

Digital Arts Inc.

2326

Tokyo Stock Exchange First Section

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<http://www.fisco.co.jp>

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Summary

Holds a top market share for web filtering software; On a new growth stage trajectory

Digital Arts Inc. <2326> is a manufacturer of information security products that plans, develops, and sells Internet security software, particularly web filtering* and email filtering products. It handles from product planning and development to sales and support on its own and has established operations to promptly address the needs of corporate and individual customers, including quick provision of support, software version updates, and web filtering databases. Digital Arts has become the top domestic supplier of web filtering software thanks to favorable response to its provision of one of the largest domestic web filtering databases, a key component of filtering products, and technology capabilities that enabled it to acquire patent approval in 27 countries and regions.

* Filtering software is a software product with a function for dividing Internet sites into those that can be viewed and those that cannot be viewed based on user settings. While anti-virus software protects PCs, smartphones, and other devices from the danger of virus infections, filtering software protects users against unintended exposure to dangers of the Internet.

Digital Arts reported FY3/17 consolidated results with all-time high sales and profits, including ¥5,058mn in net sales (+26.4% YoY), ¥1,824mn in operating profit (+81.2%), ¥1,811mn in recurring profit (+82.2%), and ¥1,125mn in net profit attributable to owners of parent (+106.1%). While it aggressively engaged in overseas upfront investment, the Company posted strong earnings as sales related to local government information security cloud and local government security enhancement initiatives rose, the company secured a new large-lot order for its i-FILTER series from a government agency, sales of the FinalCode product rose in Japan, and orders for consulting services increased smoothly.

The Company's forecast for FY3/18 is for ¥5,600mn in net sales (+10.7% YoY), ¥2,000mn in operating profit (+9.6%), ¥2,000mn in recurring profit (+10.4%), and ¥1,240mn in net profit attributable to owners of parent (+10.2%). It factors in upfront investments for overseas business of roughly ¥320mn, similar to FY3/17. However, it expects sales growth on solid underlying demand for information security products from both the public and private sectors and anticipates continued strong performance from its domestic businesses.

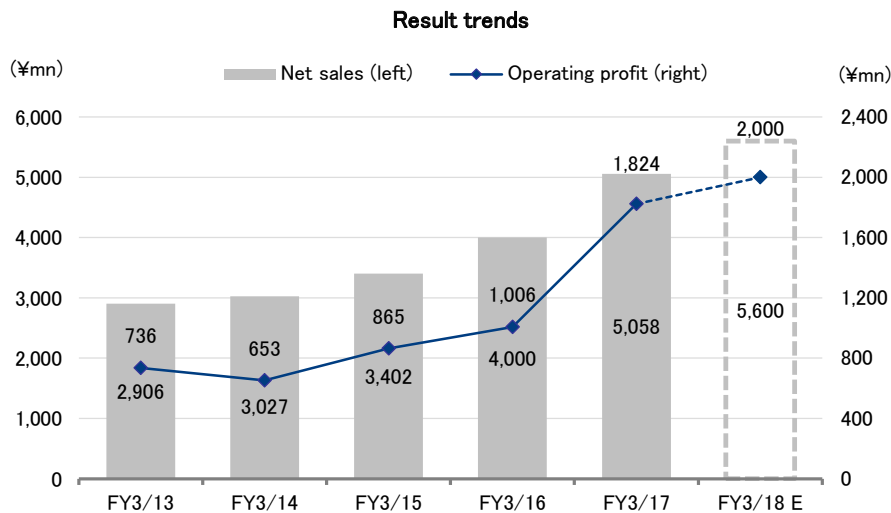
We think the Company's FY3/18 forecast is conservative and we see potential upside in light of 1) the company's tendency to issue conservative initial forecast numbers, 2) we see a resurgence in FY3/18 of sales promotion activities from the Company's partners in the corporate market, which had been somewhat weak in FY3/17 and we think this could result in new organic growth in this area of approximately ¥400mn, 3) we expect continued strong follow-up sales efforts in the local government information security cloud market and strong earnings potential of FinalCode, 4) the Company is strengthening its product lineup, including the release of new products scheduled for September and it plans to target sales growth through cross selling to customers that have not yet signed up for all of its services, and 5) overseas business is likely to benefit from ramp-up in Asia in addition to US activity.

For shareholder returns, Digital Arts adheres to a core policy of obtaining retained profits, while sustaining a stable dividend, with the aim of securing investment funds to bolster the business foundation and prepare for wider adoption of web filtering, email filtering and other information security software based on an outlook for rapid market expansion. It uses a target dividend payout ratio of about 30% of consolidated net profit attributable to owners of parent. The FY3/17 plan targets a ¥24 dividend that works out to a 29.7% dividend payout ratio. The FY3/18 plan targets a ¥28 dividend (¥14 interim dividend), which is a 31.2% dividend payout ratio.

Summary

Key Points

- Reached all-time high sales and profits in FY3/17
- Strengthening of local government security enhancement initiatives and revisions to relevant laws contributing to expansion of business
- New products (countermeasures for targeted attacks by outside attackers) slated for launch in September 2017



Source: Prepared by FISCO from the Company's financial results

Company overview

Security software manufacturer with a top share in the web filtering market

1. Company overview

Digital Arts is a security software manufacturer that plans, develops, and sells Internet security software and appliance products for companies and individuals. It has created information security solutions, such as web filtering and email filtering, that prevent dangers related to Internet access and file encryption and tracking solutions that protect important information contained in files, based on a corporate policy of “contributing to a more convenient, more comfortable, and safer Internet life” and supplies these products to corporate, public-sector (government ministries and agencies and schools), and household markets. It handles the entire process from product planning and development to sales and support on its own and has established operations to promptly address the needs of customers, including quick provision of support, software version updates, and web filtering databases. Digital Arts promotes security products for the Internet, e-mail, and files as a core business and provides one of the largest domestic web filtering databases, a key component of its filtering products. The Company’s technological capabilities have enabled it to acquire patent approval in 27 countries and regions and it has the top market share in Internet filtering software in Japan.

