COMPANY RESEARCH AND ANALYSIS REPORT

Startia Inc.

3393

Tokyo Stock Exchange First Section

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Summary

Aiming to return to a growth path through measures to break through the transition period, including by introducing freemium, forming a holding company, and promoting a recurring model

Startia Inc. <3393> (hereafter, also “the Company”) provides digital marketing-related software and one-stop solutions for IT-related services for medium and small enterprises (SMEs) with 300 or fewer employees that cannot afford to hire an IT manager and which are not served by large systems integration (SI) companies and network-equipment dealers.

1. FY3/17 was a transition period for both the business segments and some issues emerged

The Company’s FY3/17 results were higher sales but lower profits, of net sales of ¥10,282mn (up 1.1% year-on-year (YoY)) and operating income of ¥265mn (down 47.3%). It had to downwardly revise its forecasts during the period, and the reasons for this are clear. Issues emerged in both the Digital Marketing segment, in responding to changes to the customer group, and in the IT Infrastructure segment, in learning the new sales system toward realizing “Customer 1st,” and these issues adversely affected the results. The Company is currently in a transition period to reform the business models of both these segments, and our understanding at FISCO is that these issues are only temporary.

2. Aiming to recover results and return to a growth track through transitioning to a holding company and introducing freemium

In order to accelerate its current efforts, the Company has resolved to implement various new measures, including investigating shifting to a holding company with the aim of speeding-up management (scheduled for FY18), introducing freemium to acquire price-sensitive customers, and promoting a “recurring model” in order to strengthen the revenue base by raising-up stock income. Going forward, we will be focusing on the progress the Company makes in introducing these measures toward quickly resolving the previously mentioned issues in the transition period, recovering results, and returning to a growth track.

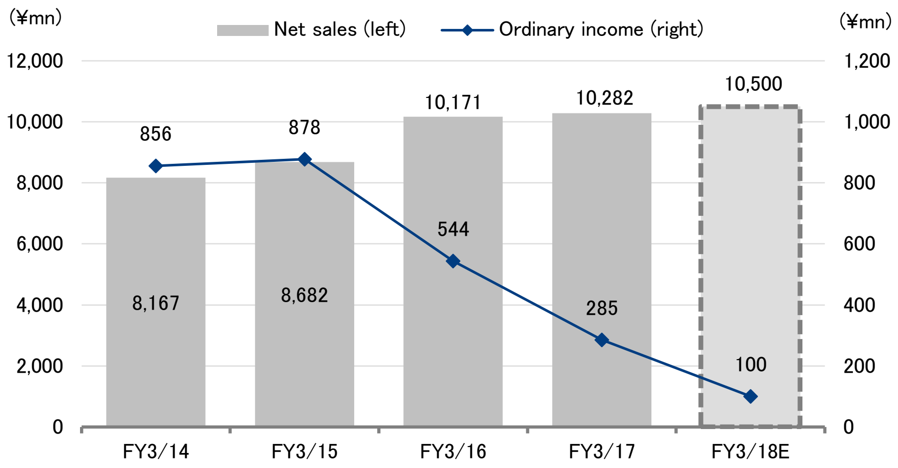
3. Has positioned FY3/18 as a period for upfront investment to make the next leap forward, and a recovery is expected after that.

For the FY3/18 full year, the Company is forecasting higher sales but lower profits, of net sales of ¥10,500mn (up 2.1% YoY) and operating income of ¥100mn (down 62.3%). In the Digital Marketing segment, its policy is to introduce the freemium model to instantly expand the customer base, but it is highly likely that this will cause results to deteriorate in the short term. The situation would seem to be that this deterioration will be covered and profits secured through the improved results in the IT Infrastructure segment, where the level of employee proficiency has increased on entering the second year of the “Customer 1st” system. At FISCO, we think that the scenario of expanding sales of digital products through introducing the freemium model is fully plausible, and we shall be watching the progress the Company makes in the near future.

Key Points

- Currently investigating transitioning to a holding company structure with the aim of speeding-up management by delegating authority
- For digital products, it will instantly expand the customer base by introducing freemium, which will lead to increased profits from pay-as-you-go billing in the future
- The Digital Marketing segment is in an upfront investment period. This will be supplemented and profitability secured from the recovery in earnings in the IT Infrastructure segment.

Consolidated net sales and ordinary income



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

Company overview

Started from sales of business phones and grew from network equipment rentals and e-book software

1. History

The Company began with the establishment of Telecomnet Limited Company by current President, CEO, and Representative Director Hideyuki Hongo in 1996. It started from sales of business phones, then launched hosting services (a rental server business) in 2000, and then developed a fully-fledged Internet-related business. Subsequently it developed other businesses, including a network equipment rental business and MFP (multifunction printer) business, and expanded its business scope. In 2009, it established the subsidiary Startia Lab Inc., that provides Web production and e-book production software, which basically completed its current business model. Since FY3/17, it has been working on organizational and business reforms with the aim of transforming itself from an IT products sales company to an IT services company.

On the stock markets, it was listed on the Tokyo Stock Exchange (TSE) Mothers market in December 2005, and then subsequently its listing was changed to the TSE 1st Section in February 2014.

History

February 1996	Was established in Tokorozawa City as Telecomnet Limited Company
October 1996	Changed company name to ND Telecom Inc.
January 2000	Started the hosting services, “Digit @ Link” Rental Server
February 2004	Changed company name to Startia, Inc.
December 2005	Listed on the TSE Mothers market
July 2007	Started providing “Managed Gate”, a network equipment rental service
October 2007	Acquired MFP and counter customers and business from Arest Inc.
April 2009	Established Startia Lab, Inc.. a subsidiary providing Web production and e-book production software
June 2009	Underwrote a capital increase by a third party allocation of shares from MAC Office, Inc., which became an equity method affiliate
October 2011	Establish STARTIASOFT INC., a joint venture company in Xian, China
January 2012	Underwrote a third-party allocation of shares from Urban Plan Co., Ltd., which became an equity-method affiliate
January 2013	Established STARTIA SHANGHAI INC.
April 2013	Opened the Eastern Tokyo branch
February 2014	Listing changed to TSE 1st Section
October 2015	Made NOS Ltd. a subsidiary
July 2016	Made BCMEDIA Co., Ltd. a wholly owned subsidiary
February 2017	Conducted additional investment in NOS Ltd. to make it a wholly owned subsidiary

