Estore Corporation

4304 JASDAQ

Company Research and Analysis Report
FISCO Ltd.
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■Restructuring business toward a model that generates revenue by increasing the sales of companies

Estore Corporation (4304) (hereafter, “Estore” or “the company”) is currently working to restructure its business model, which is its fourth since the company’s startup. Since its startup, the company’s core business has been to provide tools and systems to help stores and companies to establish an e-commerce presence. Today, the company is in the process of restructuring its business toward a model that generates revenue by increasing the sales of companies that already have an e-commerce presence.

Specifically, the company’s present focus is primarily on consulting to help small and medium-sized enterprises (SMEs) increase their e-commerce sales, an untapped market, and in operating its own product search site called PARK. Although just started, these businesses are beginning to show success in certain areas.

Since this approach to business restructuring will inevitably generate upfront costs, the company could see a decline in sales and profits in the fiscal year ending March 31, 2014 (FY3/14). However, that is not the problem, the problem is can the company confirm whether or not its current investments have the potential to produce results from next fiscal year? In that sense, we must focus out attention on the top line (gross sales or revenue) of the Customer Attraction business in FY3/14

The company’s position regarding the return of profits to shareholders remains unchanged. With the company’s buyback of a large amount of its stock as treasury stock from Yahoo (4689), earnings per share could increase y-o-y, even if profits temporarily decline in FY3/14. In that event, the company might consider a dividend increase following the one in FY3/13.

■Check Points

- Shifting from stock to flow have been favorable thus far
- E-commerce itself is still a “blue ocean” space
- EPS increased due to the repurchased of shares, the company may increase dividend

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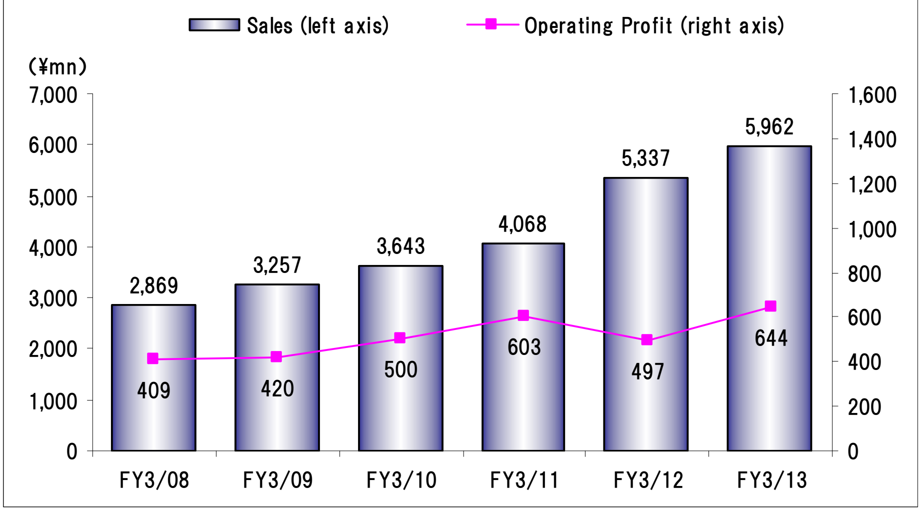
Consolidated Sales and Operating Profit



Note: Figures for FY3/08-3/11 are unconsolidated

■Corporate Profile

In the midst of a fourth attempt to restructure its business

(1) Company History

In the Internet industry, where technological advancements have produced lightening-like speed, companies too are naturally seeking rapid change. In fact, Estore is now in the midst of a fourth attempt to restructure its business. In order to better understand the business of companies that are undergoing rapid change like Estore, it may be effective to take an approach based on changes over time. On that assumption, I will discuss the course the company's business has taken since it was started.

