GROUP CFO MESSAGE

Financial Strategies to Maximize Corporate Value

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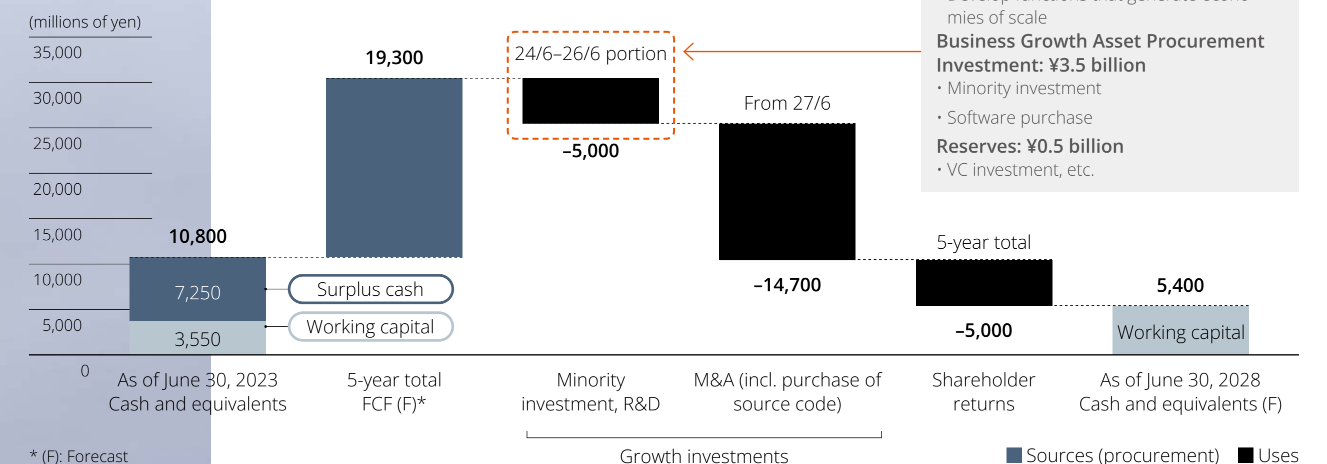
Review of the Previous Medium-Term Management Plan and Policy for the New Plan

With regard to the previous medium-term management plan, we achieved both operational and financial KPIs, but failed to achieve strategic KPIs for recurring sales ratio and GPP (net sales growth rate + operating income margin). The main reason for this was that top management believed when setting each strategic KPI in the previous medium-term plan that the key to the Group's strategy was changing the business model. However, we were unable to see this implemented by the operating companies that were responsible for realizing the strategy. Therefore, in formulating the new BE GLOBAL 2028 medium-term management plan, which was launched in July 2023, we learned from our errors in the previous plan and involved the management of the operating companies from the start, making sure we had thorough discussions with them.

Over the five years covered by the new medium-term plan, we aim to increase corporate value and more than double group-wide net sales as well as driving a more than three-fold increase in net income through average annual growth of 25% or more. The Critical Success Factors (CSFs) for achieving this will come from the implementation of the software driven strategy, and we will continue to view trends in software gross profit as our most important strategic KPI. In addition, in order to visualize the implementation of the software-driven strategy, KPIs and targets will be set and monitored for operations, product value, service value, and productivity. Furthermore, each operating company has set its own CSFs and KPIs based on their respective business models, and have formulated measures to navigate towards achieving target values, and have begun implementing these measures.

[Capital Allocation in the New Medium-Term Management Plan]

Assuming ¥20 billion for growth investments and ¥5 billion for shareholder returns (dividends) over the 5-year period of the medium-term management plan.



