STARTIA, INC.

3393 Tokyo Stock Exchange First Section

24-Jun.-14

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FISCO Ltd. Analyst
Hiroyuki Asakawa

Another level of earnings expansion from AR Services

Startia <3393> provides a one-stop shop for internet-related services to small- and medium-sized companies. While centered on network devices sales and rental server operations, it also undertakes business phone sales, the business upon which it was founded, as well as printer sales and maintenance. Further, in recent years growth in eBook production software ActiBook, which was developed at a subsidiary, and the related ActiBook AR COCOAR software (herein "COCOAR") has been remarkable.

FY3/14 results saw both net sales and profits come in slight above company forecasts. On the face of it the figures carried no particular surprises, however, if we analyze them in detail it is possible to infer that on a real underlying basis operating income reached the JPY1 billion mark. Arguably Startia's earnings capacity has risen to that extent.

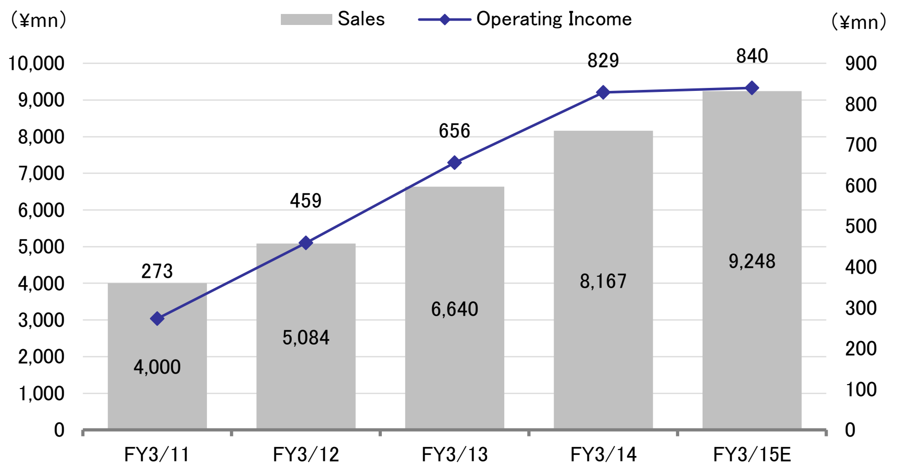
The company is forecasting FY3/15 recurring income to be almost flat at JPY866mn. However, at the same time it has announced that the combined FY3/15 and FY3/16 recurring income target shall be JPY2 bn. The reason for this year's forecast being kept low is due to upfront investment expenses arising, whilst on the other hand, given that the customer base, which produces sales is being steadily amassed, we feel that there is ample potential to realize the significant rise in FY3/16 profits.

Within Startia's numerous products and services, what attracts particular attention is the COCOAR service for using AR (Augmented Reality: a technology that adds new data into real images using computers, including mainly mobile devices). We believe that this is a service that has tremendous potential in the field of commercial advertising. Despite the broad penetration of smartphones we still see few advertisements using AR. We feel that if AR becomes a common advertising method in the future Startia's COCOAR, armed with strong price competitiveness, has the potential to take-off*4 suddenly.

Check Point

- Sound underlying performance from COCOAR & other contributions
- ROA at a high level & profitability on an upward trend
- High probability of recurring income exceeding the plan for a second consecutive year

Sales & Operating Income Trends



Company Profile

One-stop IT Environment Proposals, Including Web Solutions

(1) Corporate History

Originally, Startia was established by President, Representative Director and Chief Executive Officer Hideyuki Hongo in 1996 as the limited company Telecomnet. Initially its flagship business was the sale of business phones. Subsequently, in 2000 it started hosting services (rental server operations), commencing internet-related business in earnest. Following that it expanded its scope of business to network device rental and MFP (multi-function printer) operations. In 2009 it established the subsidiary Startia Lab, Inc. to engage in website creation and eBook production software, almost completing its current operating structure.

Proactive in overseas expansion also, starting with the establishment of a software joint venture company (of which Startia holds 30%) in China's Xian in 2011, the company has taken rapid steps to establish a 100% owned subsidiary in Shanghai in 2013 (STARTIA SHANGHAI, INC.), and make a 40% capital investment in a Taiwanese publishing company (Horma Digital Technology Co., Ltd.).

In terms of stock exchange listings, after listing on TSE Mothers in December 2005, Startia shifted its listing to the TSE First Section in February 2014.