The company's business history is shown in the chart below. The company was established as Estore in February 1999. At first, the company provided a shopping cart service called Storetool followed by a web hosting service called Siteserve. It then established marketing alliances with USEN Corp. (4842) (then known as USEN Broad Networks Corp.), So-net (then known as Sony Communication Network Corp.), and GMO Internet Group (9449) (then known as Global Media Online), and others, and expanded its operations. Subsequently, the company redesigned its service content, formed alliances, and took other measure. In 2005, the company formed business alliances with Yahoo (4689) and Kaku.com, Inc. (2371).

On the services side, it further improved and developed Storetool and Siteserve, and in 2006 it began offering Shopserve, a service providing total e-commerce support, which is now its core business. The company made Precision Marketing, Inc. a consolidated subsidiary (2011) and then started up its product search site Shoppingfeed and upgraded and redesigned PARK, which brings us to the present.

■Corporate Profile

History

February	1999	Founded Estore
July	1999	Started providing shopping cart service Storetool
September	1999	Started providing web hosting service Siteserve
March	2000	Established marketing alliance with USEN Corp. (then known as USEN Broad Networks Corp.)
June	2000	Established marketing alliance with So-net Entertainment Corp. (then known as Sony Communication Network Corp.)
May	2001	Established marketing alliance with GMO Internet, Inc. (then known as Global Media Online, Inc.) and others
June	2003	Changed name to Estore Corporation
July	2004	Established business capital alliance with Telewave, Inc. (then known as iFLAG)
November	2005	Established business alliance with Yahoo Japan Corp.
November	2005	Established business alliance with Kakaku.com
January	2006	Started providing web shop support service Shopserve under Estore’s domain name
December	2007	Opened development center in Ho Chi Minh City, Vietnam
October	2010	Signed partnership agreement with Google Shopping
June	2011	Made Precision Marketing a consolidated subsidiary
July	2012	Opened Sapporo Marketing Factory
October	2012	Renewed Shoppongfeed to PARK

EC business generates the most revenue

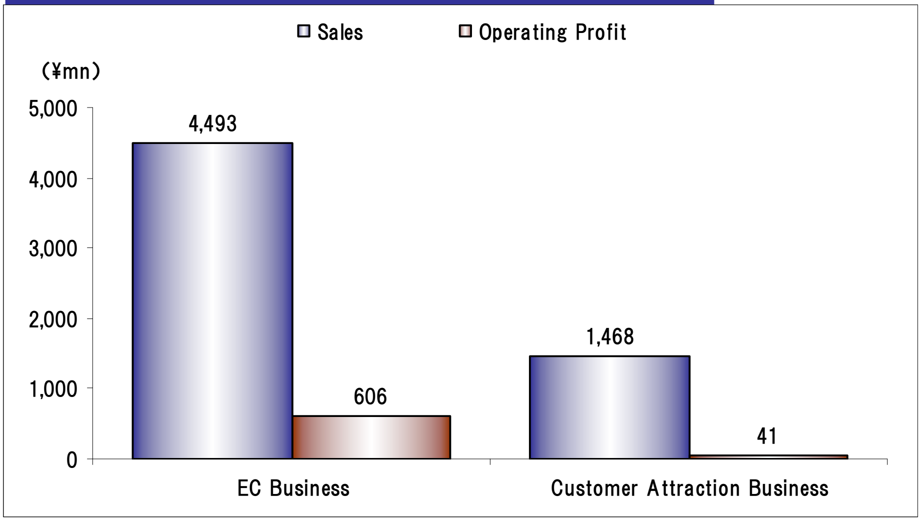
(2) Business Overview

Since its startup, Estore had only released nonconsolidated business results. However, after Precision Marketing (hereafter, “Precision”) became a consolidated subsidiary, it changed and began releasing results on a consolidated basis from FY3/12 and business segment information from FY3/13.

