COMPANY RESEARCH AND ANALYSIS REPORT

DYNAM JAPAN HOLDINGS

06889

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Index

Summary

Achieved higher operating profit through rigorous low-cost operations Announced entry into aircraft leasing as a new business

DYNAM JAPAN HOLDINGS Co., Ltd. (HK06889; hereinafter, the Company) is one of Japan's top operators of pachinko halls with the largest number of halls operated. Its strength and characteristics lie in low-cost operations based on the "chain store theory." In addition, the Company is a pioneer as the first in its industry to be listed on a stock market, aided by recognition of its high-quality management with implementation of a customer-first approach, information disclosure, compliance management, and other measures.

1. Increased operating profit by 40% YoY by leveraging its strength of low-cost operations

The Company reported sharply higher profits on reduced sales in FY3/19 1H with revenue at ¥73,583mn (-4.7% YoY) and operating profit at ¥12,268mn (+40.7%). Despite continuation of difficult business conditions, the Company has been taking steps to reinforce its operating foundation from a medium-term perspective. Specifically, it creates halls from a customer perspective of low-cost playing (ball rental) and avoiding gambling reliance in sales expansion measures and implements rigorous low-cost operations in hall management. While revenue fell YoY as a result, the decline margin is generally small and operating profit climbed 40% thanks to efforts to lower machine costs and other expenses.

2. Longer-term growth strategy unchanged, bolstering resilience in all areas, including halls, operations, and finances

The Company's longer-term growth strategy mainly consists of increasing the number of halls and boosting customer traffic at existing locations. While the Company has not changed this fundamental approach, it still confronts a harsh business environment in the pachinko hall industry and is focusing on a defensive stance rather than offensive initiatives. During 1H, it reinforced low-cost playing (ball rental) and promoted sales initiatives tailored to local areas, rather than expansion of the hall network, in order to lift customer traffic at its existing halls. In spending, the Company sharply reduced machine costs by emphasizing efficient use of game machines and scaling back new machine purchase in light of new ball output regulations that took effect in February 2018 and by expanding use of private-brand machines. In finances, it continues to repay loans while continuing steady investment in hall renovations. This stance is strengthening resilience for the future along with increase in cash and deposits.

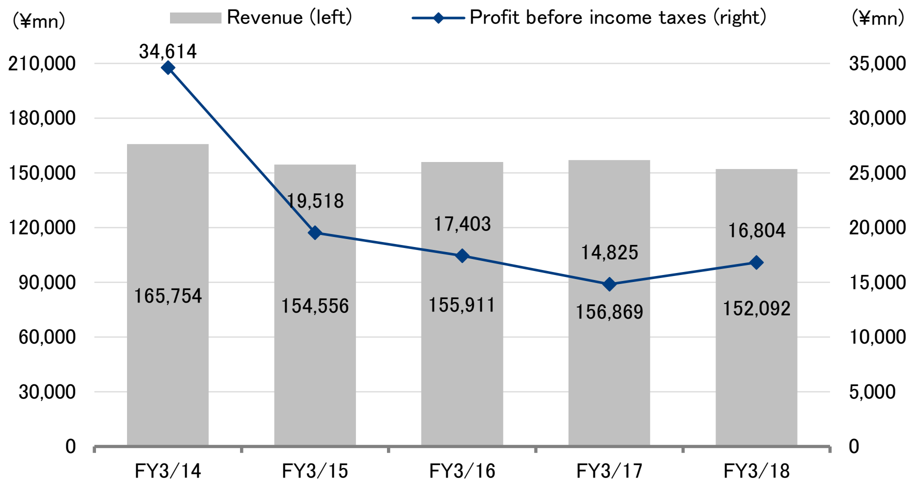
3. Announced entry into aircraft leasing as a new business

The Company announced entry into aircraft leasing as a new business. It is widely known that the number of global air passengers has been steadily growing. The aircraft leasing industry is sustaining growth in this environment, and the Company decided to pursue this area as a new business. The Company's business model fundamentally involves buying and leasing used mid-sized "narrow-body" planes, a highly fluid segment. Its near-term goal is buying about 20 planes over the next three years. While aircraft leasing business is an entirely new area, the Company intends to reduce risk by using outside advisers, enlisting external personnel, and narrowing the target market, and it hopes to promptly realize stable operations.

Key Points

- Growth strategy through expansion of the hall network is unchanged; also striving to solidify operations for full transition to machines that meet new rules at the end of January 2021
- Pursuing maximization of profits by building joint development operations for privately branded machines and a new analysis model and by purchasing machines supported by customers
- Announced entry into the aircraft leasing business

Trends in operating results



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

Company profile

Steadily expanding business with revolutionary measures based on the chain store theory and became the first in the industry to be listed on a stock market

1. History

The Company was founded as Sawa Shoji Co., Ltd. in 1967 by Yohei Sato, the father of Yoji Sato, a current senior corporate advisor. When the founder passed away in 1970, his eldest son, Yoji, who was then working at The Daiei, Inc., took over the business, and steadily expanded operations.

The Company was a pioneer in the pachinko hall industry by acting on new initiatives ahead of peers, including hiring new university graduates, opening suburban halls and low-cost halls, forming a labor union, and spreading low-fee ball rental nationwide. Yoji Sato was an important factor in the Company's adoption of a progressive corporate culture. He joined Daiei due to interest in the chain store theory that was still a novel concept in Japan. Since succeeding his father, who was the founder, he managed the Company, and expanded business by consistently applying the chain store theory to pachinko hall operations. The chain store theory is the source of low-cost operations, the Company's largest strength.

His logical approach rooted in the chain store theory took hold as the corporate culture and served as a fundamental force lifting the Company to the position of being the top company in the industry. The Company also moved quickly in embracing the most important concepts for modern management of a customer-first approach, information disclosure, and compliance, providing a foundation for its listing on the Hong Kong Stock Exchange in August 2012.

