

RIZAP GROUP, Inc.

2928

Sapporo Securities Exchange Ambitious

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■ Summary

Conducting sweeping structural reforms toward the early recovery of earnings

RIZAP GROUP, Inc. <2928> (hereafter, also “the Company”) is expanding the scope of its business while actively utilizing M&A, with the “self-investment industry” as its business domain. In 2016, it shifted to a pure holding company structure, and the group contains 85 companies, including 9 listed companies, that are developing businesses in the 3 domains of beauty and healthcare, lifestyle, and platforms.

1. Recovery of earnings delayed at subsidiaries, forecasts downwardly revised, conducting sweeping structural reforms

In the Company’s FY3/19 1H results, despite achieving record high revenue for the 7th consecutive fiscal period, it posted an operating loss of ¥8,829mn. This was mainly because earnings are recovering slower than planned, mainly at the companies and businesses that entered the group within the past year. Following this, the Company has set management’s top priority as recovering the results of group companies and businesses as soon as possible, and it has decided to conduct sweeping structural reforms. Also, in conjunction with this, it downwardly revised the FY3/19 full year forecasts, lowering the consolidated operating income forecast by ¥26.3bn, from the initial forecast of operating income of ¥23bn to an operating loss of ¥3.3bn.

2. The two main structural reforms are “the restructuring of existing businesses” and “business selection and concentration”

The Company has set five items as the specific structural reforms it is conducting, but if we consider them broadly, they can be summarized into the following two; “freeze new M&A, in principle, and focus on restructuring existing businesses” and “in the process of reconstruction, implement business selection and concentration.” As phase one of these structural reforms, the Company has announced corporate governance reforms. They involve the separation of management and execution through reforming the Board of Directors, with the number of directors on the Board being greatly reduced and the majority being outside directors. Representative Director Takeshi Seto and Mr. Akira Matsumoto, who will be in charge of the structural reforms, will remain as directors, and it is considered that the Company has put in place a framework to promote the structural reforms in a form that will be accompanied by their results. Also, with regards to the progress made for the restructuring and the specific content of the business selection and concentration, the Company has announced that on November 13, 2018, it had conducted a business transfer through a company split of the game, bowling, and cinema business of SD Entertainment, and that on January 25, 2019, it had sold its Japan Gateway shares. We can expect further such announcements in the future.

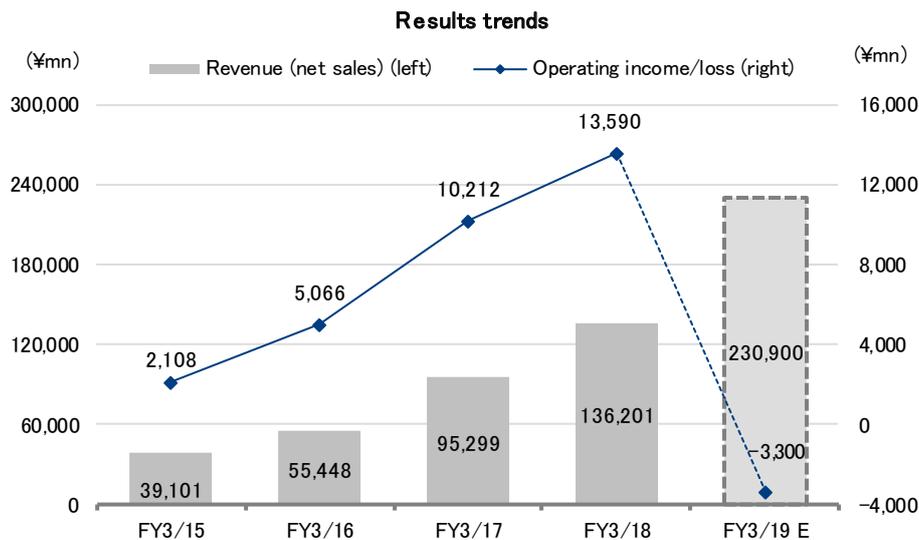
3. Expectations of the Company are great, as hard-landing measures show the Company’s confidence and commitment to a rapid recovery of earnings

Within the Company’s series of measures, the one that we are focusing on is the “hard-landing” approach that it has adopted for this crisis. Executing this requires an appropriate degree of corporate strength and an earnings recovery scenario, but there is no guarantee of its success. It is considered that the Company has a considerable degree of confidence and preparedness for its success. The earnings recovery will be undertaken mainly by the RIZAP-related businesses, particularly the body shaper business, and it seems that its number of new members is continuing to steadily increase. If the Company can carry out precise selection and concentration for its loss-making businesses and businesses for which synergies are not expected while this business steadily grows, then we can expect it to realize its earnings recovery scenario.