* (F): Forecast

Growth Investment

Investment is positioned as a key driver to implement the software-driven strategy in the new medium-term plan. During the first three years of the new plan, we have set a limit of ¥5 billion in a search phase for investment projects, with a target of ¥500 million to ¥1 billion per project for use in minority investments and in-house R&D. We are also looking to make larger investments such as M&A during the final two years of the plan, utilizing the networks developed through our investments. We established this investment policy partly to reflect the fact that we were unable to identify suitable M&A projects despite our efforts to find these during the previous medium-term plan. The reasons to initially take a small position rather than conduct outright M&A at the outset is that it will be possible to become a major shareholder as an insider and acquire shares in a target company at a later stage having been able to gain confidence in the value assessment when a target company is looking for an exit strategy. In the future, our Materiality Realization Office, which will be newly established in the holding company in July 2023, will be responsible for selecting companies and software products, etc. for investment. The Group CFO's main role will be to act as a gatekeeper to conduct financial due diligence on potential investments, as well as to develop recruitment and exit criteria for investment projects and manage them post-investment.

Our basic premise is that we will not make investments unless they are related to the group's business. In other words, the intention is not to make a net investment solely for the purpose of earning an economic return. We will invest in areas of the business that are solely related to the Group's business, particularly in targets that will contribute to increasing software sales and gross profit and enabling sustainable growth. Naturally, one selection criteria for investment is to generate a return that exceeds the minimum cost of capital. However, since many of the candidates for minority investment are likely to be unlisted startups, and may be seed-stage companies, however detailed the various assumptions made and detailed project future cash flows are, the accuracy of projections will inevitably be low. We prefer to keep cash flow forecasts moderate as a more practical method of feasibility study (verification of profitability), and estimate the expected growth rate and volatility of cash flow from similar examples of other companies. This helps set a hurdle rate for each project, which we use to discount the forecasted cash flow. We are considering using this method for our discounted cash flow projections. To be more specific, our cost of equity as of February 2024 is approximately 7%*. Therefore, the discounted present value of cash flows using the hurdle rate, including an additional risk premium for each deal, must be positive (or the IRR of the expected deal must be above the hurdle rate). The prerequisite for any potential investment is that the present discounted cash flow using the hurdle rate, to which a risk premium is added for each deal, must be positive.

That said, we fully appreciate that the results of the Feasibility Study are only numerical. The drive and passion of the person leading the project is also very important in determining whether the investment will be accepted or rejected. There will be times when the Group CFO may try to step on the brakes, but if the drive of the person still shines through, the Group CFO may decide to take on more risk. It sometimes is the case that to get the largest returns you have to be able to take more risks. We do need to add however that for our Group, the Group CEO and the Group CXOs, who are participants in the Group Management Committee that discuss investment decisions, can make evaluations based on a common language of corporate value and cost of capital, and we believe that decisions on that economic rationality are not carried out solely based on theoretical values.

* Calculated assuming a 10-year JGB yield of 0.725%, an Equity β of 1.04, and a market risk premium of 6.0%.

First 3 years will be an exploratory phase, aiming to realize results in 4th year and beyond

	24/6 › 25/6 › 26/6 ›	27/6 › 28/6
	Exploratory Phase: ¥5 billion	Implementation Phase: ¥14.7 billion
1. Software procurement	▪ Build cooperative relationships through minority investments in overseas SaaS vendors and software development companies to increase the number of software products handled by the company and expand the network to enhance the company's own development capabilities ▪ Main objective is not to acquire software, but to build a network with a wide range of options	▪ Sourcing using the network established during the exploratory phase, executing source code purchases and M&A
2. R&D to utilize generative AI, etc.	▪ Conduct research and development activities to increase the productivity of service delivery costs	▪ Linking the results of R&D activities to improved delivery cost productivity
3. Strengthening cyber security	▪ Continue to accumulate know-how and invest in equipment to help clients continue their operations	

Shareholder Returns

The balance of surplus cash and deposits as of June 30, 2023 exceeded ¥7 billion due to the fact that investments did not proceed as planned in the previous medium-term plan. Minority investments and M&A are important means of implementing the software-driven strategy set forth in the new medium-term plan. We assume that the surplus cash and deposits accumulated to date will be invested in such activities, but if appropriate investment targets are not secured, surplus cash and deposits may further increase. In such case, in addition to the ¥5 billion cash dividend planned in the current medium-term plan, the company will consider share buybacks from the market as appropriate, taking into account the benefits of not only additional returns to shareholders but also incentive compensation for employees and complementary payments from M&A transactions.