We encourage readers to review our complete legal statement on “Disclaimer” page.

Company overview

2. History

Representative Director Toshio Dogu* founded Digital Arts in June 1995 with the primary aim of developing and selling Internet-related application software. While it developed and sold Internet software tools in the company's initial years, it developed Japan's first web filtering software in August 1998 and started collecting information on problematic sites. It released the i-FILTER School Edition for schools in July 2000 and the i-FILTER Business Edition for companies in January 2001. It steadily expanded business by adding features to these products and broadening the product line-up. Digital Arts listed its shares on the Osaka Stock Exchange NASDAQ Japan market (now: Tokyo Stock Exchange JASDAQ (Growth)) in September 2002, its 7th year after being established. (It subsequently moved the listing to TSE-2 in February 2012 and TSE-1 in March 2013).

* He joined Shin Nihon Kohan Corporation (now, Forval Corporation <8275>) in 1988 and held a sales position. He then worked in programming at MacroSystem Co. and handled business planning for education and entertainment at TDK Core Ltd. (now, Nippon Columbia <6791>). He became Representative Director and President at Digital Arts in October 1997.

Digital Arts began NET iScope Internet monitoring service as a corporate risk management tool in May 2000*, and this business steadily expanded thereafter. However, it decided that it lacked sufficient resources to expand the business further alongside of the mainstay security business and sold the NET iScope business to Gala <4777> in September 2004. Digital Arts thus concentrated resources in filtering software. It acquired IQS' Co., Ltd., which mainly operates a web filtering software business, as a wholly owned subsidiary in March 2005 with the aim of supplementing mutual business resources and expanding customer bases. This move sought to strengthen the security business.

* This service provides continuous information monitoring from Internet-based entries and other sources. It searches domestic websites using key words specified by customers as the search criteria and gives customers URLs that contain information that meets the search criteria.

Digital Arts began sales of m-FILTER email filtering software in February 2007 and broadened its business scale. It started selling the D-SPA secure proxy appliance in November 2010 and launched FinalCode in June 2010, putting in place today's product line-up.

Digital Arts formed a business alliance with US-based Polkast LLC* and established Polkast Japan in order to expand service in Japan in May 2013, but it concluded that it would be difficult to provide service with high customer satisfaction and dissolved the business alliance and liquidated Polkast Japan in July 2015.

* This service lets companies and households create a cloud with their own PC and supports management of document files, video, music, and photo files, and other electronic data as well as access control and data transfers among multiple devices, including smartphones and tablets, in a high-speed and secure environment, using the Polkast application for building original clouds in the global market.

Meanwhile, it founded FinalCode, Inc. in the US in April 2014 with goals of promoting a new concept of security measures worldwide and expanding sales of FinalCode in North America. It established Digital Arts Asia Pacific Pte. Ltd. in Singapore in November 2015 and renamed it FinalCode Asia Pacific Pte. Ltd. in February 2016. It also renamed UK-based Digital Arts Europe Ltd. (founded in April 2011) as FinalCode Europe Limited. Digital Arts is working on operations for overseas sales of FinalCode. Furthermore, it founded Digital Arts Consulting Inc. in April 2016 to focus on management strategy and IT strategy consulting businesses and help recruit major corporate customers in Japan.

Company overview

History

Date	History
June 1995	Founded Digital Arts in Tokyo (Minato-ku) with ¥10mn in capital in June 1995 with the primary aim of developing and selling Internet-related application software
August 1998	Developed Japan's first web filtering software and started collecting information on problematic sites
May 2000	Began NET iScope Internet monitoring service
September 2002	Listed shares on the Osaka Stock Exchange NASDAQ Japan market (now, Tokyo Stock Exchange JASDAQ (Growth) market)
September 2004	Sold the NET iScope Internet monitoring service business and shifted to concentrating resources in filtering software.
February 2005	Gained approval for a "patent on Internet access control including filtering" in 22 countries (it had rights for this patent in 27 countries as of 31 March, 2015)
March 2005	Acquired all shares in IQS' Co., Ltd. (now a consolidated subsidiary)
December 2010	Moved its share listing to Osaka Stock Exchange JASDAQ (Standard) (now, Tokyo Stock Exchange JASDAQ (Standard))
April 2011	Established Digital Arts America, Inc. as a US subsidiary
April 2011	Established Digital Arts Europe Ltd. as a UK subsidiary (renamed as FinalCode Europe Limited in February 2016)
February 2012	Listed shares on the Tokyo Stock Exchange Second Section
May 2012	Delisted shares from Osaka Stock Exchange JASDAQ (Standard) (now, Tokyo Stock Exchange JASDAQ (Standard))
June 2012	Established Digital Arts Investment, Inc. as a US subsidiary
March 2013	Change its share listing to the Tokyo Stock Exchange First Section
May 2013	Established Polkast Japan and formed a business alliance with US-based Polkast LLC
June 2013	Formed a strategic business alliance and conducted a business transfer with NRI Secure Technologies, Ltd.
April 2014	Established FinalCode, Inc. as a US subsidiary
January 2015	Ended the business alliance with US-based Polkast LLC
July 2015	Liquidated Polkast Japan
November 2015	Established Digital Arts Asia Pacific Pte., Ltd. in Singapore in November 2015 and renamed it FinalCode Asia Pacific Pte., Ltd. in February 2016
April 2016	Established Digital Arts Consulting Inc.

