COMPANY RESEARCH AND ANALYSIS REPORT

TOKAI Holdings Corporation

3167

Tokyo Stock Exchange First Section

13-Jul.-2017

FISCO Ltd. Analyst

Yuzuru Sato

FISCO Ltd.

http://www.fisco.co.jp

Index

Summary

Announces New Medium-Term Management Plan "Innovation Plan 2020 'JUMP'" Aimed at Changing Management Stance and Jumping Forward

Based in Shizuoka Prefecture, Japan, TOKAI Holdings Corporation <3167> (hereinafter, Tokai Holdings and the Company) is expanding its two main businesses, "energy and lifestyle-related services", primarily the provision of liquefied petroleum gas (LPG), and "information and communications services". Aiming to become a "Total Life Concierge*" (TLC), a company offering a complete range of services for everyday life, in its Medium-Term Management Plan "Innovation Plan 2020 'JUMP'", TOKAI Holdings Corporation targets sales of ¥339.3bn, an increase of 1.9x from FY3/17, operating profit of ¥22.5bn, an increase of 1.8x. The Company intends to employ a strategy using M&A and alliances to reach these targets.

* The Total Life Concierge concept: it indicates the Company's aim to provide every type of lifestyle support service under a one contract, one stop, and one call center model, and while deepening its connection with customers, their local communities, society, and the global environment, to be a company that enriches people's lives, assists in the development of local communities, and contributes to protecting the global environment.

1. Record profit at all levels in FY3/17

The company posted record-high profit at all levels of consolidated results in FY3/17 as net sales declined 1.3% YoY to ¥178.631bn, but operating profit rose 54.6% to ¥12.75bn, recurring profit rose 56.7% to ¥12.775bn, and net income attributable to owners of the parent was up 112.1% to ¥7.337bn. Hikari Collaboration* services and the Aqua business showed marked improvement in earnings and contributed to these strong results. In addition, the company's financial position improved as the end-FY3/17 equity ratio rose to 34.5% from 25.6% as of end-FY3/16 owing to a reduction in interest-bearing debt. The number of group wide customers rose by only roughly 6,000 YoY to 2.564 million, falling short of the company's target, but the gas, CATV, and Aqua businesses expanded their customer bases.

* In February 2015, the Company began selling the @ T COM Hikari service and the TNC Hikari service, which bundle the Company's ISP service with NTT's fiber-optic cables for these services.

2. Medium-term management plan calls for aggressive M&A, switch to proactive management stance

In the six-year period ending with FY3/17, Tokai Holdings focused on improving its financial position and strengthening its earnings potential and was able to surpass its initial targets. As a result, the Company is now moving forward with plans to switch to a proactive management stance under its new medium-term management plan, starting from FY3/18. Over the next four years, the Company plans to make ¥100bn in strategic investments to expand the earnings bases (number of customers) in its mainstay businesses (Gas, CATV, and Information and Communications). The Company also plans to acquire new businesses to integrate with the Group such as monthly-fee-based, life services to increase cross-selling. Currently, the percentage of customers using multiple Group services is only 7% and the Company aims to raise this to 20% over the next four years, thereby boosting sales per customer and further increasing earnings. With the liberalization of retail city gas sales and the need for CATV operators to invest to convert to fiber optics owing to the expected spread of 4K and 8K UHD broadcasting, medium- and small-scale operators without the financial resources for this investment are expected to be absorbed into the larger operators. Tokai Holdings sees this as an excellent opportunity to expand its businesses and hopes to aggressively pursue M&A in these businesses.

3. Expects temporary decline in profit in FY3/18 on upfront investment in business expansion

In FY3/18, the Company expects profit to decline, targeting net sales of ¥189.4bn (up 6.0% YoY) and operating profit of ¥11.41bn (down 10.5%). This is because the Company plans aggressive investments to expand the area covered by its Gas business, introduce new services in its Information and Communications business, and introduce measures to prevent service contract cancellations. The Company expects profit to resume its uptrend starting in FY3/19.

