COMPANY RESEARCH AND ANALYSIS REPORT

DYNAM JAPAN HOLDINGS

06889

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Summary

Making steady progress in preparations ahead of a major industry reorganization phase

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. Operating revenue fell, but profit rose on lower machine costs and other spending

The Company reported ¥146,371mn in operating revenue (-3.8% YoY) and ¥19,342mn in operating profit (+11.5%) in FY3/19. Profit rose on lower sales. The Company put top priority on securing customer traffic amid continuation of a tough business environment. It sustained traffic at the previous-year level thanks to steadfast efforts to attract customers tailored to the locations and main segments of individual halls and an improved return rate for customers. The higher payout ratio, however, reduced operating revenue. In profits, meanwhile, the Company worked to lower the full range of costs with primary emphasis on machine costs. The resulting 5.7% reduction in total costs lifted operating profit.

2. Approaching the two years of FY3/20 and FY3/21 as a "preparatory period" ahead of a major industry reorganization phase

New regulations on the pachinko ball output rate took effect in February 2018 in the pachinko industry. The change requires pachinko hall operators to entirely replace existing pachinko machines with models that comply to the new rules and thereby forces pachinko hall operators, including the Company, to make decisions about continuing or exiting hall operations. Since the regulations provide a transition period until the end of January 2021, the Company views FY3/20-21 as a "preparatory period" for complying with the new rules and readying for major industry changes. Specifically, based on a principle that strengthening and maintaining management wherewithal is the most potent defense and weapon, the Company is focused on 1) increasing customer traffic, 2) preparing for acceleration of hall openings, and 3) bolstering cost controls. It aims to build operations that support sustainable growth regardless of external factors, such as the industry environment and regulations.

3. Full-fledged start of the airplane leasing business in FY3/20, obtained approval of new amusement machines for casinos too

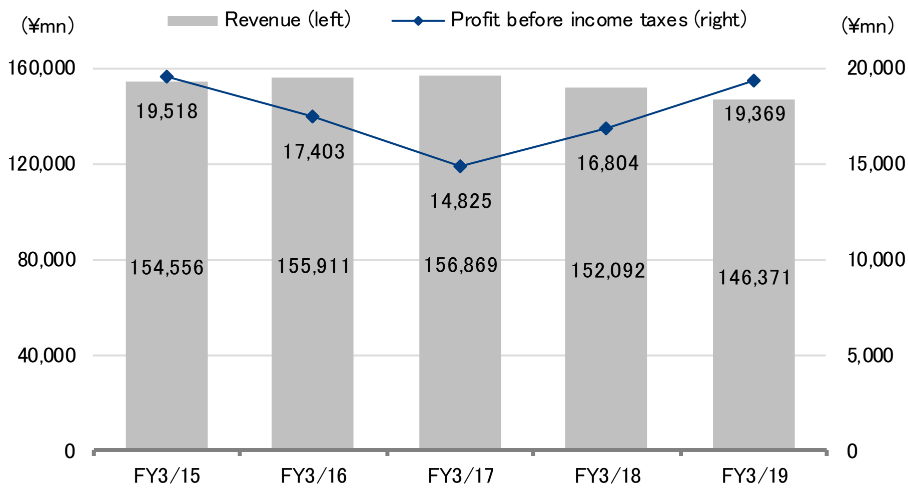
The Company is also moving ahead with initiatives in new businesses. It announced a plan to enter the airplane leasing business a year ago. Since then, it established a subsidiary for airplane leasing business in Ireland in December 2018 and is steadily preparing to begin business in FY3/20. The Company is developing amusement machines for casinos as well and applied for approval of a video slot machine with a Macau government entity *. It plans to supply video slot machines to casino operators after acquiring approval. We will monitor developments in this business.

* The Company and WEIKE obtained approval from the Macau government entity on May 3, 2019.

Key Points

- Continuing its strategy of targeting growth through “increase in store volume” and “expansion of existing-store traffic”
- Ramping up two new businesses – airplane leasing and new slot machines for casinos
- Pachinko machine replacements likely to raise costs by ¥20bn over the next two years, though expect profit recovery and acceleration of growth strategies thereafter

Trends in operation results



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

Company profile

Expanded business scope by implementing innovative measures premised on “chain story theory”, first pachinko hall operator to list shares

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 aged 24 and 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's leadership 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.