Source: Prepared by FISCO from Company materials

Main businesses are sales of digital products for sales support and the provision of comprehensive IT services for SMEs

2. Description of businesses

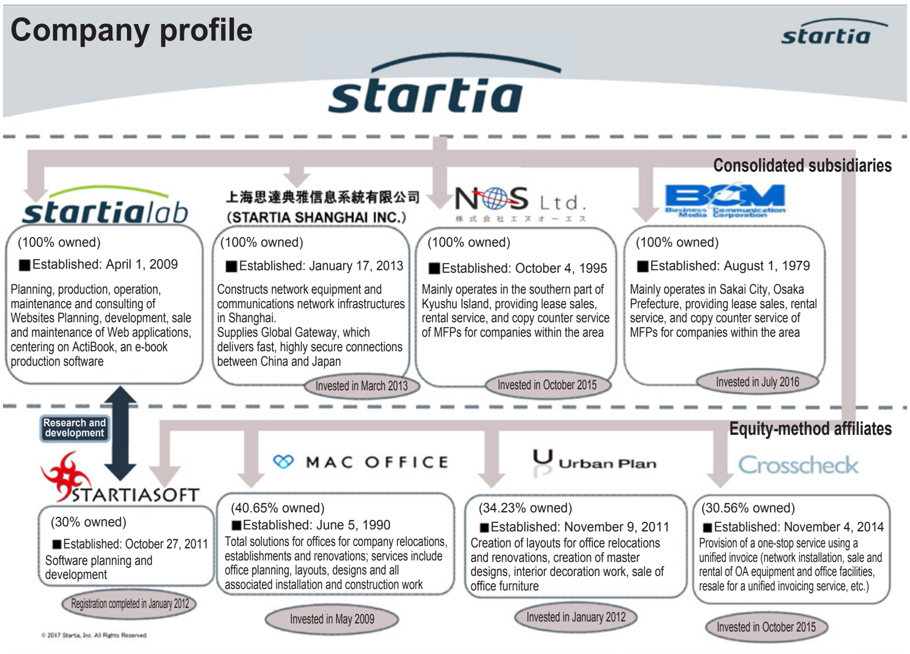
The Company has three business segments, the two main segments of Digital Marketing and IT Infrastructure, and Others, which includes a venture capital business. However, as yet Others has not recorded any revenue.

The current structure started from FY3/17, and prior to it up to FY3/16, there was a three-business-segment structure, of Web Solutions, Business Solutions, and Network Solutions. From these, the name of the Web Solutions segment was changed to the Digital Marketing segment, while the Business Solutions and Network Solutions segments were integrated into the IT Infrastructure segment, which is the current structure.

The Company’s consolidated subsidiaries are Startia Lab Inc., which is responsible for the Digital Marketing segment; BCMEDIA Co., Ltd. which conducts a community-based IT Infrastructure business, and NOS Ltd. Overseas, STARTIA SHANGHAI INC. provides the “Global Gateway” high-speed communication service in Shanghai. All of these are the Company’s wholly-owned subsidiaries and as is explained below, the preparations for the transition to the holding company structure are being advanced.

The equity-method affiliates are the software development company XI’AN STARTIASOFT INC.; MAC OFFICE Inc., which is involved in office design and construction; Urban Plan Co., Ltd.; and Crosscheck Inc., which provides unified invoicing service. While they have different business domains to the Company, their businesses are in peripheral areas.

Overview of the Startia Group



Source: The Company's results briefing materials

Being developed by the subsidiary, Startia Lab. Main products are sales-support digital products it develops in-house.

3. Overview of the Digital Marketing segment

In the Digital Marketing segment, Startia Lab handles products centered on the software developed in-house. Startia Lab is also the main sales agent, and so the Digital Marketing segment can be understood to be the business of Startia Lab itself. Examples of typical products include “ActiBook”, a tool for producing e-books, and “ActiBook AR COCOAR”(abbreviation: COCOAR) a tool for creating AR content. It also conducts other activities, including Web production on behalf of customer companies and SEO consulting.

The Company's software and services are intended primarily for companies in creative industries (advertising agencies and printing companies) to support their shift to IT for operations and to acquire customers. General companies are the customers of these creative companies, but by providing more useful IT functions to both these creative companies and their customers of general companies, the Company’s marketing-support software support their respective acquisition of business. This is the background to the Company changing the name of this business segment from Web Solutions to Digital Marketing.

Main products in the Digital Marketing segment

Name	Function	Distinguishing characteristics
ActiBook	e-book production tool	Security function that blocks forwarding to other users, log analysis into depth of content is possible
ActiBook AR COCOAR	A tool for creating AR (Augmented Reality) content	Increases the effective use of flyers, directing routes cannot be compared, measures the effect of flyer
ActiBook Docs	Document management tool	Shares materials among all sales people, allows materials to be improved based on data, enables viewing of on-site negotiations with customers
Content management system (CMS) Blue Monkey	Tool for the production and management of websites	Provides long-tail search engine optimization (SEO) function, offers work flow function with updating rights for page setting
Plusdb	Tool for producing and managing databases	Enables the generation of product databases, can be installed on existing websites, allows searches based on complex (detailed) conditions
AppGoose	Tool for producing application software programs	Simplifies online-to-offline marketing
Bow Now	Marketing automation (MA) tool	Enables the management of information on prospective customers and the nurturing of these customers, allows the configuration of one-to-one email contacts, produces content for limited parties

Source: Prepared by FISCO from Company materials

The Company has sold these software either through package sales (single-payment sales) or as cloud services (monthly billing). Presently, it is in a transition period in which the attributes of the target customers are transitioning from the early-adopter group to the early-majority group, and in response to this, the Company is being required to reform its billing system and sales methods. The billing system is described in detail below, but basically, since June 2017, it has been introducing freemium. For the sales methods, it has introduced a partnership system and is working together with creative companies to acquire general companies as customers.