Summary

Key Points

- Conducting sweeping structural reforms, with a framework including group companies' reconstruction and business selection and concentration
- The adoption of hard-landing measures expresses the strength of its confidence in a recovery
- New member numbers continue to steadily increase in the body shaper business, while the contributions to earnings of GOLF and ENGLISH are also in sight



Note: Transitioned to IFRS from FY3/17
 Source: Prepared by FISCO from the Company's financial results

Results trends

In FY3/19 1H, despite record high revenue for the 7th consecutive period, recorded an operating loss due to the delays in group companies' earnings recoveries

1. Overview of the FY3/19 1H results

In the Company's FY3/19 1H results, while revenue increased greatly, every profit item from operating income down declined for substantial losses, with revenue of ¥109,105mn (up 74.3% year on year (YoY)), an operating loss of ¥8,829mn (compared to income of ¥4,987mn in the same period in the previous fiscal year), a loss before income taxes of ¥9,705mn (income of ¥4,377mn), and net loss attributable to owners of the parent company of ¥8,532mn (income of ¥2,932mn).

Results trends

Overview of FY3/19 1H results

	FY3/18		FY3/19		
	1H	Full year	1H	YoY	
				% change	Change
Revenue	62,581	136,201	109,105	74.3%	46,524
Operating income/loss	4,987	13,590	-8,829	-	-13,816
Operating margin	8.0%	10.0%	-8.1%	-	-
Income/loss before income taxes	4,377	12,047	-9,705	-	-14,082
Net income/loss attributable to owners of the parent company	2,932	9,250	-8,532	-	-11,464

(¥mn)

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

Revenue increased greatly, up 74.3% YoY, for a record high for the 7th consecutive period. This was because sales steadily increased in the RIZAP-related businesses, which include the RIZAP body shaper business of the management of personal training gyms, RIZAP GOLF, and RIZAP ENGLISH. It was also from the effects of the new consolidation of companies that entered the group following M&A.

But profits decreased and an operating loss was recorded. This was mainly because the restructuring progressed slower than expected, particularly in the companies and businesses that joined the group in the past year, including Wonder Corporation <3344>, Japan Gateway Co., Ltd., SANKEI LIVING SHIMBUN Inc., Pado Corporation <4833>, and Tatsumi Planning's mega solar business. It was also due to the impact of production delays at MRK HOLDINGS INC. <9980>, which had been expected to contribute to earnings, and the recording of an extraordinary loss at SD Entertainment Inc. <4650> due to the effects of the Hokkaido Eastern Iburi Earthquake.

In the breakdown of the factors causing operating income to decrease, the Company cites the following three factors; 1) the total operating loss of non-listed subsidiaries increased by ¥1.82bn, from ¥1.39bn in the same period in the previous fiscal year to ¥3.21bn, 2) the total operating income of the listed subsidiaries decreased by ¥7.86bn, from operating income of ¥3.54bn in the same period in the previous fiscal year to an operating loss of ¥4.32bn, and 3) upfront investment-related expenses increased, including advertising expenses and school and store opening-related expenses (an increase of ¥7.9bn YoY on a group-wide basis). As a result of these factors, operating income decreased ¥13.8bn and as previously stated, became an operating loss of ¥8,829mn.

The Company itself applies IFRS (International Financial Reporting Standards), but many of its subsidiaries apply the Japanese standards. In IFRS, extraordinary items in the Japanese standards are also reflected in operating income. The above-described YoY profit-decrease amount of ¥13.8bn contained a non-ordinary loss of ¥6.83bn, including from structural reforms-related expenses. On looking at the qualitative aspect of the decline in profits, after excluding the amount from the effects of the non-ordinary loss, it can be said that ¥6.97bn was from the impact of the delays in the recoveries of the main businesses.

Results trends

The FY3/19 full year forecasts have been significantly downwardly revised
Compared to the previous forecast, the full fiscal year operating income forecast has been reduced by ¥26.3bn to an operating loss of ¥3.3bn

2. FY3/19 forecast

Following the 1H results, the Company decided that recovering results in the group companies and business as soon as possible should be management's top priority. In conjunction with this, it significantly downwardly revised the FY3/19 full year forecasts. The new forecasts are for revenue of ¥230,900mn, an operating loss of ¥3,300mn, a loss before income taxes of ¥4,900mn, and a net loss attributable to owners of the parent company of ¥7,000mn.

Overview of FY3/19 forecast

	FY3/18			FY3/19						
	1H	2H	Full year	1H	2H (E)	YoY	Full year (initial forecast)	Full year (revised forecast)	YoY	vs. FY3/18 forecast
Revenue	62,581	73,620	136,201	109,105	121,795	48,175	250,000	230,900	94,699	-19,100
Operating income/loss	4,987	8,603	13,590	-8,829	5,529	-3,074	23,000	-3,300	-16,890	-26,300
Operating margin	8.0%	11.7%	10.0%	-8.1%	4.5%	-	9.2%	-1.4%	-	-
Income/loss before income taxes	4,377	7,670	12,047	-9,705	4,805	-2,865	21,100	-4,900	-16,947	-26,000
Net income attributable to owners of the parent company	2,932	6,318	9,250	-8,532	1,532	-4,786	15,940	-7,000	-16,250	-22,940

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

Operating income has been downwardly revised by ¥26.3bn, from the initial forecast of operating income of ¥23bn to an operating loss of ¥3.3bn. Breaking this down, 1) the total amount of operating income downwardly revised due to the delays in restructuring at the subsidiaries (net value) is ¥7.16bn, 2) the recording of a non-ordinary operating loss, including for structural reforms-related expenses, is ¥8.35bn, 3) the effects of freezing new M&A, in principle, is ¥10.36bn, and 4) other consolidated adjustments, etc., is ¥430mn.