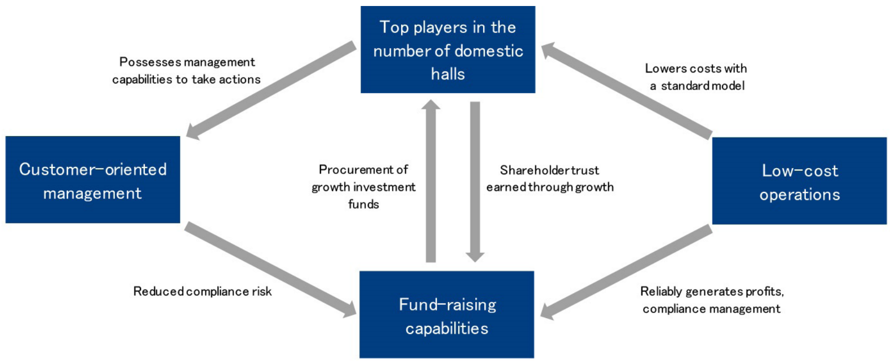
His logical approach rooted in the chain store theory took hold as the corporate culture and served as a fundamental force lifting the Company to the position of being the top company in the industry. The Company also moved quickly in embracing the most important concepts for modern management of a customer-first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

Established a robust management foundation that leverages four strengths, differentiates itself from other companies

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 domestic leader with 450 group halls (as of end-March 2019). While it is not possible to make precise comparisons due to differences in compilation timing, we estimate that the Company's domestic shares for hall volume and machine installations are both at mid-4% levels.

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.

(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 is tremendous support in enabling the Company to secure the feasibility and effectiveness of various measures, including the growth strategy.

The chain store theory provides the theoretical backdrop as a pillar 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, but the driving force of 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 72.2% of pachinko machines (47.5% for the overall industry) and 57.8% of pachislot machines (22.4% for the overall industry), substantially exceeding industry averages (as of the end of March 2019).

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 3,000 companies are listed on stock markets as of end-March, 2019. 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

Customer traffic stayed at the previous-year level thanks to steadfast sales efforts, but sales continued to weaken on decline in average customer spending
Achieved a double-digit rise in operating profits on reduction of expenses mainly for machine costs

● Summary of FY3/19 results

The Company reported double-digit gains in profits on a decline in sales in FY3/19 with revenue at ¥146,371mn (-3.8% YoY), operating profit at ¥19,342mn (+11.5%), profit before income taxes at ¥19,369mn (+15.3%), and net profit attributable to owners of the Company at ¥12,596mn (+15.9%).

Summary of FY3/19 results

(¥mn)

	FY3/18			FY3/19				
	1H	2H	Full-year	1H	2H	Full-year	YoY	Change
Ball rental fee revenue	397,217	377,843	775,060	386,840	382,017	768,857	-0.8%	-6,203
Cost of prizes	319,916	303,052	622,968	313,257	309,229	622,486	-0.1%	-482
Revenue	77,211	74,881	152,092	73,583	72,788	146,371	-3.8%	-5,721
Total expenses	68,489	66,254	134,743	61,315	65,714	127,029	-5.7%	-7,714
Operating profit	8,722	8,627	17,349	12,268	7,074	19,342	11.5%	1,993
Profit before income taxes	8,406	8,398	16,804	12,411	6,958	19,369	15.3%	2,565
Net profit attributable to owners of the Company	5,430	5,440	10,870	8,340	4,256	12,596	15.9%	1,726
EBITDA	14,783	14,741	29,524	18,049	13,087	31,136	5.5%	1,612

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

Rental ball revenue, which corresponds to gross sales, totaled ¥768,857mn (-0.8% YoY). Prize payouts, which constitute unit costs, meanwhile, totaled ¥622,486mn (-0.1%). The difference is above-mentioned operating revenue.

The percentage of prize payouts to rental ball revenue is the payout ratio, and it rose from 80.4% in FY3/18 to 81.0% in FY3/19. The Company puts a top priority on sustaining customer volume amid a long-term shrinkage trend in the pachinko industry. While it maintained customer traffic at the year-ago level thanks to steadfast initiatives to attract customers tailored to characteristics of individual stores (such as location and target segment), average customer spending continued to trend lower because of diminished gambling content. Operating revenue, which corresponds to net sales, hence dropped 3.8% (¥5,721mn).

