COMPANY RESEARCH AND ANALYSIS REPORT

SUN-WA TECHNOS CORPORATION

8137

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Summary

Is solidifying preparations for a fully-fledged recovery from FY3/21 by steadily implementing the priority measures set out in the new medium-term management plan and growing the business for the automotive industry

SUN-WA TECHNOS CORPORATION <8137> (hereinafter, "the Company") is an independent trading company that specializes in technology products. The Company has steadily expanded its businesses by leveraging coverage of three major areas (electrical machinery, electronics, and general machinery) and two-way trade in which it sells equipment and materials for manufacturers' production lines and then procures the products made by these manufacturers. In recent years, it has been focusing on the engineering business and global SCM solutions.

1.In 1H FY3/20, although sales and profits declined due to the fall in demand for capital investment, growth for the automotive industry continued

In the Company's 1H FY3/20 results, sales and profits declined, with net sales of ¥67,608mn (down 6.3% YoY) and operating income of ¥909mn (down 57.3%). Capital investment in the manufacturing industry in Japan and overseas decreased due to the impacts of the US-China trade friction and other factors, and based on this, the Company downwardly revised its full fiscal results forecasts at the time it announced its 1Q results in July 2019. However, growth was greater than expected for the automotive industry and the amusement industry, and the 2Q results greatly exceeded the revised forecasts. Sales for the automotive industry are being driven by demand for parts for driving-assist systems, and the steady growth is expected to continue for the time being. This business is becoming the second pillar of earnings after the business for the factory automation and industrial equipment industries, and expectations are rising for its growth to provide stable results in the future.

2.Is making steady progress for each of the four fundamental policies in NEXT 1800, the new medium-term management plan

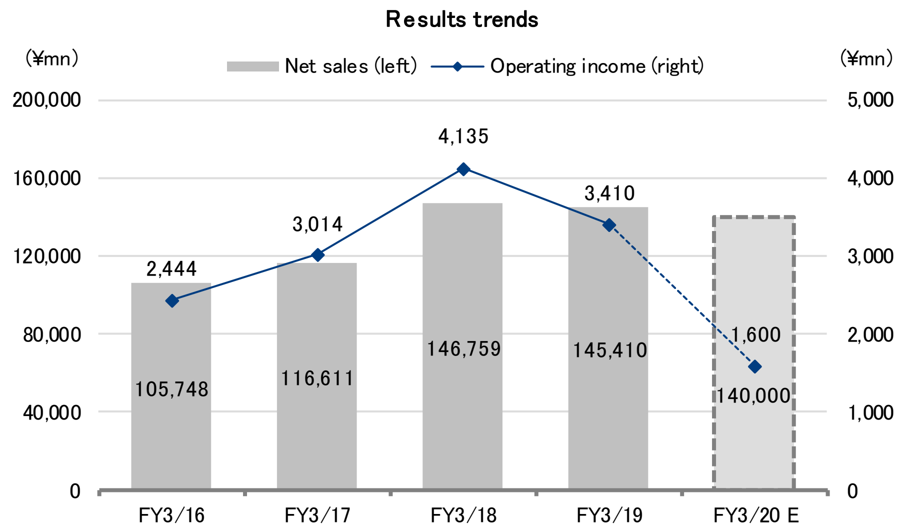
The Company has formulated NEXT 1800, a three-year medium-term management plan from FY3/20. It is working to steadily implement the four fundamental policies set-out in it, and overall, it is making steady progress for them. Within the strengthening of core businesses, for the engineering business, it is taking on the challenge of converting the business strategy toward improving the profit margin. It can be evaluated positively on the fact that it has not wasted time and taken on reforms at an early stage. On the other hand, the scope of the global SCM solutions business is steadily expanding, and in terms of profitability also, it seems to have acquired the expected level in a form that utilizes the Company's many years of experience and business infrastructure. It can also be seen to be making progress in the respective fields relating to the themes of global business development, expansion into new business areas, and contributing to a sustainable society. For the management targets, although conditions are severe in FY3/20, at FISCO we think it is fully possible that it will achieve the initially planned results targets for the plan's final fiscal year.

3. 2H FY3/20 is a period to solidify structures to steadily capture recovery demand from FY3/21

For the FY3/20 full year, the Company has slightly raised the forecasts from the forecasts in July 2019, to net sales of ¥140,000mn (down 3.7% YoY) and operating income of ¥1,600mn (down 53.1%). On looking only at the 2H, the values of the latest October forecasts are at profit levels further below the revised forecasts of July. It was necessary to downwardly revise the outlook as a result of the increased precision of the forecasts, and the severe conditions for the Company's results are expected to continue. But on the other hand, signs of a results recovery can also be seen. In the 1H, some of the Company's direct customers, of industrial machinery manufacturers (set manufacturers) conducted inventory adjustments, and therefore the Company's sales slumped more than actual demand for capital investment. But at the present time, set manufacturers have completed their inventory adjustments and orders are recovering in a form reflecting actual demand. There is also the sense that the severity of the US-China trade friction has peaked-out, and conditions are expected to transition to a recovery phase from FY3/21. It can be said that the 2H is the period to fully prepare for this time, and at FISCO, we think that, while also considering numerical results, the progress made for this will be the most important evaluation point.

Key Points

- In the engineering business, is taking on the challenge of converting the strategy toward raising the profit margin
- In the global SCM solutions business, both the business scope and profitability are trending steadily
- The focus is on whether the business for the automotive industry will become a long-term business pillar



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

Results trends

Sales to the mainstay factory automation and industrial equipment industries declined, mainly due to the impact of the US-China trade friction, and profits also decreased significantly

1H FY3/20 results

The Company reported lower sales and profits in 1H FY3/20 at ¥67,608mn in net sales (-6.3% YoY), ¥909mn in operating income (-57.3%), ¥1,036mn in ordinary income (-55.2%), and ¥689mn in net income attributable to owners of the parent (-58.3%).

The Company downwardly revised the 1H and the full fiscal year results forecasts at the time it announced the 1Q results on July 30, 2019. Compared to the revised forecasts, net sales and operating income were above forecast by ¥3,608mn and ¥609mn, respectively.