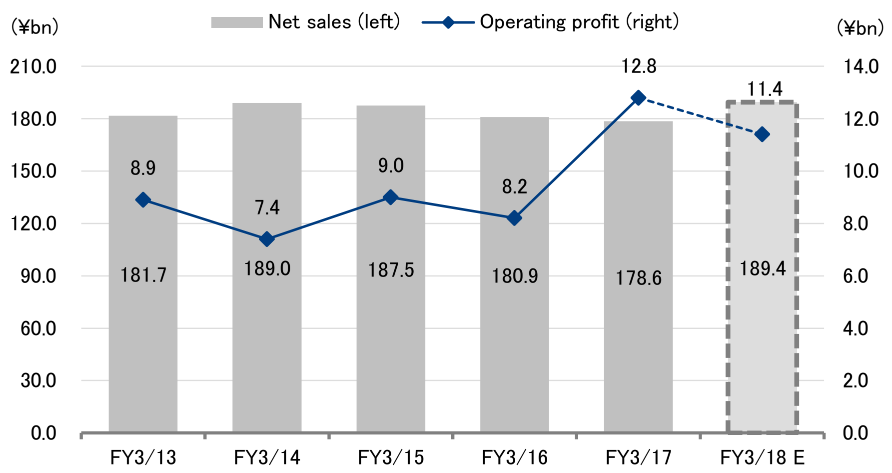
4. Continues to actively return profits to shareholders

The Company has no plan to change its policy of making stable, ongoing dividend distributions. The Company plans FY3/18 dividend distributions of ¥28 per share (unchanged from last year's distributions which included a ¥6 per share commemorative dividend), but has commented that it will consider a dividend hike in FY3/19 if net income attributable to owners of the parent rises. The Company will also continue to present Aqua products, a QUO card or ¥1,000 worth of TLC Membership Service points to shareholders at the end of September and March. When including the gifts to shareholders in an estimate of the total investment yield per share from the current share price level (¥812 on May 12), it is in the range of 4% to 8% (depending on the selection of either a QUO card or an Aqua product as the gift).

Key Points

- Focuses on energy and lifestyle-related services, primarily the provision of LP gas, and information and communications services
- Strong profit growth achieved n FY3/17 on improved earnings from Hikari Collaboration service and the Aqua business
- Targeting strong growth with strategic investment of ¥100bn over four-year period

Result tends



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

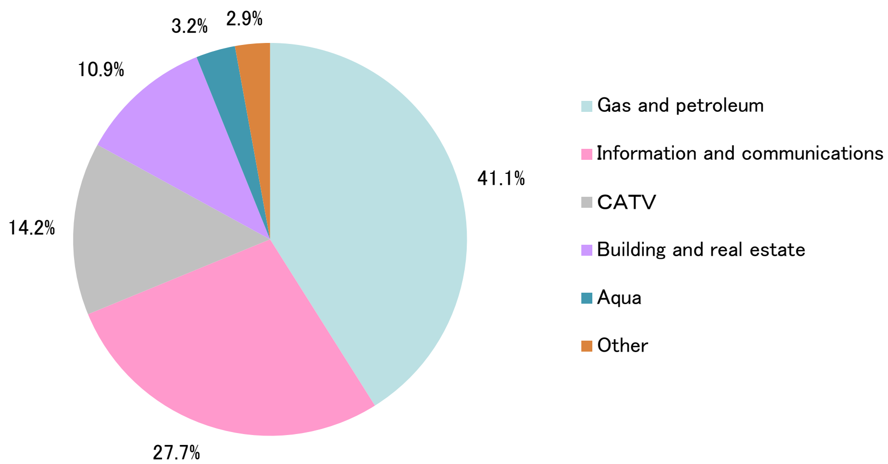
Business overview

Focuses on energy and lifestyle-related services, primarily the provision of LP gas, and information and communications services

Based in Shizuoka Prefecture, Japan, the Company is expanding its two main businesses, "energy and lifestyle-related services," primarily the provision of liquefied petroleum (LP), and "information and communications services," and it is aiming to achieve its management vision of being a "Total Life Concierge" (TLC). It provides a complete range of one-stop services for everyday life and while deepening its connections with its customers, their local communities, society, and the global environment, and it is striving to enrich people's lives and to contribute to the development of local communities and to the conservation of the global environment, and also to a grow as a comprehensive provider of life services that represents Japan.