In expenses, hall costs were down 6.4% (¥8,703mn). Hall costs include personnel costs, machinery costs, depreciation costs, advertising and promotional costs, and upkeep costs. While the Company achieved progress generally in lowering costs during FY3/19, machinery costs substantially declined. The latter is also partially the result of a strategy for replacing machinery related to the new regulations, as explained below. SG&A expenses were flat YoY, but other revenue and other expenses fluctuated. Total expenses dropped 5.7% (¥7,714mn), a larger amount than the decline margin in operating revenue. Operating profit hence increased 11.5% (¥1,993mn).

Progress in repaying loans was a major trend for the balance sheet and cash flow, just as in FY3/18. EBITDA, which adds back depreciation costs and some other cost items, rose 5.5% YoY to ¥31,136mn with support from an increase in operating profit. With these funds, the Company paid corporate tax and dividends, implemented capital investments, and repaid about ¥6bn in loans. Loan repayment value was smaller in FY3/19 after the Company's repayment of over ¥20bn in FY3/18. Period-end outstanding loan value (total for short-term and long-term loans) declined to ¥2,626mn. We think this trend also shows steady progress in preparing for future major change in the industry.

Trends in cash and deposits and outstanding interest-bearing debt value

(¥mn)

	FY3/16	FY3/17	FY3/18	FY3/19
EBITDA	30,494	28,469	29,524	31,136
New openings (gross value, including M&A deals)	53	5	6	2
(Net increase in the number of halls)	49	4	4	1
Total dividends paid (annual)	10,055	9,192	9,192	9,192
Cash and cash equivalents at the end of the period	28,134	48,499	40,533	47,537
Interest-bearing debt at the end of the period	20,763	30,049	8,572	2,626
Total assets	189,184	205,115	184,971	185,332

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

Results at DYNAM Co., Ltd., the group's core company, largely overlap with what we explained above for the Company. Profit rose on lower sales in FY3/19 with operating revenue (total value of amusement business revenue and vending machine revenue) at ¥136,584mn (-2.4% YoY) and operating profit at ¥18,161mn (+18.0%). As noted above, while operating revenue declined because of lower average customer spending and a rise in the payout ratio, operating profit improved on hefty reduction of operating expenses (particularly machine costs).

Hall volume rose by one hall to 406 halls at the end of FY3/19 based on one opening and one closure in Hokkaido (this pair involved a replacement) and one opening in Yamagata Prefecture. The Company is taking a neutral stance toward the hall network during the transition period from former regulations to new regulations following the adoption of new regulations, and this was evident in hall movements in FY3/19.

DYNAM's management situation

(¥mn)

	FY3/17	FY3/18	FY3/19	YoY
Revenue	143,162	139,940	136,584	-3,356
Operating profit	14,710	15,393	18,161	2,768
Ordinary profit	15,573	16,248	19,078	2,830
Net profit	9,914	10,582	12,388	1,806
KPIs				
No. of halls	399	405	406	1
Pachinko machine operating rate	44.7%	43.1%	43.0%	-0.1%
Pachislot machine operating rate	40.4%	39.6%	40.0%	0.4%
No. of machines	183,543	186,898	188,699	1,801
No. of private-brand machines	4,980	7,315	10,084	2,769

Source: Prepared by FISCO from the Company's materials

Medium- to long-term growth strategy and current initiatives

With continuation of difficult market conditions, new regulations are a catalyst moving the industry into a major reorganization phase

1. Business environment in the pachinko hall industry

The pachinko market continues to shrink as a long-term trend. We think major industry indicators, including pachinko and pachislot playing populations, pachinko hall market size (total ball rental income that corresponds to gross sales), and number of pachinko halls, are still moving downward.

Given these conditions, we believe the pachinko hall industry (the Company's main area) is currently in a "calm before the storm." New industry regulations for ball output rates and ball output volume took effect in February 2018 (below, referred to as "2018 regulations"). These regulations mainly consist of 1) limiting the maximum ball output rate to about two-thirds of the current level and 2) restricting ball output volume for a major win to two-thirds of the current level (see our report issued on December 25, 2018 for details on 2018 regulations).

We expect a very large impact by 2018 regulations on pachinko hall management. Besides, the impact on customer draw from decline in gambling content, the need to replace existing all amusement machines with a new type that complies with 2018 regulations has even larger implications. For example, a hall that operates 400 machines requires an investment of ¥140mn to replace all 400 machines (assuming ¥350,000 per new machine and calculated as ¥350,000 x 400 machines).