Source: Prepared by FISCO from the Company's securities report and website

Business overview

Mainly supplies security products for the web, email, and files

The Digital Arts group consists of Digital Arts and six subsidiaries. It includes three consolidated subsidiaries (as of end-March 2016) – IQS' Co., Ltd., FinalCode Inc., and FinalCode Asia Pacific Pte. Ltd. Other key subsidiaries besides these three firms are Digital Arts Consulting Inc. established in April 2016 and FinalCode Europe Limited, a strategic subsidiary for Europe.

Positioning of Digital Arts and consolidated subsidiary businesses

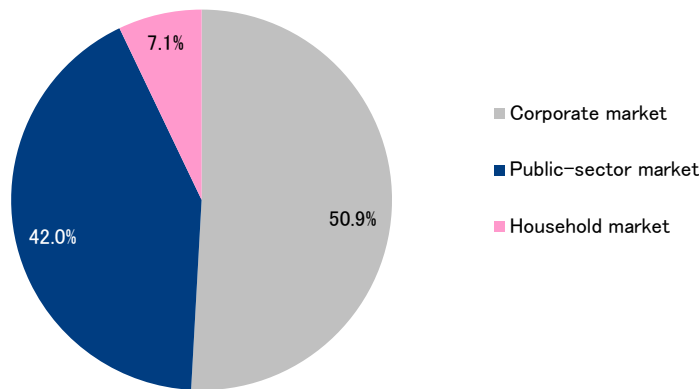
Company	Main business content
Digital Arts	Plans, develops, and sells Internet security software and appliance products
IQS'Co., Ltd.	Develops and sells Internet security software
FinalCode, Inc.	Plans, develops, and sells FinalCode (file encryption and tracking solution) products
FinalCode Asia Pacific Pte. Ltd.	Sells FinalCode (file encryption and tracking solution) products in Asia
FinalCode Europe Limited	Sells FinalCode (file encryption and tracking solution) products in Europe
Digital Arts Consulting Inc.	Operates management strategy and IT strategy consulting businesses

Source: Prepared by FISCO from the Company's securities report and press releases

Business overview

The Company’s operations are security services for general corporations, government agencies, and individuals, involving planning, development, sales and so forth of web filtering software, email filtering software, and file encryption and tracking solutions. It only discloses information about the security business segment; however, it discloses information about the status of each user market. The sales composition by market for FY3/17 was corporate 50.9%, public-sector 42.0%, and household 7.1%.

Sales ratios by market (FY3/17)



Source: Prepared by FISCO from the Company’s financial results

Products developed and sold by Digital Arts can be broadly grouped into three categories – 1) web security products, 2) email security products, and 3) file security products. Digital Arts sells products directly (in response to requests from its web site) and through sales agents and retailers. Major sales agents, such as SoftBank Commerce & Service Corp. and Daiwabo Information System Co., Ltd. (subsidiary of Daiwabo Holdings Co., Ltd. <3107>), handle the bulk of sales to corporate and public-sector customers.

1. Web security products (web filtering software)

These are software products with a function for dividing Internet sites into those that can be viewed and those that cannot be viewed based on user settings. The company’s main offerings are i-FILTER for Business, i-FILTER Browser & Cloud, and D-SPA for corporate and public-sector customers, and i-FILTER for Consumers, marketed to household customers. It has installed products at over 7,300 corporate and public-sector sites and more than 31,000 schools nationwide in the school and educational institution business.

The business model provides stable recurring revenue because software customers pay a software usage fee (software license and maintenance fees) in the first fiscal year of installing the software and then pay half of the amount paid in the first fiscal year each year from the second year. Digital Arts books software development costs with a portion that goes under expenses and a portion recognized as an asset and subsequently amortized. Its profit is the difference between these amounts and sales.

Next, we review features of the Company’s main products. (Based on the newest versions as of April 2017)

Business overview

(1) i-FILTER for Business Ver. 9

The i-FILTER for Business Ver. 9, the latest offering, achieves effective control and visualization to counter information leaks caused by shadow IT*1, a new security issue, for web usage, including cloud-based web application services. Digital Arts also started selling a collaborative option with FireEye, Inc., which leads the industry in supplying products and services that combat advanced cyber attacks. This product makes it possible for customers to stop leaks of confidential information due to multi-faceted high-level attacks, including zero-day attacks*2 that aim for weaknesses in software*3 and targeted attacks that focus on certain companies and individuals with the goal of stealing confidential information.

*1 Shadow IT refers to use of personal PCs, smartphones, and tablets and cloud services, file transfer services, and other services for business without obtaining approval from the company. It creates risks of loss, theft, and information leaks similar to the "bring your own device" (BYOD) model (employees bring personal information terminals to the company to conduct work).

*2 Zero-day attacks refer to attacks targeting software weaknesses (security holes) capitalize on the time that it takes from discovering the weakness to provision of fix programs by the developer.

*3 Targeted attacks refer to cyber attacks with a clear purpose, such as improperly obtaining information or money or obstructing business, aimed at a specific organization or person.

(2) i-FILTER Browser & Cloud

This is web filtering software for smart devices that curtails private usage and prevents information leaks by supporting centralized control of multiple operating systems that range from smart devices equipped with Android and iOS (iPhone, iPad, and others) to notebook PCs and other Windows terminals.

(3) i-FILTER for Consumers

Digital Arts supplies products for home use under the "i-FILTER for Consumers" brand. Key products are "i-FILTER for multi-devices" service that runs on all Windows, iOS, and Android devices, PC service, game player service, and smartphone, tablet, and music player service. This series supports a wide range of devices.

Products are installed as a standard feature on PCs supplied by major firms and are also available from over 160 Internet service providers nationwide in Japan, and are officially adopted in major game machine (including Nintendo's <7974> 3DS and Wii and Sony's <6758> PlayStation and PSP), TV, and mobile terminal services.