Estore has two business segments, the E-Commerce (EC) business and the Customer Attraction business. The business that generates the most revenue is the EC business, which has been around since Estore’s startup. The Customer Attraction business, on the other hand, is a new business segment that came about as a result of the company’s current business restructuring, the fourth since its startup. Consequently, sales have grown somewhat, but it is still financially dependent on the EC business in terms of generating a profit. However, it is only because the company operates the Customer Attraction business segment that it is now focusing all of its energy into restructuring this business. Because the Customer Attraction business segment’s revenue trend is a direct indicator of the success or failure of the business restructuring, it is the Customer Attraction business that we should mostly focus on when looking at the company.

■Corporate Profile

Sales and Operating Profit by Segment in FY3/13



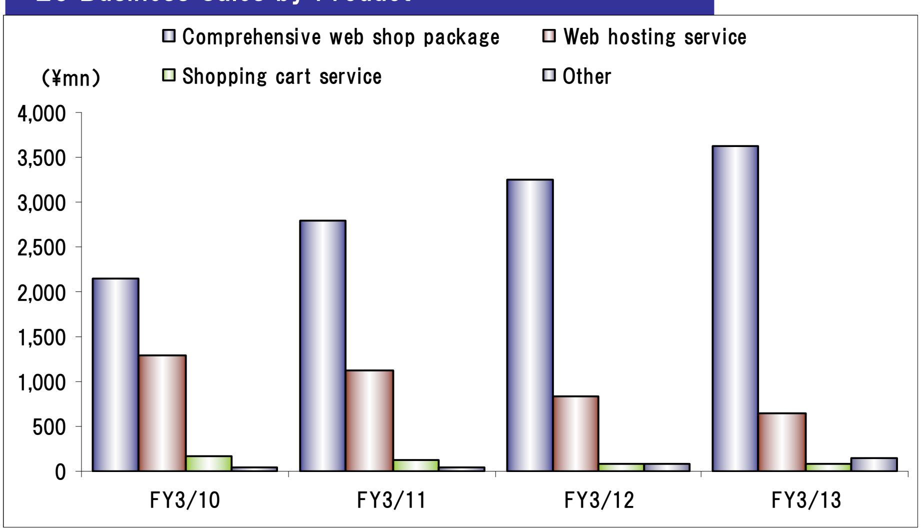
Note: During the first quarter of FY3/14, the company changed its customer attraction service, which was included in the EC Business, into the Customer Attraction Business.

Shifting from stock to flow have been favorable thus far

● EC Business

The EC business is broadly divided into the following three segments by major product, Comprehensive E-Commerce Package, E-Commerce Web Hosting, and Shopping Cart ASP. As can be seen in the chart, there is a clear difference between trends in total sales and year-on-year changes for each of the three products. The reasons for this are discussed in detail below.

EC Business Sales by Product



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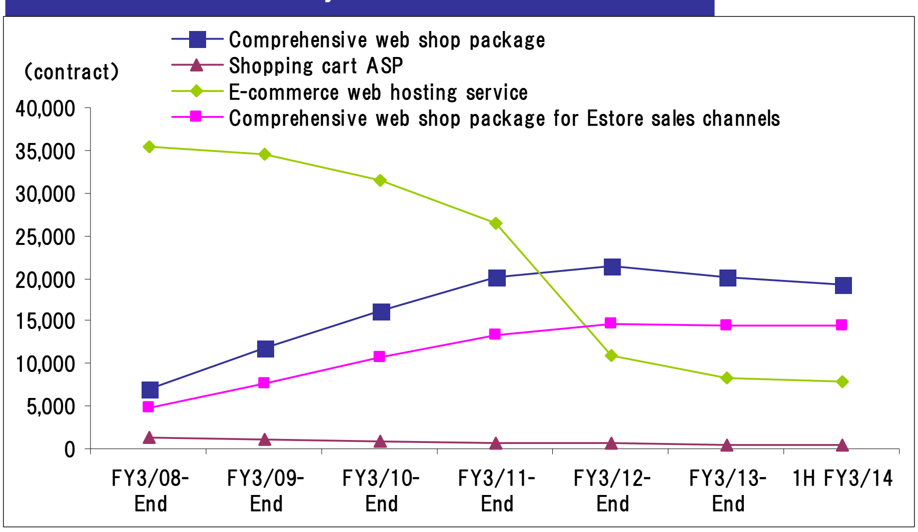
At the time of its startup, there were two businesses at Estore. The first is the Storetool business, which provides online store sites with e-commerce capabilities through the installation of Estore's shopping cart service for online stores. The second is Siteserve, the web hosting service for e-commerce stores. Subsequently, these services steadily grew and helped the company grow after its startup. Estore's forming of marketing alliances with USEN (4842), iFLAG Co., Ltd. (2759) and others as an effective means of promoting sales has already been described above.