The industry has a three-year transition period to comply with 2018 regulations. This period allows continued use of amusement machines based on previous regulations in the three years from February 1, 2018 to January 31, 2021 if approval is obtained. Many pachinko hall operators, including the Company, have selected this option and are currently operating halls with a mix of former-regulation machines and new-type machines based on 2018 regulations. However, the transition deadline is just under two years at this point (FY3/20-21 in terms of fiscal years). Pachinko hall operators currently face a major decision about whether to spending heavily to replace all amusement machines or terminate operations from February 2021. While arrival of an industry reorganization phase for pachinko halls had been anticipated for some time, we believe full-fledged implementation of 2018 regulations is likely to be the catalyst that ramps this up.

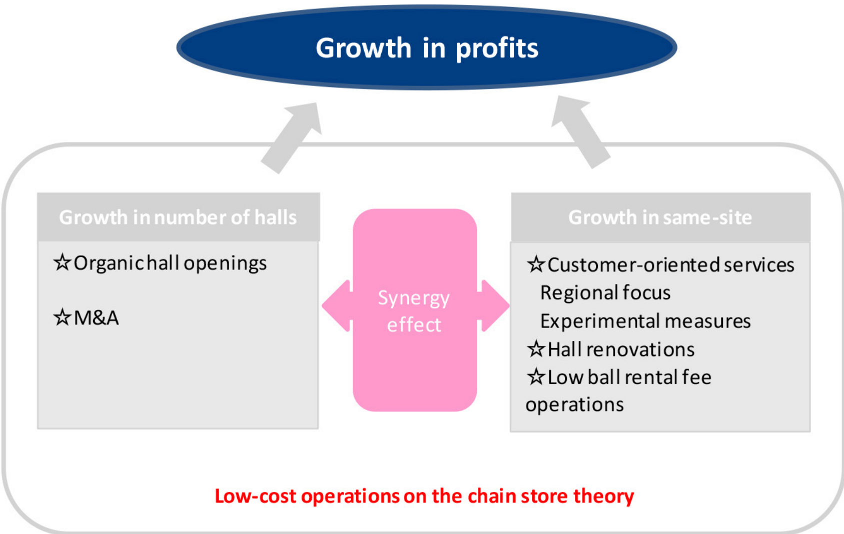
Maintaining the stance of pursuing growth through increase in hall volume and expansion of customer traffic at existing halls

2. Overview of the growth strategy at DYNAM Holdings

The Company, which is a leading industry firm with 450 halls (as of end-March 2019), sees the arrival of a large-scale industry reorganization phase as a significant opportunity. Nevertheless, the reality is that it confronts the heaviest burden from full compliance with 2018 regulations due to having the largest hall volume. The Company hence positions FY3/20-21 as a preparatory period. This means that it needs to enhance management capabilities and review and pursue various possibilities to fully support 2018 regulations in order to remain as a winner and survivor in industry reorganization from FY3/22.

As explained in our previous reports, the Company's growth strategy consists of increase in hall volume and expansion of customer traffic at existing halls. Increase in hall volume occurs either through organic openings (new openings by the Company) or M&A deals. We expect acceleration of additions once the major industry reorganization arrives. Efforts to expand customer traffic at existing halls, meanwhile, are important in maintaining and strengthening management capabilities. If neglected, the management base could weaken and the Company might be unable to pursue expansion of the hall network. We believe the Company needs to approach 2018 regulations as part of overall growth and reinforcement initiatives for existing halls. This is a serious matter than cannot be shortchanged.

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



Source: Prepared by FISCO from Company materials

Steadily achieving results with customer recruitment efforts tailored to individual hall characteristics
Focus on the timing of replacing amusement machines to models that comply with the new regulations

3. Growth and reinforcement initiatives for existing halls

Efforts to increase customer traffic are the top priority for growth and reinforcement of existing halls. The Company has been putting considerable energy into this area over the past three years. Specifically, it has changed from the past approach of conducting the uniform sales activities at all halls to a management style that implements sales activities suited to the location and target segments of individual halls. In addition to "low-priced ball rental" and "not relying on gambling content," the Company aims to attract customers by rigorously adhering to development of halls that address customer needs. These measures have been paying off. For example, the Company sustained customer traffic at the previous-year level in FY3/19 amid a difficult business environment.

