated apparel and household goods, fine-tune them to customer needs and work with tenants to create appealing sales areas
4. Implement store renewal through real estate redevelopment that leverages geographical advantages of stores near train stations, and increase the share of food items in the merchandise mix

Department Store Operations (Sogo & Seibu)

1. Promote store creation matched to regional customer needs, including expansion of food sections, while downsizing apparel sections, reflecting continued decline in apparel sales
2. Concentrate management resources into flagship stores, a process highlighted by the recent transfer of some store operations to H2O Retailing Corporation

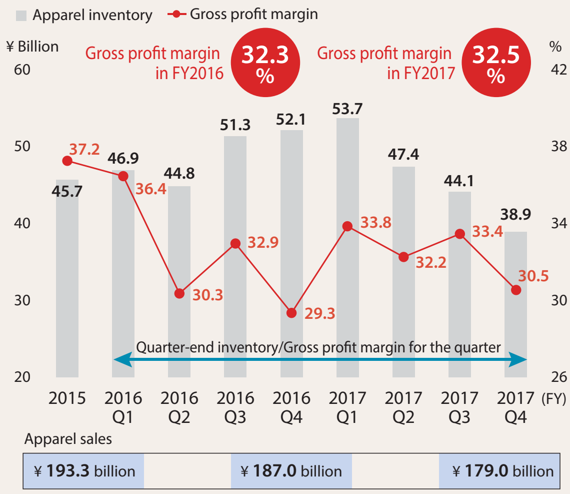
Superstore Operations (Ito-Yokado) Renewal

Shared awareness with operating companies about issues

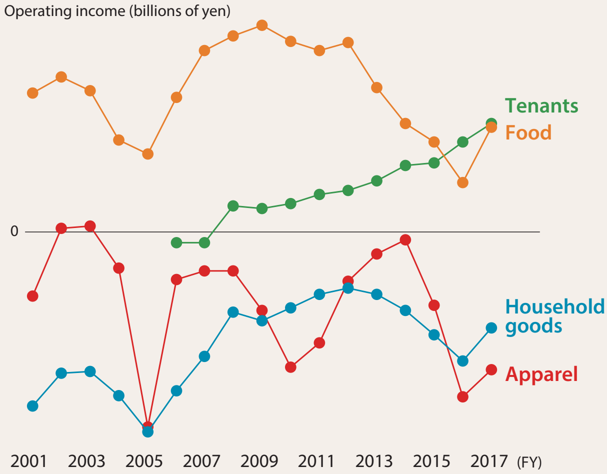
In the fiscal year ended February 29, 2016, Ito-Yokado faced its first loss since the company was established—an operating loss of ¥13.9 billion. Ito-Yokado sorted through underlying factors and identified the following primary issues. First, poor awareness of KPI in conducting business, ballooning advertising and decoration expenses (2.6% to net sales in the fiscal year ended February 29, 2016) and problems with apparel inventory optimization (93 days in inventory, as of February 29, 2016). Second, stores remain in operation even though they are saddled with losses on an operating cash flow basis. Third, a comparison of profit by category shows that apparel and household goods have consistently been in the red for many years and taken for granted as loss-makers. And fourth, a look at sales by store format reveals that general merchandise stores are low on the profitability scale.

At the same time, Ito-Yokado acknowledged positive points, such as high-profit *Ario* shopping centers, numerous geographically well-positioned stores close to train stations in the Tokyo metropolitan area and marketing power fueled by food, a growth category that represents a cornerstone of healthy profits.

Optimized Apparel Inventory Level
Apparel inventory and gross profit margin



Trends in Operating Income by Merchandise Category
(For fiscal years ended February 28, 2001 to February 28, 2017)



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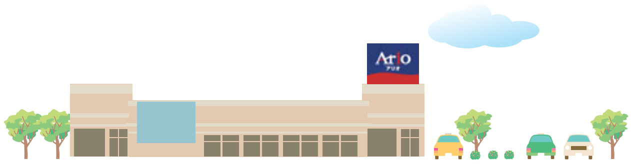


Solution —Store format conversion—

Currently, Ito-Yokado employs three store formats: the *Ario* shopping center format, the general merchandise store format and the food specialty store format.