Thereafter, the company shifted its direction from offering individual service such as web hosting and shopping cart to offering comprehensive e-commerce support services. This new service, called Shopserve, provides comprehensive e-commerce support. For example, when a confectionary store in town wants to increase its sales by launching an online store, Shopserve provides the services to help them easily accomplish this. There are many components involved in opening an online store such as creating a website, attracting customers, promoting sales, operating the website, and setting up a payment system. However, Shopserve incorporates all of these functions. Shopserve is described as an "EC-ASP business" in the sense that it provides an application (Shopserve) for developing and operating an online store to small and medium-sized shops. Shopserve has grown into an EC business as well as Estore's core business.

The first business restructuring carried out by the company was to shift from individual web hosting and shopping services to comprehensive e-commerce support services.

Later, it also rapidly restructured its business in response to changing times and the company's growth. The second business restructuring was to shift from distributor sales to direct sales. This involved reviewing contracts acquired through its marketing alliance partners in each of the previously described services, Siteserve, Storetool, and Shopserve. More specifically, the partnerships it acquired in this process contributed little to sales and profits, and in some cases were negative risks. The company has therefore dealt with this issue by working to win customers through its own and its smaller agents' efforts and at the same time by cancelling contracts with stores out of necessity due to its sales and marketing alliance partners. As a result, although it outwardly appears that the number of contracts has fallen sharply, the quality of customers in terms of relationships and profitability has increased substantially.

Number of Contracts by Main Product



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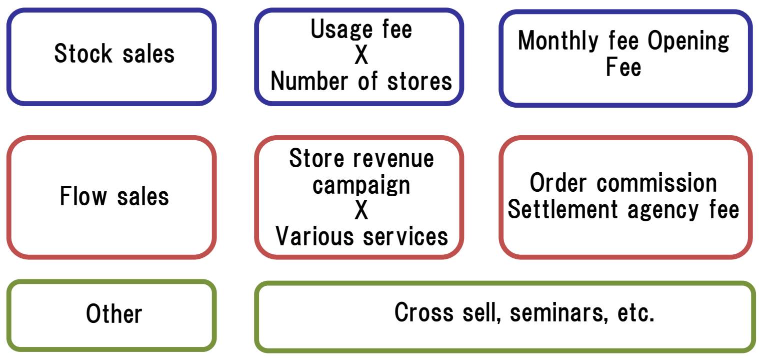
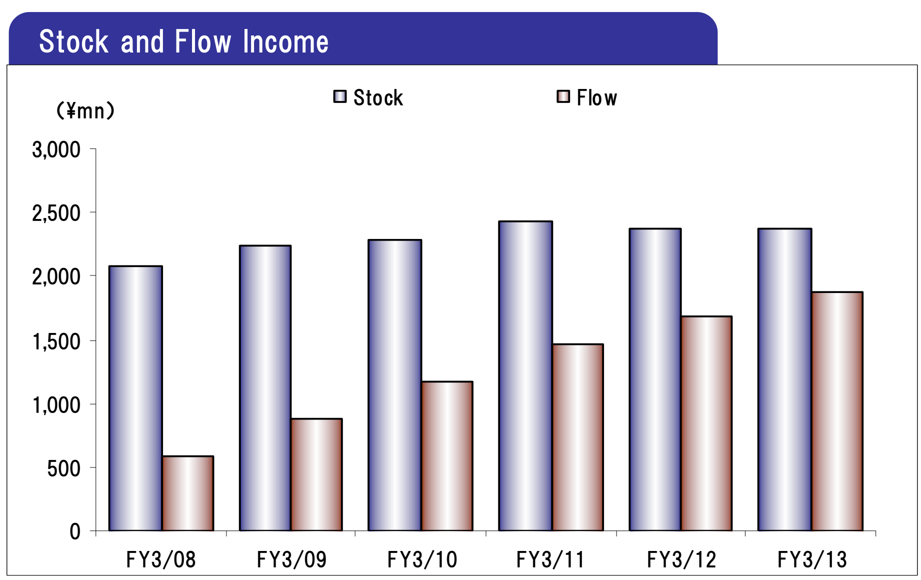
The third business restructuring was to "shift from stock to flow" by building a stronger business structure focused on income stream generation. This shift from stock to flow was probably inevitable so long as the earlier-described second structural change could keep the decline in the number of contracts to a tolerable level. As shown in the graph, stock is determined by the accumulation of monthly usage fees and number of stores. As long as the number of stores decreases, income that is not influenced by the number of stores takes on greater importance; In other words, income that is linked to store sales.