1H FY3/20 results

(¥mn)

	FY3/19			1H FY3/20					
	1H results	2H results	Full year results	Initial forecast	YoY	Revised forecast	YoY	Results	YoY
Net sales	72,164	73,246	145,410	74,000	2.5%	64,000	-11.3%	67,608	-6.3%
Operating income	2,129	1,281	3,410	1,500	-29.6%	300	-85.9%	909	-57.3%
Operating margin	3.0%	1.7%	2.3%	2.0%	-	0.5%	-	1.3%	-
Ordinary income	2,312	1,315	3,627	1,600	-30.8%	400	-82.7%	1,036	-55.2%
Net income attributable to owners of the parent	1,651	977	2,628	1,150	-30.4%	350	-78.8%	689	-58.3%

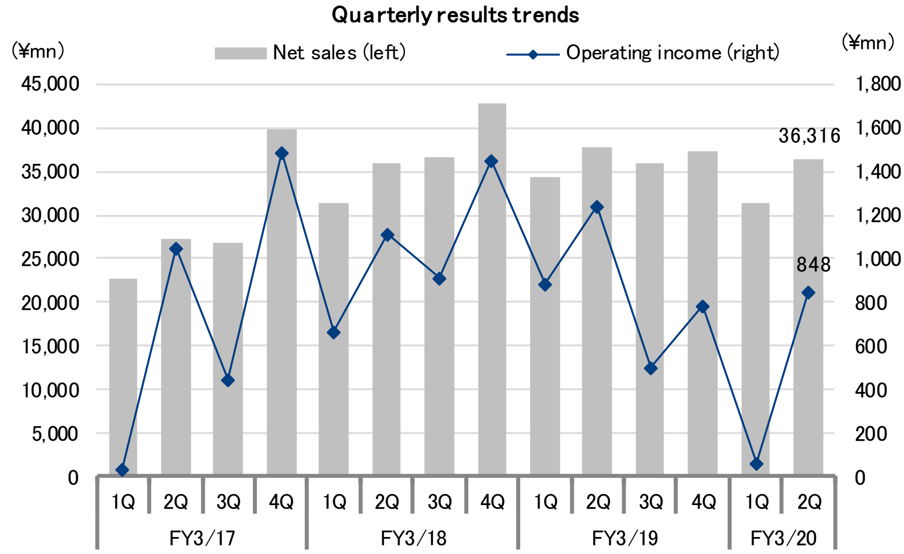
Source: Prepared by FISCO from the Company's financial results

The Company has formulated NEXT 1800, its new three-year medium-term management plan from FY3/20 to FY3/22. FY3/20 is the first fiscal year of this plan, but due to the impact of the US-China trade friction, capital investment cooled down for a wide range of manufacturers, regardless of industry, and this had a major impact on the Company.

As stated above, the results were a decline in sales and a major decrease in profits. But in a situation in which the US-China trade friction has intensified in the form of tariffs being raised and an expansion in the scope of items subject to them, the negative impact on the results of this on Japanese companies, including the Company, was fully expected. In this environment, it prompted a swift downward revision in the results forecasts at the stage of announcing the 1Q results, and subsequently achieved 1H results that exceeded these revised forecasts. At FISCO, we think that this was appropriate, as the method of disclosing information to market participants (investors).

Looking on a quarterly basis, breaking down the 1H, it is possible to read that results bottomed-out in the 1Q and showed signs of recovery in the 2Q. Also, results slumped for the factory automation and industrial equipment industries, which is the Company's mainstay field, but they continued to grow for the automotive industry, which is growing remarkably. Moreover, due to its position, a feature of the Company's results is that they tend to fluctuate up and down more than actual demand for products, and the current 1H was a period in which they greatly fluctuated in a downward direction. It is possible that they will fluctuate greatly upward in the form of recovering this downward portion in the recovery process in the future. So at FISCO, our evaluation is that these results are not necessarily a cause for pessimism.

Results trends



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

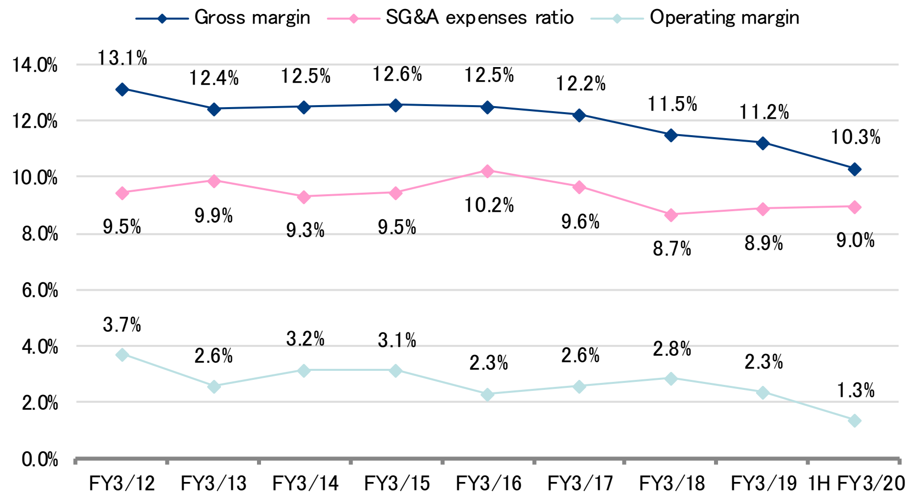
As stated above, net sales declined 6.3% (¥4,556mn) YoY, while by business segment, net sales decreased 20.8%(¥2,767mn) in the electrical machinery segment, which had the biggest impact. In contrast, they declined only 2.0% (¥1,083mn) in the electronics segment, which was the smallest decline in the 3 business segments.

Compared to the revised forecasts announced on July 30, 2019, net sales were ¥3,608mn above forecast. The factors behind this were the greater-than-expected growth of sales of electronic parts for the automotive industry (mainly for vehicle on-board electronic parts) and for the amusement industry in Asia and Europe/US.

On the other hand, in profits, the biggest impact was from the decline in profits due to the lower sales. Also, while sales slumped to the factory automation and industrial equipment industries, they grew to the automotive industry. As a result, the product mix deteriorated, which caused the gross profit margin to decline. The Company worked to cut costs and on other measures, but these efforts could not absorb the decline in gross profit, so operating income declined greatly, down by more than 50% YoY.

Compared to the July revised forecast, operating income was ¥609mn above forecast. The reasons for this were net sales grew more than expected for the automotive industry and for the amusement industry in Asia and Europe/US, and also from the effects of the efforts to cut costs. Compared to the extent to which net sales were above forecast, the extent to which profits were above forecast was small. This was because net sales increased mainly for sales in the automotive industry, which has a relatively low profit margin. This can also be understood from the previously described deterioration of the product mix.

Trends in various margins



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

In a severe business environment in general, net sales to the automotive industry continue to increase from the strong demand for driving-assist systems

2. Segment and regional trends

The Company discloses net sales after breaking them down into the three business segments of electrical machinery, electronics, and general machinery, according to the products handled. It also discloses net sales and operating income as segment information by region. An overview is provided below.

Trends in net sales by business segments

(¥mn)

	FY3/19			1H FY3/20
	1H	2H	Full year	
Electrical machinery	13,332	11,237	24,569	10,565
YoY	7.6%	-24.0%	-9.6%	-20.8%
Electronics	53,553	55,817	109,370	52,470
YoY	6.4%	-7.1%	-1.0%	-2.0%
General machinery	5,278	6,192	11,470	4,571
YoY	14.3%	36.5%	25.3%	-13.4%
Total net sales	72,164	73,246	145,410	67,608
YoY	7.2%	-7.8%	-0.9%	-6.3%

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

In the electrical machinery segment, sales increased of electrical machinery parts for the semiconductor industry, but they decreased of electrical machinery parts for the industrial machinery industry. Therefore, this business segment's net sales declined 20.8% YoY to ¥10,565mn.

In the electronics segment, sales grew of electronic parts for the automotive industry, but they decreased of electronic parts and electronic equipment for the industrial machinery industry, and also of electronic equipment for the semiconductor industry. Therefore, this business segment's net sales declined 2.0% YoY to ¥52,470mn.