2. Email security products (email filtering software)

This software is capable of controlling email transmission and reception based on user settings. Main products are m-FILTER and m-FILTER MailAdviser. Digital Arts has installed products at over 3,000 entities, including companies and public ministries and agencies (as of September 2016). Customers pay a software licensing fee in the first fiscal year and then pay maintenance fees from the second year.

(1) m-FILTER (Ver. 4)

This product realizes diverse and reliable measures to prevent mistaken mail transmissions, such as holding transmissions going out of the company for a certain amount of time and blocking transmissions that lack approval from a superior.

(2) m-FILTER MailAdviser

This is a client-type software that prevents mistaken mail transmissions by giving on-the-spot "notices" to email senders.

3. File security products (file encryption and tracking solutions)

This is a password-less encryption service that can track and remotely control electronic files. The main product is FinalCode (Ver. 5), and it has been installed at roughly 400 companies. It costs ¥1,000 per month per person (annual contract) for the Express version that enables basic encryption only, ¥2,000 per month per person for the Business version that offers the added features summarized below, and ¥3,600 per month per person for the Enterprise version. Optional functions can be added to each package.

Key features are 1) a file encryption and tracking solution that encrypts important files, tracks usage, and facilitates remote deletion (file encryption software), 2) absence of risk of indirect information leaks to a third party through a transfer (secondary leak) because of file encryption for a specified user group, and 3) an ability to easily recover (eliminate) important encrypted files, which had been impossible in the past, through active revision of rights after distribution.

Strengths and business risks

Integrated provision from development to support, built one of the largest domestic web filtering databases

1. Strengths

We think an important strength is the integrated operation from development to support. Digital Arts handles from collection of information for the core web filtering database to product planning, development, sales, and support directly in an integrated manner as a specialty developer of filtering software in Japan. This stance enables it to properly grasp customer needs and quickly reflect them in development activities. It also helps in creation of differentiating factors, such as advanced product performance and ease of use. Digital Arts hence has captured a large share in the filtering software market and realizes high customer satisfaction with a repeat rate of 95% or more.

The “Comparative Survey of Web Filtering Product Quality” prepared by Veriserve Corporation <3724> shows i-FILTER at a much higher average blocking rate in tests of 10 major categories (such as pornography and adult sites, bulletin boards, and games) at 96.3% versus 66.7% for the No.2 product. We think this outcome confirms the very high efficacy of the Web filtering database, which is also one Japan’s largest, visually assessed and compiled by an expert team based on proprietary collection technology* and rating standards.

* ZBRAIN is a proprietary filtering technology, and Digital Arts has received patent rights in 27 countries and regions, including Japan, the US, Asia, and Europe.

We see establishment of a stable income base using a business model of recurring revenue as an important strength too. As noted above, web filtering uses a business model with recurring revenue by charging a renewal fee (half of the value of the first fiscal year) from the second year in order to sustain usage after the first year. This model provides a stable income source.

Strengths and business risks

Primary rivals are US-based Blue Coat Systems Inc., Alps System Integration (ALSI;*), and Trend Micro <4704>. Cultural differences serve as an entry barrier for major foreign companies, and these firms have not sufficiently addressed the Japanese market. Furthermore, Digital Arts constantly provides the latest and highly precise database as explained earlier, and this aids in differentiation from other companies and sustaining a high market share.

* Consolidated subsidiary of Alps Electric <6770> that offers manufacturing and distribution solutions, security solutions, and firmware solutions.

2. Business risks

Two major business risks are high reliance on sales agents and human resource outflow and recruiting and training personnel.

The majority of group products are sold to customers through sales agents. Group sales hence might fluctuate substantially based on sales conditions at major sales agents and changes in the management environment, such as corporate M&A and bankruptcies. Sales agents also carry products that are rivals, and there is a possibility of agents handling rival products prior to the company's products. Reliance on the top three sales agents (SoftBank Commerce & Service, Daiwabo Information System, and PFU Limited) in FY3/17 was 51.6%.

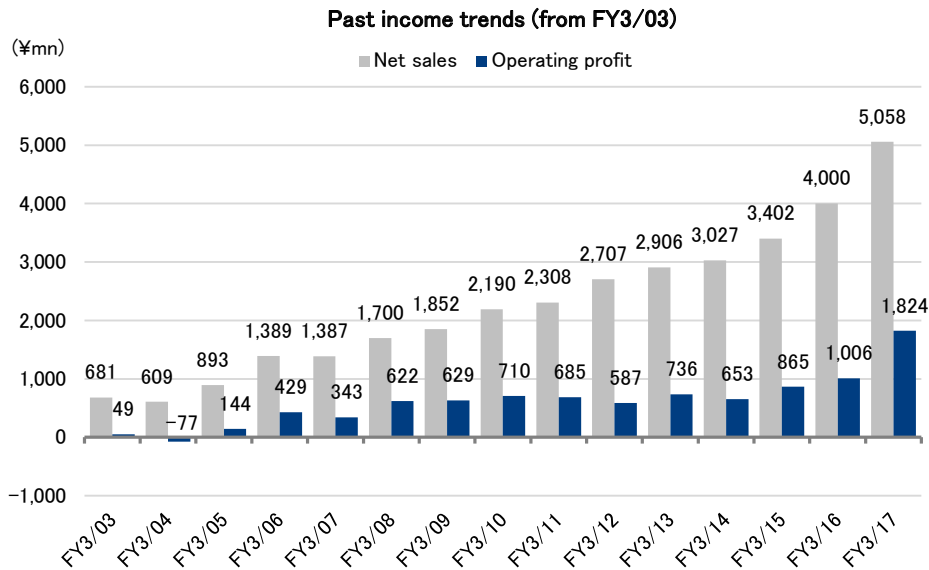
The information security market is faring well, and we expect further expansion of demand for cyber security measures and personal data protection measures due to regulatory advances with the Basic Law on Cyber Security, My Number Law, and Revised Personal Information Protection Law. Digital Arts, which has the leading market share, is currently in an upbeat environment, given these conditions, in which it can obtain more business if it has the personnel. Therefore, if an outflow of personnel occurred, it could have a major impact on business results. We think recruitment and training of personnel is an important issue from the standpoint of longer-term growth. The company's current remuneration system is mainly performance-based and employees are methodically evaluated based on results. The Company has also implemented a stock option system (roughly half of the company's employees were enrolled in this system as of end-FY3/17). The Company reports that the average period of employment for its employees as of FY3/16 was roughly five years.