Breakdown of the downward-revision amounts for the FY3/19 full year operating income forecast

		(¥bn)
Initial forecast		230.0
Factors	1 Delays in restructuring (mainly at companies that entered the group within the past year)	-71.6
	2 Non-ordinary loss, including from structural reforms-related expenses	-83.5
	3 Freezing of new M&A, in principle	-103.6
	4 Other consolidated adjustments, etc.	-4.3
Total		-263.0
Revised forecast		-33.0

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

The breakdown of the non-ordinary loss, which includes from structural reforms-related expenses, is as follows. Wonder Corporation is scheduled to record an extraordinary loss for the full fiscal year of ¥3.9bn. Also, among the non-listed subsidiaries, structural reforms-related expenses of more than ¥3bn are forecast, mainly for Japan Gateway and the mega solar business of Tatsumi Planning.

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Results trends

Breakdown of the non-ordinary loss, including from structural reforms-related expenses

(¥bn)

	Company	Amount	Detail
H1	PADO	-0.23	Partial impairment of unprofitable business (extraordinary expenses)
	WonderCorporation	-3.36	Restructuring related expenses (extraordinary expenses)
	Unlisted companies	-2.75	Restructuring related expenses of Japan Gate Way and Tatsumi Planning's solar power business
	Others	-0.49	Extraordinary expenses of SD Entertainment related to the 2018 Hokkaido Eastern Iburi Earthquake, and change in accounting the initial fee of RIZAP Body Making studios due to adoption of IFRS 15.
	Subtotal	-6.83	
H2	WonderCorporation and Japan Gate Way, etc.	-1.52	Restructuring related expenses of WonderCorporation, Japan Gate Way, and Tatsumi Planning's solar power business
	Subtotal	-1.52	
	Total	-8.35	

Source: The Company's results briefing materials

The operating loss forecast after the downward revision is ¥3.3bn, which is a contraction from the 1H result of approximately ¥8.82bn. In other words, the forecast for 2H is for a return to profitability to record operating income of ¥5.5bn. Compared to the same period in the previous fiscal year, income is forecast to decline by approximately ¥3bn, from the 2H result of ¥8,603mn in the previous fiscal year.

Trend in profit/loss

(¥mn)

	FY3/16	FY3/17	FY3/18	FY3/19	
				1H	Full year E
Revenue	53,937	95,299	136,201	109,105	230,900
YoY	-	76.7%	42.9%	74.3%	69.5%
Gross profit	32,513	46,034	65,816	47,732	-
YoY	-	41.60%	43.0%	54.9%	-
Gross margin	60.3%	48.3%	48.3%	43.7%	-
SG&A expenses	28,635	41,738	59,682	53,132	-
YoY	-	45.8%	43.0%	86.5%	-
SG&A expenses ratio to sales	53.1%	43.8%	43.8%	48.7%	-
Other income/loss	227	6,687	9,817	1,794	-
Other expenses	947	770	2,360	5,223	-
Operating income	3,159	10,212	13,590	-8,829	-3,300
YoY	-	223.3%	33.1%	-	-
Operating margin	5.8%	10.7%	10.0%	-8.1%	-1.4%
Income/loss before income taxes	2,806	9,604	12,047	-9,705	-4,900
YoY	-	242.2%	25.4%	-	-
Net income/loss attributable to owners of the parent company	1,587	7,678	9,250	-8,532	-7,000
YoY	-	383.7%	20.5%	-	-
EPS after the stock split (¥)	3.13	15.06	18.15	-15.9	-12.81
Dividend after the stock split (¥)	1.9	3.03	3.65	-	0

Note: The FY3/18 results are the values at the time of the results announcement in May 2018