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Corporate History

Feb 1996	Established as limited company Telecomnet in Tokorozawa-shi, Saitama Prefecture
Oct 1996	The company' s name is changed to ND Telecom Inc.
Jan 2000	Hosting service [Digit@Link Rental Server] starts operations.
Apr 2004	The company's name is changed into Startia, Inc.
Dec 2005	The company is listed on the "Mothers" section of the Tokyo Stock Exchange.
July 2007	The network equipment rental service [Managed Gate] is made available.
Oct 2007	Agreement to take over the MFP customers and counter business from Arest Inc.
Apr 2009	Web production, e-book creation software, Startia Lab, Inc. is established as a consolidated subsidiary
Jun 2009	The company accepts a 3rd party allotment of shares from MAC Office, Inc., making it an equity method affiliate
Oct 2011	The company establishes joint venture subsidiary STARTIASOFT Inc. in Xian, China
Jan 2012	The company accepts a 3rd party allotment of shares from Urban Plan Co., Ltd., making it an equity method affiliate
Jan 2013	STARTIA SHANGHAI, INC. established
Apr 2013	Tokyo Branch established
Jun 2013	Acquired shares in Horma Digital Technology Co., Ltd., Taiwan forming a capital and business alliance
Feb 2014	Shifted listing to the TSE First Section

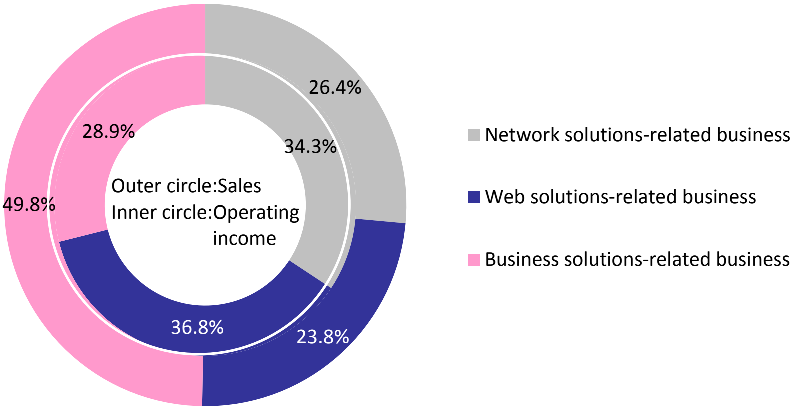
Source: Company homepage

(2) Description of Businesses

Startia has as its mission "to eliminate the digital divide among companies, and to help create energetic business organizations", making one-stop IT environment proposals for companies with less than 300 staff.

In 2009, along with reviewing its business domain, it organized its operating segments into the current 3-pronged structure. At present, this 3-pronged business structure has Web Solutions, Network Solutions and Business Solutions segments. In broad terms, we may categorize them as web solutions being for internet software and services, network solutions as being for devices and services relating to core internet (activities), and business solutions being for devices and services involving internet terminal devices.

Sales & Profit Contribution by Segment (FY3/14)



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Results of Operations & Analysis of Financial Condition

Sound underlying performance from COCOAR & other contributions

(1) FY3/14 Results

FY3/14 results came in slightly above company forecasts, with net sales of JPY8,167mn (+23.0% y-o-y), operating income of JPY829mn (+26.5% y-o-y), recurring income of JPY856mn (+30.6% y-o-y) and net income of JPY432mn (+10.5% y-o-y).

By business, web solutions sales were JPY1,943mn (+31,1% y-o-y), with segment profit of JPY323mn (+95.8% y-o-y). Flagship eBook production software ActiBook and AR service COCOAR both saw steady sales growth. In particular, COCOAR sales grew significantly on the success of the strategies for the dynamic development of new graduate hires and cross-selling to existing ActiBook customers.

Network solutions showed sales of JPY2,160mn (+17.2% y-o-y) and segment profit of JPY301mn (-16.9% y-o-y). In respect of sales, all of the products, including Digit@Link Managed Gate, Digit@Link Netless Q and Digit@Link Secure Samba, increased sales steadily. The decline in profit was due to incurring expenses for upfront investments for systems investment and strengthening security.

Business solutions showed sales of JPY4,063mn (+22.6% y-o-y) and segment profit of JPY254mn (+50.3% y-o-y). Despite this operating segment having the old-fashioned business phone product, engagement from replacement demand made a contribution. Progress in the acquisition of new MFP (multi-function printer) customers, which is another major product, due to the impact of the opening of the Tokyo Branch, (also) contributed to sales increases. Due to the impact of increased sales, cost increases such as those in support divisions were absorbed, and operating income also increased significantly.