The Company currently discloses information on six business segments; the gas and petroleum business, the information and communications services business, the CATV business, the building and real estate business, the Aqua business, and other businesses. Looking at the sales structure by segment in FY3/17, the Company's original business, the Gas and Petroleum segment accounted for 41.1% of sales, the Information and Communications for 27.7%, and CATV for 14.2%. These three mainstay businesses accounted for over 80% of sales. The details by business segment are as follows.

Sales structure by segment (FY3/17)



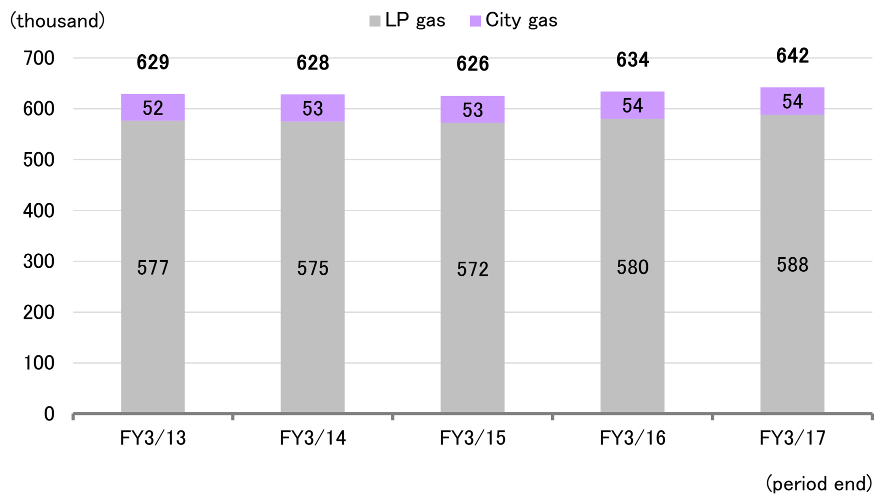
Source: Prepared by FISCO from the Company's financial results

1. Gas and Petroleum

In this business, approximately 90% of net sales are provided by the LP gas business and around 10% by the city gas business. The mainstay LP gas business is developed by TOKAI Corporation, primarily for homes and businesses. The service areas are mainly in the Shizuoka and Kanto regions, but since 2015 it has also sequentially expanded into the south Tohoku, Chubu, and Tokai areas and has been focusing on increasing customer numbers. As of the end of March 2017, it had 588,000 contracts, and in direct sales, it ranked third after Iwatani Corporation <8088> and Nippon Gas <8174>. In terms of market share, it is the leader in Shizuoka, its home territory, with around 22%, while it has an approximately 6% share of the highly competitive Kanto region. As there are approximately 20 million households nationwide that use LP gas, its nationwide market share is slightly less than 3%, and going forward there remains room for it to grow its share, including by expanding sales areas and conducting M&A.

Conversely, in the city gas business, TOKAI GAS CORPORATION supplies city gas in Yaizu City, Fujieda City, and Shimada City in Shizuoka Prefecture. As the service area is limited, the number of contracts, which was 54,000 at the end of March 2017, remains basically constant. Currently, there are 203 city gas business operators nationwide, but with the exception of the four largest companies, most are small- to medium-sized operators with limited service areas. Following the liberalization of the retail city gas market in April 2017, the Company plans to expand its customer base by aggressively pursuing M&A deals.