In the general machinery business segment, sales increased of production equipment for the semiconductor industry, but they decreased of production equipment for the industrial machinery industry. As a result, in this business segment as a whole, net sales declined 13.4% YoY to ¥4,571mn.

Detailed trends by regions

(¥mn)

		FY3/19			1H FY3/20
		1H	2H	Full year	
Japan	Net sales	57,653	58,340	115,993	53,889
	YoY	10.1%	-6.8%	0.9%	-6.5%
	Operating income	1,065	874	1,939	529
	YoY	13.9%	-37.5%	-16.9%	-50.3%
	Operating margin	1.8%	1.5%	1.7%	1.0%
Asia	Net sales	18,646	18,542	37,188	16,243
	YoY	5.1%	-14.8%	-5.8%	-12.9%
	Operating income	778	430	1,208	289
	YoY	15.4%	-47.2%	-18.8%	-62.9%
	Operating margin	4.2%	2.3%	3.2%	1.8%
Europe/US	Net sales	4,204	3,880	8,084	3,746
	YoY	11.9%	-24.0%	-8.8%	-10.9%
	Operating income	275	-21	254	35
	YoY	69.7%	-	-18.3%	-87.2%
	Operating margin	6.5%	-0.5%	3.1%	0.9%

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

In Japan, net sales were ¥53,889mn (down 6.5% YoY) and operating income was ¥529mn (down 50.3%). Sales grew of electrical machinery parts for the semiconductor industry and electronic parts for the automotive industry. But overall, sales decreased for the industrial machinery industry in each business segment, while they also fell of electronic equipment for the semiconductor industry. Therefore, sales and profits declined.

In Asia, net sales were ¥16,243mn (down 12.9% YoY) and operating income was ¥289mn (down 62.9%). Although sales increased of electronic parts for the amusement industry, this was insufficient to cover for the decreases in sales of electrical machinery parts and electronic parts for the industrial machinery industry and of electronic parts and production equipment for the semiconductor industry. As a result, sales and profits declined significantly.

In Europe/US, net sales were ¥3,746mn (down 10.9% YoY) and operating income was ¥35mn (down 87.2%). Sales of electronic parts for the amusement industry were strong, but sales of electronic parts for the industrial machinery industry decreased, so sales and profits declined significantly.

Looking at the trends by business segment and region described above, the sales conditions by demand destination are as follows.

Segment and regional trends

	Japan			Asia			Europe/US		
	Electrical machinery	Electronics	General machinery	Electrical machinery	Electronics	General machinery	Electrical machinery	Electronics	General machinery
Automotive industry		○							
Semiconductor industry	○	×	○		×	×	×		
Industrial machinery industry	×	×	×	×	×			×	
FPD industry									
Smartphone industry									
Amusement industry					○			○	

*○ and × indicate YoY increases and decreases in sales, respectively.
Source: Prepared by FISCO from the Company's financial results

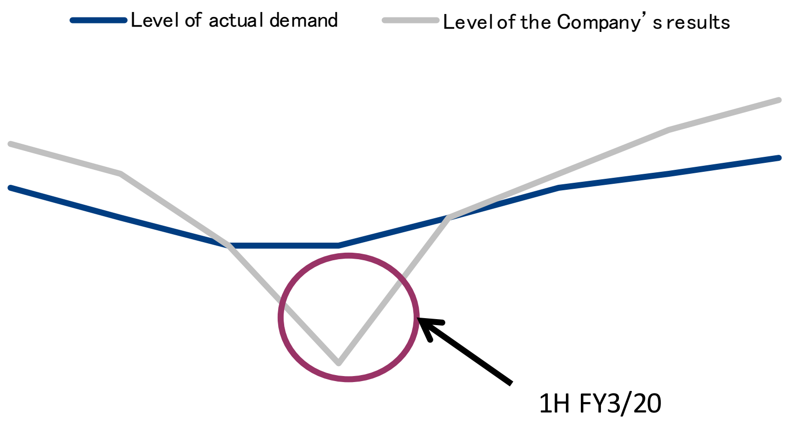
In the business for the industrial machinery industry, results were sluggish in all three business segments, while regionally also, there was a worldwide slump, including in the mainstay markets of Japan and Asia. For the semi-conductor industry, in Japan sales increased of electrical machinery parts and general machinery (mainly production equipment), but the declines in sales in Asia and Europe/US stood out. Within Japan also, sales declined in the electronics segment, which is considered to provide the highest percentage of total net sales.

Even in this situation, net sales for the automotive industry grew firmly. The Company's products for the automotive industry are broadly divided into two types; 1) vehicle on-board electronic parts, and 2) production equipment. It seems that the current situation is that on-board electronic parts constitute 70% to 80% of net sales for the automotive industry, and in the 2Q, sales grew both of on-board electronic parts and production equipment. The Company does not disclose information specifically on "on-board electronic parts," but it seems that they are parts used in fields relating to driving-assist systems like collision prevention and automated driving, which have become a major development in the automotive industry. Therefore, at FISCO we estimate that their sales will continue to grow firmly.

As previously stated, due to its position, a feature of the Company's results is they tend to fluctuate up and down more than actual demand for products, and the structure of this is as follows. On dividing the Company's earnings according to the industry where demand occurs, earnings from the industrial machinery industry are overwhelming large. Conversely, when looking at the actual product flow, we see that there are broadly two cases; cases of direct sales by the Company to the end user (a typical example being a case of the Company directly delivering production line equipment to a manufacturer), and cases of the Company providing parts to set manufacturers, such as production equipment. In the mainstay business for the industrial machinery industry, there are many cases of the latter.

In the case of the latter, it occurs in the form of the Company being inserted between set manufactures and movements in "companies' capital investment," which is, so to speak, actual demand. Set manufacturers, based on their own demand forecasts, order many parts from the Company if they expect demand to be strong in the future, but conversely, if demand becomes weak, they prioritize liquidating their inventory on-hand. Therefore, there is a tendency for orders to the Company to be narrowed-down more than movements in actual demand. This is the structure that causes the significant variability of the Company's results. The formula is "The extent of the fluctuation (variability) in the Company's results = the extent of changes in capital investment in the manufacturing industry (trend in actual demand) + the effects of set manufacturers' inventory adjustments."

Fluctuations in the Company's results and changes in actual demand



Source: Prepared by FISCO from interviews, etc.

At FISCO, we think that this structure itself is rooted in the Company's position, so fundamentally, it would be difficult to eliminate it. However, we should not forget that this structure also works to push-up its results during a phase in which demand bottoms-out and recovers. Also, even if it is difficult to eliminate this variability of results, there are policies that can mitigate it, of changing the demand (customer) structure and the product structure. If speaking of the present time, an example of this is steadily growing sales for the automotive industry and each year improving their percentage of total net sales. As previously stated, a fairly large part of the Company's net sales for the automotive industry are from on-board electronic parts, which correspond to cases of direct sales to the final customer. For the part for which it is inserted between set manufacturers, the Company's results fluctuations are similar to changes to actual demand, and the situation above all at the current time is that actual demand is trending upward. At FISCO, we think that expanding to other products and markets, while maintaining the structure of the business for the industrial machinery industry, which is Company's mainstay business and strength, will improve the stability of results and enable the creation of an earnings structure that can demonstrate explosive power to expand profits during times of economic boom.