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

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Results trends

Trend in the balance sheet

	Transition to IFRS date (Apr. 1, 2015)	As of March 31, 2016	As of March 31, 2017	As of March 31, 2018	As of September 30, 2018
(¥mn)					
Current assets	22,724	32,522	62,086	116,614	141,167
Cash, deposits and equivalents	8,366	10,483	24,643	43,630	57,220
Trade and other receivables	8,974	12,062	20,544	33,019	33,598
Other	5,384	9,977	16,899	39,965	50,349
Non-current assets	16,400	21,255	33,562	57,760	61,117
Property, plant and equipment	9,647	11,331	17,616	29,696	30,184
Goodwill	2,473	4,675	6,291	7,820	7,953
Intangible assets	846	689	1,013	2,160	3,197
Investment, other	3,434	4,560	8,642	18,084	19,783
Total assets	39,125	53,777	95,648	174,375	202,285
Current liabilities	19,898	27,296	43,636	80,579	85,780
Trade payables	10,766	13,756	24,326	39,204	41,020
Interest-bearing debt	7,820	10,914	15,996	33,587	36,947
Other	1,312	2,626	3,314	7,788	7,813
Non-current liabilities	12,286	15,344	30,557	50,912	49,644
Interest-bearing debt	10,371	12,853	25,204	43,197	40,835
Other	1,915	2,491	5,353	7,715	8,809
Total equity attributable to owners of the parent company	6,077	10,226	17,018	28,401	53,553
Capital stock	132	1,400	1,400	1,400	19,200
Capital surplus	200	1,799	1,692	5,436	23,453
Retained earnings	5,720	7,001	13,696	21,406	10,401
Other capital composition items	23	25	228	158	498
Non-controlling interests	863	910	4,436	14,481	13,307
Total equity	6,940	11,137	21,454	42,882	66,860
Total liabilities and equity	39,125	53,777	95,648	174,375	202,285

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

Cash flows

	End-FY3/16	End-FY3/17	End-FY3/18	End-FY3/19 1H
(¥mn)				
Cash flow from operating activities	868	175	87	-7,616
Cash flow from investing activities	-3,973	2,914	-3,495	-8,764
Cash flow from financing activities	5,137	11,088	22,725	29,945
Cash, deposits and equivalents conversion difference	-27	-18	-35	24
Change in cash, deposits and equivalents	2,004	14,160	19,282	13,589
Cash, deposits and equivalents at the start of the period	8,478	10,483	24,643	43,630
Cash, deposits and equivalents at the end of the period	10,483	24,643	43,630	57,220

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

The structural reforms and the state of progress

Announced sweeping structural reforms comprised of 5 items, including Group companies' management reconstruction and business selection and concentration

1. Overview of the sweeping structural reforms toward sustainable growth

Following the FY3/19 1H results, as previously explained the Company downwardly revised its forecasts on November 14, 2018, while it also announced that it had started sweeping structural reforms toward achieving sustainable growth.

These structural reforms are comprised of five items, with the first being the “early completion of restructuring of group companies and businesses.” The content of the reforms is not limited to these five items, but the Company intends to first conduct the reforms with a focus on these five.

The five items for “sweeping structural reforms for sustainable growth”

The five main items	Content
1. Completing restructuring of group companies and businesses	The Company is aiming to quickly return to profitability from the next period onwards by concentrating its management resources into the early completion of restructuring that is currently underway at companies and businesses, including Wonder Corporation, Japan Gateway, SANKEI LIVING SHIMBUN, Pado, and the mega solar business (of Tatsumi Planning), and also at MRK HOLDINGS, which is being affected by a temporary factor.
2. Transforming to a strong management structure	During the current fiscal period, the Company will record structural reforms-related expenses, such as to optimize the inventories of companies and businesses, including Wonder Corporation, Japan Gateway, Pado, and the mega solar business (of Tatsumi Planning), and also for the impairment of non-current assets.
3. Business selection and concentration	Targeting all the businesses in the group, the Company will withdraw from, contract in scale, sell, or conduct other such measures for businesses for which improving earnings will be difficult in the short term, and businesses for which the initially envisaged Group synergies cannot be expected.
4. Freezing of new M&A, in principle	In order to concentrate management resources into steadily implementing items one to three described above, the Company will freeze new M&A (including acquisitions of companies and businesses), in principle, during the period until the recovery of the group companies and businesses that are currently undergoing restructuring.
5. Concentrating management resources into growth businesses	The Company intends to strengthen its management foundation by accelerating the concentration of management resources into the RIZAP-related businesses, which include the RIZAP body shaper business, GOLF, and ENGLISH, and also into the growth fields that have high affinity with the RIZAP method, of sports, food, and healthcare.

Source: Prepared by FISCO from news releases

Announced corporate governance reforms as phase one Separate management and execution and shift to structure in which the majority of directors are outside directors

2. Corporate governance reforms

Within the five items described above, due to the nature of the two items of “completing restructuring of group companies and businesses” and “transforming to a strong management structure,” they will be mainly conducted individually by each operating company. However, as the holding company, the Company is expected to be more deeply involved than it has been until now in each of the structural reforms, including these two items.

The structural reforms and the state of progress

As the specific actions in phase one, on December 28, 2018, the Company announced that it would change the representative directors and officers as part of its series of corporate governance reforms (the effective date for the changes of officers was January 1, 2019).

The corporate governance reforms consist of the following four points; 1) reforming the Board of Directors, 2) introducing an executive officer system, 3) transitioning to a structure with one representative director, and 4) appointing a director in charge of structural reforms.

In the Board of Directors reforms, the number of directors has been reduced from the previous 12 to 5 directors, with the majority of them, of 3 people, being outside directors. The 2 inside directors are the President and Representative Director Seto, and Mr. Matsumoto (formerly a representative director, who will now be the director in charge of the structural reforms). In conjunction with the introduction of the executive officer system, the Company has implemented a structure aimed to separate supervision and execution.