Results Trends by Segment

Segment	Item	Unit	FY4/12*13	FY3/13	FY3/14 (Actual)	FY3/14 Change (YoY)
Web solutions	Sales	¥mn	1,073	1,482	1,943	31.1%
	Segment income	¥mn	220	165	323	95.8%
	Operating income margin	%	20.5%	11.1%	16.6%	-
Network solutions	Sales	¥mn	1,424	1,843	2,160	17.2%
	Segment income	¥mn	179	362	301	-16.9%
	Operating income margin	%	12.6%	19.6%	13.9%	-
Business solutions	Sales	¥mn	2,585	3,314	4,063	22.6%
	Segment income	¥mn	91	169	254	50.3%
	Operating income margin	%	3.5%	5.1%	6.3%	-

The proportion of one-time sales and steady revenues was JPY5,572mn (+26.7% y-o-y) and JPY2,594mn (+15.8% y-o-y) respectively. The ratio of steady revenues was 31.8%, declining from 33.7% in FY3/13, however, there is arguably no need for concern in relation to this point. In the distinction between one-time sales and steady revenues whereas there are cases where they are essentially divided based on contractual format, in the first year they are treated as one-time sales at the point of sale, however, there are also cases where maintenance services that arise from the second year are treated as steady revenues. In FY3/14 business solutions-related business, MFP (one-time) sales rose, however, from this year this will lead to counter sales (steady revenue).

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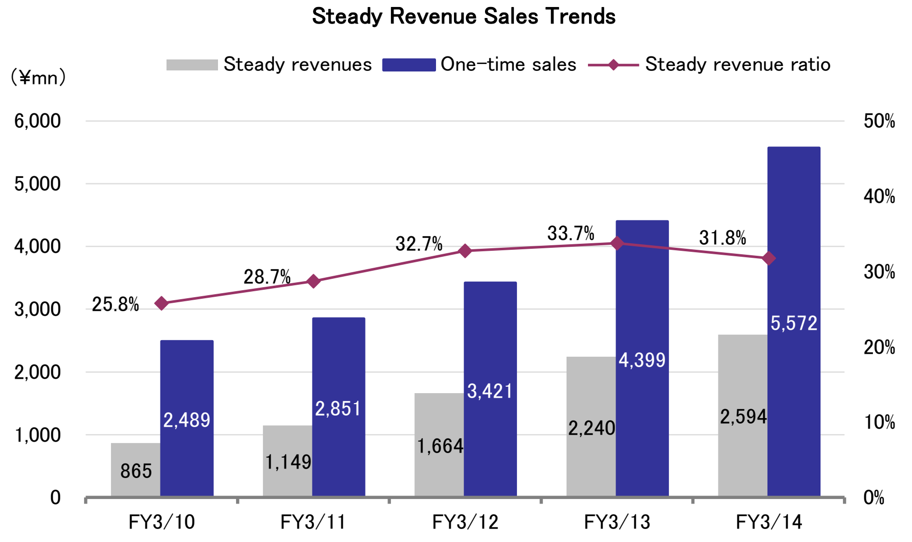


Focus on upfront investment this year to continue underlying revenue & earnings growth

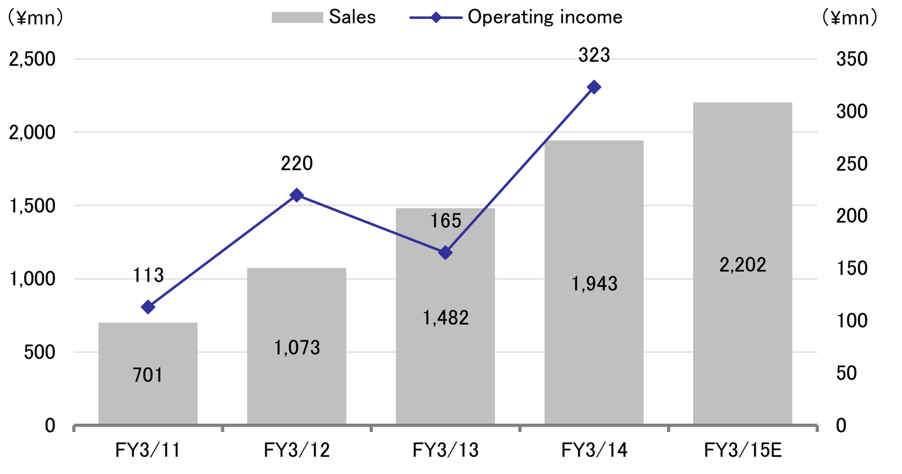
(2) FY3/15 Results Outlook

Startia plans for net sales of JPY9,248mn (+13.2% y-o-y) in FY3/15, with operating income of JPY840mn (+1.3% y-o-y), recurring income of JPY866mn (+1.2% y-o-y), and net income of JPY433mn (+0.2% y-o-y). In respect of forecasting profits to be almost flat, despite double-digit sales growth, the company explains that FY3/15 is positioned as year of unprecedented upfront investment, in order to (establish a base to) recoup that upfront expenditure in FY3/16. Details are set out below, however, cumulative 2-year FY3/15 and FY3/16 recurring income of JPY2bn is planned, with recurring income of JPY1,134mn in FY3/14 (+30.9% y-o-y) if things proceed according to plan.