Company history

Date	History
July 1967	Founded Sawa Shoji Co., Ltd. (opened the Kameari and Kanamachi halls)
November 1987	Renamed as DYNAM Co., Ltd.
April 1989	First group of new university graduates entered the firm
October 1993	Became a corporate member of the Pegasus Club, an organization that analyzes chainstore operations.
August 1994	Opened the Company' s first low playing cost pachinko hall made of wood in Ebetsu, Hokkaido.
July 1997	Held the Company's first business results briefing with securities analysts.
April 1998	Established the Dynam Union, the first labor union in the pachinko industry
December 2006	Started the first low ball rental fees (pachinko ¥2, slot ¥10) at the Ebetsu hall Established DYNAM HOLDINGS Co., Ltd.
September 2011	DYNAM JAPAN HOLDINGS Co., Ltd. is established, as a result of incorporation-type company split from DYNAM Holdings Co., Ltd.
August 2012	Listed shares on the Hong Kong Stock Exchange
January 2013	Incorporated the Hong Kong entity, Dynam Hong Kong Co., Limited
June 2013	Announced an investment of $35mn in Macau Legend Development Limited
October 2013	Announced an investment of $15mn in IGG Inc.
November 2015	Consolidated Yume Corporation Co., Ltd.
December 2018	Announced entry into the aircraft leasing business

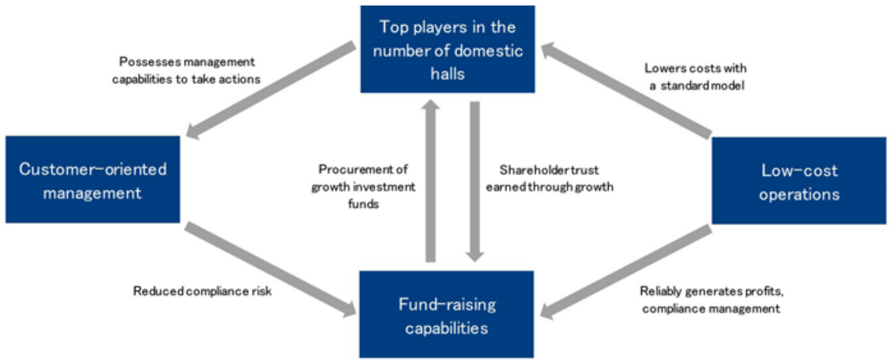
Source: Prepared by FISCO from the Company's website and securities report

Possesses a robust business foundation and achieves differentiation from other companies by leveraging four strengths

2. DYNAM JAPAN HOLDINGS Group's features and strengths

We focus on four points as the Company's attributes and strengths – 1) top player in terms of the number of halls in Japan, 2) low-cost operations, 3) customer-oriented management, and 4) fund-raising capabilities. Importantly these strengths are mutually interactive. We think it is difficult for other companies to realize the same combined strength seen at the Company.

Relationship among the four strengths of the Dynam Japan Holdings Group



Source: Prepared by FISCO from interviews

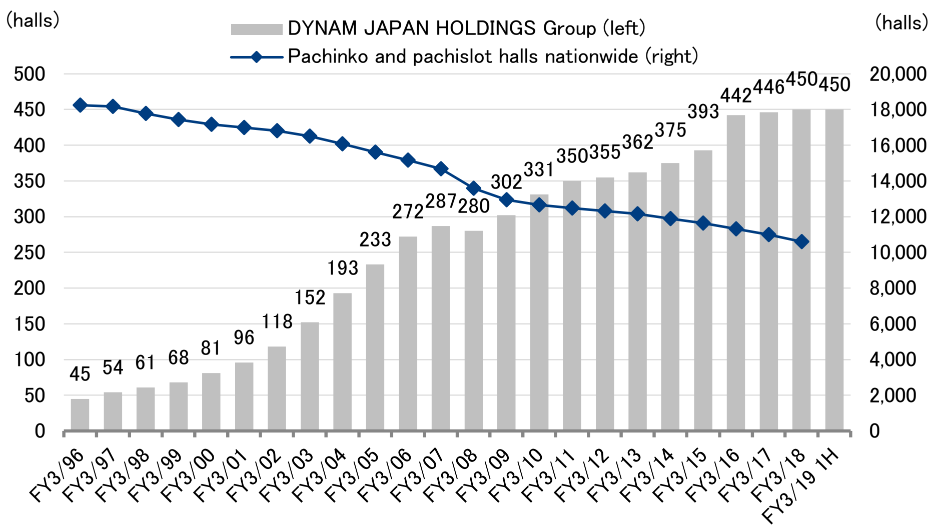
(1) Top group with 450 halls in Japan

The Company is the top hall operator in Japan with 450 halls managed within its group (as of the end of September 2018). The market share in Japan was 4.3% in terms of the number of halls and 4.7% based on the number of machines.

Economies of scale are a benefit of having a large number of halls. They extend to new hall openings, renovations, machine purchasing, prize procurement, logistics and others. Machine purchasing is particularly important. The large number of halls naturally means having many pachinko and pachislot machines, thereby enhancing buying (price negotiating) power with manufacturers. The Company also develops and deploys private-brand machines and seeks to attract customers and lower costs by expanding inter-hall transfer of machines. These measures are feasible because of the Company's large network of halls.

Benefits at Yume Corporation, which entered the Group in November 2015, offer a specific example. Yume Corporation reduced costs by a total of about ¥700mn (on an annualized basis) after joining the Group in items such as machine purchases, logistics, and financing costs. The savings corresponds to 12% of Yume Corporation's previous costs.

Trend in number of group halls



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

(2) Low-cost operations based on the chain store theory

Low-cost operations are a vital source of the Company's competitiveness. Our understanding is that this aspect enables the Company to realize and benefit from various measures, including the growth strategy.

The chain store theory provides the theoretical backdrop to low-cost operations. Costs of personnel and machines constitute a large portion of the total cost of operating a pachinko hall. Yet it takes more than just direct cost cutbacks. The Company is succeeding with low-cost operations as an overall group by deploying hall designs and hall operating systems (such as ball counters at each machine) that facilitate operations with a small number of employees and by standardizing new halls. The chain store theory plays an important role in a variety of ways and is enabling low-cost operations for the Group.

The Company is the industry leader in Japan, as mentioned earlier, with 450 halls. Aggressive hall network expansion supports this position and low-cost operation know-how has been an essential enabler. Hall network expansion has created a virtuous cycle of cost reductions through economies of scale that has put the Company in its strong position. We think the customer-oriented management explained below is an outcrop from low-cost operations as well.

The history section explained the background to the Company's utilization of the chain store theory in its management. The Company established the Pachinko Chain Store Association (PCSA), an industry group, with peers who have a similar view, and this entity has been researching application of the chain store theory to pachinko hall management. PCSA activities have not only contributed to strengthening the business foundation of industry peers, but also played a major role in the Company's expansion with the addition of Yume Corporation to the Group.

(3) Implementing management from a customer perspective

The Company advocates a customer-first approach as one of its five business policies and has been practicing it. This stands out because we think few peers who promote a similar policy are actually seeing actions through.