Provides IT services to SMEs as one-stop solutions

4. Overview of the IT Infrastructure segment

The IT Infrastructure segment was formed from the integration of the former Network Solutions segment and Business Solutions segment. The Network Solutions segment mainly engaged in the construction of networks, the sales of related equipment, and the provision of various cloud services, while the Business Solutions segment primarily involved the sales of communication lines and communication equipment. In other words, the new segment that was created when these two segments were combined covered the business area of system integrators (SIers). As an IT service provider, the area the Company most wants to strengthen is its provision of SI services with even higher value-added, including replacing aging infrastructure servers and upgrading the speed of the network environment, the complete migration to the cloud environment, and constructing, maintaining, and operating networks on AWS (Amazon Web Service), targeting medium-sized business establishments. In order to achieve this objective more efficiently, it would seem that the integration of these two former businesses was inevitable.

Together with these organizational changes, the Company has also changed the sales structure. Specifically, based on the slogan of “Customer 1st,” it changed from its traditional sales structure of a “product-orientated structure” in which it trained and deployed product specialists, to a “customer-orientated structure,” in which it focuses more on the needs of individual customers through assigning individual account managers to each of them. Seen from the customer side, it is a framework in which they can receive a one-stop solution for their various needs through their account manager. The Company’s customers are SMEs that cannot afford to appoint a specialist in-house IT manager, and its value lies in realizing “the outsourcing of the IT manager.” Therefore, the transition to a “customer-orientated structure” can be said to be a natural development.

Result trends

The two business segments struggled, mainly due to the changes to the customer groups and to the sales structure

1. Overview of the FY3/17 results

The Company's FY3/17 results were a slight increase in sales but a major decrease in profits, with net sales of ¥10,282mn (up 1.1% YoY), operating income of ¥265mn (down 47.3%), ordinary income of ¥285mn (down 47.6%), and profit attributable to the owners of the parent of ¥5mn (down 97.7%).

The Company downwardly revised the full fiscal year results forecasts when it announced the Q2 results, and then revised them again in March 2017 near to the end of the fiscal year. In the end, the results for net sales, operating income, and ordinary income slightly exceeded their most recently revised forecasts. However, profit attributable to the owners of the parent was greatly below forecast due to the recording of an impairment loss.

Overview of the FY3/17 results

(¥mn)

	FY3/16			FY3/17						
	1H	2H	Full year	1H	2H	Full year (f)	YoY	Full year	YoY	Vs. forecast
Net sales	4,761	5,409	10,171	4,774	5,508	10,180	0.1%	10,282	1.1%	1.0%
Gross profit	2,176	2,432	4,609	2,027	2,509	-	-	4,536	-1.6%	-
Gross profit margin	45.7%	45.0%	45.3%	42.5%	45.6%	-	-	44.1%	-	-
SG&A expenses	2,089	2,016	4,106	2,146	2,124	-	-	4,271	4.0%	-
Ratio of SG&A expenses to sales	43.9%	37.3%	40.4%	44.9%	38.6%	-	-	41.5%	-	-
Operating income	86	416	503	-119	384	200	-17.0%	265	-47.3%	32.7%
Operating income margin	1.8%	7.7%	5.0%	-2.5%	7.0%	2.0%	-	2.6%	-	-
Ordinary income	107	437	544	-110	395	232	-23.3%	285	-47.6%	23.1%
Profit attributable to owners of parent	-5	258	253	25	-19	286	10.7%	5	-97.7%	-97.9%

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

On the start of FY3/17, the Company changed its organizational structure to reform itself from being an "IT products sales company" to being an "IT services company." Specifically, it changed its former three-business-segment structure to a two-business-segment structure, of the Digital Marketing segment (the former Web Solutions segment) and the IT Infrastructure segment (the integration of the former Network Solutions and Business Solutions segments).

In the Digital Marketing segment, the slump in the sales of the package software it develops in-house continued from the previous fiscal year. Since the previous fiscal year it has been in a period of switching the customer groups, and in this situation it aimed to recover sales in the current fiscal year, but results continued to fall below expectations. The Company decided to record an impairment loss at the end of the fiscal year based on the poor sales of package software, and recorded an impairment of the full amount of the development-use software (intangible non-current assets) owned by the subsidiary Startia Lab.

Conversely, in the IT Infrastructure segment, alongside the organizational changes, the Company also changed the sales structure to a customer-orientated structure by product based on its "Customer 1st" slogan. The tasks required for this include re-educating human resources and establishing new sales methods and sales styles, and these tasks are taking longer than anticipated. As a consequence, profits fell slightly compared to the previous fiscal year.

Results by segment

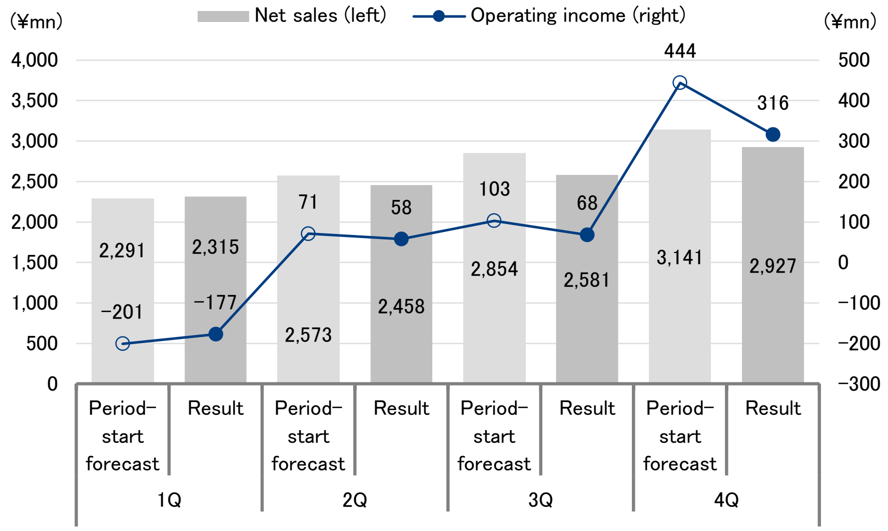
(¥mn)