The issue is with the particulars of the upfront expenditure, and while details have not been clarified they may be inferred as a succession to activities from FY3/14 actual results. That is, measures such as securing and training staff for the future, developing and consolidating domestic and overseas locations, and security measures.

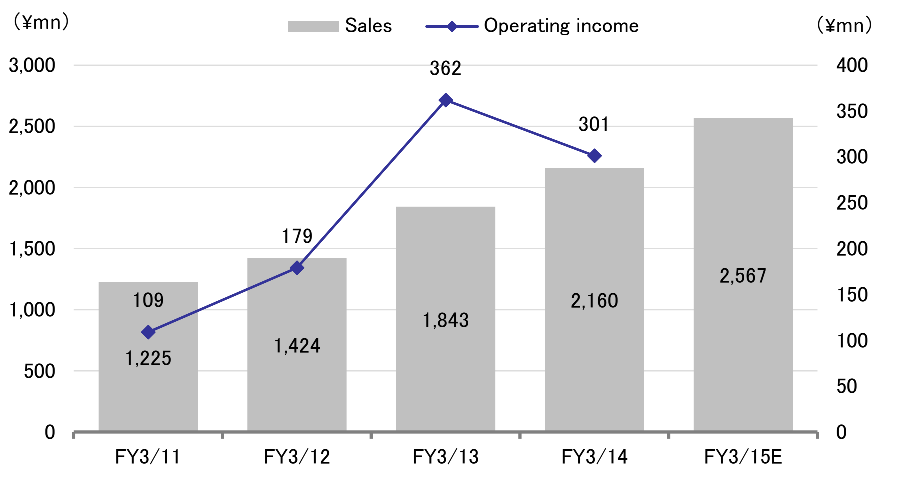
The plan by segment calls for sales from web solutions to be JPY2,202mn (+13.3% y-o-y). eBook production software ActiBook and AR service COCOAR sales are also expected to rise. The cumulative number of companies that have installed ActiBook has come to exceed 2,200. In addition to cross-selling COCOAR to existing ActiBook customer performing soundly, due to heightened degree of recognition, progression in new customer acquisition may also be expected.

Web Solutions Results Trends



Sales from network solutions shall be JPY2,567mn (+18.8% y-o-y). Maintenance service Digit@ Link Netless Q has opened the way for network device sales strategy to proceed extremely well, with this trend likely to continue in FY3/15. As a result of the network device rental service Digit@Link Managed Gate also amassing customers, from a profit perspective (also) the contribution is increasing. This is a typical steady revenue service, and it is expected that is will solidly underpin sales in FY3/15 also.

Network Solutions Results Trends



Business solutions sales of JPY4,479mn (+10.2% y-o-y) are planned. It is expected that business phone and MFP (multi-function printer) sales will continue to increase. While there is no novelty in these products, they are the most basic business infrastructure devices, and the accumulation of customers flowing from replacement demand forms the backbone of this business. Additionally, for MFPs the high degree of compatibility with Startia's rental server service Digit@Link Secure Samba is rated highly, with the fact that at the same time the cases of replacement commissions*9 increasing also attracting attention.

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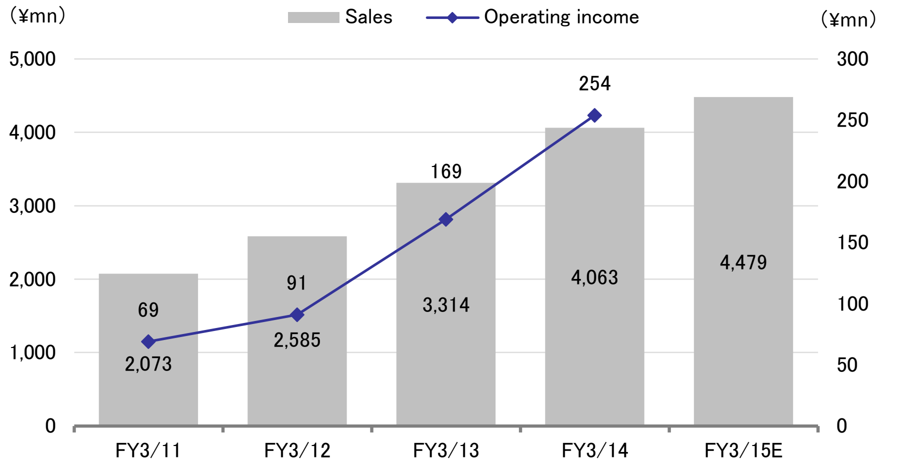
Business Solutions Results Trends



ROA at a high level & profitability on an upward trend

(3) Analysis of Financial Condition

FY3/14 return on equity (ROE) was 13.2%. While this has declined marginally from the 13.8% at the end of the previous fiscal year, it is arguably at a passing grade level for a Japanese company. ROE can be decomposed into ROA and financial leverage, however, looking at Startia's ROA as the ratio of recurring income to total assets, it is at the high value of 18.1% exceeding ROE. Arithmetically speaking financial leverage is a negative, however, given that the balance of interest bearing liabilities is zero, the cause of ROA＞ROE is the structure of the company's balance sheet. That is, it is rooted in the fact that the shareholders' equity ratio is high at approximately 70%.