Among the Company's business policies, we have a favorable view of a) low ball rental fees and b) operations that do not rely on gambling appeal. These are also key words for understanding the Company's business policy and growth strategy.

a) Low ball rental fee operations

Pachinko is a game that is played with rented balls. The fee for renting balls (halls lend the balls) had been ¥4 per ball. Low ball rental fee operations take a cheaper approach that lowers the fee to ¥1 or ¥2. Customers can rent more balls for the same amount, extending their playing time in accordance with the additional balls. The Company's low ball rental fee machines account for 71.7% of pachinko machines (47.4% for the overall industry) and 56.9% of pachislot machines (22.7% for the overall industry), substantially exceeding industry averages (as of the end of September 2018).

Data shows that halls offering low ball rental fees have attracted more customers than halls charging higher fees. Yet it takes substantial company wherewithal to adopt this type of strategy as margin declines at halls with low ball rental fees see weaker revenue than halls charging higher fees without much difference in operating costs. A measure to offset this aspect is growth through expansion of hall numbers. The Company has followed this path.

b) Operations that do not rely on gambling appeal

The Company does not position models with strong gambling appeal as a central strategy. Pachinko machines range from ones with high probability of major wins to ones with low probability. Machines with lower probability give a larger number of balls in a major win and are preferred by pachinko fans. Many pachinko halls hence attract customers by operating halls with a high ratio of machines that have low major-win probability (in other words, machines with strong gambling features).

However, authorities introduced regulations to curtail gambling appeal in FY3/17, lifting the lowest probability threshold from 1/400 to 1/320. The industry removed 1/400 machines by December 2016. Regulations on gambling appeal address the addiction issue and authorities applied new rules in February 2018. These changes are eroding the pachinko hall management style of attracting customers with gambling.

The Company, meanwhile, has a lower ratio of gambling-type machines than the industry and conversely the share of machines with the lowest gambling features at 1/100 probability is 20 percentage points higher than the industry average. While the Company cannot avoid an impact from stricter gambling appeal regulations, we think the negative impact is fairly light due to its existing pursuit of operations that do not rely on gambling appeal.

(4) Fund-raising capabilities that leverage strength as a listed company

The Company became the first in the pachinko hall industry to list its shares with its IPO on the Hong Kong Stock Exchange in 2012. Only three companies, including the Company, out of the pachinko hall industry's roughly 3,200 companies are listed on stock markets as of September 30, 2018. The industry is projected to face realignment going forward. An important point for a buyer in this environment is obviously whether it has fund-raising capabilities. The Company capitalized on its strength as a listed company to acquire Yume Corporation in November 2015 through a stock swap for all of its shares. We anticipate very strong benefits for the Company as a listed company in non-M&A areas too because of the likely need for a variety of funds in the future for hall investment, new business development and other initiatives.

Results trends

Achieved sharply higher profits by promoting efficient utilization of expenses

The Company reported higher profits on a decline in sales in FY3/19 1H with revenue at ¥73,583mn (-4.7% YoY), operating profit at ¥12,268mn (+40.7%), profit before income taxes at ¥12,411mn (+47.6%), and net profit attributable to owners of the Company at ¥8,340mn (+53.6%). The Company has delivered higher operating profit YoY in three straight half-year periods since FY3/18 1H.

Summary of FY3/19 1H results

(¥mn)

	FY3/18	FY3/19		
	1H	1H	YoY	Change
Ball rental fee revenue	397,127	386,840	-2.6%	-10,287
Cost of prizes	319,916	313,257	-2.1%	-6,659
Revenue	77,211	73,583	-4.7%	-3,628
Total expenses	68,489	61,315	-10.5%	-7,174
Operating profit	8,722	12,268	40.7%	3,546
Profit before income taxes	8,406	12,411	47.6%	4,005
Net profit attributable to owners of the Company	5,430	8,340	53.6%	2,910
EBITDA	14,783	18,049	22.1%	3,266

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

Authorities introduced regulations on output ball ratio and output ball numbers from February 1, 2018. Key points are setting 1) the upper limit on the output ball ratio to around two-thirds of the former level and 2) the number of balls received per major win to roughly two-thirds of the former level. Nevertheless, the regulations allow for a three-year transition period with continued use of pachinko machines with existing ball output standards for as long as three years (through the end of January 2021) if approval is obtained. This means the Company's halls have a mix of pachinko machines that comply with the new rules (referred to below as new rule machines) and pachinko machines based on former rules (former rule machines).

Ball rental revenue, which corresponds to gross sales, was down 2.6% YoY to ¥386,840mn in 1H, which started under the new rules. While former rule machines remain installed at halls, restriction of major win probability in FY3/18 and the latest application of output ball restrictions substantially affected core pachinko customer and other pachinko fans. In response to this situation, the Company reinforced low-cost playing (ball rental) and implemented measures to attract customers tailored to local areas around halls in order to boost the number of visits by existing customers and acquire new customers. Pachinko operating data and other information suggest a relatively lighter setback in the Company's business compared to peers, but sales fell YoY. Cost of prizes declined 2.1% YoY along with the drop in rental ball revenue. Revenue ended up shrinking 4.7% YoY (¥3,628mn).

Spending, meanwhile, was down 10.5% (¥7,174mn) to ¥61,315mn (this is the total of hall operating costs, SG&A expenses, and net value of other income and other expenses). In individual items, hall operating costs dropped by ¥7,254mn and covers nearly all of the decline in operating costs. Lower machine costs accounted for the largest portion at just over 90% of the decline in hall operating costs. Key factors in the reduction were curbing purchases of new machines that comply with former rules and rolling out private-brand machines that the Company has been focusing on. Combined decline in expenses hence exceeded the drop in revenue, and this outcome resulted in a 40.7% YoY (¥3,546mn) increase in operating profit.

The number of the DYNAM Group's halls was unchanged from six months earlier at 450 based on one new opening at DYNAM and one closure at Yume Corporation. In format conversions, DYNAM changed two locations from high-cost playing (rental balls) to low-cost playing halls and one location from a low-cost playing to high-cost playing hall. These adjustments put the percentage of low-cost playing halls at 60.2% of total at the end of September 2018.

Hall changes during FY3/19 1H

		No. of halls at start of period	New openings	Closures	Conversions	No. of halls at end of period
High-cost playing (ball rental) hall	DYNAM	168			-1	167
	Cabin Plaza	2				2
	Yume Corporation	10				10
	High-cost playing (ball rental) hall total	180	0	0	-1	179
Low-cost playing (ball rental) hall	DYNAM	237	1		1	239
	Cabin Plaza	6				6
	Yume Corporation	27		-1		26
	Low-cost playing (ball rental) hall total	270	1	-1	1	271
	Total number of group halls	450	1	-1	0	450

Source: Prepared by FISCO from the Company's materials, interviews, etc.