■ Performance trends

Continuing a trend of income expansion with reinforcement of the product lineup

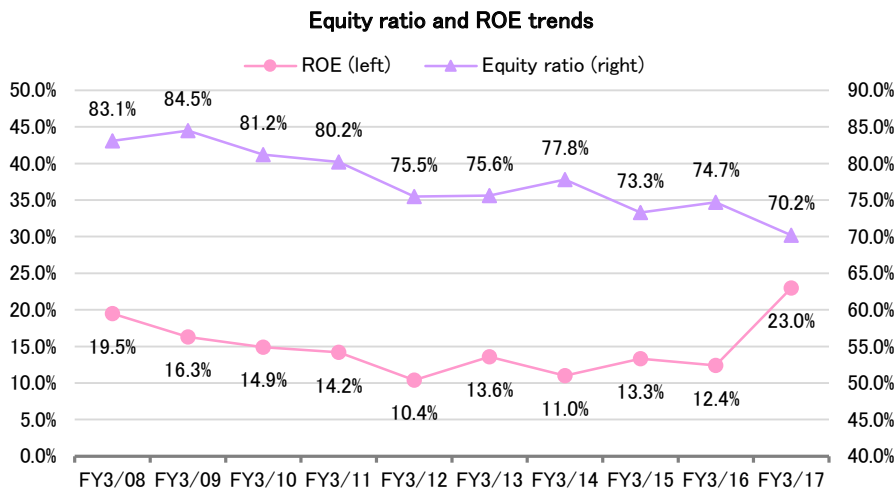
A review of past results clarifies consistent expansion of sales along with broadening of the product lineup. Profits largely expand in line with sales growth other than the two dip phases: 1) FY3/03 to FY3/04 under pressure from listing-related costs, added personnel to expand businesses, and investment cutbacks at schools and local government entities and 2) FY3/11 to FY3/12 affected by heavy use of sales promotion costs aimed at expansion of the household market.

Performance trends



Source: Prepared by FISCO from the Company's financial results

Looking at the balance sheet, we see steady build-up of net assets supported by the stable earnings model with recurring revenue. This is enabling Digital Arts to sustain the equity ratio at over 70%, giving it healthy financial standing.



Note: Consolidated for the equity ratio from FY3/05 and for ROE from FY3/06

Source: Prepared by FISCO from the Company's financial results

Achieving all-time high sales and profits thanks to upbeat corporate and public-sector business

1. Review of FY3/17 results

Digital Arts reported FY3/17 consolidated results with all-time high sales and profits, including ¥5,058mn in net sales (+26.4% YoY), ¥1,824mn in operating profit (+81.2%), ¥1,811mn in recurring profit (+82.2%), and ¥1,125mn in net profit attributable to owners of parent (+106.1%).

Overview of FY3/17 results

	FY3/16		FY3/17		
	Actual	Ratio to sales	Actual	Ratio to sales	YoY change
Net sales	4,000	100.0%	5,058	100.0%	26.4%
Cost of sales	926	23.1%	1,007	19.9%	8.8%
SG&A expenses	2,067	51.7%	2,227	44.0%	7.7%
Operating profit	1,006	25.2%	1,824	36.1%	81.2%
Recurring profit	994	24.9%	1,811	35.8%	82.2%
Net income attributable to owners of parent	545	13.6%	1,125	22.2%	106.1%

Source: Prepared by FISCO from the Company's financial results

In response to the Ministry of Internal Affairs and Communications' "policy for strengthening local government security" prefectural, city, and town governments strengthened Internet security measures and sales of the Company's main products for the public sector market, the i-FILTER series and the m-FILTER series, rose. The Company accepted a new large-lot order from a government agency for i-FILTER, which contributed greatly to earnings. Sales of FinalCode Ver. 5 also increased as it met the needs of companies and organizations requiring high-level file security. Consulting order volume also rose steadily at subsidiary Digital Arts Consulting Inc., founded in April 2016.

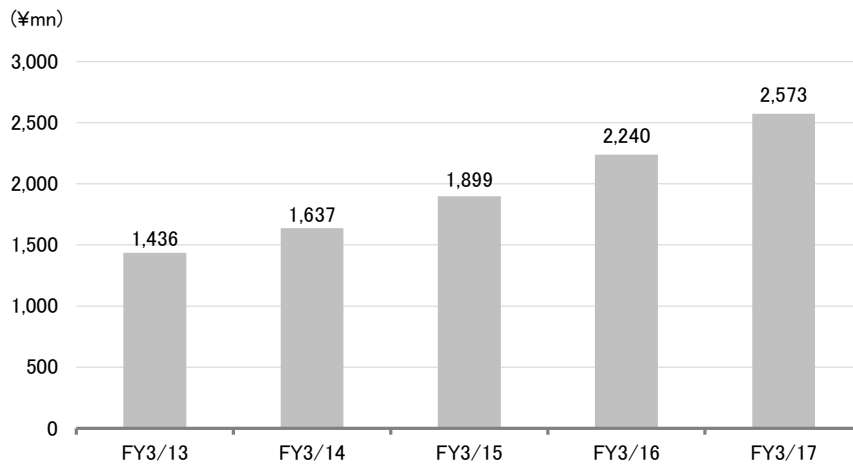
Cost of sales rose by ¥81mn YoY as labor costs increased because the number of domestic development and consulting employees increased as the company developed new products. However, the cost of sales ratio improved by 3.2ppt to 19.9% on sales growth. SG&A expenses, meanwhile, climbed ¥159mn owing to a rise in domestic labor costs, higher advertising expenses, and higher tax expenses due to the higher tax rate imposed on the Company and this lowered the SG&A expenses ratio by 7.7ppt to 44.0%. Overseas investment was also kept within the initial budget. As a result of the above, the operating margin improved by 10.9ppt to 36.1%.