Stock and Flow Income



Estore's efforts to shift from stock to flow have been favorable thus far. The fact that a number of its contracted customers were on a downward trend has already been discussed. Stores that should have departed have nearly all done so, and it now appears that the number of contracts has bottomed out. However, reflecting the decrease in the number of contracts, stock income peaked at ¥2,429 million in FY3/11 and is now leveling out. Cash flow, on the other hand, was ¥586 million in FY3/08, but it more than tripled to ¥1,874 million in FY3/13.



As explained above, Estore is fundamentally an EC business that has pursued growth while significantly changing its direction three times since its startup. Since its founding, the company's performance has not always been ever-increasing sales and profits, as profits have also declined at times. Yet, the company's history is defined by a constant attempt to stem this earnings rollercoaster by making various changes in its EC business.

■Corporate Profile

EC Malls PARK is an open-system business model

● Customer Attraction Business

The Customer Attraction business was created as a result of the fourth business restructuring. Specifically, the EC Business provides systems and equipment for turning a customer’s brick and mortar store into an online store. In contrast, the Customer Attraction business provides a variety of strategies for increasing sales to customers who already have an e-commerce presence.

The Customer Attraction business that Estore now operates is divided broadly into, (a) providing systems, and (b) providing services.

PARK, the product search site, constitutes the core of the “providing systems” part of the business. On the surface, PARK looks just like Rakuten and other EC Malls, but is fundamentally different. Rakuten only deals with its member stores (naturally, it opens its doors widely to all comers), but on the other hand, it is a closed-system business model (also called a “walled garden”) that fences in consumers with its point system. In contrast, PARK is an open-system business model. In other words, PARK, as its name suggests, is nothing more than a place (or park) that serves as a market. Gathered on PARK are stores that have set up online shops, and they are able to freely come to PARK and open a shop. Estore, the main operator of PARK, understandably needs to make PARK an appealing place and to attract stores. To that end, its strategy is to place its field-specific special site right within PARK. The strategy has already proven effective, for example, in the survival game field, PARK has earned a reputation among consumers and stores as the runaway leader. By rapidly spreading such examples in other fields, the company’s strategy is to not only get customer shops in the EC business, but also to get online stores that have shops on other malls to operate on PARK. PARK aims to be an open-system business model in the sense that it actively brings in outside customer shops. PARK’s billing model for advertising is based on choosing either to pay per click or pay per action. This is considered fair to both Estore, the main operator of PARK, and online customer stores, and dovetails with the direction that both parties are aiming for.