The Company continued to repay loans during 1H, as it had done in FY3/18. Profit rose sharply YoY in 1H with a gain of over 40%, and EBITDA, which restores depreciation costs and some other expenses, reached ¥18,049mn. Use of these funds consisted of ¥3bn each for income tax payments and capital investments (hall renovation investments, new openings) and an equal three-way split of the remaining ¥12bn for dividends, loan repayment, and cash and deposits build-up. These allocations put the interest-bearing debt balance at ¥5,156mn and the cash and deposits balance at ¥44,921mn at the end of September 2018.

Changes in cash and cash equivalents, and interest-bearing debt at the end of the period

(¥mn)

	FY3/16	FY3/17	FY3/18	FY3/19 1H
EBITDA	30,494	28,469	29,524	18,049
New openings (gross value, including M&A deals)	53	5	6	1
(Net increase in the number of halls)	49	4	4	0
Total dividends paid (annual)	10,055	9,192	9,192	4,596
Cash and cash equivalents at the end of the period	28,134	48,499	40,533	44,921
Interest-bearing debt at the end of the period	20,763	30,049	8,572	5,156
Total assets	189,184	205,115	184,971	187,315

Source: Prepared by FISCO from the Company's materials

Business conditions at core group company DYNAM almost entirely overlap with the explanation of parent company results. Revenue fell YoY on lower number of customers and decline in average customer spending. Cutbacks in operating expenses (mainly machine costs) more than offset the decline and led an increase in operating profit.

During 1H, the Company opened one new hall, converted two halls from the high-cost playing (rental balls) to low-cost playing format, and conducted hall renovations and updates at the same pace as a normal year.

In key performance indicators, pachinko and pachislot machine operating rates modestly improved during 1H versus FY3/18 (full-year basis) results and remain well above rates at rival halls. The Company has been lowering machine costs through deployment of private-brand machines, and the ratio of private-brand machines installed at its halls was 5.8% at the end of 1H.

DYNAM's management situation

(¥mn)

	FY3/18 1H	FY3/19 1H	YoY	Summary
Revenue	71,336	68,581	-2,755	Decline in pachinko machine operating rates, impact from removing machines with high gambling features
Operating profit	7,246	10,014	2,768	Higher profit on lower expenses mainly in machine costs
Ordinary profit	7,670	10,505	2,835	
Net profit	5,047	7,011	1,964	
KPIs				
No. of halls	405	406	1	Yamagata Tendo hall
Pachinko machine operating rate	43.1%	43.3%	0.2%	+10.7pp vs. rival halls
Pachislot machine operating rate	39.6%	39.9%	0.3%	+6.3pp vs. rival halls
No. of machines	186,898	187,667	769	4.2% share of all machines in Japan
No. of private-brand machines	7,315	7,785	470	5.8% of all machines at DYNAM halls

Note: KPIs listed under FY3/18 1H are either end-FY3/18 values or full-year average values.
Source: Prepared by FISCO from the Company's materials

Medium-term growth strategy and current initiatives

Pachinko market weakened to less than ¥20tn, possible impact of gambling restrictions

1. Business environment in the pachinko hall industry

(1) Market size and number of halls

Japan's population of pachinko and pachislot players in 2017 was down 4.3% (400,000 people) YoY to 9mn people. Reflecting this change, the pachinko hall market (total rental ball revenue at pachinko halls that corresponds to gross sales) weakened to less than ¥20tn, declining 4.3% YoY to ¥19,540bn in 2017.

The number of pachinko halls nationwide has also been steadily dropping due to ongoing market contraction. According to National Police Agency data, it was down by 390 halls from the previous year to 10,596 halls as of December 2017. While it has been falling at a pace of 200-300 halls per year over the last few years, it slightly accelerated in 2017.

(2) Regulatory actions

The government has been strengthening regulations that target pachinko and pachislot businesses as part of efforts to "address gambling and other addictions." Regulatory action primarily aims to reduce gambling appeal as a specific measure. It heavily affects pachinko hall management because gambling is one of the appeals of pachinko and pachislot games.

Following a regulatory change in 2016 that raised the major-win probability ratio of pachinko machines*, authorities introduced regulations on output ball ratio and output ball numbers from February 1, 2018. Key points are setting 1) the upper limit on the output ball ratio to around two-thirds of the previous level and 2) the number of balls received per major win to roughly two-thirds of the previous level.

* Machines with the strongest gambling appeal prior to then utilized a major-win probability of 1/400. After industry removal of these machines by the end of 2016, today's most potent machines for gambling are those with a 1/320 ratio. Stricter regulation hence changed pachinko from a high-risk, high-return game to a middle-risk, middle-return game.

These regulations have a very large impact. An even bigger impact than diminished customer appeal from dilution of gambling appeal is the need to replace machines. Machine costs are the one of the largest expenses for hall operations along with wages, and higher machine costs put significant pressure on hall profits.

Nevertheless, the February 2018 ball output regulations have a three-year transition period with continued use of former rule machines for as long as three years (through the end of January 2021) if approval is obtained. While it costs about ¥10,000 per machine to acquire approval, hall operators can avoid incurring the capital investment burden accompanying the regulations (machine replacements) immediately and take actions to transition to machines that meet the new rules at a moderate pace.

We think the February 2018 regulations closed the discussion of curtailing gambling appeal in pachinko business for the time being and the pachinko hall industry and pachinko game manufacturers have moved to a stage of gradually complying with the rules.

Content of ball output regulations

	Current regulations	New regulations
Upper limit on output balls	Maximum rounds: 16R Maximum paid output balls: 2,400 balls	Maximum rounds: 10R Maximum paid output balls: 1,500 balls
Playing tests	1 hour: Output ball ratio 3x or less 10 hours: Output ball ratio at no less than 1/2x and up to 2x	1 hour: Output ball ratio at no less than 1/3x and up to 2.2x 4 hours: Output ball ratio at no less than 2/5x and up to 1.5x 10 hours: Output ball ratio at no less than 1/2x and up to 4/3x
Setting	No setting	Supports settings at 1-6 levels similar to pachislot machines

Source: Prepared by FISCO from Company materials

Similar to pachinko, authorities are implementing stricter regulations on gambling appeal in the pachislot business too. They plan to incrementally lower the permissible percentage of machines with high gambling appeal from the current 30% threshold to 0% by the end of January 2021. Zenkoku Yuugi Jigyou Kyoudou Kumiai Rengokai, the industry organization, adopted voluntary regulations in June 2015 to lower the percentage of machines not in compliance with new standards (so-called machines with high gambling appeal) to 30% or less by the end of November 2017. It subsequently proceeded to formulate voluntary regulations to incrementally reduce this ratio to 0% in April 2018.