Trends in customer numbers in the gas business



Source: Prepared by FISCO from Company materials

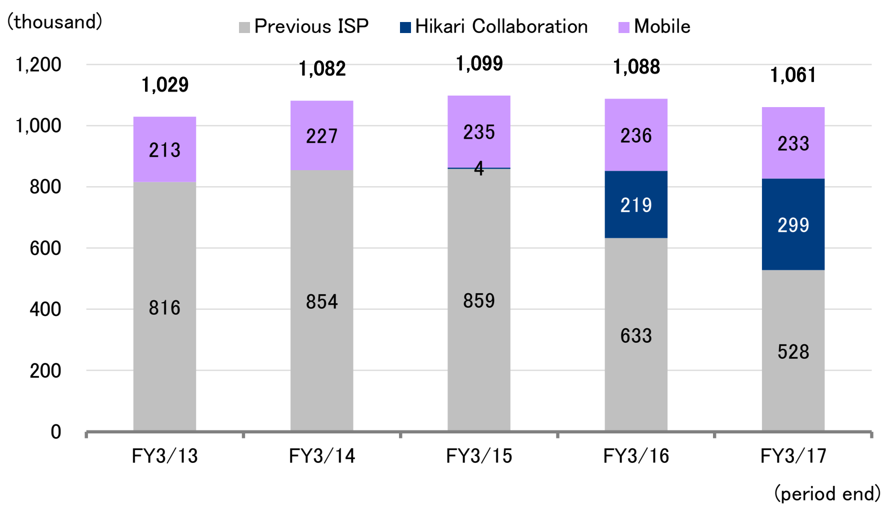
2. Information and Communications Service

This business is developed by TOKAI Communications Corporation, and in addition to an ISP (Internet service provider) business, it includes a mobile business (sales of mobile phones), corporate communication services, and a systems development business, as well as other operations. Looking at the percentages of net sales in FY3/17, the ISP business and corporate communication services, and the systems development business, each provided slightly more than 40%, with the remainder being provided by the mobile business.

The ISP business provides the "@ T COM" service for the nationwide area and the TOKAI Network Club (TNC) service for the Shizuoka Prefecture area, and it has the leading share within Shizuoka Prefecture of approximately 23%. In addition, from 2015 it launched the @TCOM Hikari and TNC Hikari services, in which it is receive wholesale provision of optical lines from NTT <9432> and provides its own optical (hikari) Internet connection service. As of end-FY3/17, the Company had 528,000 customers using its previous ISP model service and 299,000 customers using its Hikari Collaboration service and customers are shifting toward Hikari Collaboration. The two services have a total of 827,000 customers. This number has declined for two consecutive years because the Hikari Collaboration service is facing more competition as mobile phone operators have entered the market, making use of NTT's wholesale optical line business.

The mobile business operates mobile phone stores, mainly within Shizuoka Prefecture, as a sales agency of SoftBank Mobile, and as of the end of March 2017, it had 233,000 customers. In addition, the Company is expanding its portfolio of telecommunications services in 2014 it launched sales of inexpensive SIM cards as an MVNO (mobile virtual network operator), while it also began sales of inexpensive smartphones (LIBMO) in February 2017.

Information and communications services business customer numbers



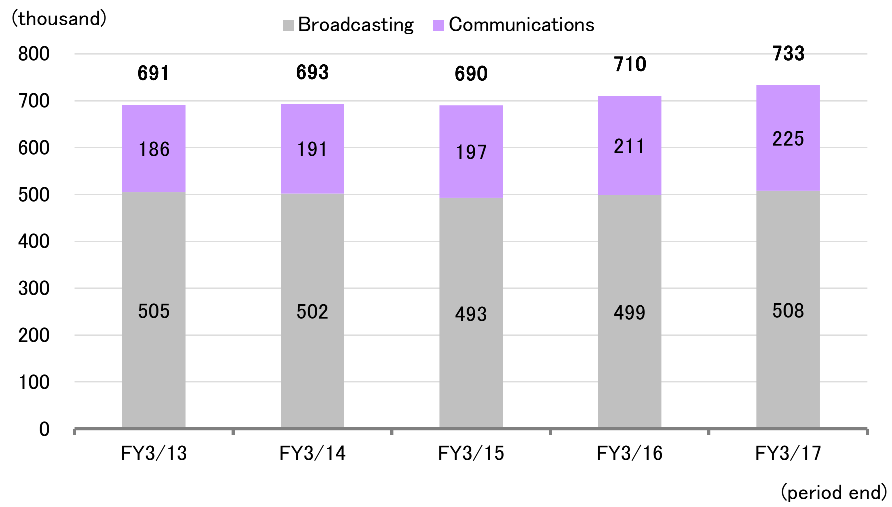
Source: Prepared by FISCO from Company materials