Medium- to long- term growth strategy and its progress

Aiming to realize sustainable growth in the medium- to long-term based on NEXT 1800, the new three-year medium-term management plan

1. New medium-term management plan NEXT 1800

(1) Overview of the medium-term management plan

In May 2019, the Company announced NEXT1800, its new three-year medium-term management plan. Its medium- to long-term growth strategy is to use this three-year medium-term management plan as a signpost toward realizing sustainable growth in the medium- to long-term through steadily implementing the priority measures and achieving the numerical targets described within it.

In its long-term management vision "Sun-Wa Vision 2025," the Company calls for "strengthening core businesses to build operations that contribute to advances in industrial activity in local societies as a total coordinator of production sites and distribution and help in attaining the goal of ¥250bn in consolidated net sales in FY3/26." It positions NEXT 1800, the new medium-term management plan, as an action plan for the next three years toward realization of the corporate mission and Sun-Wa Vision 2025, similar to previous medium-term management plans.

NEXT 1800 presents four items as fundamental policies, including "contribute to customer production activities by strengthening core businesses." It also highlights priority measures for each of the policies. We review the details of plan measures later in this report. In the core portion of income growth, the Company hopes to make improvements and achieve further advances versus Challenge 1500, the previous medium-term management plan, and realize a growth strategy with even higher certainty, while also carrying out initiatives for new business creation that lay the groundwork for growth over a longer term as a new initiative. Additionally, it places more emphasis on themes with strong social content, such as work style reforms that enhance productivity by utilizing ICT in a way that addresses changes in society, achievement of a corporate culture that stimulates interest in work, and contributions to SDGs (sustainable development goals), than previously.

Fundamental policies in NEXT 1800

Contribute to customer production activities by strengthening core businesses
★ Strengthen core businesses ★ Promote collaboration with business partners to bolster solution proposals
Expand global business capabilities to support market demand
★ Strengthen hiring of overseas local employees and organizational capabilities ★ Consider establishment of new locations
Pursue new business fields to accelerate sustainable growth
★ Strengthen investments in new business creation ★ Cultivate managerial personnel by adopting an intrapreneurship program ★ Create new value through SCM improvements
Initiatives to realize a sustainable society
★ Foster a corporate culture that stimulates interest in work by boosting employee engagement ★ Implement work style reforms that "enhance productivity" utilizing ICT ★ Conduct initiatives that contribute to SDGs ★ Fulfill corporate social responsibility (promote CSR and compliance)

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

(2) Management goals in the NEXT 180 plan

Management goals in NEXT 1800, as suggested by the plan name, are ¥180,000mn in net sales, ¥4,800mn in operating income, and ¥5,000mn in ordinary income in FY3/22, the final fiscal year.

In FY3/20, which is the plan's first fiscal year, the 1H results were below the initial forecasts, so the Company downwardly revised the full fiscal year forecasts from the initial forecasts. Due to this situation, the management targets for FY3/21 and FY3/22 may be revised in the future.

Management targets of NEXT 1800

(¥mn)

	FY3/19 results	Medium-term management plan NEXT 1800		
		FY3/20 management targets	FY3/21 management targets	FY3/22 management targets
Net sales	145,410	150,000	165,000	180,000
Operating income	3,410	3,100	3,800	4,800
Operating margin	2.3%	2.1%	2.3%	2.7%
Ordinary income	3,627	3,300	4,000	5,000
Ordinary margin	2.5%	2.2%	2.4%	2.8%

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

But as previously explained, a feature of the Company's results is that they fluctuate up and down greatly compared to the actual demand for the products it handles. Results fluctuated downwardly in FY3/20, but conversely, in the demand-recovery phase. the Company's results are expected to show strong momentum greater than the movement in actual demand.

The issue is the timing of this, but one factor behind the current deterioration of results is the US-China trade friction, and it is considered that the fourth phase of tariff measures by the US (the first half was implemented on September 1, 2019, for imports worth US$112.0bn, and the second half is scheduled to be initiated on December 15 for imports worth US$160.0bn) is considered to have temporarily ended. This is because tariff sanctions have been imposed on almost all of the US$550.0bn value of imports from China. While it is possible that the movement toward strengthening sanctions, such as raising the tariff rate, will continue, at FISCO, we think that in the future, the two countries will shift the focus onto mitigating the friction through trade talks.

If this opinion is correct, the worst period for the Company's business environment may have been the 1H. This is because company managers conduct upfront investment and steadily capture actual demand, while forecasting the future. The US-China trade friction is intertwined with problems such as Hong Kong and Uyghur, while there are also factors other than US-China related ones, such as Brexit, and we should not imagine that these problems will be solved immediately. However, if they gradually and steadily improve, we can expect the Company's results to also bottom-out and recover to an upward trend. When considering the sense of speed for this, at FISCO we think that actual demand will reach a period of fully-fledged recovery in FY3/22, and that benefiting from this, it is fully possible that the Company's results will trend above forecast. The launch pad for this has been temporarily lowered due to the downward revision to the FY3/20 forecasts, but we think that the level of the FY3/22 results may settle in line with the initial forecasts.

Separate to these external factors, the Company itself is also steadily progressing measures for growth. It has started the new medium-term management plan without any problems, and while there are many aspects not clearly reflected in corporate results, it is making steady progress below the surface. Below, the specific progress made for the four fundamental policies (themes) are described.

In the engineering business, is finetuning the strategy toward raising the profit margin
The global SCM solutions business continues to grow steadily

2. Progress for "contribute to customer production activities by strengthening core businesses"

Among the four fundamental policies set out in the new medium-term management plan, at FISCO, we think the theme of "contribute to customer production activities by strengthening core businesses" is the most important, in the sense that it directly relates to the Company's earnings growth.

Compared to the previous medium-term management plan, the point to focus on is that the scope of the "core businesses" has been widened and two businesses, the engineering business and the global SCM solutions business, have been newly added to the core businesses. This change suggests that both businesses have a scale suitable to be "core businesses" and have grown to be important businesses.

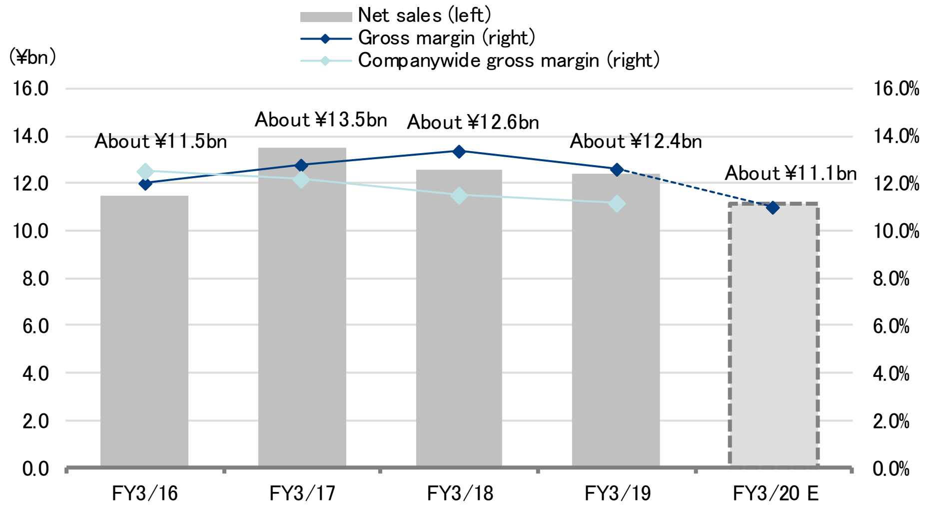
The specific content of these two business has been repeatedly discussed in previous reports, so here, the main progress made for them is described.