Installation ratio rules for pachislot machines with high gambling content

Period	Percentage of machines with high gambling content
Present through end-January 2019	Lower from 30% or less to 15% or less
February 2019 to end-January 2020	Lower from 15% or less to 5% or less
February 2020 to end-January 2021	Lower from 5% or less to 0%

Source: Prepared by FISCO from interviews

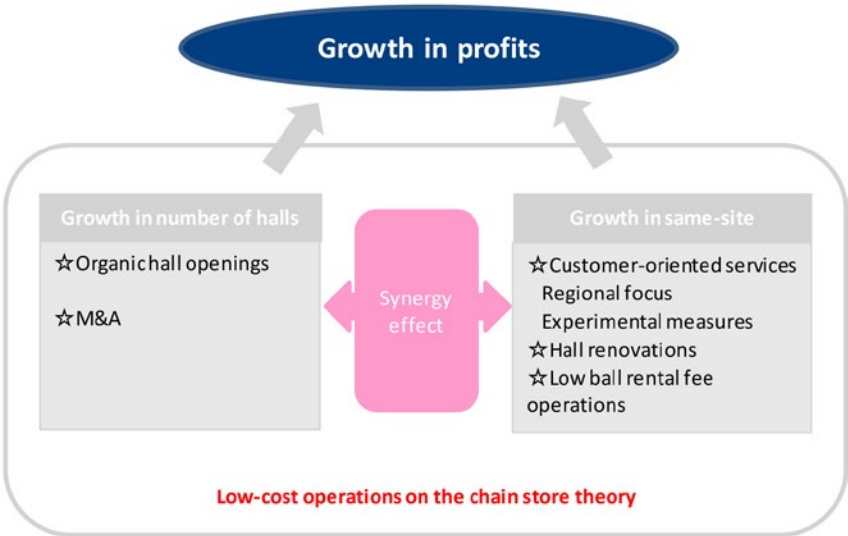
* In November 2018, the industry organization decided to extend the period because of sales and supply shortages for machines that comply with the new rules.

Growth strategy through expansion of the hall network is unchanged Also striving to solidify operations for full transition to machines that meet new rules at the end of January 2021

2. Growth strategy and initiatives

The Company adopted a two-pronged approach in the growth strategy that adds a push to boosting customer traffic at existing locations to its efforts of driving higher sales through hall network expansion. Both initiatives are similarly important to the two approaches. We think a key point is flexible use of the growth strategy depending on the business environment in the industry and conditions of rivals. (Please refer to previous reports on for details on how the Company expanded its network of halls based on a hall opening model, and on initiatives it has used to increase the number of customers at existing halls).

Image of the two-pronged growth strategy – hall network expansion and increasing revenue of existing halls



Source: Prepared by FISCO from Company materials

The Company is not overtly applying the axle or brakes to expansion of the hall network. Instead the number of halls has been flat in recent years because of the extremely small number of opportunities that meet its standard based on the chain store theory for direct openings and M&A deals.

Despite these conditions, meanwhile, it is necessary to update all equipment to new rule machines by the end of January 2021 when the 2018 regulations fully apply. Many pachinko hall operators are likely to face difficult decisions on whether to continue or exit their businesses. The three years through FY3/21 hence could be seen as a preparatory phase for realization of the above-mentioned growth strategy (especially expansion of the hall network and market share).

Within this context, the Company pursued reduction of machine costs and started building joint development operations for machines and a joint analysis model as longer-term initiatives in FY3/19 1H.

Sharply lowered machine costs in 1H by curbing new machine purchases and promoting private-brand machine deployments

3. Update on initiatives to lower machine costs

As mentioned earlier, the Company reported sharply higher profits (YoY) in 1H with reduction of machine costs as the main driver. Machine costs are the second-largest item in hall operating expenses after wages, and savings in this area have a very large impact on profits. For FY 3/19, the Company has cut machine costs (YoY), which lead to increased operating profit. Specific measures for reducing machine costs during 1H were 1) cutbacks in new machine purchase and 2) lowering the average price of machines via deployment of private-brand machines.

Ball output regulations that took effect in February 2018 are a key factor in understanding activities related to machine costs. As explained earlier, halls can continue to use former rule machines, even after the regulations begin, up until the end of January 2021 if approved, but they must fully switch to new rule machines thereafter. The transition phase covers three years from FY3/19 to FY3/21. In FY3/19, the Company strategically utilized existing former rule machines (about 131,000 machines) with approvals and curtailed new machine (particularly former rule machine) purchases.

Meanwhile, the Company deployed about 1,800 private-brand machines in 1H with an average purchase price at 73% of national-brand machines with the same performance.

To support machine cost reduction, the Company formed a dedicated team to analyze machine data using big data gathered from its 450 group halls. The analysis team identified ideal solutions from the standpoint of costs and customer appeal through data analysis.

Machine cost savings were unquestionably the largest profit increase factor contributing to earnings in 1H. However, we advise caution in outlooks due to the prospect of a smaller machine-related savings effect in 2H and a switch to rising costs in FY3/20. This view takes into account the need to replace existing former rule machines in order to comply with new output ball regulations described above. The Company has roughly 131,000 group machines that comply with former rules and received approval in FY3/18. This roughly works out to 65,000 machines a year when split into two years. While the number itself is on par with the level in a normal year for the Company through FY3/17, we expect a rise in machine costs and pressure on profits compared to FY3/18 and FY3/19 that curtailed new machine purchases.

Pursuing maximization of profits by building private-brand machine joint development operations and a new analysis model and by purchasing machines supported by customers

4. Initiatives for the future

Machine costs occupy about one-fourth of hall operating costs and are the second-largest item after wages, as explained earlier. The Company has been striving to rectify these costs from a longer-term perspective. It conducted the following activities in 1H.

(1) Lowered costs of developing machines through new joint development operations

Private-brand machines are an important aspect of efforts to rectify machine costs. While private-brand machines lower average machine pricing, they come with risk of underperforming national-brand machines in customer attraction in terms of name recognition and other aspects. From this perspective, the Company fundamentally used an approach of adjusting specifications based on national-brand machines in private-brand machines developed up to now and thus was unable to achieve major cost savings and product feature improvements.

Recently, however, core operating company DYNAM adopted an efficient development scheme with a developer and machine manufacturer for three-way joint development operations. DYNAM intends to implement co-work with the developer from the design stage and work toward lower parts and materials costs and development costs. It hopes to develop machines that meet customer needs by continuing initiatives over the long term and reduce prices to 50% of the national-brand machine level by realizing stable supply and installations.