Analyzing the factors behind achieving its high ROA, we may discern it is due to a total asset turnover ratio of 1.73x per annum and a recurring income to sales ratio of 10.5%. As an IT service company its turnover ratio is average, however, its recurring income margin may be highly regarded as a worthy effort for Startia's enterprise type, which has a labor intensive element.

Another important point is that Startia's profit margin has risen annually. We can see that, compared with expansion in sales, its cost of goods and SG&A have been controlled well. In particular, the fact that even in FY3/14 when 87 new graduate hires were made, SG&A declined 0.8% as a percentage of sales may be highly rated.

Judging from factors including the current operating environment, Startia's business structure, and the sales conditions for its products and services, we may also expect profit margins to rise going forward, and further the likelihood of its total asset turnover ratio deteriorating is slight. As a result, it may be expected that ROA will rise to a new level from the 18.1% at the end of FY3/14. On the other hand, whether ROE will catch-up with ROA or not, is difficult to speculate on to the extent that it is closely linked to dividend policy. We feel that, if current dividend policies continue, for the time being the likelihood of circumstances prevailing where ROA＞ROE is high.

Analysis of Financial Position

		Unit	FY3/10	FY3/11	FY3/12	FY3/13	FY3/14	FY3/15E
Main results	Sales	¥mn	3,353	4,000	5,084	6,640	8,167	9,248
	Gross profit	¥mn	1,966	2,257	2,779	3,487	4,245	–
	SG&A	¥mn	1,806	1,984	2,319	2,831	3,415	–
	Operating income	¥mn	160	273	459	656	829	840
	Recurring income	¥mn	164	278	475	655	856	866
	Net income	¥mn	115	129	278	391	432	433
	Total assets	¥mn	2,543	3,439	3,777	4,279	5,167	–
	Shareholders' equity	¥mn	1,362	2,404	2,658	3,044	3,450	–
	Interest bearing liabilities	¥mn	593	293	141	0	0	–
	Depreciation	¥mn						–
	EBITDA	¥mn						–
Profitability & Efficiency	Shareholder's equity ratio	%	8.8%	6.9%	11.0%	13.8%	13.2%	–
	ROA	%	6.8%	9.3%	13.2%	16.3%	18.1%	–
	Total asset turnover ratio	(x/year)	1.39	1.34	1.41	1.65	1.73	–
	Recurring income margin	%	4.8%	6.8%	9.0%	9.9%	10.5%	9.4%
Growth	Net sales	%	22.5%					
	Operating income	%	39.3%					
	Net income	%	30.4%					

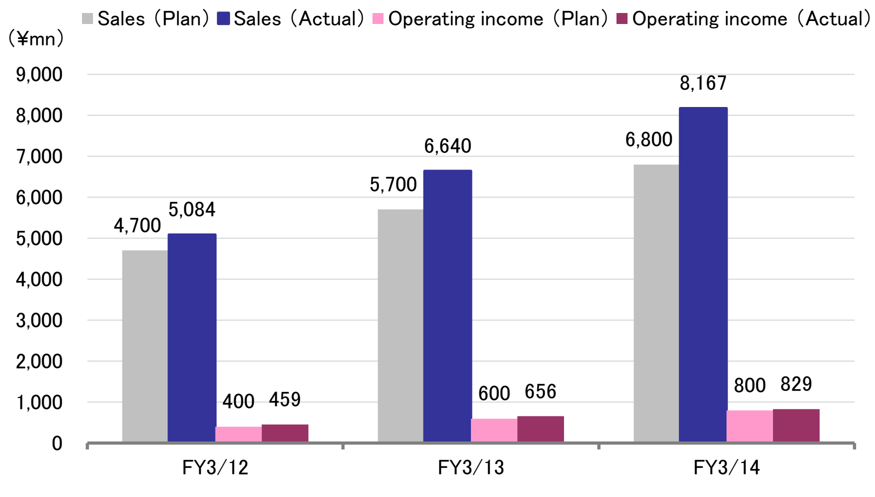
※ Note: Balance sheet items are calculated using the average of the period opening and closing balances, with growth being the CAGR from FY3/10 to FY3/15

■ Medium-term Results Outlook

Significant potential for exceeding the 2-year recurring income plan

In the previous 3-Year Mid-term Management Plan announced in May 2011 (FY3/12-FY3/14) both sales and profits were exceeded. Looking at the details, each of the web solutions, network solutions and business solutions segments displayed growth exceeding 20% per annum. In particular, web solutions' eBook production software ActiBook and peripheral software were the drivers, achieving growth exceeding 40% per annum.