Service provision is consulting with the goal of increasing the sales of each company. The IT service business and other businesses have set out to do the same thing, but basically most of their customers are either Japan’s leading companies or large companies that are expanding throughout Japan. Consulting fees in these cases are extremely high, running into millions of yen, at least. Estore and its subsidiary Precision are walking an independent path in that they are targeting SMEs. Fees appear to be a single digit smaller than those charged by major corporations, but there are no powerful competitors and, in terms of earnings structure, it is a field that is difficult for major competitors that work with large companies to get into. As a result, the two companies have high expectations for this business in what is regarded as a “blue ocean” (or uncontested) market space.

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■Corporate Profile

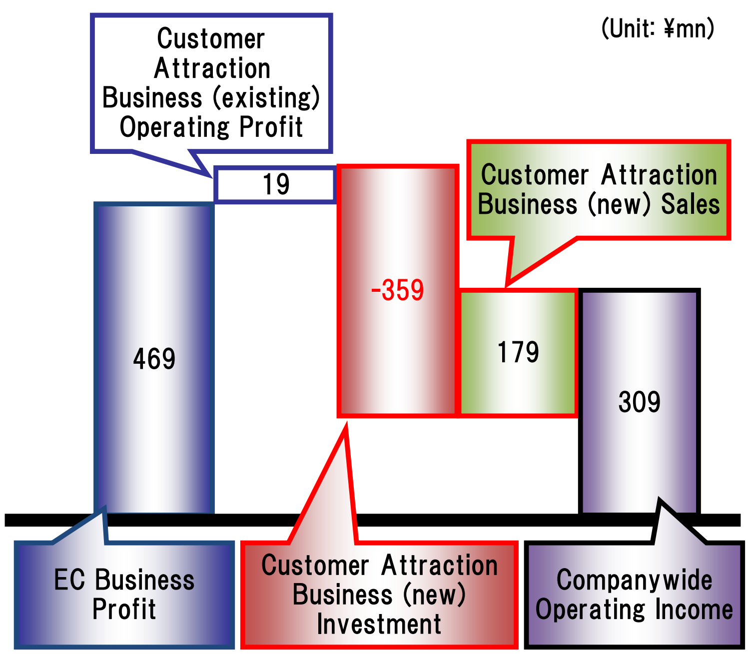
The consulting that the company provides includes website creation and search engine optimization (SEO) countermeasures, but the core of its consulting involves listing advertisements. At present, consultants provide services that are segmented, with Precision mainly focused on medium-sized companies and Estore focused on smaller companies. Further, software has been developed that systemizes consulting know-how and expertise and can be easily used by very small enterprises and individual proprietorships. This software is a listing advertisement service called "Single Hand." Listing advertisements are an advertising method with a promising impact, but controlling costs is sometimes difficult. Therefore, the potential need for the personal and system application consulting that the company provides is said to be extremely high.

The Customer Attraction business is still in the early investment stage and earnings are in the red. New areas such as the PARK startup and consulting are notably at that stage. Nevertheless, Representative Kenichi Ishimura stresses the importance of solid investing in these areas at this stage. In 1H FY3/14, 20% of all employees and about 40% of operating income earned in the EC business was invested in these two main new areas in the Customer Attraction business. However, Representative Ishimura considers this amount of investment too small and has great expectations for the medium-term growth potential of this business.

H1 FY3/14 Results

(Unit: ¥mn)

	EC Business	Customer Attraction Business		Companywide
		Existing	New	
Sales	2,079	610	179	2,869
Expenses	1,609	591	-359	2,560
Operating income	469	19	179	309
Personnel	138	16	40	194



■Medium-Term Outlook

E-commerce itself is still a "blue ocean" space

According to Representative Ishimura's analysis, the current state of the e-commerce industry is the "late majority stage." "Late majority" refers to the second to the last of the five stages in Innovator Theory. This is the stage where people who are skeptical about new things and services finally jump on the bandwagon, like everyone else, and try using them. The next remaining stage, the fifth stage, is called "laggard" and refers to a person who does not accept the new service or innovation until the very end. In other words, being near the "late majority stage" means that there is very little room for new development of e-commerce.