(2) Joint construction of an analysis model for new machine selection and deployment

The Company formed a dedicated analysis team in 1H and is also developing a new analysis model for data analysis. It is collaborating with an external analysis expert company and has begun trial operation of three models (new machine purchase decision model, used machine purchase decision model, and inter-hall transfer model. Through these tests, it plans to improve the precision of each model and boost the efficiency of machine purchases.

(3) Response to a phase of industry changes

Full transition from former rule machines to new rule machines might cause significant changes in the pachinko hall industry because of heavy cost burden. The Company's biggest near-term goal is capitalizing on this phase as a growth opportunity. As preparation, the Company is making maximum use of analysis technology to prevent customer attraction opportunity losses and invest efficiently in machine that reflect results of machines supported by customers. These efforts aim to maximize profits.

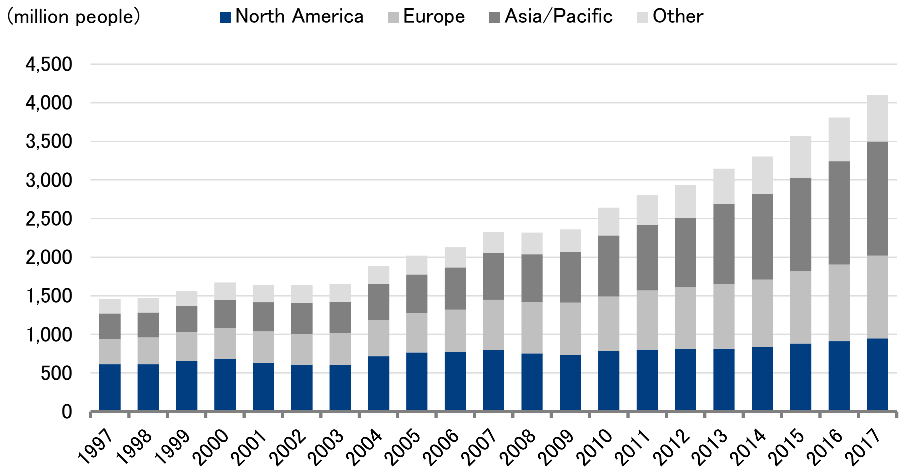
We think the Company's future-oriented measures are likely to produce concrete results in FY3/20 because they just started in FY3/19 1H. The usage term of former rule machines expires at the end of January 2021. However, related activities, including industry changes, might arrive substantially sooner because of the need for lead-time (preparation) in various areas. We expect fairly rapid progress with these initiatives in order to deliver a sufficient effect.

Announced entry into the aircraft leasing business, aims to reduce risk with a model of leasing used planes in top-selling segments

5. New business: Entering the aircraft leasing business

The Company announced that it would launch aircraft leasing service as a new business. The growth in the number of global air passengers has been accelerating in recent years with globalization and progress in emerging countries. According to the International Air Transport Association (IATA), the number of global air passengers reached about 4.1bn people in 2017 and average annual growth in the 17 years since 2000, which recorded 1.672bn people, was 5.4%. The average annual pace in the past 10 years has been 6.5% amid acceleration since after the Lehman shock.

Trends in the number of global air passengers



Source: Prepared by FISCO from International Air Transport Association (IATA) materials

A relatively small number of companies dominate the aircraft leasing industry with the top 10 companies (led by US-based GE Capital Aviation Services (GECAS) and AerCap)) holding a market share of just over 60% and the top 20 companies controlling almost 100% of the market. This is the leasing market for new planes. The Company, meanwhile, is targeting the market for used planes with a business model in which it has transaction relationships with global major leasing companies, rather than competing with them. Airplane leases typically utilize a lease period of about 7-10 years, and airlines agree to purchase planes they had been leasing when the lease period finishes. Since airlines prefer to operate under a leasing format, instead of directly owning planes, there is demand for renewal of the lease contract with a new leasing company. The Company's business model aims for this type of secondary lease demand. It reduces risk because the airline that will use the plane is already arranged at the time of buying the plane.

As a way of lowering risk even more, the Company plans to narrow its scope of plane purchases to "narrow body" models, a highly fluid segment. Specific examples are the Boeing 737 series and Airbus A321, A320, and A319 models with 125-180 seats. The Boeing 737 and Airbus A320 are top volume sellers at these companies. They also dominate orders backlog at 4,668 out of 5,864 planes at Boeing and 4,009 out of 7,265 planes at Airbus as of 2017 and are large enough markets for the Company's purpose.

The near-term business plan calls for establishing a wholly owned subsidiary and beginning business in 2019 with an actual start in FY3/20. It also aims to purchase and conclude lease contracts for 20 used planes within three years. We expect further steady purchase of planes thereafter. The lease business income model involves initial cash outlays to purchase planes and then cash inflow from lease fees. This business finalizes income from a subject lease deal at the point when the lease expires and the plane is sold. Given this pattern, the ideal approach is arranging lease contracts to have a certain number of contracts expire each year, though it will take some time to establish such operations. We think the Company's business plan for acquiring 20 planes over the next three years takes into account this aspect.

Business outlook

Estimate shows increase in full-year operating profit even with tough assumptions

● FY3/19 outlook

We prepared our own simulation for an outlook based on certain conditions because the Company does not disclose forecast.

Ball rental revenue, the basis of revenue, dropped 2.6% YoY in FY3/19 1H. At the start of the year, we projected a 2.3% YoY decline in ball rental revenue, assuming a 4.3% decline in industry ball rental revenue (applying the average annual growth rate for the pachinko market over the past 10 years) with an adjustment for core subsidiary DYNAM's pachinko machine operating rate that exceeds rival halls by 10 percentage points. While it is possible to think that the disparity is "in line with expectations," we took a cautious view that the "business environment is tougher than anticipated" and revised our FY3/19 ball rental revenue estimate to a 3.5% YoY decline, which works out to ¥747,933mn.

Revenue (gross margin) was 19.0% of ball rental revenue in 1H. We initially forecast a higher level than in FY3/18 (19.6%) at 20.0%, but the Company bolstered return to customers. Based on the 1H result, we changed our FY3/19 gross margin estimate to 19.2% and thus project ¥143,603mn in FY3/19 revenue (-5.6% YoY).