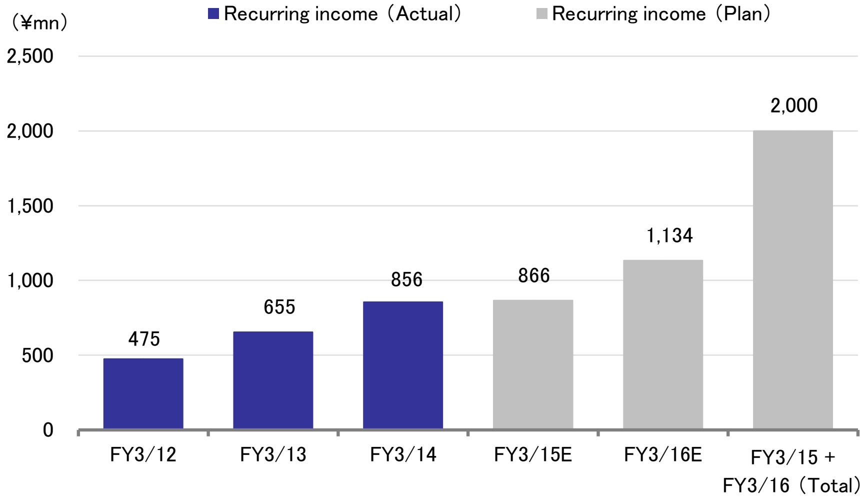
Review of Previous Mid-term Management Plan



Note: Plan figures are those from the time of the 2011 Mid-term Plan

At the same time, along with the FY3/14 results, Startia announced a plan for a 2-year FY3/15 and F3/16 recurring income of JPY2bn. The particulars call for a 2-year cumulative income of JPY2,000mn, with JPY866mn in FY3/15 and JPY1134mn in FY3/16. These figures are the same as has previously been indicated by the company.

Review of Previous Mid-term Management Plan (Actual) & 2-Year (Forecast)



The main point is how the likelihood of the company realizing this 2-year recurring income plan is viewed. Our conclusion is that the likelihood of exceeding this plan is high. The major reasons for this are as follows.

●It possesses products and services with high growth potential, including the web solutions business, which has the highest growth expectations, with ActiBook and COCOAR, and other related software services.

●In the network solutions business maintenance and new format hosting services are obtaining higher than expected appraisals by customers, and the fact that this is translating into actual results as sales is verifiable.

●In business solutions, where the mainstay is the old-fashioned business phone product, from angles such as replacement demand, benefits from being the last man standing, and integration with new services that utilize cloud, it is possible to eke out a market, with the room for growth being corroborated by the previous mid-term management plan.

●Startia is developing know-how in effectively mobilizing the large volume of FY3/14 new graduate hires, while at the same time hiring almost the same level of new graduates in FY3/14 and thus proceeding to steadily secure (a good pool of) human resources.

●The impact of the introduction of incentives for management and staff.

As noted above, we believe that the likelihood of achieving the 2-year recurring income plan is high, however, on the other hand we feel that likelihood of significantly exceeding the JPY2,000mn target to JPY2,500mn or JPY3,000mn is low. Examining Startia management's past track record this is because in cases where there is leeway in sales, without hesitation they make upfront capital investments. We cannot predict whether the investment will be in human resources or some technology or a business, however, their results are the best proof that capital has been utilized effectively in the past.

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■ Attention worthy services that will support growth

COCOAR is armed with price competitiveness & high user-friendliness

Within Startia's numerous goods and services, what has attracted attention in particular is COCOAR for the use of AR (Augmented Reality: a technology that adds new data into real images using computers, including mainly mobile devices). In the future, if AR becomes a common advertising method Staria's COCOAR, armed with strong price competitiveness, has the potential to take-off suddenly.