3. CATV

In the CATV business, seven Group companies provide broadcasting and communication services (Internet connection services) in five prefectures; Shizuoka Prefecture, Kanagawa Prefecture, Chiba Prefecture, Nagano Prefecture, and Okayama Prefecture. The number of customers is rising smoothly and, as of end-FY3/17, the Company had 508,000 for its broadcasting services business and 225,000 customers for its communication services business. In terms of sales, it is the third largest city CATV provider (sixth largest in terms of customer numbers). Roughly 30 million households subscribe to CATV in Japan and there are approximately 500 CATV broadcasters (of which, 318 also provide Internet connection services.

With the competitive environment in the CATV industry becoming more severe as major communication carriers have begun providing broadcasting services using optical communication lines, operators will need to invest to convert to fiber optics owing to the expected spread of 4K and 8K high-definition broadcasting. A sizable 71% of the area where the Company operates has optical line coverage and medium- and small-scale operators without the financial resources for this investment are expected to be absorbed into the corporate groups of the larger operators. In March 2017, the Company acquired 25.8% of the shares of Tokyo Bay Network, converting it into an equity-method affiliate. Tokyo Bay Network has approximately 250,000 subscribers (ninth largest in the industry) and we expect to see more M&A activity like this in the future.

Trends in customer numbers for CATV services



Source: Prepared by FISCO from Company materials

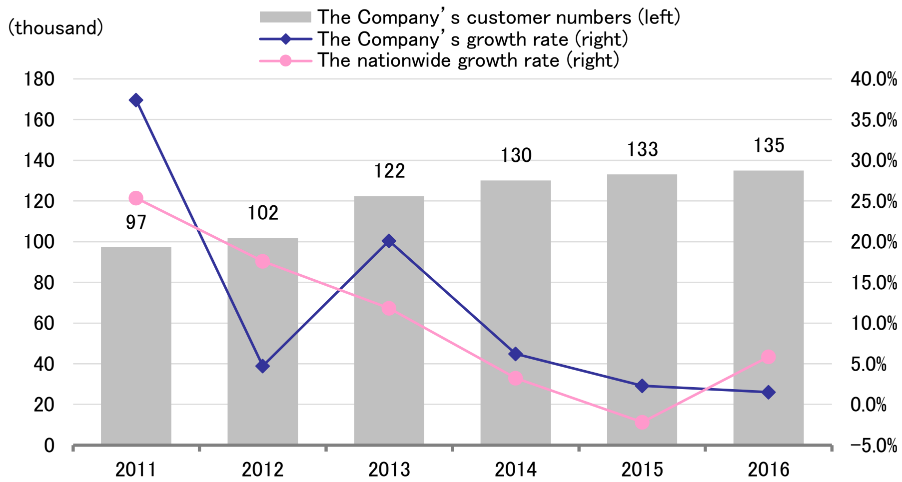
4. Building and Real Estate

In this business, TOKAI Corporation engages in the construction and design of detached housing, multi-dwelling housing, stores, and office buildings. It also provides a building management service, sells home facilities and equipment, provides a security service (classified in the gas and petroleum business), operates insurance agencies (classified in other businesses), and develops and trades real estate. In addition, TOKAI Corporation and Tokai Gas Corporation are developing a renovation business.

5. Aqua

This business began in 2007 when the Company launched a bottled water home delivery service in Shizuoka Prefecture. It provides a returnable bottle service in Shizuoka Prefecture, while in 2011 it also launched a one-way (non-returnable, disposable) bottle service in areas other than Shizuoka Prefecture, and customer numbers have increased. It bottles Mt. Fuji natural spring water at its own factories, and it has two factories within Shizuoka Prefecture that have a total production capacity of approximately 170,000 customers. Although the bottled water home delivery market as a whole is mature, in the last one or two years customer numbers have still been increasing at a moderate pace, and the Company had 135,000 customers at the end of March 2017. The overall industry had 350,000 customers in 2016, giving the Company a share at a level just below 4%.