	FY3/16 Full year	FY3/17 1H	FY3/17 2H	FY3/17 Full year	FY3/17 YoY
Digital Marketing segment	1,845	795	1,015	1,810	-1.8%
IT Infrastructure segment	8,355	3,988	4,501	8,489	1.6%
Others segment	-	-	-	-	-
Net sales before adjustment	10,200	4,783	5,516	10,300	1.0%
Adjustment amount	-29	-9	-8	-18	-
Net sales	10,171	4,774	5,508	10,282	1.1%
Digital Marketing segment	12	-99	97	-2	-
IT Infrastructure segment	557	-3	311	308	-44.7%
Others segment	-66	-16	-17	-33	-
Operating income before adjustment	503	-119	391	272	-45.9%
Adjustment amount	-	-	-7	-7	-
Operating income	503	-119	384	265	-47.3%

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

The Company anticipated from the start a temporary decline in profits alongside the organizational changes, and so it kept its profit forecasts low for the first half of FY3/17. Conversely, it envisaged a scenario in which the pace of recovery would accelerate in Q3 and Q4. But in the end, the pace of the recovery in Q3 and Q4 was slower than expected, and therefore the results were below the initial forecasts on a full fiscal year basis.

Results trends by quarter



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

Is in a transition period of converting from package sales to cloud services in response to changes to the customer groups

2. Digital Marketing segment

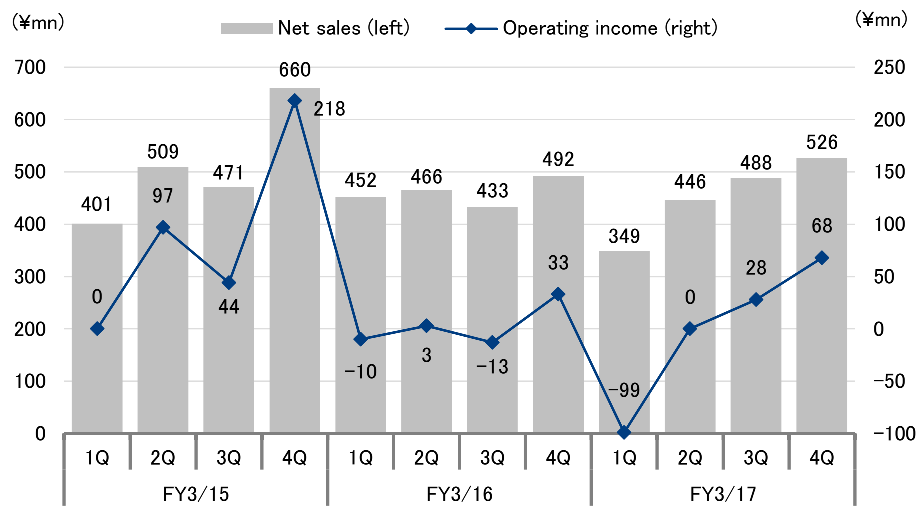
In the Digital Marketing segment, net sales were ¥1,810mn (down 1.8% YoY) and the operating loss was ¥2mn (compared to profit of ¥12mn in the previous fiscal year). It is difficult to ascertain the situation in this segment compared to in FY3/16 and FY3/17. In FY3/14 and FY3/15, this business segment (the Web Solution segment at those times) recorded net sales of around ¥2,000mn and operating income in excess of ¥300mn. Subsequently in FY3/16, net sales declined around 10%, while profits also fell significantly.

The Company cited the change to the customer groups as the factor behind this. Its main products are highly innovative software, such as the e-book software ActiBook and the AR software COCOAR, and the demand for these products from the early-adopter group who strongly wanted to purchase them ran its course. On entering the next, so-called terminal-gap period, there was a delay in the purchases of these products by the early-majority group that replaced the early-adopter group.

The Company aimed to recover sales in FY3/17 by uncovering and activating sales to this early-majority group that were delaying purchases. As one measure to increase sales, it introduced partnership plans with creative companies, but the partnership-plan activities seems to have remained limited due to the sluggish sales of the package software. A direct factor behind the lack of progress in the introduction of these products appears to be that there is a major gap between the price ranges sought be the early-majority group and the sales prices set by the Company.

Looking at the results trend on a quarterly basis, compared to the previous fiscal year, both sales and profits further declined in FY3/17. Net sales rose in each quarter, from Q1 to Q4, but the YoY fall was large in Q1 and so the decline compared to the previous fiscal year continued until the end of the fiscal year.

Quarterly results trend in the Digital Marketing segment



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

Aiming for growth by thoroughly implementing its "Customer 1st" system. Struggled to adapt to the changed sales structure, but results recovered sharply at the end of the fiscal year

3. IT Infrastructure segment

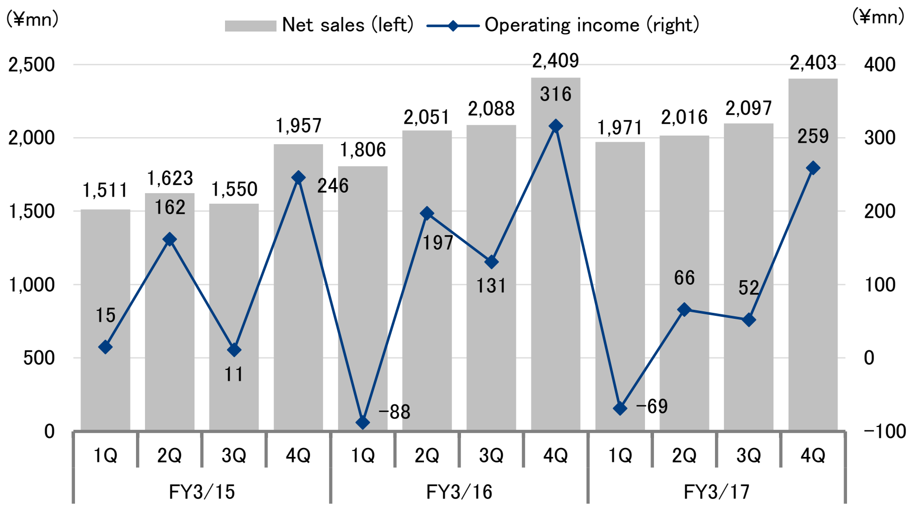
In the IT Infrastructure segment, sales increased but profits decreased, with net sales of ¥8,489mn (up 1.6%) and operating income of ¥308mn (down 44.7%)