2. Trends by market segment

(1) Corporate market

Sales to the corporate market grew 14.9% YoY to ¥2,573mn. Sales of mainstay products, the i-FILTER series and FinalCode rose smoothly. Sales of m-FILTER recovered in 2H, resulting in steady growth on a full-year basis. Amid a series of incidents involving leaks of important customer information, sales of FinalCode Ver. 5 increased as it is able to meet the needs of companies that handle large volumes of customer information. i-FILTER sales rose by 9.2% and m-FILTER sales were up 8.3%. Sales of strategic product FinalCode jumped 97.7%.

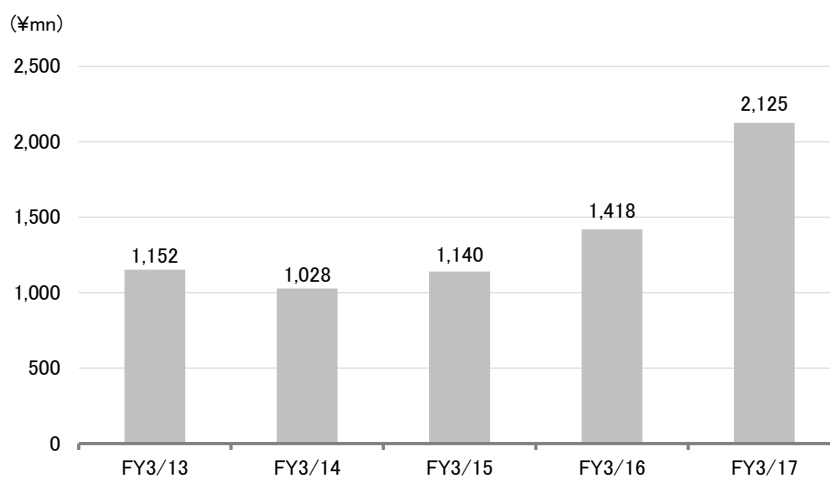
Performance trends

Sales trend for the corporate market


Source: Prepared by FISCO from the Company's results briefing supplementary materials

(2) Public-sector market

Sales to the public-sector market increased 49.9% YoY to ¥2,125mn, driving the Company's overall earnings growth. In response to the Ministry of Internal Affairs and Communications' "policy for strengthening local government security" prefectural, city, and town governments strengthened Internet security measures and sales of the Company's main products for the public sector market, the i-FILTER series and the m-FILTER series, rose. An increasing number of public bodies such as prefectural offices, city halls, and town halls installed the local-government version of FinalCode as is meets the needs of these groups. Sales growth was strong, as sales of mainstay i-FILTER rose 33.6%, while m-FILTER jumped 189.6%, and FinalCode sales grew by 47.8%.

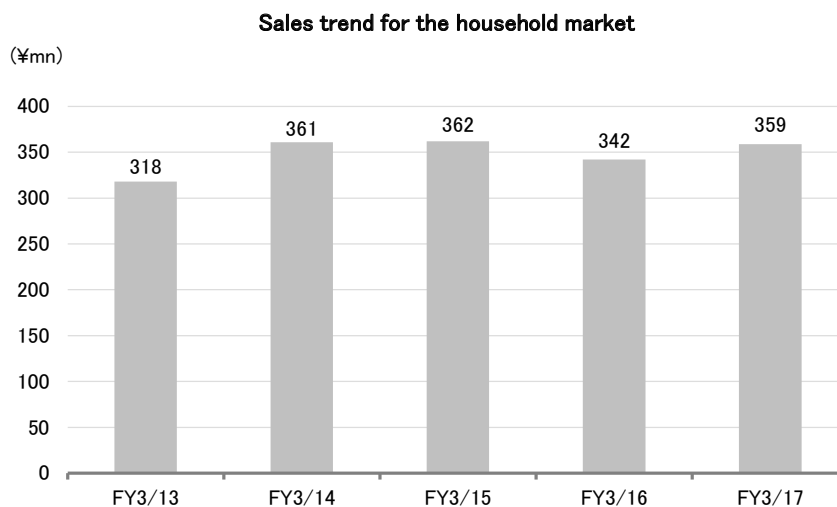
Sales trend for the public-sector market


Source: Prepared by FISCO from the Company's results briefing supplementary materials

Performance trends

(3) Household market

Sales to the household market rose 5.0% YoY to ¥359mn, showing firm results even amid a continued decline in domestic PC shipment volume. The Company continued to partner with mobile and MVNO operators to expand sales and collaboration on mobile terminal version of i-FILTER for smartphones. Despite the downtrend in domestic PC shipment volume, sales of the PC version of i-FILTER were firm, rising 5.5% due to OEM-driven sales and robust shipments of multi-year packaged products. Mobile-version sales, meanwhile, expanded 15.8% because of growth in sales of “i-FILTER for multiple devices” that can be used on multiple operating systems with a single serial ID. However, game console and TV version sales, which were strong in FY3/16, declined 13.0% YoY in FY3/17.



Source: Prepared by FISCO from the Company's results briefing supplementary materials

The Company's equity ratio remained above 70% as it prepares to invest in growth through M&A, etc.