The three outside directors who have been appointed are Mr. Shoji Otani, who has extensive experience as an executive and corporate auditor in the Company's listed subsidiaries; Mr. Naohiro Chikada, who is a certified public accountant; and Mr. Yoshihiro Yoshida, who is a lawyer.

As the executive officers, five of the seven directors who left their positions as directors have been appointed to work as the heads of divisions and the representatives of operating companies.

The representative-director structure had previously been for two people. But due to the Board of Directors reforms and alongside the transition to a two-person structure for the inside directors, founder Mr. Seto will continue and remain as the sole representative director.

The Company is currently advancing structural reforms, so it decided to appoint a director in charge of these reforms so that they will be quickly and assuredly implemented. Mr. Matsumoto has been appointed to this position.

Details of changes in representative directors and officers (effective January 1, 2019)

Name	New title and main responsibilities	Former title and main responsibilities
Takeshi Seto	Representative Director, President Also supervising the healthcare business	Representative Director, President
Akira Matsumoto	Director in charge of structural reforms	Representative Director in charge of structural reforms
Masayoshi Naito	Executive Officer supervising the platform business Representative Director, Chairman and President of Wonder Corporation	Director, General Manager of Purchasing & Logistics Division Representative Director, Chairman and President of Wonder Corporation
Tetsuo Kozai	Executive Officer supervising business strategies General Manager of Business Strategy Office	Director General Manager of Corporate Alliance Division
Shoji Okada	Executive Officer in charge of information systems General Manager of IT Infrastructure and Development Division	Director General Manager of IT Infrastructure and Development Division
Masato Mori	Executive Officer supervising the lifestyle business Representative Director and President of IDEA INTERNATIONAL CO., LTD.	Director Representative Director and President of IDEA INTERNATIONAL CO., LTD.
Shinji Iwamoto	Executive Officer supervising the beauty business Representative Director and President of MRK HOLDINGS INC.	Director Representative Director and President of MRK HOLDINGS INC.

Source: The Company's news releases

The press release of December 28, 2018, stated that, in addition to the corporate governance reforms described above, the specific policies decided at the current stage were two items; "redefining the business domain" and "transforming to a strong business foundation."

The structural reforms and the state of progress

“Redefining the business domain” is comprised of two contents; concentrating on the important segments (the growth businesses, centered on the beauty and healthcare fields) and arranging the non-core businesses (including contractions in scale, withdrawals, and sales), but the Company has made no further comments on it at the present time. “Transforming to a strong business foundation” is also comprised of two contents; converting to cash flow management, and implementing cost reductions and rationalization across the group. But it has not yet touched on the specific measures for it, and we await further announcements in the future.

The adoption of hard-landing measures expresses the strength of the Company’s intent and confidence to recover earnings. It will be important to judge its success or failure through a careful analysis, based on the results announcements.

3. The outlook for the future

Above, we reflected on the developments alongside the passage of time from the FY3/19 1H results announcement until the start of January 2019. The 1H results and the downward revisions to the full fiscal year results forecast represent a 180 degree change of direction from the Company’s rapid growth trend up to the current time. The magnitude of this is extremely large, and it is thought that it will take a considerable amount of time for stakeholders and market participants to digest its impact. But at FISCO, we consider that by organizing the details and thinking about these developments while thoroughly examining individual items, the points to focus on in the future and the evaluation criteria will eventually become clearer, which should enable the improvements in the accuracy of judgments about the future.

(1) Downward revisions to the results forecasts

Following the major decline in profits in 1H, the Company significantly downwardly revised the full fiscal year forecasts. With regards to this, our understanding at FISCO is that the Company is taking a so-called “hard-landing” approach. One choice to resolve a problem should it occur is a “soft landing” approach to reduce its impact, but the Company has instead chosen a hard-landing approach. A hard landing causes a temporary shock, but if the correct path is taken, this approach makes it possible to achieve a recovery in a shorter period of time. The problem is that making a hard landing a success requires considerable corporate strength and an earnings recovery scenario.

It would seem that the Company’s confidence in its corporate strength is supported by the fact it greatly strengthened its balance sheet through a capital increase by a public offering in June 2018.

On the other hand, it is considered that in the background to the earnings recovery scenario is the fact that member numbers are steadily increasing in the core body shaper business, while maintaining the same upward trend as up to the present time (based on an increase of 1,500 to 2,000 people a month). There is also the sense that it is performing strongly in the healthcare domain, such as through collaborations with local governments and industry-academia collaborations.