Management Direction by Store Format

Ario	Downsize directly operated sales floor space for apparel and household goods in line with the expiration of leases, targeting an operating profit margin of 3% by strengthening shopping centers overall.
General merchandise stores	Improve efficiency per area by downsizing floor space for apparel and household goods and increase share for food. Pursue real estate redevelopment utilizing excellent geographical locations of stores.
Food specialty stores	For food, a growth category, conduct operations primarily in the Tokyo metropolitan area.

The existing three store formats will be tweaked so that each generates the best possible operating results. The objective is to break away from standardized chain-store-style store creation.

First off, at *Ario* shopping centers, which are a profit pillar for Ito-Yokado, the mix of directly operated sales floor space, particularly food sections, and tenant space is delivering good results. This format stayed in the black in the fiscal year ended February 29, 2016, even when Ito-Yokado posted losses overall. Going forward, Ito-Yokado will continue to raise the ratio of appealing tenants at its own *Ario* operations to replace directly operated floor space for apparel and household goods, which are low-profit categories. The underlying objective is to improve the ability to draw in customers and contribute to higher overall profitability.

General merchandise stores represent more than 70% of the entire store network. This store format has been plagued by difficult business conditions, mainly due to lackluster performances from the apparel and household goods sections. To realize a more profitable position, Ito-Yokado will downsize these loss-generating sections while, in individual stores, enhancing food sections, focusing on *Seven Premium* private-brand products that distinguish these stores from the competition and product lineups well matched to regional characteristics. As of March 2017, Ito-Yokado had 127 stores in the general merchandise store format but plans to close 20 poor-performing stores by February 28, 2021. The remaining 107 stores will continue operations in a new form: nine locations with large sales floor space will be converted into *Ario* shopping centers, 31 locations will be targeted with tenant mix initiatives to improve sales area efficiency and 67 locations will be tapped for real estate redevelopment or other store-restructuring measures to utilize advantages afforded by location.

As the term implies, food specialty stores focus on food, a growth category. Ito-Yokado will take a flexible approach toward store openings, opting for high-density urban neighborhoods where general merchandise stores are not as easy to place on the retail landscape.

Number of Stores in Fiscal 2017, and 2020 Target

Number of stores by store format

	Ario	General merchandise store	Food specialty store	Total
Beginning of fiscal 2017	17	136	29	182
Opened in fiscal 2017	1	–	3	4
Closed in fiscal 2017	–	9	6	15
Beginning of fiscal 2018	18	127	26	171
Opening in fiscal 2018	1	–	–	1
Closing between fiscal 2018–fiscal 2021	1	20	4	25
Number of stores at the end of fiscal 2021	18	107	22	147

Converted to *Ario*	Tenant mix	Redevelopment or other restructuring
9	31	67

Solution
—Store renewal through real estate redevelopment utilizing advantages of location such as train station proximity, and stronger emphasis on food—

Ito-Yokado, with its emphasis on business expansion in the Tokyo metropolitan area, has many stores in crowd-drawing station-front locations but is also pushing ahead on plans to combine stores and facilities, such as residential units and day-care centers, in harmony with local needs, and revitalize stores as key components of multi-purpose facilities. Buildings owned by Ito-Yokado will be rebuilt using the equivalent exchange system (exchanging the selling price of land for an equity stake in a new building), while the repurposing of leased buildings will be decided in consultation with owners. This kind of real estate redevelopment will underpin efforts by Ito-Yokado to maintain its ability to attract customers and realize higher sales over the medium to long term by emphasizing food and downsizing apparel and household goods, areas of low profitability.

<Real Estate Redevelopment Example>

Ito-Yokado Kawagoe store redevelopment plan (Scheduled opening 2019)

Rebuild using the equivalent exchange system (exchanging the selling price of land for an equity stake in a new building)

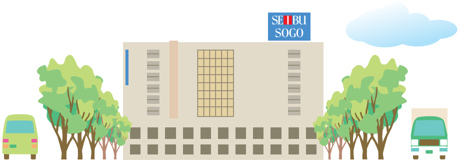
Store opened	November 1967
Store closed	October 2016
Sales floor space	4,125 m²

Store opening	2019 (planned)
Sales floor space	1,419 m² (planned)

* First and second floors: supermarket; third floor and above: condominiums
* Concept image

Moving forward

Ito-Yokado returned to the black in the fiscal year ended February 28, 2017. Factors contributing to that achievement included sharing issues of concern in one-on-one meetings as well as efforts to control expenses, optimize inventory control and resolutely implement steps to close unprofitable stores. In the current fiscal year, which is the first year of the Medium-Term Management Plan, Ito-Yokado will maintain this steely attitude toward unprofitable stores while converting general merchandise stores to the *Ario* format and strengthening the tenant mix, then prepare for real estate redevelopment projects as part of full-scale reforms in superstore operations.