Given these conditions, we think the biggest near-term management issue is its response to 2018 regulations. Below we provide a detailed review of the Company's strategy for the response and progress thus far.

(1) Current state of machine costs

The Company has a total of 450 halls as a group and its core DYNAM unit operates 406 pachinko halls. Pachinko machine volume at these sites totaled about 210,000 machines for the group (including 186,000 machines at DYNAM). New machines that comply with 2018 regulations only amounted to 16,000 machines (8% of all group machines) at the end of March 2019. The other 92% (184,000 machines at the group level) are still former-standard machines.

The market itself currently has insufficient supply of new machines with only a few models available from amusement machine firms. This is a major issue if the industry tried to accelerate replacements. Meanwhile, since former-standard machines can no longer be used from February 2021, hall operators want to curtail purchases of new machines that do not comply with the new regulations as much as possible.

These circumstances apply to the Company as well. During FY3/18-19, it limited new machine purchases and focused on expanding internal distribution (moving amusement machines within the group). This stance sharply lowered machine costs and contributed to higher operating profit in FY3/19, as noted above.

(2) Next actions

The Company will be replacing the 184,000 former-standard machines it currently operates in FY3/20-21. Since this involves a heavy burden, the Company hopes to reduce machine costs related to replacement through a combination of measures.

These include 1) development and deployment of a data analysis system aimed at maximizing investment efficiency, 2) deploying private-brand machines, and 3) effective utilization of used machines by leveraging its own distribution network (logistic centers).

Development and deployment of a data analysis system aimed at maximizing investment efficiency refers to an effort to quickly determine whether newly released machines that comply with the new standard are popular by utilizing big data that it possesses. If it determines that a specific machine is popular (attracts customers), the Company plans to promptly deploy it and thereby expand hall sales and raise the efficiency of investments in new machines.

The private-brand machine initiative leverages price difference with national-brand machines. Private-brand machines are handled either as OEM supply from an amusement machine firm or through consignment product based on the Company's own specifications. The latter case offers larger price benefits. In OEM supply, it is also possible to obtain a volume discount by boosting the number of machines supplied through joint procurement with other hall operators.

We think the Company is naturally interested in expanding purchases of used machines that comply with 2018 regulations, but do not expect much used-machine availability in the market until FY3/21. Furthermore, many pachinko hall operators might be seeking deployment of used machines at that time and resulting tight market conditions could make it difficult to acquire desired volume and raise prices in the used machine market.

We expect the timing of machine replacements to substantially affect period earnings. The Company appears to be reviewing the best timing for replacements at this point and has only presented a basic stance of "flexibly responding to market sales trends." Considering limited line-ups of new-type machines that comply with 2018 regulations, as explained earlier, we see a possibility of more replacements in FY3/21 than in FY3/20.

Consumption tax hike and second-hand smoke prevention measures as near-term issues, though unlikely to have a major negative impact on earnings

4. Other changes in the environment facing pachinko halls

(1) Consumption tax hike

We do not expect much impact from the planned consumption tax hike in October 2019. The Company already has a track record of taking steps that offset the impact of the previous hike from 5% to 8%. We think it is capable of absorbing the impact, particularly in earnings, through measures to increase customer traffic and enhance cost controls.

(2) Second-hand smoke measures

Japan passed partial revisions to the Health Promotion Act in July 2018, and these changes take effect in April 2020. Along with the new legislation, Tokyo and other regional public entities have been adopting ordinances to prevent second-hand smoke exposure. While restrictions on smoking at restaurants have attracted most attention, the same constraints apply to pachinko halls. For example, metropolitan Tokyo's ordinance prohibits smoking in amusement spaces and restricts it to a dedicated smoking room once it takes effect. Halls need to create new dedicated smoking spaces. If they do not have space for a smoking room, halls will have to covert some operating space and incur construction costs.

The Company intends to implement second-hand smoke measures at all group halls ahead of other firms as a nationwide project and has already addressed the smoking issue as a management topic from early on. Specifically, it operates 24 Shinrai-no-Mori halls with fully separated smoking rooms at core group company DYNAM and has been designing new halls to include a fully separated smoking room (self-opened halls) for some time. These halls are ready to carry out second-hand smoke measures at no extra cost.