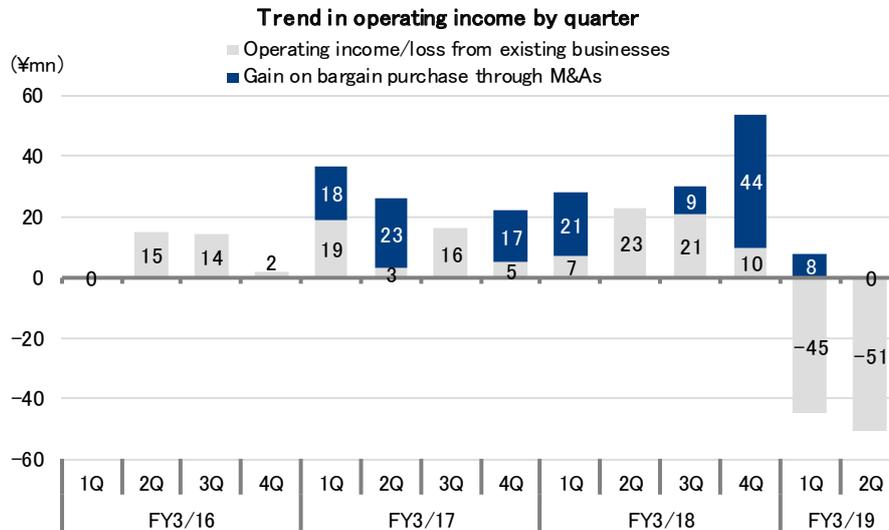
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The structural reforms and the state of progress

The companies that have suffered a sudden and major deterioration in results and a dramatic change to their business environment are not limited to the Company. Based on the experiences of many such companies that we have seen up to the present time, our impression is that those that adopted the hard-landing approach successfully achieved an earnings recovery. As a major reason for this, at FISCO we think that although it is somewhat analogue, the key seems to be the psychological aspect. Specifically, companies that select a hard landing have a certain level of “preparedness.” In contrast, choosing a soft landing had a negative impact in the end in many cases because it ultimately only postponed dealing with the core problem even though it dealt with immediate factors such as corporate strength and earnings recovery. From these experiences, we consider that the Company’s bold selection of a hard-landing scenario can be positively evaluated.

(2) Possibility of achieving the full year forecasts

At the current point in time, there is no information on which to judge whether the Company’s adoption of hard landing measures is the correct one or not. The evaluation criteria for its success or failure will primarily be the results, so the first evaluation point will be the 3Q results. As previously stated, in the current 2H, the Company is forecasting operating income of ¥5.5bn. On dividing this into the results of 3Q (October to December) and 4Q (January to March), in the most recent 3 years (FY3/16 to FY3/18), after excluding a gain on bargain purchases, operating income was higher in 3Q than in 4Q. Therefore, in terms of securing profits in the current 2H, at FISCO we think that whether or not it can steadily record profits in 3Q (October to December) will be the first step for the judgement on the feasibility of the Company’s earnings recovery scenario.



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

The structural reforms and the state of progress

When evaluating the results' numerical values, it goes without saying that one point is whether a profit or a loss was recorded, but it is also necessary to examine their quality. The Company's consolidated results would seem to be easier to understand on dividing the group companies into three sub-groups; the RIZAP-related businesses, the listed subsidiaries, and the non-listed subsidiaries. Ideally, it would be preferable that all three of these sub-groups achieve an increase in profits in 2H compared to 1H, but it is also necessary to pay attention to other factors when evaluating the results. As previously stated, the Company's consolidated results are based on IFRS, so operating income includes the extraordinary profit and loss items of each of the operating companies (structural reforms-related expenses are mainly recorded in extraordinary losses). Therefore, in addition to a decrease in the extraordinary loss recorded in 1H, we think an important task is to ascertain whether or not earnings have bottomed out in the results of the main businesses. On this point, at the very least the listed subsidiaries can be examined individually.

The operating income forecast for 2H is ¥5.5bn, which on a reporting basis, is a YoY decline of approximately ¥3bn. However, after excluding the gain on bargain purchases, operating income in the same period in the previous fiscal year was around ¥3.2bn, so in actuality it will be an increase in income of ¥2.3bn. So while this is absolutely not a low hurdle to clear, at FISCO we think that it is fully possible that the Company can achieve it if it succeeds with two aims; firmly growing profits in the profitable businesses, like the body shaper business, and stemming the bleeding in the loss-making businesses. Through interviews with the Company itself and some of the listed subsidiaries, we received the impression that basically, steady progress is being made in the profitable businesses. On other hand, the impression is that there remain uncertain points for the situation for the healing (stemming the bleeding) of the loss-making companies and businesses, which are mainly the non-listed companies.

(3) The content of the structural reforms and the state of progress

As stated above, the Company's structural reforms consist of five items, with the first being the "early completion restructuring of group companies and businesses." All of the items are related, so they can be summarized into two items; 1) in principle, freezing new M&A and concentrating management resources into the restructuring of existing businesses, and 2) in the management reconstruction process, implementing business selection and concentration.

The specific policies for phase one, which were announced on December 28, 2018, are centered on the reforms of the Board of Directors as corporate governance reforms. For the items of "redefining the business domain" (leading to business selection and concentration) and "transforming to a strong business foundation" (relating to the restructuring as the other side of the same coin), a part of SD Entertainment's business was sold on November 13, 2018, although a symbolic example of a fully-fledged measure was the sale of the shares of Japan Gateway announced on January 25, 2019.