The IT Infrastructure segment was created through integrating the former Business Solutions and Network Solutions segments. The background to this is the Company's reforms intended to convert from being an IT products sales company to being an IT services company. In the new segment, under the slogan of "Customer 1st," it shifted to a "customer-orientated structure" as a system considered preferable in order to take the viewpoint of customers (SMEs) and to respond to their needs. In the previous sales structure, multiple sales managers would visit customers for each of the individual products that they were responsible for. But in the customer-orientated structure, one account manager becomes the point of contact for the customer for all the products, who is provided with various solutions.

However, the transition to the customer-orientated structure required that the Company educate its sales managers to improve their skills and also necessitated new sales methods, and putting this into practice is taking time. So the situation in FY3/17 was that this transition actually took more time than anticipated.

Looking at the results trend on a quarterly basis, we can clearly see that the Company tends to struggle in 1H. In 1H in a typical year, profits will be low due to factors such as the increase in new recruits, but then the profit level steadily rises from Q2 onwards as these new recruits complete their training and start contributing to results. But in FY3/17, profits did not rise as expected up to Q3 and only returned to the level of a typical year in Q4. Net sales have been trending upward, even though there is some unevenness in this trend because of seasonal factors due to the high ratio of stock products.

Quarterly results trend in the IT Infrastructure segment



Note: the figures for FY3/15 were revised by FISCO
Source: Prepared by FISCO from the Company's financial results

Measures to recover results

Adding new mechanisms and concepts to strengthen and accelerate the direction it is currently aiming for

1. Overall image

The Company does not formulate a medium-term management plan and does not announce interim results forecast. However, it does constantly take a medium- to long-term perspective and is aware of the need for management that aims to realize sustainable growth. The goal of "converting from being an IT sales company to being an IT services company" can be found on a line extending from this. As time is required for this conversion, results are temporarily being kept down, but at FISCO we evaluate that the direction that the Company is currently taking is the correct one. There has also been no wavering whatsoever by the Company in terms of its management focus.

Based on the current policy, the Company will add a number of new measures from FY3/18 toward speeding-up the recovery in results and achieving new record high results at an early stage. In FY3/18, there will appear several new keywords to focus on, including "recurring model," "freemium," and "transition to a holding-company structure." Including the previous "Customer 1st," at FISCO we think that understanding these keywords will deepen the understanding of the Company's medium- to long-term growth potential.

Aiming to transition to a holding-company structure to speed-up management by delegating authority

2. Transitioning to a holding-company structure

The Company published a press release on April 4, 2017, entitled "Announcement of the Start of the Investigation to Transition to a Holding-company Structure." In it, it explained the reason for investigating transitioning to holding company to be "To promote management with rapid decision making and mobility so as not to lag behind in the changing of the times in today's IT industry."

The Company is developing businesses in the Digital Marketing segment and the IT Infrastructure segment, but the Digital Marketing segment is the responsibility of Startia Lab, its wholly-owned subsidiary. Conversely, the IT Infrastructure segment is the responsibility of the Company itself and the other subsidiaries. The current situation is that both businesses are supervised by Mr. Hideyuki Hongo, the President and CEO, and the specific aim of transitioning to a holding-company structure is to delegate authority to the heads of each business company and thereby speed-up management.

The Company is currently steadily making the preparations to transition to a holding-company structure. It has made an equity-method affiliate of Crosscheck, which has a different business domain, and in addition, it has separated the hosting business by a business split. Conversely, in July 2016, it made a wholly owned subsidiary of BCMedia, which is based on Osaka and conducts the same business as the Company, of the IT Infrastructure segment. It also acquired additional shares in and made a wholly-owned subsidiary of NOS, which is based in Kagoshima and provides the same services as the Company in southern Kyushu (February 2017).

At FISCO, we think that the Company's rationale for transitioning to a holding-company structure is extremely persuasive. In addition to the fact that the two business segments have different customer groups and business models, the businesses themselves are different and up to the present time, they have basically operated independently of each other. Therefore, we think that rather than aiming unrealistically "to pursue synergies" in name only, growing each business on their respective vectors will directly lead to the recovery and expansion of profits. It can be said that the transition to a holding-company structure is a policy in line with such a development.

Instantly expanding the customer base through free plans, which will lead to higher profits through pay-as-you-go billing in the future

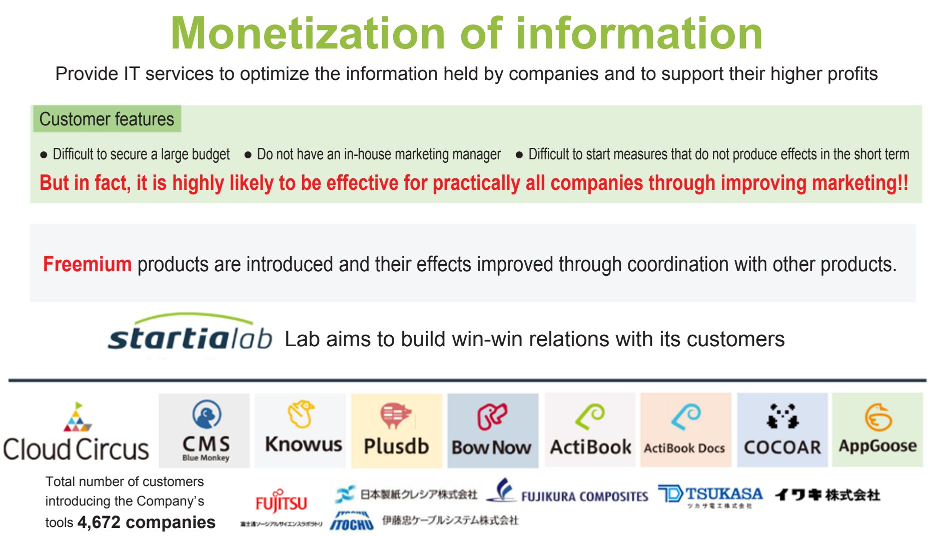
3. Introduction of the freemium model

(1) Overview of the freemium model

The details of the issues facing the Digital Marketing segment are as previously described. The reality is that the early-majority group, who were expected to become the next-generation main customers, tend to have tighter purse strings than the early-adopter group who "enjoy new things." On the other hand, the the Company is confident that the various marketing-support software packages provided by the Digital Marketing segment will demonstrate their usefulness for SMEs, which tend to have no marketing or IT specialists, and be highly evaluated by them.