Relatively older halls, meanwhile, require installation work to create a smoking room. The Company has 243 halls in this category groupwide (200 DYNMA halls, eight Cabin Plaza halls, and 35 Yume Corporation halls). The category covers about half of core group company DYNAM's halls and group company halls. The Company estimates that it needs to spend a few hundred million yen to make these reforms. We see the estimated outlay is well within the Company's annual hall upkeep costs and hence should not pressure earnings.

Full application of 2018 regulations is the timing to accelerate hall network expansion, possibility of mainly opening new stores rather than relying on M&A

5. Initiatives to expand the hall network

The Company has not given much disclosure at this point on initiatives to expand the hall network. We think arrival of a major reorganization phase prompted by full application of 2018 regulations (on February 1, 2021) is the timing for the Company to accelerate hall network expansion. We believe the Company has already been implementing surveys for expansion of the hall network and acquiring land based on this awareness.

While there is a tendency for people to envision large-scale M&A deals when hearing about "industry reorganization," we think M&A is not necessarily the best choice for the Company. We explain how hall development and operation rooted in chain store theory serve as a vital source of the Company's competitiveness in the corporate overview section. The Company is unlikely to benefit much from acquiring halls from other companies with less management efficiency, and we think it might expand at a relatively modest pace in the first few years due to adhering to hall openings with this mentality. If the Company utilizes M&A, we only expect it to occur in special cases with clear justifications, such as businesses that apply chain store theory in management (just as the Company) or those with commercialization zones not covered by the Company.

Established a subsidiary for airplane leasing business and ramping up operations from FY3/20, acquired approval for production and sales of new slot machines in casino-related business, later expected to shift to sales

6. New business trends

(1) Airplane leasing business

The Company announced its entry into the airplane leasing business as a new business in fall 2018. Refer to our report issued on December 25, 2018 for details. Below we review the business plan and subsequent progress.

The Company is entering the airplane leasing business through a wholly owned subsidiary. The leasing subsidiary will handle the business on its own, rather than form a syndicate and recruit other investors. It plans to lease mid-sized "narrow model" planes, a segment with high transaction activity, including the Boeing 737-model series and the Airbus A319, A320, and A321 models. The Company will purchase about 20 used planes (from among these models) over the next roughly three years and lease them to airlines worldwide.

The Company established Dynam Aviation Ireland Limited (DAIL), a wholly owned subsidiary, in Ireland in December 2018 (with about ¥100mn in capital and a March fiscal year). This subsidiary will purchase 20 airplanes over three years from FY3/20 with an estimated total investment of ¥90bn (averaging ¥30bn a year). It intends to purchase 6-7 airplanes for ¥30bn in FY3/20. The planned ¥30bn in first fiscal-year investment includes ¥10bn in surplus funds and ¥20bn in funds raised from external sources. The Company already contributed the ¥10bn in surplus funds. Its subsidiary will be purchasing the first plane and arranging a leasing contract next. Leasing business income is not finally confirmed until the lease contract ends (the Company expects a seven-year period for leases). While lease fees are collected during the covered years, we do not expect much impact on the Company's FY3/20 results because of the small number of airplanes.

(2) Development of video slot machines for casinos

The Company has designed and developed products with the aim of supplying mass-market video slot machines to the Macau casino market. The development concept is a straightforward time-consuming game that incorporates pachinko elements. The Company worked on development of this video slot machine jointly with WEIKE GAMING TECHNOLOGY (S) PTE. LTD. (below, WEIKE), which holds a license for manufacturing and selling casino machines in Macau. *

* The Company and WEIKE obtained final approval from a Macau government entity on May 3, 2019.

This business will be moving to production and sales of video slot machines with the Company in charge of planning and developing gaming software and WEIKE developing hardware, installing the subject gaming software, and selling machines.

The outlook for income contributions from casino video slot machines is unclear at this point, but we do not expect much for the time being. Macau holds the position of being the world's largest casino market after it surpassed Nevada (Las Vegas) in 2006. It generates just over 90% of revenue from gaming and differs considerably from Nevada (Las Vegas), the second largest market, that obtains about 60% of revenue from non-gaming business. While Macau is clearly the top casino market, it is difficult to forecast how the market will react to the "time-consuming game" and "pachinko elements" concept at this point. We will closely monitor progress.

Business outlook

Estimated additional burden of ¥20bn over two years to replace amusement machines
Expecting profit recovery and accelerated growth strategy thereafter

● **FY3/20 outlook**

Since the Company does not disclose forecasts, we review key points and perspectives for projections.