We can expect even further progress to be made in the future, but a certain amount of time will be required for business transfers, sales, and withdrawals, and also there must be the other party to such transactions. External third parties will have no choice but to wait for announcements in the future, but to some extent speculation is possible. At FISCO, we speculate that the intention of the corporate governance reforms is to optimize the management team and the execution structure by changing directors and rapidly achieve the recovery scenario from a hard-landing approach. We consider this to be correct choice as a first step. So it would seem that the foundation for executing the structural reforms is in place, and we assume that the Company has shifted to a phase of fully progressing the business selection and concentration and restructuring.

The structural reforms and the state of progress

a) Business selection and concentration

For business selection and concentration, the points to pay attention to are where and to what extent to cut.

On the point of “where,” the briefing materials for the 1H results provide us with one clue. The materials disclose in detail which companies and businesses have caused the deterioration of results. Also, the delays in restructuring suggest at which companies and businesses it has not been possible to realize the synergies that were expected. It would seem that the business selection and concentration will be advanced from these viewpoints.

“To what extent” means the number of companies and businesses for which measures such as transfers and withdrawals will be implemented. Investors may be disappointed if this is limited to only a few companies. Looking at the current deterioration of results by operating company, there are only a few large ones, such as Wonder Corporation’s extraordinary loss and Japan Gateway’s operating loss, and these losses take the form of the accumulation of “miscalculations” and operating losses on units of a few hundred million yen to around ¥500mn to ¥600mn. If the loss is around a few hundred million yen, then in terms of the possibility of a sufficient recovery, it is possible that a recovery can be achieved by many of the companies simply by maintaining the current path.

Ultimately this could of course be correct, but on the other hand, it is conceivable that the investors and other stakeholders feel that there is potential risk from the number of companies in the group, of 85 companies (as of the end of September 2018). The freezing of new M&A, in principle, has eliminated the concerns that this number will increase in the future, but the investors’ biggest concern is whether it is possible for the Company to carry out the restructuring (and the strengthening of the business foundation), while monitoring all 85 companies. On setting the viewpoint of the “possibility of recovering results” when implementing the business selection and concentration, it is possible that the Company will narrow down the businesses to sell or withdraw from. However, it goes without saying that the sustainability of this is not guaranteed over the medium to long term. At FISCO, we think that the viewpoint of whether or not it can realize synergies for sustainable growth is the more important viewpoint. In this case, the reduction in the number of Group companies should become larger.

For the time frame, the significance of taking a hard-landing approach is increased by realizing it in the shortest time possible. It is thought that the Company itself is taking this approach with a considerable sense of urgency and speed. However, it needs to have partners to transactions, so we should assume that it might take more time than it expects and has planned for.

b) Restructuring

The progress made in restructuring will first of all be judged from the numerical values in each of the quarterly results. The Company’s consolidated results are important, but in the current situation of advancing restructuring of each individual operating company, it is more important than ever to ascertain the management reconstruction situation at each operating company. All of the main operating companies have fiscal years ending in March, except for IDEA INTERNATIONAL (ending in June). Basically, there are many B-to-C companies, and also many companies with seasonality in that their 3Q results grow due to the demand period from Christmas until the New Year. In light of this situation, in the cumulative 3Q results, first of all the key point will be whether or not we can see improvements in profits in 3Q (October to December) compared to the results in the previous quarter and in the same quarter in the previous fiscal year.

For the qualitative aspect, it is important whether or not the improvements to the results are sustainable and reproducible. In addition to the business cycle and the demand cycle, if synergies can be confirmed for each group company, then expectations will rise accordingly for the likelihood of the improvements being sustainable.

The structural reforms and the state of progress

In the 1H results briefing materials, the Company described a recovery and restructuring scenario for MRK HOLDINGS and other listed subsidiaries. On the one hand, there are operating companies for which the likelihood of a successful restructuring is high, including Jeans Mate <7448>, which achieved profitability in the 1H results, and MRK HOLDINGS, for which the reason for the slump in 1H is clear and it is progressing measures in response. But on the other hand, there are also cases like Wonder Corporation whose results deteriorated in 3Q also, so the unpredictable situation is continuing.

New members continue to steadily increase in the body shaper business

GOLF and ENGLISH have also reached the profit-loss breakeven point and their contributions to earnings are in sight

4. Conditions in the RIZAP-related businesses

Among the reasons why the Company selected a hard landing, it is considered that the presence of the RIZAP-related businesses, centered on the RIZAP body shaper business, occupies the major position.

The core RIZAP body shaper business had 121,796 members at the end of September 2018, which was an increase of 116,000 people on the end of June 2018, and the pace of increase of 2,000 people a month is continuing. The results were announced in the middle of November and also the Company's deterioration of results was reported on by television and in newspapers, and on the same timing it narrowed down its broadcasting of TV commercials. Therefore, there might be the opinion that the momentum and the popularity of the RIZAP body shaper business has declined, but at FISCO we think that the risk of this is small. It seems that the reason for narrowing down the TV commercials was a seasonal factor, of being in advance of the end-of-year holidays. The situation is that the Company resumed TV commercials as normal to reflect the New Year demand period, and the same as in a typical year, it is working to capture demand from 4Q to 1H of the next fiscal year.