(1) Progress of the engineering business

The engineering business sells to customers what the Company itself combines and systemizes from the products previously sold individually that are handled in each of the three respective business segments, of electrical machinery, electronics, and general machinery. In other words, the engineering business is not some sort of separate, new business, but it is a so-called sales method for each product in an agency business. In this background to which the Company is focusing its attention, there have been a sequence of events that include shifts to higher functionality for various products and from hard to soft aspects alongside the technological developments and the increasing sophistication of customer needs. In this situation, selling only individual products would not meet needs and also tend to create a situation in which it is difficult for business opportunities to grow.

The engineering business has been steadily expanding and continues to remain stably above the ¥10bn level, which had been the primary goal at the business launch, in the past few years. We think this is a major reason for "upgrading" engineering business to a core business.

Trend in net sales and gross margin in the engineering business



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

The engineering business has progressed steadily up to the present time. But on the other hand, an issue can also be seen, which is that the profit margin in this business has not increased above the initially expected level (specifically, this seems to be in a range of 25% to 30%).

On digging a little deeper on this point, we find that the factors causing the profit margin to not rise is that the Company, rather than conducting the engineering business in a form that utilizes the knowledge and experience it has accumulated in the past, seems to be conducting the work exactly as requested by customers, and the part that is inherently supposed to be profits as “value added” becomes a cost that it incurs in advance.

The Company’s engineering business has been described by comparing it to curry. That is to say, previously it sold the meat, vegetables, and rice individually as the ingredients (an agency business). But in contrast, the engineering business attempts to use each of these ingredients to make and to sell curry rice, and the structure is that the work to make and season the curry rice provides the value added. But it can be said that in this current situation, the Company is not making and providing the curry as a completed recipe, but rather it is developing a curry from scratch every time to suit the preferences of the customer.

Based on this situation, the Company has begun to rebuild the business model of the engineering business. It has already adopted an orders policy that prioritizes profitability, of passing on orders for projects that do not utilize its past knowledge. Other than this, it is also working to review various points, including the business model, the service structure, and the list of fees.

An orders policy prioritizing profitability may cause net sales to decline in the short term. But at FISCO, we think that the biggest reason that the Company decided to strengthen the engineering business is that such a change of stance for ordering can be justified when considering the improvement to profitability. In terms of the next step, it is considering measures that will achieve both sales growth and improved profitability, and we shall be focusing on the specific measures it creates for this.

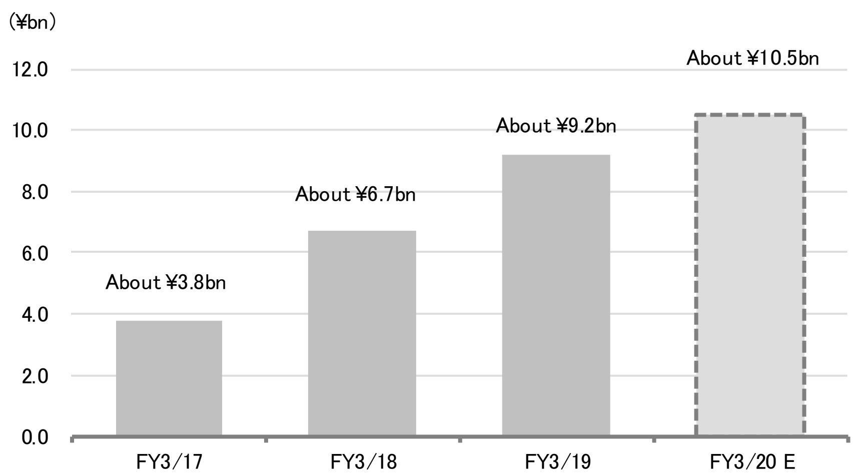
(2) Progress of the global SCM solutions business

The global SCM solutions business is rooted in the services that the Company has provided since the distance past of procurement agent, logistics agent, and delivery management services. The various manufacturers that are its main customers have been pursuing efficiency as major companies and progressing business structural reforms and restructuring. In this process, they have targeted reducing personnel and bases in areas such as global logistics, inventory management, and materials procurement, so the reality is that they currently have shortages of personnel. The Company's global SCM solutions business captures the need for outsourcing that arises due to these shortages. The same as the engineering business, this is also one sales method and business method for the products of the three business segments of electrical machinery, electronics, and general machinery.

Using the moving business as an example, conventional procurement agent and logistics agent services just moving a person's items from the former home to the new home. In global SCM solutions business, meanwhile, the service also extends to setting up televisions and PCs for immediate use after the move and procuring and installing antennas and Wi-Fi equipment. Engineering business corresponds to selection and procurement of antennas and Wi-Fi equipment suited to the new area and wiring installation. The move might lead to more business too if an order is received for landscaping and softscaping work. The Company is aiming to grow the global SCM solutions business by utilizing the expertise it has accumulated over its long history as a technology trading company and its strength of having an overseas network.

The Company did not announce numerical net sales targets for the global SCM solutions business in the new medium-term management plan. But at FISCO, we think the target at the present time is ¥20bn.

Trends in net sales in the global SCM solutions business



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

On the start of the new medium-term management plan, the Company launched the global SCM solutions division in April 2019. The aim of this was to accelerate growth compared to up to that time as a profitable business by changing direction by 180 degrees to a proactive stance from a stance that had been slightly passive, which was because the roots of this business are found in the procurement agent, logistics agent, and delivery management services.

Following the launch of the global SCM solutions division, the Company has progressed the transition to professionalism for both the aspects of establishing systems for business execution and reforming employee awareness. As a result, the situation is that a development has started of creating a "spillover business" toward higher profitability by developing the capturing of customers' outsourcing needs (which fundamentally has a low profit margin as it takes-over the "time" of customers) to breaking through to capture other transactions.

Established a base in Ho Chi Minh City, Vietnam. Expected to contribute in the global SCM solutions business

3. Progress for "expand global business capabilities to support market demand"

This theme includes the establishment of a second base in Ho Chi Minh City, Vietnam in August 2019. Vietnam is growing remarkably and increasing in importance on a seemingly daily basis, so the Company is aiming to strengthen its sales structure by establishing bases in the main cities in the north and south.

The base's specific activities will include supporting Japanese companies, discovering excellent global companies and products, and expanding sales channels to the ASEAN region. In addition to these activities, at FISCO, we think that the collaborations with the global SCM solutions business to which the Company is placing its focus can also contribute.