Operating revenue (net sales) is the difference between ball rental income (gross sales) and prize payout value. Ball rental income was down 0.8% YoY in FY3/19. This was a smaller drop than we expected mainly on support from keeping customer traffic at the same level as the previous fiscal year. We think the Company's measures to attract customers paid off and this can be recreated in FY3/20. Prize payout value, meanwhile, stayed on par with the previous fiscal year in FY3/19, and the resulting rise in the payout ratio to customers widened the decline margin in operating revenue. Change in the payout ratio could contribute to an increase or decrease in operating revenue (for example, even if ball rental income was down 1% YoY, operating revenue would rise 4% at an 80% payout ratio). The payout ratio, however, affects customer draw too and hence is a double-edged sword for the Company.

We think profits should be viewed in terms of two years (FY3/20-21) because of the issue of replacement to new models that comply with 2018 regulations. The Company needs to purchase 184,000 new-model machines as replacements over the next two years. We estimate total spending on these machines at about ¥60bn over two years for a mix of new and used machines. In FY3/19, the Company curtailed new machine purchases and appears to have spent about ¥20bn on amusement machine purchases (covering new and used machines) and its profit level relied on this much amusement machine spending. As noted above, an assumption of ¥60bn in machine purchases over two years (FY3/20-21) works out to a ¥20bn setback in profit during these two years.

The main issue is how the Company decides to allocate the ¥20bn in additional costs in the two periods. If it restricts purchase volume and sustains operating profit on par with the previous year in FY3/20, manifestation of the ¥20bn in extra costs all at once could push operating profit to breakeven in FY3/21.

While the actual allocation method is unknown, it is important to recognize that the Company faces a profit setback of about ¥20bn over the next two years. Another key point is the prospect of diminished cost burden in the following fiscal year (FY3/22). While we cannot say conclusively that profit will sharply rise because other factors affect the profit trend too, amusement machine purchase costs should normalize.

Higher machine spending (¥20bn in the Company's case) is not an issue just for the Company, but all pachinko hall operators. This burden is likely to prompt hall operators to review whether they should remain in business or not, and we believe numerous operators are likely to exit the market (including by selling their business). If the Company successfully overcomes this hurdle and restores profit to a certain level, it should be capable of quickly accelerating the growth strategy.

We reviewed changes in the income statement above. Since the Company has repaid loans and accumulated surplus funds over the past few years, we think it is capable of absorbing the above-mentioned rise in costs.

The main thing to monitor on the balance sheet is the change in lease accounting under IFRS, which the Company has adopted, with application from FY3/20 results. The IFRS rule brings all lease contracts onto the balance sheet and thus requires balance-sheet recognition of licensing assets and lease liabilities. The Company rents land for hall sites and other properties and these need to appear on the balance sheet. Company estimates suggest that the total value might be about ¥85bn. This revision does not affect cash flow, but expands gross assets on the balance sheet. With an increase in gross assets from ¥185,332mn at end-FY3/19 to about ¥270,000mn at end-FY3/20, the Company's capital ratio is likely to drop substantially. We think it is necessary to acknowledge this aspect because some investors might react to the lower ratio as weakening of the balance sheet.

Indome statement

(¥mn)

	FY3/15	FY3/16	FY3/17	FY3/18	FY3/19
Revenue	154,556	155,911	156,869	152,092	146,371
YoY	-6.8%	0.9%	0.6%	-3.0%	-3.8%
Hall operating expenses	134,659	138,326	142,142	136,727	128,024
YoY	-0.9%	2.7%	2.8%	-3.8%	-6.4%
SG&A expenses	5,456	5,798	5,622	5,049	5,023
YoY	33.5%	6.3%	-3.0%	-10.2%	-0.5%
Other income	6,850	8,184	9,224	9,458	8,971
Other expenses	1,947	1,805	2,430	2,425	2,953
Total expnese	135,212	137,745	140,970	134,743	127,029
YoY	0.9%	1.9%	2.3%	-4.4%	-5.7%
Operiting profit	19,344	18,166	15,899	17,349	19,342
YoY	-39.0%	-6.1%	-12.5%	9.1%	11.5%
Financial income	2,151	311	233	236	471
Financial expenses	1,977	1,074	1,307	781	444
Profit before income taxes	19,518	17,403	14,825	16,804	19,369
YoY	-43.6%	-10.8%	-14.8%	13.3%	15.3%
Tax expenses	8,259	6,864	5,520	5,879	6,778
Net profit for the year	11,259	10,539	9,305	10,925	12,591
YoY	-47.0%	-6.4%	-11.7%	17.4%	15.2%
Net profit attributable to owners of the Company	11,303	10,544	9,360	10,870	12,596
YoY	-46.8%	-6.7%	-11.2%	16.1%	15.9%
EBITDA	30,637	30,494	28,469	29,524	31,136
YoY	-28.3%	-0.5%	-6.6%	3.7%	5.5%
EPS (¥)	15.22	13.92	12.23	14.19	16.44
Dividend per share (¥)	14.00	13.00	12.00	12.00	12.00