Simulation of FY3/19 revenue

Factors		Amount	Remark
FY3/18 rental ball revenue for the Company (¥mn)	(A)	775,060	
FY3/19 average rental ball revenue growth estimate for the industry		-4.3%	Average growth rate for pachinko market size (ball rental fee revenue basis) over the 10 years through 2016 with 2006 as the starting point
FY3/19 rental ball revenue growth estimate for the Company	(B)	-3.5%	Updated our outlook in light of the 1H result (-2.6%) to -3.5% for FY3/19
FY3/19 rental ball revenue estimate for the Company	(C = A × B)	747,933	
FY3/19 gross margin estimate for the Company	(D)	19.2%	Gross margin is the percentage of revenue to ball rental revenue, projecting 19.2% in FY3/19 given the 1H result (19.0%)
FY3/19 revenue estimate for the Company	(E = C × D)	143,603	5.6% YoY decline

Source: Prepared by FISCO from the Company's materials

Overall expenses, meanwhile, declined 10.5% in 1H with a steep 10.4% drop in hall operating costs because of a hefty reduction of machine costs as well as savings in SG&A expenses and other areas. A key point is whether steep decline in machine costs continues in 2H. As explained earlier, we think the market reality of few new rule machine releases and primarily existing rule machine releases played a major role in machine cost savings during 1H. This matters because former rule machines bought now still have to be replaced by the end of January 2021. However, we expect steady deployment of new rule machines from 2H because it would be difficult for the Company to replace the number of machines it owns in just one year in terms supply capacity on the manufacturer side and funding burden, as noted earlier. We assume an increase in machine costs from 1H and scale back the anticipated decline in hall operating costs to 3.0%. We hence estimate a 2.7% decline in 2H costs, including SG&A expenses, to ¥64,459mn and full-year costs at ¥125,774mn (-6.7%).

Simulation of FY3/19 expenses

(¥mn)

	FY3/18			FY3/19		
	1H	2H	Full year	1H	2H (E)	Full year (E)
Hall operating expenses	69,706	67,021	136,727	62,452	65,000	127,452
YoY	-3.8%	-3.8%	-3.8%	-10.4%	-3.0%	-6.8%
SG&A expenses	2,445	2,604	5,049	2,241	2,559	4,800
YoY	-9.2%	-11.1%	-10.2%	-8.3%	-1.7%	-4.9%
Other income (vending machine fee income)	4,441	5,017	9,458	4,764	4,500	9,264
Other expenses	779	1,646	2,425	1,386	1,400	2,786
Total expenses	68,489	66,254	134,743	61,315	64,459	125,774
YoY	-4.3%	-4.5%	-4.4%	-10.5%	-2.7%	-6.7%

Source: Prepared by FISCO from the Company's materials

Our estimates for revenue and expenses shown above suggest ¥17,829mn in FY3/19 operating profit (+2.8% YoY). Main points are 2H ball rental revenue, gross margin, and cost reduction measures (mainly machine costs). We obtain a rise in operating profit even using tougher assumptions than 1H results and hence think the Company has leeway to expand operating profit in FY3/19.

Income statement

(¥mn)

	FY3/15	FY3/16	FY3/17	FY3/18	FY3/19 1H
Revenue	154,556	155,911	156,869	152,092	73,583
YoY	-6.8%	0.9%	0.6%	-3.0%	-4.7%
Hall operating expenses	134,659	138,326	142,142	136,727	62,452
YoY	-0.9%	2.7%	2.8%	-3.8%	-10.4%
SG&A expenses	5,456	5,798	5,622	5,049	2,241
YoY	33.5%	6.3%	-3.0%	-10.2%	-8.3%
Other income	6,850	8,184	9,224	9,458	4,764
Other expenses	1,947	1,805	2,430	2,425	1,386
Total expenses	135,212	137,745	140,970	134,743	61,315
YoY	0.9%	1.9%	2.3%	-4.4%	-10.5%
Operating profit	19,344	18,166	15,899	17,349	12,268
YoY	-39.0%	-6.1%	-12.5%	9.1%	40.7%
Financial income	2,151	311	233	236	322
Financial expenses	1,977	1,074	1,307	781	179
Profit before income taxes	19,518	17,403	14,825	16,804	12,411
YoY	-43.6%	-10.8%	-14.8%	13.3%	47.6%
Tax expenses	8,259	6,864	5,520	5,879	4,086
Net profit for the year	11,259	10,539	9,305	10,925	8,325
YoY	-47.0%	-6.4%	-11.7%	17.4%	53.2%
Net profit attributable to owners of the Company	11,303	10,544	9,360	10,870	8,340
YoY	-46.8%	-6.7%	-11.2%	16.1%	53.6%
EBITDA	30,637	30,494	28,469	29,524	18,049
YoY	-28.3%	-0.5%	-6.6%	3.7%	22.1%
EPS (¥)	15.22	13.92	12.23	14.19	10.89
Dividend per share (¥)	14.00	13.00	12.00	12.00	6.00

Balance sheet

(¥mn)

	FY3/15	FY3/16	FY3/17	FY3/18	FY3/19 1H
Current assets	48,723	43,240	63,072	53,145	56,576
Cash and cash equivalents	29,239	28,134	48,499	40,533	44,921
Trade receivables	486	459	563	469	463
Non-current assets	132,213	145,944	142,043	131,826	130,739
Property, plant and equipment	99,961	109,532	106,687	98,794	96,931
Intangible assets	1,029	3,991	3,833	3,545	3,460
Total assets	180,936	189,184	205,115	184,971	187,315
Current liabilities	31,380	30,838	38,496	39,643	37,754
Trade and other payables	20,468	17,786	18,282	19,220	17,923
Borrowings	3,160	2,369	7,281	7,351	4,370
Non-current liabilities	14,503	25,727	29,738	7,813	7,293
Borrowings	9,160	18,394	22,768	1,221	786
Equity attributable to owners of the Company	135,077	132,645	136,953	137,532	142,300
Share capital	15,000	15,000	15,000	15,000	15,000
Capital reserve	10,129	12,883	12,741	12,741	12,741
Retained profits	111,037	110,253	112,403	114,106	117,860
Other component of equity	-1,089	-5,202	-3,191	-4,315	-3,301
Non-controlling interests	-24	-26	-72	-17	-32
Total equity	135,053	132,619	136,881	137,515	142,268
Liabilities and net worth	180,936	189,184	205,115	184,971	187,315