Based on this, the Company decided to introduce "freemium." Freemium is a business model in which basic functions are provided for free, and customers are billed for the portion that goes beyond a certain amount and for special functions in the form of pay-as-you-go fees or additional fees. It can be said to be a model similar to F2P (free to play) in online gaming

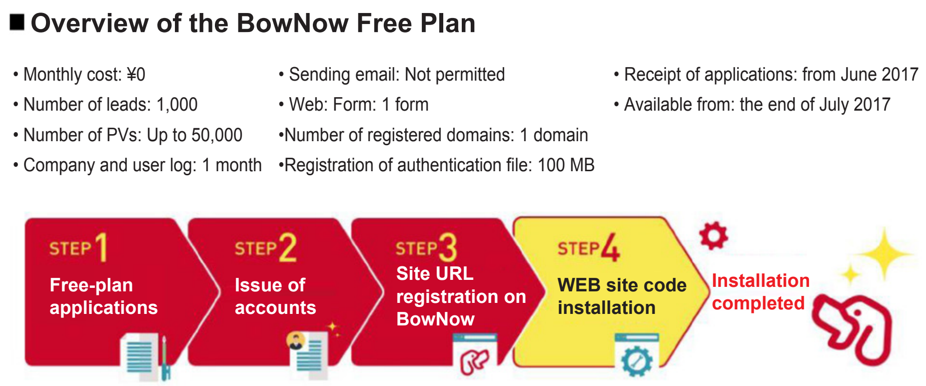
Background to the introduction of the freemium model



Source: The Company's results briefing materials

As the first service, the Company announced a free plan for "creca," which is a landing page (hereafter, LP) website production software for smartphones (press release of June 7, 2017), and then as the second service, it announced the addition of a free plan for "AppGoose," which is application production software (June 12, 2017). As the third service, it announced the addition of a fee-paying plan for the freemium model of "BowNow," an MA (marketing automation) tool, which will start at the end of July (press release of May 24, 2017). BowNow is an MA tool that enables users to utilize corporate IP and personal logs to ascertain potential customers, and well as the automated sending of emails. In the free plan, the basic functions except for the sending of emails can be used the same as in the fee-paying plan. The Company's policy is to encourage users to change to the fee-paying plan after they become convinced of the tool's effectiveness.

Overview of the BowNow Free Plan



Source: reprinted from press release of May 24, 2017

The sales-support software handled in the same business segment is diverse and ranges from CRM (customer relationship management) to SFA (sale force automation). The Company plans to sequentially introduce the freemium model for these software packages in the future.

(2) Scenario to recover profits after introducing the freemium model

The Company's originally sold various types of software packages. Roughly speaking, its business model was to sell 1 package for a single price of ¥3 million. Subsequently from FY3/17, it started providing them also as cloud services also. This business was a stock-type model in which customers could use services with monthly fees ranging from a few thousand yen to tens of thousands of yen, and it could be described as an instalment-payments plan when viewed from the side of the customer. The introduction of the freemium model further progresses this plan. For the Company, it is possible that temporarily sales to new customers will be zero and the only revenue it will receive will be from existing customers, and therefore revenue growth will cease.

But even so, it is considered that the Company's decision to introduce the freemium model was because it read the situation to be that a certain percentage of customers will choose to switch to a fee-paying plan once they have accumulated a track record of usage in the free plan. This indicates the great confidence that the Company has in its own products. In the background to this confidence are the results achieved by products such as COCAOR, the software for utilizing AR. To give COCOAR as an example, its app has already been downloaded more than 1 million times and its name recognition among individuals is rising. Therefore, an increasing number of companies, particularly major food companies, are wanting to use it for sales promotions. The Company has also added a stamp-collecting rally function and it anticipates demand for this function from local governments, such as for town planning. Based on this track record, it expects that after a certain period of time has passed from the introduction of the freemium model, the various other software packages, including the MA tool, and the app and LP website production software packages, will also steadily capture fee-paying users and become sources of revenue.

At FISCO, we expect that the introduction of the freemium model will be highly effective. It can be said that having users first of all actually experience the usefulness of the product in the form of a free plan is a much more positive approach than selling packages or cloud services, as in these cases the prices and fees can become a bottleneck causing the sales negotiations to stall. At the current stage, it is impossible to know what the conversion rates to the fee-paying plans will be, but at FISCO we think that it is possible that LTV (lifetime value: the sales over the entire membership period) of customers who convert to the fee-paying plan will exceed the amount of one-time package software sales. A total of 4,672 companies have so far introduced the Company's tools (as of the end of FY3/17) and we can expect that the pace of companies introducing the free plans will accelerate and that this number will be surpassed at an early stage.

Aiming to realize a strong profit structure through increasing sales of stock-type products

4. A growth strategy from a "recurring model'

An initiative on which the Company is focusing on a Group-wide basis is strengthening stock-type products, and it has introduced the concept of the "recurring model" as the slogan shared throughout the Group to promote this.

"Recurring" has the meaning of "repeating" and "circulating." In business, there is the approach of the recurring business, which refers to a type of business such as selling mobile phones or printer machines inexpensively and then obtaining recurring revenue from the call charges or sales of ink cartridges. The Company's recurring model is the same as this, and it is aiming to realize a strong profit structure that is unaffected by fluctuations in economic conditions through introducing and increasing sales of stock-type products.