Rectifying SCM through the introduction of a Warehouse Management System and working to create new value

4. Progress for "pursue new business fields to accelerate sustainable growth"

One specific progress made for this theme is the start of operations of the Warehouse Management System (WMS) from April 2019. The introduction of the WMS is expected to have benefits on the points of improving logistics quality and strengthening traceability, making logistics costs visible, and improving production. The Company intends to realize these benefits at an early stage by utilizing the WMS and improving proficiency in it.

Utilizing ICT to newly establish a low-cost sales base in Shikoku

5. Progress for "initiatives to realize a sustainable society"

For this theme, one of the targets is utilizing ICT to realize workstyle reforms that "improve productivity." The Company is taking on the challenge of achieving this target by newly establishing a sales base in Shikoku in July 2019. In previous sales bases, two types of staff were needed, sales staff (front office) and administrative staff (back office), and this division tended to cause base management costs to increase. However, there are only front-office staff permanently stationed at the Shikoku sales office, as the back-office work is covered by teleworking by the Osaka branch office, its head office. This has enabled the Company to establish a base in which staffing costs are greatly reduced.

If it can be confirmed that this mechanism works as intended, the Company intends to newly establish sales bases using the same method in Tohoku and other regions, which will lead to the discovery of excellent companies in the regions and the expansion of business scope.

Net sales for the automotive industry are being driven by driving-assist systems and growing rapidly. The focus is on whether it will become a long-term business pillar.

6. Growth of the automotive business

In the 1H FY3/20 results briefing materials, the Company disclosed new values for net sales to the automotive industry. There has been no change to the fact that its main market is the factory automation and industrial equipment industries. But the growth in the last few years of net sales for the automotive industry has been more rapid than expected, while the scale of net sales is also higher than anticipated.

There is no particular focus on growth of net sales for the automotive industry in the new medium-term management plan. But as stated below, when looking at the Company's results trends, in terms of the percentages of total sales and also as the engine of earnings growth, we see that it has come to occupy an important position that cannot be overlooked. Below, the Company's business for the automotive industry is described in detail.

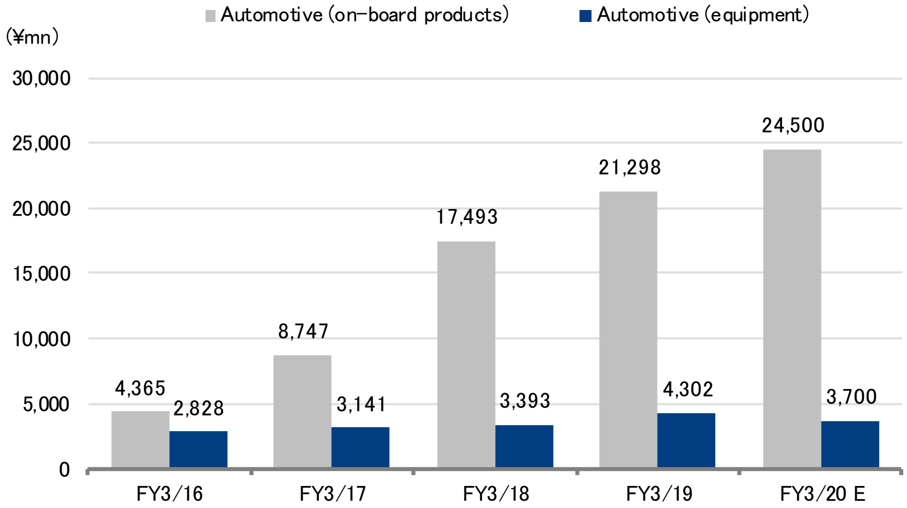
(1) Overview of the business scale

The Company's net sales to the automotive industry can be broadly divided into parts for vehicles' on-board products and machinery and materials for plants' production equipment. Internally, they are respectively called and divided into automotive (on-board products) and automotive (equipment). In the FY3/19 results, automotive (on-board products) net sales were ¥21,298mn and automotive (equipment) net sales were ¥4,302mn. So when combining both, total net sales for the automotive industry were ¥25,600mn (17.6% of total net sales).

For FY3/20, the forecasts are for net sales from automotive (on-board products) of ¥24,500mn (up 15.0% YoY), from automotive (equipment) of ¥3,700mn (down 14.0%), and total net sales of ¥28,200mn (up 10.2%). Their percentage of Companywide net sales of ¥140,000mn, will be 20.1%, which means they will pass sales for semiconductors and LCDs to rank second (first place is expected to be maintained by sales for factory automation and industrial equipment)*.

* In the 1H FY3/20 results briefing materials, the Company disclosed the increases or decreases and the percentage shares of total net sales in the individual results. According to which, automotive (on-board products) sales grew to 22.8 and automotive (equipment) sales were 3.5%, meaning that in total, sales for the automotive industry contributed 26.3% of total net sales. It is possible that, in the individual results, this was a temporary acceleration occurring only in this 1H, but it does indicate that the automotive industry has grown to become the Company's largest customer.

Trend in net sales for the automotive industry



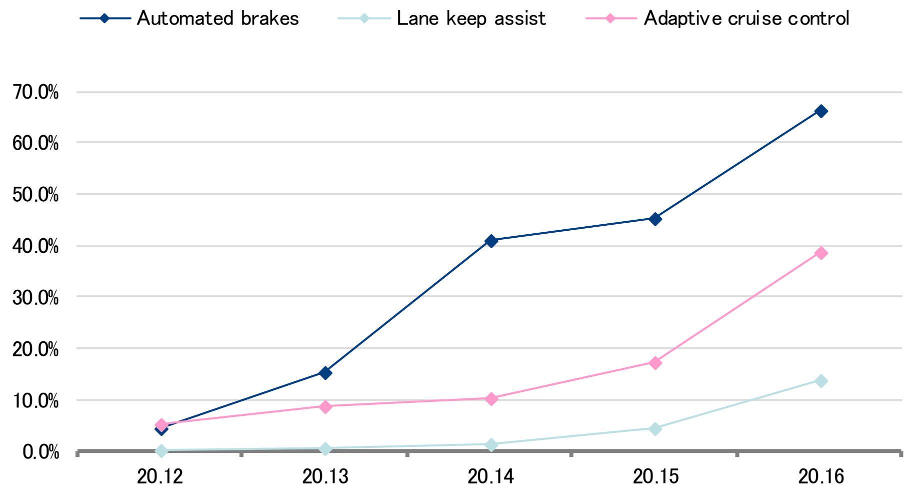
Source: Prepared by FISCO from the Company's results briefing materials

(2) The main product and business areas

Information on specific customers and products is essential to make decisions about future growth potential, but the Company is restricted on disclosing such information, such as by confidentiality contracts with customers, and it does not disclose any details. What it currently publishes for automotive (on-board products) is information on electronic parts related to so-called driving-assist systems, including automated breaks and collision-prevention devices.

Looking at the extent of the dissemination of these various driving-assist systems, as of 2016, the percentage of new cars installed with automated breaks (breaking to mitigate collision damage) had risen to 66.2%. But conversely, the percentage of new vehicles installed with adaptive cruise control (ACC, a device that automatically controls the speed and the distance to the vehicle in front on a highway, etc.) was 38.7%. Lane keep assist (a device for automatically controlling driving to keep close to the center of a lane on a highway, etc.) was 13.7%.