In addition to capital allocation, it is very important to put the PDCA cycle of the new medium-term plan into operation as quickly as possible. For this purpose, it is also essential to have internal software infrastructure in place that can draw on the latest information as necessary. At the start of the new medium-term management plan, the Group used its own product, AVANT Cruise, for the central oversight of management data within the Group. This automatically renews and extracts several KPIs in the new medium-term plan, enabling visualization and efficient monitoring of the plan's progress. At the same time, we are also working on digitization (DX) of our own group business management in order to provide appropriate and prompt feedback to each operating company. We expect this to be useful for early detection of issues and prompt response to them.

Review and Policy on Corporate Value Enhancement

We emphasize Total Shareholder Return (TSR) and Internal Rate of Return (IRR) in our corporate valuation. For example, if you purchased our shares at the beginning of the previous medium-term plan and held them for 5 years, the TSR would be 304.6%, sharply in excess of the TOPIX TSR

including dividends (149.3%) over the same period. Meanwhile the IRR would be 25.2%, significantly higher than that for the TOPIX. Furthermore, the Sharpe ratio, which is the excess return divided by the rate of change in return, and the trainer ratio, which is the excess return divided by the β value, both exceeded the metrics for the TOPIX over the same period. Therefore, we believe that we were able to deliver returns to shareholders that were sufficiently higher than the market, even taking risk into account.

TSR is divided into capital gains and income gains. Regarding income gains, TSR comes from plans to pay dividends in accordance with the shareholder return policy. As shown in the diagram below, capital gains can be broken down into EPS growth and PER. With regard to EPS, we plan to grow net profit by more than three times during the new mid-term plan period by implementing our software driven strategy.

[Evaluation of Investment Return Performance]

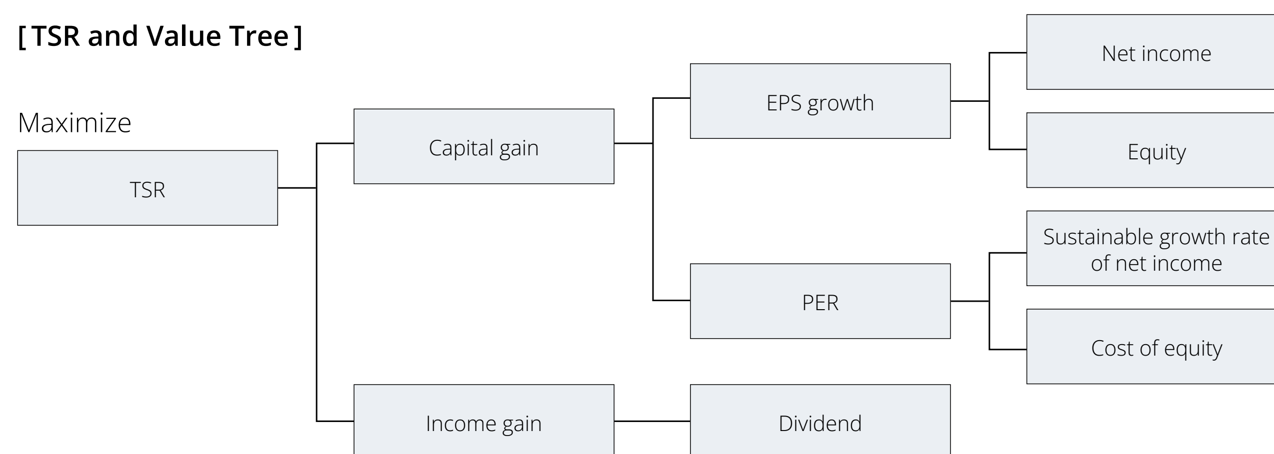
(yen)