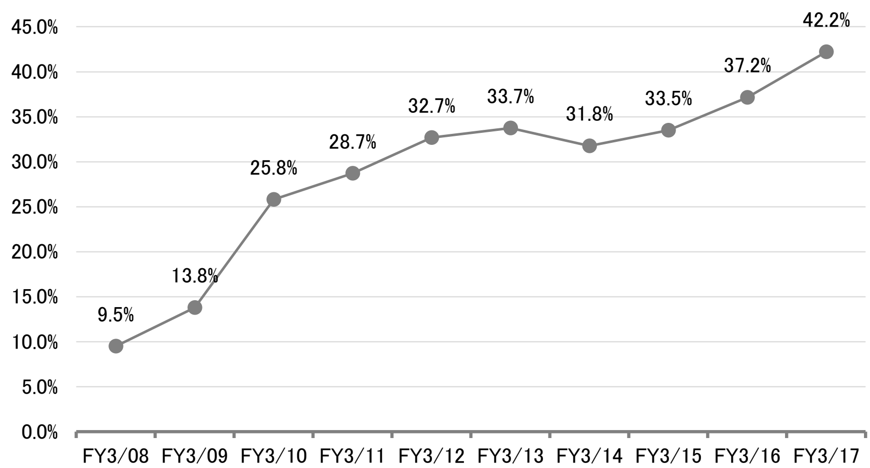
In FY3/17, the Company targeted stock-product net sales of ¥4,290mn, but the actual result of ¥4,330mn exceeded this target. In the Digital Marketing segment, the customer group is transitioning to the early-majority group who tend to have tighter purse strings, while the transition from package sales to stock-type cloud services is also being progressed. As mentioned above, the Company intends to accelerate this transition by introducing the freemium model.

Since the past, the IT Infrastructure segment has provided many stock-type services, including counter services for copy machines, Startia Hikari optical lines, and Secure Samba, which is an online storage service.

The Company's stock-products ratio has risen steadily year by year and reached 42.2% in FY3/17. An important point is that during this period, total net sales continued to increase. Up to the present time, stock-type products have mainly been provided by the IT Infrastructure segment. As previously mentioned, many of the products in this business segment are fundamentally stock-type, so it seems that this segment will be the main engine driving the recurring model in the future. On the other hand, the Digital Marketing segment is also in the middle of switching from a revenue model to a stock-type model, and at FISCO we expect that when the freemium model is functioning smoothly and starts to contribute to profits, the stock-product ratio will greatly exceed 50% and the Company will realize the strong revenue base that it is aiming for.

In addition, as the percentage of sales provided by stock products rises, business stability will also increase. So we think that the Company has future growth potential if it can realize a business model based on stock revenue.

Trend in the stock-product ratio



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

Forecasts

The Digital Marketing segment is in an upfront investment period, which will be supplemented and profitability secured from the recovery in earnings in the IT Infrastructure segment.

1. FY3/18 earnings forecast

For the FY3/18 full year, the Company is forecasting net sales of ¥10,500mn (up 2.1% YoY), operating income of ¥100mn (down 62.3%), ordinary income of ¥100mn (down 65.0%), and profit attributable to the owners of the parent of ¥60mn (up 914.7%).

Overview of the FY3/18 earnings forecasts

(¥mn)

	FY3/17			FY3/18					
	1H	2H	Full year	1H (E)	YoY	2H (E)	YoY	Full year (E)	YoY
Net sales	4,774	5,508	10,282	4,922	3.1%	5,578	1.3%	10,500	2.1%
Operating income	-119	384	265	-126	-	226	-41.2%	100	-62.3%
Operating income margin	-2.5%	7.0%	2.6%	-2.6%	-	4.1%	-	1.0%	-
Ordinary income	-110	395	285	-126	-	226	-42.8%	100	-65.0%
Profit attributable to owners of parent	25	-19	5	-76	-	136	-	60	914.7%

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

While there may be some anxieties and concerns that the profit level will fall even further in FY3/18, at FISCO we think there is no need to be excessively concerned. The Company has positioned FY3/18 as a period to take the next leap forward and is changing its business model and organizational structure. On the other hand, we understand its forecasts of operating income and ordinary income of ¥100mn and a dividend forecast of ¥9 to include the message that management is strongly aware of shareholders and the share price.

The Company does not announce a breakdown of the results forecasts by business segment. But from the previously described situation, it seems that the main factor behind the major decrease in profits in FY3/18 will be the temporary fall in profits in the Digital Marketing segment. The Company has decided to introduce the freemium model as the sales method for each of the products in the Digital Marketing segment, and it appears that it will gradually expand its introduction, starting from the MA tool BowNow.

A total of approximately 4,700 companies have introduced the Digital Marketing segment's software, and among them there are those that have previously entered-into a cloud agreement, so it is not the case that profits will be zero even after introducing the freemium model. However, it is possible that revenue from new agreements will temporarily cease, and so at FISCO we think that the operating loss in this segment may increase YoY corresponding to this amount.

In the IT Infrastructure segment, the "Customer 1st" system will have entered its second year, and it seems that profits will recover significantly compared to the previous fiscal year. This is because the sales managers will have become more knowledgeable about the products they are responsible for and the foundation on which to provide one-stop solutions will be in place. Also, after the passage of one year, these managers are likely to have accumulated knowledge and expertise on optimizing the frequency of contacts with customers and the contact methods. In FY3/17 Q4, segment operating income reached ¥259mn, which is a level equivalent to that in F3/15. Based on this, it would seem possible that in FY3/18, it may recover to the record-high level that the Company is aiming for.

One of the indicators that we should be paying attention to in FY3/18 is the number of companies that introduce the freemium model. This is because this corresponds to the foundation for the growth model through freemium. Related to this, another important point will be the progress made in increasing the number of software packages that use the freemium model. We shall also be focusing on the increase in sales of COCOAR. Awareness of AR is rising and therefore the number of cases of sales promotions using AR are steadily increasing. The Company is aiming to instantly increase users of COCOAR, including by adding a stamp-collecting rally function. As COCOAR is a BtoBtoC product, it is expected that as the number of C (individual consumer) users expand, the number of B (business) users will also naturally increase. Therefore, we consider that the number of downloads of the COCOAR app by individuals and the number of active users are also indicators worth paying attention to.