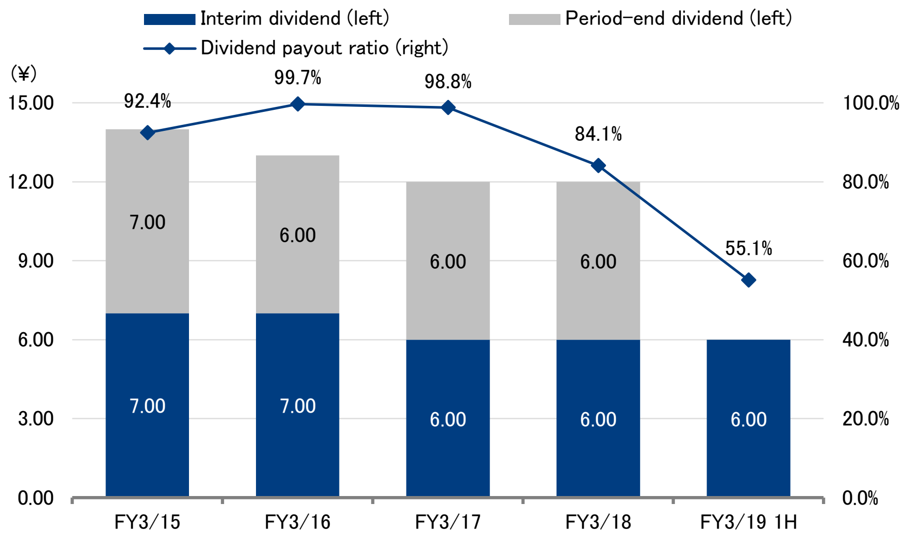
Returns to shareholders

Approved a ¥6 dividend for the FY3/19 interim period

The Company is highly conscious of the significance of returns to shareholders because it recognizes the importance of raising shareholder value in order to achieve sustainable growth. Based on this view, its policy is to pay stable dividends.

Based on the 1H result, the Company decided to pay a ¥6 dividend for the FY3/19 interim period. With its ¥8,340mn in net profit attributable to owners of the Company, the ¥4,596mn dividend payment puts the payout ratio at 55.1%. While the business environment remains difficult, the Company booked sharply higher profit in 1H thanks to low-cost operations and dividend payout ratio slipped from the level seen through FY3/18.

Trends in dividend per share and dividend payout ratio



Source: Prepared by FISCO from financial statements

CSR/ESG initiatives

Aiming to enhance long-term enterprise value as “regional infrastructure” in dealing with working style reforms, fostering and appointing women managers, and other important themes

1. CSR initiatives and enhancement of long-term enterprise value

As a listed company, the Company conducts compliance management in line with the laws and seeks to maximize profits. It also aims to build “regional infrastructure” (being a presence that is vital to local areas) and possesses strong CSR (corporate social responsibility) awareness. Amid discussions of working style reforms, fostering women managers, and other themes, the Company addresses these as important topics in an effort to understand where society is headed and seeks to enhance long-term enterprise value.

(1) Focus on working style reforms (Important theme: Work friendly environment)

The Company reinforced the program for shorter working hours in May 2018 by opening it up to employees with nursing care, pregnancy, and illness situations and removing the limit on the number of times it can be used. As other work style reforms, it extended the retirement age to improve its record of employing seniors, converted non-regular employees to regular employees, and formulated the “healthy management declaration.”

(2) Earthquake reconstruction assistance (Important theme: Co-existence with local society)

The Company has been continually engaged in activities for earthquake reconstruction assistance. The Company's total donations to the three Tohoku prefectures affected by the Great East Japan Earthquake in 2011 are well above ¥600mn thus far. It is also providing recovery assistance for the Kumamoto Earthquake in 2016 and torrential rainfall in July 2018. It is also actively involved in hands-on assistance in the area. One example is the participation of many employees in planting trees to create a row of sakura (cherry) trees along the roughly 170km line where the tsunami reached furthest inland in Rikuzentakata city (Iwate Prefecture) organized by the Sakura Line 311, a nonprofit organization (NPO). The Company assists employees in volunteer activities too.

(3) Fostering women managers and interaction assistance (Important theme: Diversity and human resource development)

The Company has created an internal "Nadeshiko Team" to promote training of women managers. The Nadeshiko Team has repeatedly exchanged views with representatives in charge of promoting women at industry peers and recently held an event called the Nadeshiko Summit 2018 that also invited representatives from three companies in other industries. The Company intends to continue and bolster initiatives to utilize women.

(4) Continued hiring of new university graduates (Important theme: Diversity and human resource development)

The Company was the first in the pachinko hall industry to establish a framework for hiring new university graduates and continues to hire them without being affected by changes in the business environment. In FY2018, it hired 91 new university graduates (69 men, 22 women). It intends to continue hiring new university graduates based on the employment plan.

(5) "Torepachi!" playing events at welfare facilities (Important theme: Co-existence with local society)

The Company has been steadily implementing playing events using the "Torepachi!" pachinko machine developed for welfare facilities since 2016. This event aims to provide enjoyment and rehabilitation training to residents. The Company plans to continue these events and contributions to local society.

(6) Secondhand smoke prevention (Important theme: Provision of an enjoyable and safe playing environment)

The Company operates 26 halls in the network with complete separation including the 24 halls from the Shinrai no Mori brand that incorporates smoker separation in the hall concept and 2 halls from the Yuttari Kan brand. Other halls in the Company's network are structurally ready for complete separation. We expect the Company to expand halls with this feature in light of societal trends and customer reaction.

Disclosed an integrated report, enhancing non-financial (ESG) information and provision of tools for dialogue with long-term investors

2. ESG activities

The Company issued its annual report (Annual Report 2018) on May 29, 2018. The Hong Kong Stock Exchange requires companies listed on the exchange to disclose ESG information since 2017, and listed companies are ramping up their disclosure of non-financial information. The Company's annual report also added to information disclosure on its views of and initiatives with the environment (E) and society (S) in light of the CSR activities reviewed above.

Additionally, the Company's annual report uses a structure that reflects the international integrated report framework defined by the International Integrated Reporting Council (IIRC) and the "guidance on comprehensive disclosure and dialogue to promote collaborative value innovation" presented by the Ministry of Economy, Trade and Industry. Pursuit of improvements in enterprise value from a long-term perspective, including ESG, is gaining recognition as a common theme among long-term investors and companies in an environment that encourages closer dialogue between investors and companies. We have a positive view of the Company's information disclosure in an integrated report as evidence of its openness to dialogue with global long-term investors. The Company also disclosed a CSR report (CSR Report 2018) in July. We expect steady enhancement of tools for dialogue with long-term investors to broaden opportunities for appropriate assessment of the Company in the stock market.

Information security

Strives for rigorous management of personal information (acquired a privacy mark)

The Company issues member cards as part of its efforts to build a fixed customer base. It currently has about 4mn members and possesses massive amounts of personal information on members. Given these circumstances, it is highly conscious of information security in its activities. As a specific measure, it established operations that comply with JISQ15001:2006, a set of guidelines for appropriate management of personal information defined by JIS (Japan Industrial Standards) and thereby obtained a privacy mark. It also undergoes periodic assessments of overall management operations by the Pachinko Trustee Board, a third-party evaluation entity for pachinko hall operators, and has continuously received the highest rating (AAA) for items that include information security. We believe the Company has already built sufficient information security operations in light of these results.

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