Trends in customer numbers in the Aqua business and the industry growth rate



Note: The nationwide growth rate is from a survey by the Japan Delivery Water & Server Association
Source: Prepared by FISCO from Company materials

6. Others

Other businesses include a nursing care business operated by TOKAI LIFE PLUS CORPORATION, a wedding ceremony business by TOKAI City Service Corporation, and a shipbuilding and repairs business by Tokaizosen-unyu Corporation.

The Company launched the nursing care business in 2011 and at the end of March 2017, it operated a total of seven facilities within Shizuoka Prefecture, of day care facilities, short-stay facilities, and paid-for nursing homes. It also operated 2 facilities in Shizuoka Prefecture in the wedding ceremony business, although it closed 1 facility in March 2017 and now operates only 1.

Results trends

Strong profit growth achieved in FY3/17 on improved earnings from Hikari Collaboration service and the Aqua business

1. Overview of the FY3/17 results

On May 9, 2017, the Company announced FY3/17 results, posting net sales of ¥178,631mn (down 1.3% YoY), operating profit of ¥12,750mn (up 54.6%), recurring profit of ¥12,775mn (up 56.7%) and net income attributable to owners of the parent of ¥7,337mn (up 112.1%). Sales declined slightly, but profit reached record highs and surpassed the Company's forecasts at all levels.

FY3/17 consolidated results

(¥mn)

	FY3/16	FY3/17				
	Results	Company forecast	Results	YoY change	YoY change	Versus Company forecast
Net sales	180,940	179,700	178,631	-2,309	-1.3%	-0.6%
Operating profit	8,245	12,750	12,750	4,504	54.6%	0.0%
(Hikari Collaboration)	-3,007	-442	-67	2,940	-	-
(Aqua)	-1,119	301	298	1,417	-	-1.1%
Recurring profit	8,150	12,360	12,775	4,625	56.7%	3.4%
Net income attributable to owners of the parent	3,458	6,500	7,337	3,878	112.1%	12.9%

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

The main reason for the decrease in net sales was the impact of the reduction in sales prices in the gas and petroleum business, which reduced net sales by approximately ¥6.5bn. Conversely, the higher profits were due to the improvement in earnings in the Hikari Collaboration and Aqua businesses, which caused profits to rise by approximately ¥4.3bn. In addition, the amortization of goodwill declined about ¥800mn, which also contributed to the higher profits.

The number of customers for the Group as a whole at the end of March 2017 was 2,564,000, which was up by 6,000 on the end of the previous fiscal year. Looking at customer numbers for each of the main services, in the gas business they increased by 8,000, in the CATV business they rose by 23,000, and in the Aqua business they climbed by 2,000. The total number of fixed-line and wireless services customers (excluding mobile customers) in the Information and Communications business declined by 24,000 (the mobile business also declined by 2,000). This was because, while the total number of Hikari Collaboration customers increased by 79,000, this was more than offset by an even higher number of subscription cancellations for the previous ISP model, etc. The Company had forecast a companywide total of 2.575mn customers as of end-FY3/17, but fell slightly short of this mark because the number of customers in the Gas, Information and Communications, and Aqua businesses was lower than expected. The number of members in the TLC Membership Service, launched by the Company in December 2012 as a means to retain customers and increase the ratio of customers with multiple service contracts, rose to 586,000 (up 94,000 YoY).