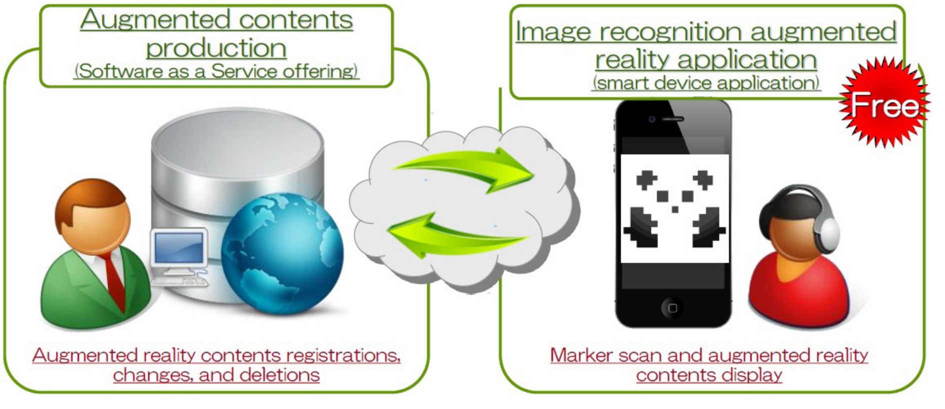
●AR with a growing degree of visibility as an advertising tool

AR is technology for realizing a supplementing via linking to the internet for (those that) want to know more (or inform more) about the real world. While it has attracted a great deal of attention in advertising and other fields, in actuality from a cost stance it has not gained a significant penetration. The reason that costs balloon in typical existing AR services is because application software containing AR content for each project being developed. The result of that is that tremendous costs from several million yen to several tens of million of yen are incurred.

●Success in dramatic cost reductions compared with other companies' AR services

COCOAR has significantly reduced costs by way of a structure that uploads and calls to the server*10 each time, rather than creating AR content within the application. Software that undertakes a series of processing (tasks) is packaged and is sold either as an outright sale or in a monthly rental format. The price in the case of an outright sale is JPY3 million, however, because you may create as much content as you want if the server capacity is 10GB or less, considering it on a per project basis, it is possible to significantly reduce costs. Startia, armed with this low cost and user-friendliness, is opening up the AR market. By the very fact that in reality COCOAR is the only AR service able to be used by small- and medium-sized companies, Startia arguably has this market all to itself*11.

Conceptual Diagram of the COCOAR Service



Source: Company

●**The point of differentiation is the simple structure of AR Contents+COCOAR Servers**

As in the diagram above, the sender of the data (company) prepares the marker image (able to be set freely) and the AR object (the data they want to send - video, music, website etc.) and uploads them to the server. Additionally, prints the market image on name cards, advertising handouts etc. (strictly speaking they don't have to be printed but may be still images on the monitor screen). When the receiver of the data (an individual) downloads a free application films*12 the printed marker, the AR object content is shown on the smartphone screen. Because in existing formats, the AR object and application needed for the individual to film it were integrated, there was no scalability or versatility, with development costs arising each time and being significant amounts. COCOAR's point of differentiation is its structure that manages the AR object and marker in the server, enhancing versatility. It is as it were the difference between tailor-made and ready-made clothes.

●**QR service is similar but different, marked difference in depth of content & user-friendliness**

Usage of the QR code, which is a similar type o service to AR, has become relatively popular. However, there are a number of significant points of difference between the QR code and AR, starting with the volume of content data. COCOAR is vastly superior in terms of user-friendliness and richness of data, including marker designability and the scalability and versatility of content.

Comparison of COCOAR with QR Code

Check items	QR code	Augmented reality marker
Design changes	× Impossible QR code fixing	○ Possible Paper design possible
Contents scalability	△ Limited Only through URL	○ Possible Because marker retains information
Three-dimensional object recognition	× Impossible Impossible apart from code	○ Possible Can recognize three dimensional objects
Marker size	△ Limited Can scan with camera	△ Limited Size recognizable with characteristic point
Secondary paper usage	× Impossible Need to print new code	○ Possible Can set where already printed

Source: Results briefing materials

●**Significant room for growth even from existing customer acquisition alone**

There is (now) a track record of over 280 companies having installed COCOAR (as of May 2014). A breakdown by industry type shows that approximately 50% are in the printing industry or printing related industries, approximately 25% are in the telecommunications industry and the remaining 25% are in publishing-related, manufacturing, wholesaling, retailing or other industries. Currently, Startia is employing a strategy of cross-selling AR to existing eBook production software ActiBook users, which we feel accounts for the industry type distribution. Cumulatively, ActiBook users exceed 2,200 companies with still significant room for (customer) acquisition from the cross-selling strategy. Additionally, there is arguably potential for it to be utilized in a variety of industries including direct marketers, retailers, consumer product manufacturers for end-users, as well as the real estate and construction industries.

Breakdown by Business Category of COCOAR Installation Track Record

Industry type	Number installed
Printing, printing-related industries	139
Telecommunications	73
Publishing	14
Manufacturing, wholesaling & retaining	21
Other	37
Total	284

Source: Startia Lab, Inc homepage

●Predicted to be a highly profitable product with a high degree of results contribution

Contributions by COCOAR to the overall business performance are highly expected. The actual sales figures have not been disclosed, however, if there have already been 280 sales of software at the JPY3 million per transaction as mentioned above, this translates to cumulative sales of JPY840 million. This is one yardstick for imagining the current scale of COCOAR operations. Further, the expected value of contribution from a profit perspective is also high. Given that Startia undertook research and development of this service in conjunction with eBook research and development, it may be presumed that the profitability is extremely high.