Trends in the rates of installation of driving-assist systems in new vehicles



Source: prepared by FISCO from the Ministry of Land, Infrastructure and Transport's Evolution and Dissemination of Driving-Assist Technologies and Automated-Driving Technologies

Speaking for the first time on this situation, there remains plenty of room for growth for the rates of installation of these systems in new vehicles. Driving-assist systems are essential to improve the marketability of vehicles, and except for a few types of vehicles like economy cars, it is possible that they will substantively be installed in 100% of vehicles. One more aspect is the transition to high functionality for the various devices. The current driving-assist systems are not themselves the ultimate goal, and rather it seems that they are being positioned as the transition period toward completely automated driving. The government and others have set targets for the present time toward realizing completely automated driving by 2025. But toward achieving these targets, the impression has not been eradicated that driving-assist systems still lack accuracy. The strengthening of their functions will also mean the strengthening of the functions of the various electronic parts that constitute them, which in turn will lead to the higher prices of these parts. It is considered that this will increase business opportunities for the Company, which handles these parts.

(3) The medium- to long-term direction

It is unclear whether the Company has positioned the automotive business as the second business pillar after the business for factory automation and industrial equipment, or alternatively, whether the large-scale demand, of the demand relating to driving-assist systems, is a temporary phenomenon that it will capture only at the present time. Or in other words, we do not know if the Company's stance for the automotive business is proactive or passive.

Centered on the automotive industry, it is said that “vehicles are being electrified” alongside the appearance of EV (electric vehicles), while memories are still fresh of the many new entrants other than from the traditional automotive industry. Currently, CASE (acronym of Connected, Autonomous, Shared & Services, Electric) has become a keyword in the strategic direction being taken by the automotive industry. The current expansion of the Company’s automotive business is also a part of this development, and at FISCO, we estimate that its stance for the automotive business is naturally a proactive one. But on the other hand, it has not indicated any clear strategy for business expansion in the medium- to long-term, such as launching the next product to follow-on from the demand from driving-assist systems. This does not mean that the Company is taking a passive stance, but instead it is highly likely that it is progressing business talks below the surface (as was the case with the projects for driving-assist systems) toward launching the next business. Up to the present time, at FISCO, we have frequently conducted analysis on the Company and taken approaches by looking at how its capital investment is trending, and going forward, we think it will be necessary for it to be analyzed from the automotive angle as well.

Outlook

While results seemed to have hit bottom in FY3/20 1H, the outlook is for their fully-fledged recovery from FY3/21 onwards

For the FY3/20 full year, the Company is forecasting ¥140,000mn in net sales (-3.7% YoY), ¥1,600mn in operating income (-53.1%), ¥1,900mn in ordinary income (-47.6%), and ¥1,400mn in net income attributable to owners of the parent (-46.7%).

The Company significantly made downward revision to the full fiscal year results forecasts when it announced the 1Q results in July 2019, and it again revised the full fiscal year forecasts, based on the results up to that time, when it announced the 2Q results. Comparing the most recent forecasts of October 2019 to the July 2019 forecasts, the net sales forecast is unchanged, but the forecasts for respective income items including operating income have been upwardly revised.

Overview of the FY3/20 forecasts

(¥mn)

	FY3/19			FY3/20						
					2H			Full year		
	1H	2H	Full year	1H	Initial forecast	July forecast	October forecast	Initial forecast	July forecast	October forecast
Net sales	72,164	73,246	145,410	67,608	76,000	76,000	72,392	150,000	140,000	140,000
Operating income	2,129	1,281	3,410	909	1,600	900	691	3,100	1,200	1,600
Operating margin	3.0%	1.7%	2.3%	1.3%	2.1%	1.2%	1.0%	2.1%	0.9%	1.1%
Ordinary income	2,312	1,315	3,627	1,036	1,700	1,000	864	3,300	1,400	1,900
Net income attributable to owners of the parent	1,651	977	2,628	689	1,250	650	711	2,400	1,000	1,400

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

To be honest, it is quite difficult to evaluate the Company's full fiscal year forecasts. After it announced the initial forecasts, it revised the full fiscal year forecasts at the end of July 2019 (when it announced the 1Q results) and then again at the end of October 2019 (when it announced the 2Q results). As a result, the 2H operating income forecast has been downwardly revised from the July forecast of ¥900mn to the October forecast of ¥691mn. On this point, it seems that for the 2H forecasts, the October 2019 forecasts are more accurate than the July 2019 forecasts.

Although the Company's explanation itself is persuasive to a certain extent, there is a feeling of puzzlement about the consistency of the operating income forecast with the net sales forecast, which is that net sales in the 2H will exceed net sales in the 1H. On this point, it is considered that there are a number of profit-decrease factors in the 2H, such as the incorporation of costs that were not in the 1H and a lower profit margin due to the deterioration of the product mix. So rather than one factor, it seems that there are a number of overlapping factors that led to the forecast that operating income will decrease in the 2H compared to in the 1H, which is the opposite to the net sales forecast.

Conversely, some positive signs are starting to appear for FY3/21 and beyond. As already stated, the Company's mainstay businesses are targeting the factory automation and industrial equipment industries. For the distribution channels, it is focusing on delivering parts to industrial equipment manufacturers (set manufacturers). As was previously explained, set manufacturers exist between the Company and the final customers, which means that the Company's earnings tend to fluctuate up and down more than actual demand for capital investment.

Changes are appearing on this point at the present time. As stated above, in the 1H, set manufacturers conducted in-house inventory adjustments, which caused the number of orders to the Company for parts to decrease. As a result, in the Company's results, the extents of the declines in sales and profits were higher than the actual change in demand. But since then, the set manufacturers have completed the inventory adjustments, and while the level has not yet returned to that during the previous economic boom period, the situation seems to be that the Company is receiving orders reflecting the trend in actual demand.

It is unclear to what extent the Company has incorporated this completion of inventory adjustments by the set manufacturers into the results forecasts. At FISCO, we believe it is reasonable to assume that it has incorporated it into the part that "the October 2019 forecasts are highly accurate compared to the July 2019 forecasts." Therefore, we think it would be excessive to expect that the 2H results will exceed the Company's current forecasts.

However, on entering FY3/21, although it will depend on the situation at that time, such as the state of the US-China trade friction, it is considered that actual demand for capital investment will further strengthen and that this will be reflected in the production activities of set manufacturers. At this time, at FISCO we think it is possible that orders to the Company for parts will be above the actual demand trend, as has been seen in the past. While there is also the aspect that Chinese companies are catching up, it is thought that the Company intends to establish a system able to respond immediately to demand from Japanese set manufacturers. In this case, we consider it highly likely that a behavior will repeat itself among customers, of pushing forward orders for parts to facilitate deliveries of products on the shortest delivery times. This can be expected to have a significantly positive effect on the Company's results.