Department Store Operations (Sogo & Seibu) Renewal

Establish a model for success through selective investments and apply it to other stores

In department store operations, market scale surpassed ¥10 trillion in the early 1990s but has since steadily contracted, dropping below ¥6 trillion in 2016. This trend is largely due to the rise of category killers and stalled progress in solving the problem of homogenization of department stores. Obviously keen to survive amid unavoidable balanced contraction of the market, Sogo & Seibu entered into one-on-one meetings with Seven & i Holdings and, like Ito-Yokado, reconfirmed issues that require attention.

As of February 28, 2016, the Sogo & Seibu network comprised 23 domestic stores, of which 17 were in the suburbs, that is, outside major urban areas such as Tokyo and Osaka. Profits in Japan have been squeezed by the effects of a department store market that shrinks a bit more every year and by sluggish demand for apparel, which limits the extent of investment that can be made. Against this backdrop, management concluded that the department store operations under the Sogo & Seibu brand had the potential to create department stores that are regional leader stores. Also from this perspective, four stores were closed in the fiscal year ended February 28, 2017: Sogo Kashiwa, SEIBU Asahikawa, SEIBU Yao and SEIBU Tsukuba. With this, a call for voluntary retirement was made and answered by 370 people, and an impairment loss on goodwill was also booked, highlighting a restructuring process that is unfolding at unprecedented speed. Sogo & Seibu also applied a process of selection and concentration to the allocation of resources, culminating in a decision to sell Sogo Kobe and SEIBU Takatsuki to H2O Retailing Corporation, which seeks to capture an overwhelming share of the market in the Kansai area.

Meanwhile, at existing stores, SEIBU Tokorozawa was tapped as the new model for suburban-type department stores and underwent renovations. Previously, marketing efforts specifically targeted customers coming into the store, but the perspective was widened and a meticulous analysis of customer groups in the catchment area was performed to formulate store concepts. The analysis confirmed that SEIBU Tokorozawa is located in a commercial district with growth potential, fueled by an expanding number of condominiums for a growing population as well as an increase in commercial facilities near the train station. But it also revealed that access to city shopping from this location is relatively easy and that customer visits as well as sales have slowed here, mainly because of competition from nearby shopping centers. In addition, there is a strong tendency among customers who shop at the Tokorozawa store—more so than at any other store—to come in with specific purchases in mind. If the store can capitalize on this consumer trait and provide greater incentive for a visit, customers might buy more, which will increase sales.

Of note, sales of food at SEIBU Tokorozawa have been brisk over the last few years, representing about 30% of store sales and trending higher than at other stores. This revealed a business opportunity in enhancing the food section.

<Example: Efforts at SEIBU Tokorozawa>

Food section	**Expanded** sales area from **one** floor to **two** floors
Floor space for food	From about **3,135** m^2 to about **4,950** m^2

Management came to the conclusion that for SEIBU Tokorozawa to survive as a suburban-type store, it was essential that the apparel floor space be downsized due to persistently sluggish demand while the characteristic department store food section, featuring fine-quality daily items, be expanded to two floors and steps be taken to encourage local customers to visit more frequently. Typically, the first floor—as the gateway to a department store—is reserved primarily for cosmetics, but at SEIBU Tokorozawa, the first floor and the first basement level were remodeled into a two-floor format for food to capitalize on demand. This new format—an experiment with a new approach—includes tenants that are popular locally. The renovated SEIBU Tokorozawa held its grand opening in May 2017. The number of customers is up, especially in the food section, indicating success in creating a store showcasing inherent strengths.

Going forward, this example of success at SEIBU Tokorozawa will be applied to other stores, based on the PDCA cycle. Management resources will be selectively allocated to four stores in the Tokyo metropolitan area—flagship store SEIBU Ikebukuro and Sogo Yokohama, Sogo Chiba and Sogo Omiya—and efforts will be directed toward boosting customer numbers by creating appealing stores emphasizing the growth categories of food, cosmetics and luxury items.

Sales Trends by Product Category at Sogo & Seibu