What is likely to get confused here is that it is the EC–ASP business that Estore is engaged in that has entered the "late majority stage" and that e-commerce itself is still a "blue ocean" space. In other words, the final stage is when stores and companies launch online stores en masse, after which is the stage of deciding how much revenue they can earn from the online stores

According to Estore, the size of Japan's e-commerce market is ultimately ¥320 trillion, but at present the e-commerce-related market in Japan is still only about ¥20 to 26 trillion. These figures include components for creating systems for operating the online stores that Estore provides. As for the still untapped ¥300 trillion of this market, we can speculate that the proportion of actual store sales and Internet advertising expenses will rise higher than the ¥20 trillion market size thus far.

Since its startup, Estore has repeatedly attempted to restructure its business and it is now focused on the Customer Attraction business, and this is the point it all comes down to. Under Representative Ishimura's leadership, the company believes that it is heading in the right direction. Next, the only thing to do is to deliver financial results.

The company has never announced medium-term earnings results. Accordingly, the viewpoint of outside analysts including investors falls into the following two categories, (1) Is the EC market expanding at the expected rate or not? (2) Is Estore's earnings growth rate outperforming the market's growth rate?

■First Half FY3/14 Performance

Profit decrease was itself in line, due to aggressive invest in Customer Attraction business

In the first half of FY3/14, sales came to ¥2,869 million, down 3.5% y-o-y, and operating profit was ¥307 million, down 13.0%. Recurring profit and net profit both decreased, but since the number of shares, the basis for calculating earnings per share, decreased from 4,252,500 shares to 3,597,188 shares because the shares owned by Yahoo (4689) were turned into treasury stock, only earnings per share (EPS) increased, rising from ¥48.91 to ¥53.31 y-o-y.

With respect to the sales and profit decrease in the first half, the profit decrease was itself in line with the company's assumptions. That is because Estore had originally planned to aggressively invest (not in the sense of acquiring fixed assets, but to aggressively invest in personnel and other costs) in the Customer Attraction business segment. However, Representative Ishimura believes that the company has still not spent enough on costs. He has shown a strong desire to get the Customer Attraction business fully launched as early as possible in FY3/15.

■First Half FY3/14 Performance

Meanwhile, the reason that the company’s performance fell below projections is because the number of customers contracted as distributors for the company’s mainstay product Shopserve decreased by 69 customers y-o-y. However, compared with March 31, 2013, there was an increase of 22 customers. Since it has been confirmed that the decrease has bottomed out, the situation is not overly gloomy. Because clear growth in the skills of new sales staff over the past year is obvious, Estore is showing confidence regarding the issue of bottomed out distributor numbers.

H1 FY3/14 Results

(Unit: ¥mn, %)

	H1 FY3/14	y-o-y
Sales	2,869	-3
EC Business	2,079	+0
Stock	1,194	+1
Flow	849	+2
Other	34	-41
Customer Attraction Business	790	-12
Advertising	703	-17
Media	87	+60
Operating Profit	307	-13
EC Business	469	+15
Customer Attraction Business	-160	-
Recurring Profit	308	-12
Net Profit	191	-8
EPS (¥)	53.31	+9

■Performance Outlook for 2H FY3/14 and FY3/15

■Performance Outlook for 2H FY3/14 and FY3/15

Growth of the Customer Attraction business becomes the ultimate evaluation axis in FY3/15

It is believed that the same basic earnings trend that prevailed in the first half of FY3/14 will continue in the second half as well. Because the second half includes the busy year-end and New Year consumer-spending period, this seasonal factor could lead to higher sales and profits than in the first half. However, the company’s approach of aggressively using profits earned in the EC business as anticipatory investments in the Customer Attraction business remains unchanged. Hence, the potential for a profit decline is sufficiently high. There are three points we must watch in terms of second-half performance, 1) will the number of customers contracted as distributors by the company in the EC business turnaround and increase? 2) Is the top line (sales and revenue) of the Customer Attraction business increasing in line with costs? 3) Are customer store sales increasing? Whether these are increasing or not according to expectations should set the direction for earnings over the next two to three years for the company.