Customer numbers by service

(thousand)

	End of FY3/13	End of FY3/14	End of FY3/15	End of FY3/16	End of FY3/17	Change
Gas (LP gas, city gas)	629	628	626	634	642	8
Information and communications (fixed and wireless)	816	854	864	852	827	-25
Hikari Collaboration			4	219	299	79
Information and communications (mobile)	213	227	235	236	233	-2
CATV	691	693	690	710	733	23
Aqua	102	122	130	133	135	2
Security	19	19	18	18	17	-1
Total	2,445	2,519	2,537	2,558	2,564	6
(Number of TLC members)	105	306	396	491	586	94

* The number of customers below a thousand is rounded to the nearest thousand. Information and Communications and CATV both offer communications services, so total figures avoid duplication.
Source: Prepared by FISCO from Company materials

2. Trends by business segment

Results by segment

(¥mn)

	Net sales			Operating profit		
	FY3/16	FY3/17	Growth rate	FY3/16	FY3/17	Growth rate
Gas and petroleum	80,745	73,344	-9.2%	8,991	9,161	1.9%
Information and communications services	44,246	49,508	11.9%	2,308	4,213	82.6%
CATV	24,608	25,396	3.2%	1,975	2,752	39.3%
Building and real estate	20,975	19,511	-7.0%	1,266	1,098	-13.3%
Aqua	5,487	5,762	5.0%	-1,119	298	-
Other businesses and adjustments	4,875	5,108	4.8%	-5,177	-4,774	-
Total	180,940	178,631	-1.3%	8,245	12,750	54.6%

* Operating profit is prior to the allocation of indirect costs and other costs
Source: Prepared by FISCO from the Company's results briefing materials

(1) Gas and petroleum business

In this business, net sales decreased 9.2% YoY to ¥73,344mn, but operating profit increased 1.9% to ¥9,161mn. Despite the decrease in sales of approximately ¥6.5bn from the impact in the reduction in the sales price due to the lowering of raw materials prices implemented in the previous fiscal period, the effect from the reduction in purchase prices was greater and as a result, an increase in profits was secured.

In the mainstay LP gas business, the number of customers as of end-March 2017 had steadily risen, by 8,000 YoY, to 588,000. The main reasons for this were the progress made in acquiring customers in the areas newly entered into in FY3/16, of the south Tohoku area and one part of Aichi Prefecture (Toyokawa City) and expansion of the Company's area of operations in FY3/17 including in Gifu Prefecture and the Nishimikawa area of Aichi Prefecture. The total number of customers in these new areas was approximately 8,000 as of end-March 2017. Sales volume remained flat YoY as sales volume per customer declined slightly. The number of customers in the city gas business was basically unchanged YoY at 54,000, but sales declined due to the impact of the reduction in the sales price.

(2) Information and communications services business

Information and Communications Services business sales increased 11.9% YoY to ¥49,508mn, while operating profit grew significantly, up 82.6% to ¥4,213mn. The number of customers in the broadband business declined 37,000 YoY to 765,000, but as a result of the progress made in the shift from the previous ISP service to the Hikari Collaboration, monthly net sales per customer rose (previous ISP service: approximately ¥1,200 per month, Hikari Collaboration: approximately ¥5,100 per month), which accounted for the majority of the higher sales. In terms of profits also, growth in customer numbers and lower customer acquisition costs for Hikari Collaboration boosted profit by ¥2,940mn YoY.

Conversely, in corporate data communication services and system development, both net sales and operating profit increased slightly YoY.

(3) CATV business

CATV business sales increased 3.2% YoY to ¥25,396mn, and operating profit rose 39.3% to ¥2,752mn. The number of customers at end FY3/17 had increased by 9,000 YoY in the broadcasting service to 508,000 and by 15,000 in the communications service to 225,000 with smooth increases in both services. The Company is making progress in acquiring new customers by continuing to provide discount smartphone sets through collaborations with major mobile carriers and strengthening bulk sales to housing complexes. Customer contract numbers have risen thanks to the sale of discount sets including broadcasting and communication services and efforts to prevent contract cancellations by strengthening customer support. The segment's profit ratio improved by 2.8 percentage points YoY on growth in sales combined with a ¥614mn YoY decrease in amortization of goodwill and depreciation costs.

(4) Building and real estate business

Building and real estate business sales decreased 7.0% YoY to ¥19,511mn and operating profit decreased 13.3% to ¥1,098mn. This was the only segment in the Company posting declines in sales and profit in FY3/17. The declines were due to declines in home sales and of solar power generation equipment in the renovation business. However, sales in the reception desk business (building management support) rose on an increase in the number of properties managed.