At FISCO, we think that 2H FY3/20 is a period to ascertain whether or not the "signs" of a results recovery are leading to a "genuine" recovery "in FY3/21, and also, on entering this recovery phase, to solidify foundations that will lead to the Company's earnings growth through steadily capturing demand. If speaking on what is specifically meant by "solidifying foundations," it means nothing more than steadily implementing the fundamental polices and priority measures set out in the new medium-term management plan. As stated above, the Company has made steady progress for the most part up to 2Q, but we believe that whether the Company will be able to maintain this progress in the 2H is a more important point for evaluation than focusing on the numerical value of performance results.

Summary income statement

(¥mn)

	FY3/16	FY3/17	FY3/18	FY3/19	FY3/20	
					1H	Full year E
Net sales	105,748	116,611	146,759	145,410	67,608	140,000
YoY	-5.0%	10.3%	25.9%	-0.9%	-6.3%	-3.7%
Gross profit	13,256	14,255	16,883	16,318	6,984	-
Gross margin	12.5%	12.2%	11.5%	11.2%	10.3%	-
SG&A expenses	10,812	11,240	12,747	12,908	6,075	-
YoY	2.8%	4.0%	13.4%	1.3%	-6.2%	-
SG&A expenses ratio	10.2%	9.6%	8.7%	8.9%	9.0%	-
Operating income	2,444	3,014	4,135	3,410	909	1,600
YoY	-29.6%	23.3%	37.2%	-17.5%	-57.3%	-53.1%
Operating margin	2.3%	2.6%	2.8%	2.3%	1.3%	1.1%
Ordinary income	2,645	3,215	4,349	3,627	1,036	1,900
YoY	-29.7%	21.6%	35.3%	-16.6%	-55.2%	-47.6%
Net income attributable to owners of the parent	1,690	1,584	3,085	2,628	689	1,400
YoY	-31.5%	-6.3%	94.8%	-14.8%	-58.3%	-46.7%
EPS (¥)	117.76	113.64	222.65	164.08	42.97	87.27
Dividend (¥)	28.00	28.00	30.00	34.00	17.00	34.00

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

Summary balance sheet

(¥mn)

	End of FY3/16	End of FY3/17	End of FY3/18	End of FY3/19	End of 1H FY3/20
Current assets	46,857	55,507	65,852	64,209	61,840
Cash and deposits	6,359	6,759	8,596	10,005	12,768
Notes and accounts receivable	34,554	41,168	46,077	42,256	37,807
Non-current assets	8,581	9,309	11,401	9,905	10,195
Property, plant and equipment	3,788	3,056	3,005	2,861	2,799
Intangible assets	240	222	168	143	149
Investments and other assets	4,553	6,030	8,227	6,900	7,247
Total assets	55,439	64,816	77,254	74,114	72,036
Current liabilities	28,691	36,596	43,077	37,199	34,617
Notes and accounts payable - trade	24,732	31,182	34,298	31,427	28,015
Short-term loans payable, etc.	2,317	2,489	5,722	3,805	3,803
Non-current liabilities	4,484	4,581	6,182	4,970	5,033
Long-term loans payable	2,400	2,300	3,500	2,900	2,900
Shareholders' equity	20,217	21,034	23,731	29,056	29,473
Capital stock	2,553	2,553	2,553	3,727	3,727
Capital surplus	1,958	1,958	1,958	3,548	3,548
Retained earnings	15,761	16,950	19,647	21,781	22,198
Treasury shares	-54	-427	-428	-	-
Total accumulated other comprehensive income	2,045	2,603	4,262	2,888	2,912
Net assets	22,263	23,637	27,993	31,944	32,385
Total liabilities and net assets	55,439	64,816	77,254	74,114	72,036

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

Cash flow statement

(¥mn)

	FY3/16	FY3/17	FY3/18	FY3/19	1H FY3/20
Cash flow from operating activities	-60	1,679	-2,221	1,636	3,251
Cash flow from investing activities	-384	-235	29	-153	-74
Cash flow from financing activities	-654	-818	3,962	28	-308
Effect of exchange rate change on cash and cash equivalents	-125	-224	66	-103	-103
Net increase (decrease) in cash and cash equivalents	-1,225	400	1,837	1,408	2,763
Cash and cash equivalents at beginning of period	7,100	5,875	6,275	8,112	9,521
Cash and cash equivalents at end of period	5,875	6,275	8,112	9,521	12,284

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

Shareholder return policy

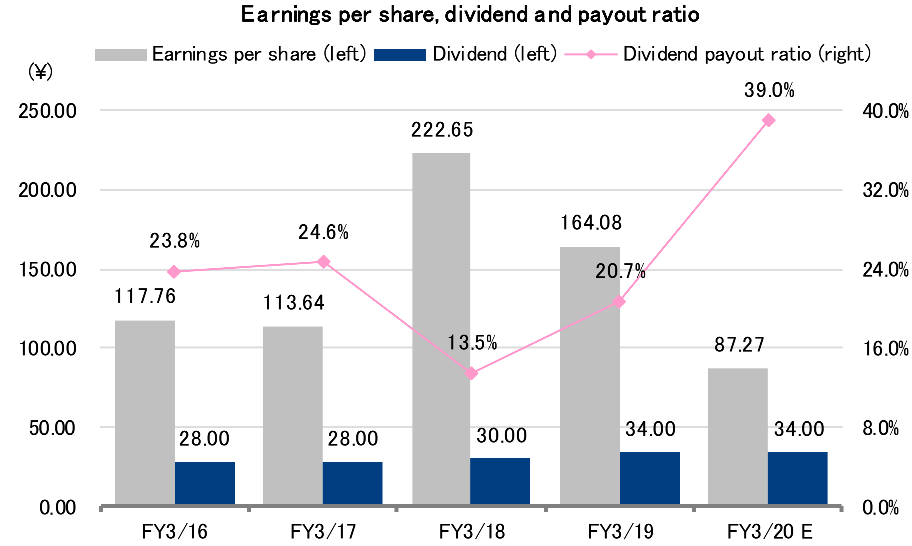
The FY3/20 dividend forecast is unchanged YoY at ¥34

The Company's basic policy is to provide returns to shareholders in the form of dividends. Management prioritizes providing stable, continuous dividends, as demonstrated in its track record to date. While the Company does not sharply raise dividends in response to temporary rapid profit expansion, it has steadily increased them in keeping with earnings growth.

In FY3/19, the Company increased the dividend by ¥4 YoY to ¥34 (interim dividend of ¥17 and a period-end dividend of ¥17), for a dividend payout ratio of 20.7%. Based on this, for FY3/20 it initially announced a dividend forecast of ¥34 (an interim dividend of ¥17 and a period-end dividend of ¥17), which is unchanged YoY. As explained above, subsequently it downwardly revised the FY3/20 results forecast, but it maintained the initial dividend forecast unchanged at ¥34. In the most recent forecasts, the forecast earnings per share (EPS) is ¥87.27, which means the forecast dividend payout ratio is 39.0%.

We think that the Company decided to maintain the forecast of a YoY unchanged dividend because of its stance of prioritizing dividend stability, despite the fact the profits are expected to decline. The forecast dividend payout ratio is higher than previously, but on considering factors such as that it is still below 40% and the appearance of signs that results have bottomed-out, at FISCO, we consider this decision to be a sufficiently reasonable one.

Shareholder return policy



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

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