●Risk in competition with the QR Code, but there is the possibility concerns will prove unfounded

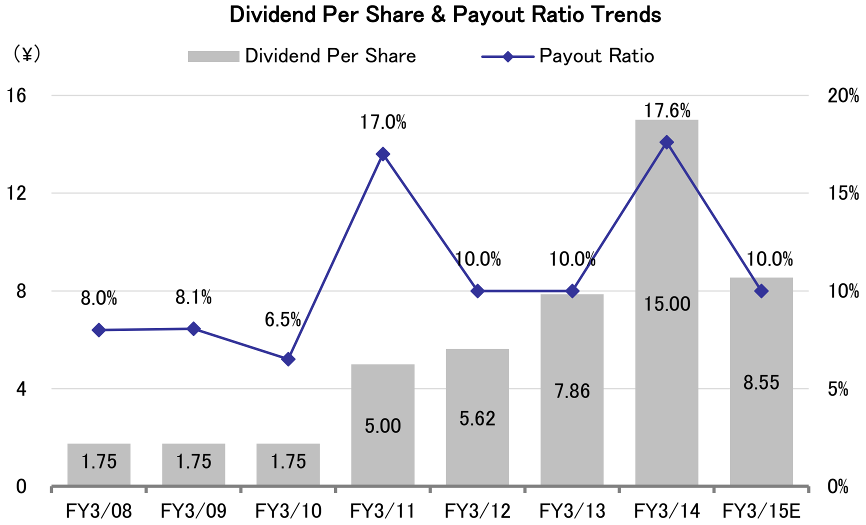
A risk factor that may be considered for COCOAR is possibly the evolution of the QR code. In the case that can achieve evolution whereby the contents of the homepage that is jumped to from the QR code is overflowing with rich content, including video and music, the gap between COCOAR and the QR code will narrow. Both COCOAR and the QR code are basically tools utilized by companies for advertising, in a scheme where the users are individuals. Because the corporate sender of the data will of course possess a homepage, whether turning that into rich content is done by COCOAR or the QR code will ultimately boil down to an issue of cost. In that case, there is the potential for the QR code to demonstrate superiority. However, COCOAR is superior in terms of the most important points in appealing to individuals such as freedom of marker design, and realistically we do not see that superiority shifting.

Returns to Shareholders

Engaging a flexible policy for returns to shareholders

At Startia returns to shareholders are based primarily on dividends, with the basic policy from FY3/13 in respect of the amount of dividends being that they are equivalent to 10% of net income. It cannot be argued at all that a dividend payout ratio of 10% is high amongst Japanese companies. However, Startia is a company in the growth stage, and it is expected that in the future also a variety of investment opportunities will emerge. Staria's logic in retaining internal reserves for them has a certain persuasiveness.

In FY3/14 the dividend was JPY15.00, with a commemorative dividend (commemorating the TSE First Section listing) of JPY6.45 in addition to the ordinary dividend of JPY8.55. The payout ratio was 17.6%. While, in order to secure high growth potential from a capital perspective, the payout ratio is being kept to 10%, the stance is to flexibly undertake rewarding shareholders at crucial junctures, and may be rated highly as being in no way inferior to the stance on shareholder interests at other companies.



Summary Income Statement

	FY3/11	FY3/12	FY3/13	FY3/14			FY3/15E		
	Full-year	Full-year	Full-year	1H	2H	Full-year	1H	2H	Full-year
Net sales									
Web solutions	701	1,073	1,482	861	1,082	1,943	-	-	2,202
Network solutions	1,225	1,424	1,843	980	1,180	2,160	-	-	2,567
Business solutions	2,073	2,585	3,314	1,842	2,221	4,063	-	-	4,479
Total Sales	4,000	5,084	6,640	3,683	4,484	8,167	4,145	5,103	9,248
Segment Profit									
Web solutions	113	220	165	79	244	323	-	-	-
Network solutions	109	179	362	157	144	301	-	-	-
Business solutions	69	91	169	26	228	254	-	-	-
Operating income	273	459	656	237	563	829	138	702	840
Recurring income	278	475	655	241	559	856	138	728	866
Net income	129	278	391	144	256	432	69	364	433
EPS (¥)	29.41	56.24	78.62	-	-	85.50	-	-	85.51
Shares outstanding ('000 shares)	4,953	4,956	5,012	-	-	5,064	-	-	-
Shareholders' equity ratio	69.8	70.2	70.9	-	-	67.6	-	-	-

Note: There was a 200:1 stock split on Oct 1, 2010, so prior dividends have been adjusted retrospectively.

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