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

Balance sheet

(¥mn)

	FY3/15	FY3/16	FY3/17	FY3/18	FY3/19
Current assets	48,723	43,240	63,072	53,145	59,875
Cash and cash equivalents	29,239	28,134	48,499	40,533	47,537
Trade recivalbes	486	459	563	469	614
Non-current assets	132,213	145,944	142,043	131,826	125,457
Property, plant and equipment	99,961	109,532	106,687	98,794	95,445
Intangible assets	1,029	3,991	3,833	3,545	3,112
Total assets	180,936	189,184	205,115	184,971	185,332
Current liablities	31,380	30,838	38,496	39,643	36,452
Trade and other payables	20,468	17,786	18,282	19,220	19,297
Borrowings	3,160	2,369	7,281	7,351	2,124
Non-current liablilities	14,503	25,727	29,738	7,813	7,080
Borrowings	9,160	18,394	22,768	1,221	502
Equity attributable to owners of the Company	135,077	132,645	136,953	137,532	141,821
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	115,204
Other componet of equity	-1,089	-5,202	-3,191	-4,315	-1,124
Non-controlling interests	-24	-26	-72	-17	-21
Total equity	135,053	132,619	136,881	137,515	141,800
Liabilites and net worth	180,936	189,184	205,115	184,971	185,332

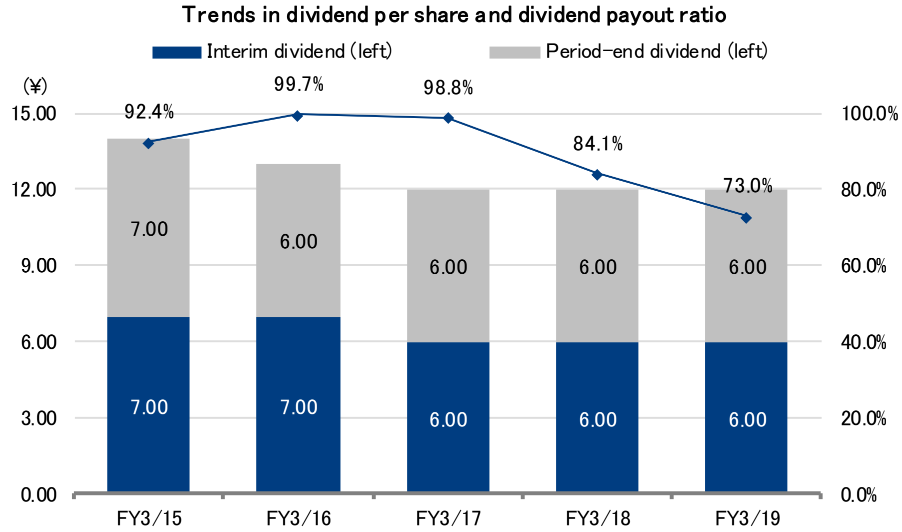
Source: Prepared by FISCO from the Company's financial results summary materials

Returns to shareholders

Approved a ¥12 annual dividend for the FY3/19

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.

The Company decided to pay a ¥12 dividend in FY3/19 (¥6 interim dividend and ¥6 year-end dividend). Dividend payments totaled ¥9,192mn versus ¥12,596mn in net profit attributable to parent shareholders, putting the dividend payout ratio at 73.0%.



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

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.

Refer our report issued on December 25, 2018 for details. The Company conducts internal discussions and also interacts with external parties (other companies, local society, etc.) and engages in other activities to address social themes, such as work style reforms, training female managers, and efforts to prevent second-hand smoke. It aims to enhance long-term corporate value.

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

2. ESG activities

The Company made a major revision to the CSR section on its website on February 25, 2019. 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 website 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.

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 on its website 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.

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