	Year	0	1	2	3	4	5
Cash out	Original share price*1	–482					
Cash in	Dividend per share		6	7.5	9	11	13
	Stock price after 5 years*2						1,411
Cash flow		–482	6	7.5	9	11	1,424
IRR (Internal Rate of Return)							**25.2%**

*1 Closing price of our stock on July 1, 2018
*2 Our closing price on June 30, 2023

2018/7/1–2023/6/30	Avant Group	TOPIX
IRR (Internal Rate of Return)	25.2%	5.75%
Risk-free rate	0.03%	0.03%
Volatility	39.14%	15.34%
β	1.2165	1.0
Sharpe ratio	**0.643**	**0.373**
Trainer ratio	**0.207**	**0.057**

[TSR and Value Tree]



Moving on to PER. This can be calculated as 1 divided by (cost of equity – sustainable growth rate of net income). Theoretically, therefore, PER can be increased by lowering the denominator, cost of equity, and increasing the sustainable growth rate of net income. In the CAPM model, the cost of shareholders' equity is the risk-free rate + β × market risk premium, of which β is the only parameter that can be affected through individual corporate activities, In the case of our group, we believe that the cost of shareholders' equity may decrease as a result of a reduction in the volatility of earnings or cash flows. Specifically, an increase in recurring revenues from the SaaS and BPO businesses would likely lead to a lower β.

On the other hand, we believe the Group needs to work on raising the sustainable growth rate of net income, as well as reducing the cost of shareholders' equity, in order to achieve a significant increase in PER. In our case, the profitability of in-house software product sales is much higher than that of service sales, so the key to improving profitability is to increase the proportion of our own in-house products. Sustainability is synonymous with a large amount of ongoing income, so further growth in SaaS, BPO, and other businesses is another option.

In summary, we expect PER, capital gains, and consequently TSR to increase by combining the sales of in-house software products with a business model that focuses on SaaS and BPO. These kind of processes are key to our software driven strategy, which is a central factor for realizing the new medium-term management plan, and we believe that implementing these strategies will also enhance our corporate value.

Recognition of Issues as Group CFO

In addition, we highlight two other issues to be addressed in future. The first is to increase the number of future group CFO and operating company CFO candidates. We are currently carrying out discussions with the CFOs of each operating company what skills the future CFOs will require and what kind of human resources are desirable to take on this role. However, I personally intend to widen the scope beyond only candidates whose future career goal is to become a CFO. Even if top management comes from a non-financial background, I do not consider it appropriate to have to defer to a CFO on financial matters. We believe that human resources with the potential to assume top management roles in the future should take on a CFO role at least once in their career.

The second is related to the adoption or rejection of International Financial Reporting Standards (IFRS) in our group. Be Global 2028 continues to aim for global standards from the previous medium-term plan. Although the adoption of international accounting standards has been discussed several times to work towards this goal, it was not adopted because it did not seem necessary. However, assuming capital allocation is executed in accordance with the new medium-term plan and large M&A projects occur in the third year of the plan or later, the amortization of goodwill under Japanese GAAP could significantly affect profit at various levels. This could threaten achievement of the net income growth target of 25% or more per year on average. Of course, goodwill amortization does not affect cash flow, and differences in accounting standards do not change the intrinsic value of a company. That said, during a recent IR meeting with a global institutional investor, I was asked about the feasibility of tripling or more net income even after implementing M&A involving large amounts of goodwill amortization. After reflecting on this, I feel the need to reexamine the cost-effectiveness of adopting International Financial Reporting Standards, keeping in mind it may be one way to achieve the net income goal.