3. Financial status and management indicators

Total assets rose ¥1,247mn from the end of the previous fiscal year to ¥7,380mn at end-FY3/17. Current assets were up ¥1,113mn owing to increases in cash and deposits and accounts receivables accompanying business expansion. Fixed assets gained ¥134mn due to additions to intangible fixed assets and investment securities.

Liabilities grew ¥619mn to ¥2,110mn because of higher prepaid amounts from unearned maintenance revenue and higher unpaid corporate taxes. Net assets expanded ¥628mn from the end of FY3/16 to ¥5,270mn due to a rise in surplus profit from booking net profit attributable to owners of parent.

For cash flow, cash and equivalents rose ¥855mn from the end of the previous fiscal year to ¥3,298mn. Cash flow from operating activities had a net surplus of ¥2,012mn because of booking ¥1,802mn in net profit prior to taxes and adjustments and ¥523mn in amortization costs. Cash flow from investing activities had a net deficit of ¥671mn because of acquiring intangible fixed assets worth ¥619mn. Cash flow from financing activities reported a net deficit of ¥503mn due to ¥300mn in share buyback and ¥249mn in dividend payments and other items.

Performance trends

Looking at management indicators, the equity ratio, which reflects financial soundness, declined to 70.2% as growth in total assets outpaced growth in net assets as the Company expanded its business. The current ratio also declined to 260.2%. However, both of these indicators remained at high levels and the Company has no interest-bearing debt. We therefore see no problems in terms of the Company's financial soundness. ROA, ROE, and operating margin, which indicate profitability, rose further despite pressure from upfront investments. The Company has plentiful cash on hand and we believe it is positioned to make investments in long-term growth, such as flexibly executed M&A.

Balance sheet, cash flow statement, and management indicators

	(¥mn)		
	FY3/16	FY3/17	Change
Current assets	4,262	5,375	1,113
Cash and deposits	2,942	3,898	956
Fixed assets	1,871	2,005	134
Total assets	6,133	7,380	1,247
Current liabilities	1,448	2,066	618
Fixed liabilities	43	44	1
Interest-bearing debt	-	-	-
Total liabilities	1,491	2,110	619
Net assets	4,642	5,270	628
Stability			
Current ratio	294.3%	260.2%	-34.2pt
Equity ratio	74.7%	70.2%	-4.5pt
Interest-bearing debt ratio	-	-	-
Profitability			
ROA (return on assets)	16.7%	26.8%	10.1pt
ROE (return on equity)	12.4%	23.0%	10.6pt
Operating margin	25.2%	36.1%	10.9pt
Cash flow from operating activities	1,027	2,012	985
Cash flow from investing activities	-441	-671	-230
Cash flow from financing activities	-187	-503	-316
Cash and cash equivalents	2,443	3,298	855

Source: Prepared by FISCO from the Company's financial results

■ Outlook

Conservative forecast for FY3/18, possible upside

● Outlook for FY3/18

Digital Arts forecasts for FY3/18 net sales of ¥5,600mn (+10.7% YoY), operating profit of ¥2,000mn (+9.6%), recurring profit of ¥2,000mn (+10.4%), and net profit attributable to owners of parent at ¥1,240mn (+10.2%). It factors in upfront investments for overseas business of ¥320mn, but expects continuous, stable growth in the Japanese market on the launch of new products in new markets.

Outlook

Overview of FY3/18 forecast

	FY3/17		FY3/18		
	Actual	Ratio to sales	Forecast	Ratio to sales	YoY change
Net sales	5,058	100.0%	5,600	100.0%	10.7%
Operating profit	1,824	36.1%	2,000	35.7%	9.6%
Recurring profit	1,811	35.8%	2,000	35.7%	10.4%
Net profit attributable to owners of parent	1,125	22.2%	1,240	22.1%	10.2%

Source: Prepared by FISCO from the Company's financial results

Digital Arts explains that, of its projected FY3/18 net sales of ¥5,600mn, it expects to generate ¥4,850mn in sales through natural growth in existing products and obtain the remaining ¥750mn from new growth achieved by launching new products in new markets. It expects new growth to come from (1) sales growth to corporations and local governments and (2) sales growth achieved through priority initiatives.

(1) Growth in sales to corporations and local governments

The Company sees potential for sales growth to corporations and local governments and plans to work to fulfill this potential.

- a) Calculated on the Company's average growth rate of new customers (22.41% annually for the past four years) it works out that new acquisitions account for about ¥430mn, so it believes ¥400mn in sales growth to new companies in FY3/18..
- b) In addition, the Company sees potential sales growth of roughly ¥2,100mn from cross selling of m-FILTER to existing i-FILTER customers who have not yet installed m-FILTER.
- c) The Company sees potential sales growth of roughly ¥4,100mn from sales of FinalCode to local governments (city and prefectural governments) that have not yet installed the software.

(2) Priority initiatives

- a) The Company's three priority initiatives are a) launching new products, b) responding to revisions to laws, and c) responding to national plans to place Wi-Fi in all public elementary, junior and senior high schools

a) Launching new products

In the area of outside security, which has become an important issue in recent years owing to an increasing number of incidents involving information security, in September, the company plans to begin offering a service that integrates i-FILTER Ver. 10 and m-FILTER Ver. 5. By integrating its services including web filtering, e-mail filtering, and file encryption, the Company can protect its corporate customers' important information from outside targeted attacks. The Company mainly targets medium-sized companies with 500 to 1,000 employees, government agencies, and local governments. The Company has not announced a FY3/18 sales forecast for this integrated product as the price has not yet been determined, but we are confident that it will become one of its featured products.

b) Response to revisions of laws

FinalCode satisfies the requirements by the Electronic Books Maintenance Act* to electronically store accounting books in a form that prevents data manipulation.

* Law allowing preservation in digital form of accounting ledgers and transaction documents that were formerly required to be preserved on paper.