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■Performance Outlook for 2H FY3/14 and FY3/15

Investment in the Customer Attraction business is expected to continue in FY3/15 as well. That is to say, the basic earnings framework, what the company is focused on, and the company' s performance as a result of these is essentially the same as in FY3/14. Of course, in looking at the company, the points are essentially the same, but the increase in sales in the Customer Attraction business should be focused on more. Since the company seeks "vertical startup" (i.e., maximum output from the start) in the Customer Attraction business, it can' t be denied that aggressive investment is justified now. In earning for FY3/15, Customer Attraction business sales growth becomes the ultimate evaluation axis. If Customer Attraction business sales follow expectations and the number of core contracted distributors (customers) in the EC business turns around and increases, it is sufficiently probable that sales and profits could once again increase, even with aggressive running up of costs through upfront investment in the Customer Attraction business.

■Financial Analysis

Repurchased nearly all of the shares caused deterioration of the balance sheet

Estore' s balance sheet as of March 3, 2013 was solid and commendable, with shareholders' equity of ¥2,087 million (capital adequacy ratio of 47.2%), balance of cash and deposits of ¥2,873 million, and balance of interest-bearing debt of ¥15 million.

However, in the first quarter (April – June) of FY3/14, Estore repurchased nearly all of the shares (12,380 shares; 24% of total outstanding shares) of its stock held by Yahoo (4689), which had been a major shareholder, and with this treasury stock, a major change in the structure of the company' s balance sheet has occurred. As of September 30, 2013, the balance sheet recorded shareholders' equity of ¥864 million (capital adequacy ratio of 28.3%), balance of cash and deposits of ¥1,565 million, and interest-bearing debt of ¥286 million, paling somewhat in comparison to the previous six-month period.

The cause of the deterioration of the balance sheet was not attributable to its core business, but strictly to the buyback of its shares held by Yahoo (4689). Accordingly, the reason for the buyback and what to do with the treasury stock have now become two key points to consider.

As for the reason behind the transfer of shares, Representative Ishimura said that, "It was not because Yahoo wanted to let go of the shares, but rather, Estore had the intention of increasing the amount of its treasury stock as a strategic move for the future, and therefore decision was reached with the agreement of both parties. There is no change whatsoever in our business relationship with Yahoo." As for the future handling of the treasury stock, President Ishimura has stated, "Although we have various options, such as using the shares to fund mergers and acquisitions, retiring the shares, or selling the shares, we still have not reached a final decision."

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■View on Returning Profits to Shareholders

EPS increased due to the repurchased of shares, company may increase dividend

The company’s basic view on returning profits to shareholders is to divide profits equally between shareholders, customers, and employees. Based on this view, in the past the company has increased dividends based on its performance. This basic approach remains unchanged, even today. The company has clearly stated that it will actively return profits to shareholders by increasing dividends when profit growth is achieved in the future.

In FY3/14, bearing in mind that Estore is making anticipatory investments in the Customer Attraction business, a next-generation growth field, it could see operating income and recurring income decrease y-o-y in the second half of the fiscal year. Nevertheless, in the first half of FY3/14, EPS increased y-o-y, even though operating income declined. This is due to the repurchased of a large number of shares held by Yahoo (4689), which the company now holds as treasury stock. In the event that the EPS increase seen in the first half reappears in full FY3/14, the probabilities of a dividend increase following the one in FY3/13 is substantially high.