Condensed consolidated income statement and per-share data

(¥mn)

	FY3/15	FY3/16	FY3/17	FY3/18	
				1H (E)	Full year (E)
Net sales	8,682	10,171	10,282	4,922	10,500
YoY	6.3%	17.1%	1.1%	3.1%	2.1%
Gross profit	4,356	4,609	4,536	-	-
YoY	2.6%	5.8%	-1.6%	-	-
Gross profit margin	50.2%	45.3%	44.1%	-	-
SG&A expenses	3,609	4,106	4,271	-	-
YoY	5.7%	13.8%	4.0%	-	-
Ratio of SG&A expenses to sales	41.6%	40.4%	41.5%	-	-
Operating income	747	503	265	-126	100
YoY	-10.0%	-32.6%	-47.3%	-	-62.3%
Operating income margin	8.6%	5.0%	2.6%	-2.6%	1.0%
Ordinary income	878	544	285	-126	100
YoY	2.6%	-38.0%	-47.6%	-	-65.0%
Profit attributable to owners of parent	592	253	5	-76	60
YoY	37.2%	-57.3%	-97.7%	-	914.7%
Adjusted EPS (¥)	58.09	24.82	0.58	-7.52	5.94
Adjusted DPS (¥)	10.00	9.00	9.00	3.00	9.00
Adjusted BPS (¥)	389.90	400.57	393.04	-	-

Note: Conducted a 2 for 1 stock split on October 1, 2015
Source: Prepared by FISCO from the Company's financial results

Consolidated balance sheet

(¥mn)

	FY3/15	FY3/16	FY3/17
Current assets	4,057	4,700	4,498
Cash and deposits	2,335	2,638	2,221
Notes and accounts receivable	1,319	1,597	1,772
Non-current assets	1,604	1,828	1,396
Tangible non-current assets	150	172	108
Intangible non-current assets	811	927	531
Investments and other long-term assets	642	728	756
Total assets	5,662	6,529	5,894
Current liabilities	1,684	1,878	1,712
Trade accounts payable	565	640	681
Short-term borrowings, etc.	-	333	346
Non-current liabilities	-	561	211
Long-term borrowings	-	559	200
Shareholders' equity	3,960	4,095	3,932
Capital stock	824	824	824
Additional paid-in capital	965	965	926
Retained earnings	2,208	2,344	2,268
Treasury stock	-38	-38	-87
Accumulated other comprehensive income	15	-11	37
Subscription rights to new shares	2	2	0
Net assets	3,977	4,088	3,970
Total liabilities and net assets	5,662	6,529	5,894

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

Statement of Cash Flows

(¥mn)

	FY3/15	FY3/16	FY3/17
Cash flow from operations	768	366	155
Cash flow from investing	-595	-762	-165
Cash flow from financing	-82	705	-403
Changes in cash and cash equivalents due to currency exchange fluctuations	48	-24	-6
Absolute change YoY in cash and cash equivalents	139	284	-420
Balance of cash and cash equivalents at start of fiscal year	2,195	2,335	2,620
Balance of cash and cash equivalents at end of fiscal year	2,335	2,620	2,199

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

Shareholder return policy

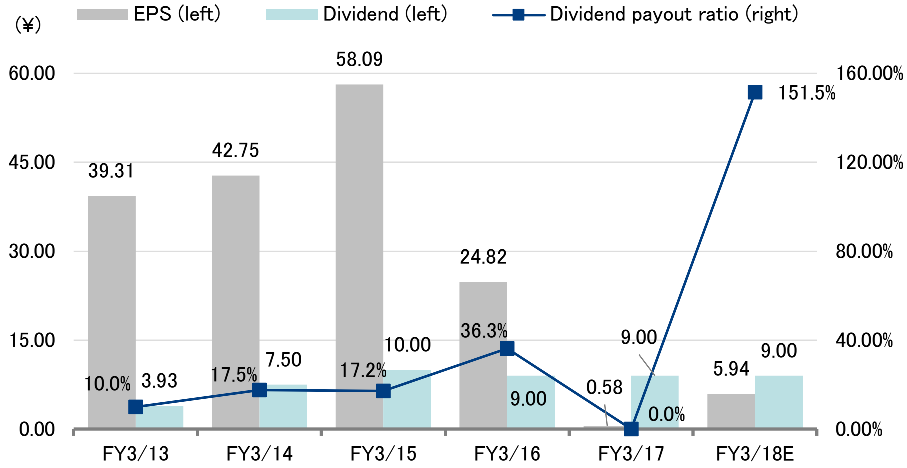
Paid a dividend of ¥9 in FY3/17 and announced that the dividend will be unchanged in FY3/18

The Company values its individual shareholders and actively returns profits to them. Its basic policy for shareholder returns is to determine the dividend while maintaining a balance with supplementing internal reserves to invest in growth for the future. In the past, the Company adopted a rule of a dividend payout ratio of 10% as a guideline, but from FY3/15, it raised the dividend payout ratio standard for the ordinary dividend from 10% to 15%, and then raised it again to 20% from FY3/16.

In FY3/17, just as forecast the Company paid an annual dividend unchanged from the previous fiscal year of ¥9 (interim dividend of ¥3 and end-of-period dividend of ¥6). EPS declined to ¥0.58 following the Company's decision to record an impairment loss at the end of the fiscal year. But as this was a temporary, non-financial cost, it is judged that it will have no effect on the dividend payment.

For FY3/18, the Company has announced a dividend forecast that is again unchanged from the previous fiscal year of ¥9 (interim dividend of ¥3 and end-of-period dividend of ¥6). In FY3/18, although there will be new measures in the Digital Marketing segment, the outlook is for profits to remain at a low level, the same as in the previous fiscal year. However, based on the Company's confidence that profits will recover fully from the next fiscal year onwards, at FISCO we estimate that it will choose to continue to stably pay a dividend.

Trends in the EPS, the dividend, and the dividend payout ratio



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

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