Outlook

Because FinalCode uses high-level encryption technology to make files secure, it can eliminate the reporting obligation required by the Amended Private Information Protection Law* in the event of a data security breach and prevent improper viewing of important information contained in such files.

* In the event of a data security breach involving personal information, said breach must be reported to the Personal Information Protection Commission. This places a heavy burden on companies. However, if the personal data has been encrypted with high-level encryption, no actual breach is deemed to have occurred and there is no obligation to make an information security breach report.

c) Response to plans to install Wi-Fi in public elementary, junior and senior high schools

The Ministry of Internal Affairs and Communications plans to place Wi-Fi in over 30,000 public schools and community centers nationwide by 2020 as a measure for disaster prevention. ¥3,190mn has been budgeted for this project in FY2017 and the Company aims to secure orders for this work. This budget includes not only Wi-Fi routers, but also tablet devices, and related software (i-FILTER).

Digital Arts expects net sales to increase by ¥600mn YoY in FY3/18 owing to new growth from sales to corporations, public sector organizations, and households as well as growth in overseas businesses.

However, while the Company expects only a small increase in depreciation costs, owing to higher development costs, it expects cost of sales to increase by 14.2% YoY to ¥1,150mn and gross margin to deteriorate by 0.6ppt YoY to 79.5%. SG&A expenses, meanwhile, are expected to increase by 10.0% YoY to ¥2,450mn on an increase in the number of domestic and overseas employees and higher advertising costs. However, this increase is not expected to be able to be in line with sales growth and the SG&A expense ratio is expected to improve by 0.3ppt. Therefore, while the company expects the operating margin to deteriorate by 0.4ppt, it is expected to remain well over 30% (at 35.7%).

We think the Company's FY3/18 forecast is conservative and we see potential upside in light of 1) the company's tendency to issue conservative initial forecast numbers, 2) we see a resurgence in FY3/18 of sales promotion activities from the Company's partners in the corporate market, which had been somewhat weak in FY3/17 and we think this could result in new organic growth in this area of approximately ¥400mn, 3) we expect continued strong follow-up sales efforts in the local government information security cloud market and strong earnings potential of FinalCode, 4) the Company is strengthening its product lineup, including the release of new products scheduled for September and it plans to target sales growth through cross selling to customers that have not yet signed up for all of its services, and 5) overseas business is likely to benefit from ramp-up in Asia in addition to US activity.

■ Longer-term management strategy

Entering a new growth stage

● Management plan and growth strategy

Digital Arts does not offer detailed numerical goals because it has not disclosed a medium-term business plan. However, it is targeting net sales of ¥10,000mn by FY3/21 as a result of implementing a policy of “contributing to a more convenient, more comfortable, and safer Internet life.” This is roughly double the level of net sales in FY3/17 and therefore looks like a very high target at first glance (average annual growth of approximately 20%). However, given that we view the Company’s FY3/18 forecast for 10.7% YoY sales growth as conservative and that sales grew 26.4% YoY in FY3/17, we think the target of net sales of ¥10,000mn by FY3/21 looks achievable.

Its longer-term management strategy aims to expand sales through priority allocation of business resources to the security business, mainly driven by development and sales activities for web filtering software and email filtering software. It also plans to pursue reforms that help create profits by improving organizational efficiency and cutting spending and other costs.

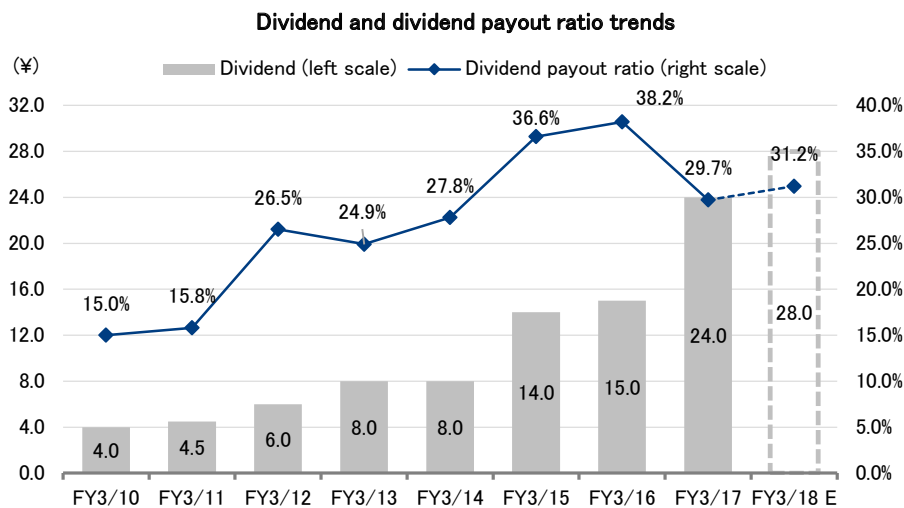
We think Digital Arts is entering a new growth stage, based on larger deal size aided by collaboration with third-party products and FinalCode proposals and progress in recruitment of local governments and large corporate customers, and we will be closely monitoring sales trends of i-FILTER Ver. 10 and m-FILTER Ver. 5, scheduled for launch in September.

Shareholder return policy

Continuing a stable dividend with a 30% payout ratio

● Dividend distribution plan

Digital Arts adheres to a fundamental policy in shareholder returns of continuing a stable dividend while retaining profits to obtain investment funds needed to strengthen its business foundation and support wider use of web filtering, email filtering and other information security software with the prospect of rapid market expansion. It targets a dividend payout ratio of roughly 30% of consolidated net profit. It intends to pay a ¥24 dividend for FY3/17 (29.7% payout ratio) and is aiming for ¥28, a 31.2% payout ratio, in FY3/18 (with a ¥14 interim dividend).



Note: Implemented a stock split of 1:100 shares on April 1, 2014.

Source: Prepared by FISCO from the Company's financial results



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