In the body shaper business, the Company is developing RIZAP WOMAN, which is exclusively for women, and EXPA, which are weight training and diet studios intended for women. These developments are backed by needs and are expected to steadily grow.

It is also working to continue and steadily expand the collaborations with local government and the developments for corporations from the same routes as previously. In terms of earnings, it would seem to be at the upfront investment stage, but in its medium- to long-term strategy in which it is aiming to enter into the healthcare domain with RIZAP body shaper as the core business, this investment is an element that cannot be avoided. Therefore, the Company's concentrated investment of management resources into these growth businesses and domains is sufficiently persuasive. Even within the five sweeping structural reforms described above, its consistent attitude of strengthening for this point is expressed in the item "concentrating management resources in growth businesses."

The structural reforms and the state of progress

In addition to the body shaper business, RIZAP GOLF and RIZAP ENGLISH are also making comparatively strong progress. Since April 2018, 13 RIZAP GOLF schools have opened, and as of the end of September, it had a network of 27 schools. In terms of earnings, on a quarterly basis it continued to record an operating loss up to 1H, but on a single-month basis, it achieved profitability in September and October. It would seem to have put in place a structure in which profits can be generated if new school openings are kept down, so going forward, the focus will be on whether it can achieve a balance between securing profits and the pace of school openings. RIZAP ENGLISH doubled its number of schools in 1H, and as of the end of October 2018, it had a network of 8 schools. For earnings, it achieved profitability in 2Q (July to September), but it would still seem necessary to ascertain whether it is the narrow gap between new school openings and temporary or has continuity. Also, compared to the body shaper business and GOLF, it is difficult to develop this business in regions and there are also a number of competing alternatives, and therefore there remains room to examine whether it would be appropriate to apply to it the growth pattern achieved by the body shaper and GOLF businesses.

The starting point for the RIZAP-related businesses is to aim to develop in each business “the power to do,” which is the core of the RIZAP method. In addition to the three businesses for which progress has already been made, of body shaper, GOLF, and ENGLISH, the group is developing businesses in various other fields, including cooking, children, sports, dance, and health. However, there remains some doubt about whether or not the development of all of these businesses is appropriate in terms of their affinity with the RIZAP method and marketability. As part of the structural reforms, it seems likely that re-examining the contents of each of the RIZAP-related businesses will be extremely significant from the viewpoint of selection and concentration.

■ Shareholder returns

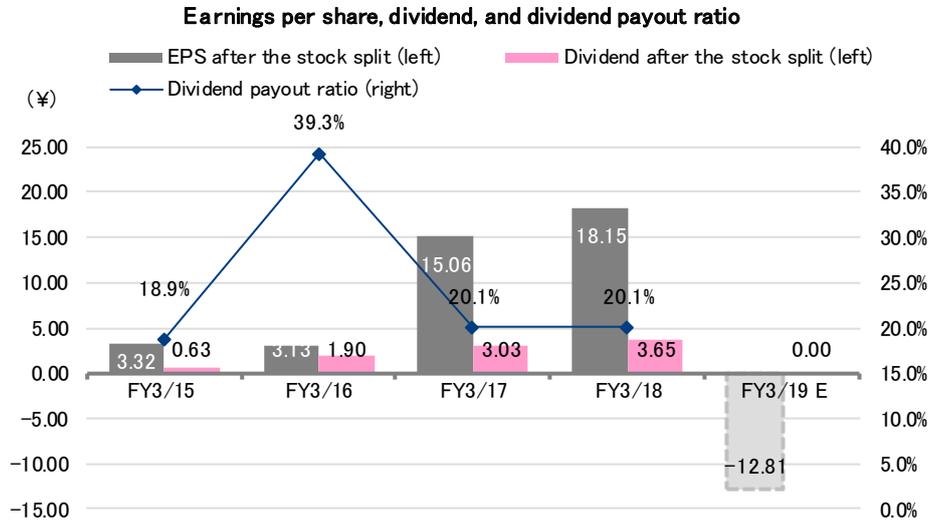
Announced it will not pay a dividend in FY3/19 based on the revised forecasts and the implementation of structural reforms

The Company positions returning profits to shareholders as an important management issue. It has a basic stance of returning profits to shareholders and accompanying shareholder benefit program as it strives to strengthen returns, centering on individual investors. There has been no change to this stance and policy. In terms of the dividend amount, since FY3/17 the Company has revised the standard for the dividend to a consolidated dividend payout ratio of 20%.

As was announced in the press release of November 14, 2018, the Company will not pay a dividend in FY3/19 based on the revised forecasts and the implementation of structural reforms.

It is maintaining the shareholders’ benefit program in the current fiscal year, in which it also granted shareholders additional points as a special 15th anniversary benefit. In addition, it has newly introduced a system to accumulate shareholders’ benefit points as a permanent measure to improve the program’s usability.

Shareholder returns



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



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