(5) Aqua business

Aqua business sales increased 5.0% YoY to ¥5,762mn and the segment entered the black at the operating level for the first time, posting operating profit of ¥298mn (¥1,119mn operating loss in FY3/16). Sales rose as the number of customers increased by 2,000 YoY as of end-FY3/17. Profit rose on a reduction in customer-acquisition costs and advertising costs and the shift to a more efficient marketing strategy (focusing on cost efficiency).

(6) Other businesses and adjustments

In other businesses and adjustments, sales rose 4.8% YoY to ¥5,108mn. Sales in the nursing care business increased due to the rise in user numbers and sales also increased in the shipbuilding and repair business on a rise in the volume of ship repair work. On the other hand, sales in the wedding ceremony business remained at basically the same level YoY. Including internal adjustments, the segment posted an operating loss of ¥4,774mn, a YoY improvement of ¥403mn (¥5,177mn loss in FY3/16).

Continued improvement in financial position and progress in strengthening earnings potential

3. Financial position and management indicators

As of end-FY3/17, total assets were up ¥808mn YoY to ¥162,112mn. Main factors behind the change included a ¥476mn increase in current assets to ¥38,594mn, with a ¥838mn decrease in cash and deposits, a ¥553mn decrease in inventory, and a ¥1,532mn increase in trade receivables. Fixed assets increased by ¥342mn to ¥122,496mn. Tangible fixed assets declined by ¥1,417mn due to progress on depreciation of assets, goodwill declined by ¥727mn, and investment securities rose by ¥2,196mn owing to an increase in the price of shares held.

Total liabilities were down ¥13,666mn YoY as of end-FY3/17 to ¥104,665mn. The main factor behind this change was a ¥17,273mn decline in interest-bearing debt on progress in the conversion of zero-coupon convertible bonds (¥7,200mn negative impact) and progress made in the repayment of debts. Net assets were up ¥14,475mn to ¥56,446mn. Dividend distributions had a negative impact of ¥2,158mn, but this was more than offset by positive impacts from the posting of ¥7,337mn in net income attributable to owners of the parent and ¥7.200mn from the conversion of zero-coupon convertible bonds.

As a result, the end-FY3/17 equity ratio rose by 8.9 percentage points YoY to 34.5% while the interest-bearing-debt-to-EBITDA ratio improved to 1.9x from 2.9x. ROE also improved by 6.9 percentage points to 15.2%. Since changing to a holding company structure in April 2011, the Company has worked to improve its financial position and increase its earnings potential. We believe these efforts are now bearing fruit. We note that end-FY3/11 interest-bearing debt was ¥124,036mn and the equity ratio was 7.7% and during the six-year period since then, interest-bearing debt was cut in half and the equity ratio more than quadrupled.

Consolidated balance sheet and management indicators

(¥mn)

	FY3/14	FY3/15	FY3/16	FY3/17	Change
Assets total	173,620	165,702	160,303	161,112	808
Liabilities total	135,291	122,234	118,332	104,665	-13,666
Net assets total	38,329	43,467	41,970	56,446	14,475
Balance of interest-bearing debt	85,843	73,114	71,410	54,137	-17,273
EBITDA (operating profit + depreciation costs)	24,965	26,233	24,980	28,392	3,411
Equity ratio	21.6%	25.7%	25.6%	34.5%	8.9pt
Interest-bearing debt/EBITDA ratio	3.4x	2.8x	2.9x	1.9x	
ROE	7.4%	9.9%	8.3%	15.2%	

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

Medium-term management plan “Innovation Plan 2020 ‘JUMP’”

Targeting strong growth with strategic investment of ¥100bn over four-year period

1. Basic policy of medium-term management plan

Tokai Holdings announced its new medium-term management plan Innovation Plan 2020 “JUMP,” starting in the fiscal year ending March 31, 2018. The basic strategy of the plan is to prioritize top-line growth and “switch from a defensive to a proactive management stance”. Over the four-year period covered by the Plan, the Company plans to aggressively pursue M&A and alliances in order to expand its customer base, making strategic investments totaling ¥100bn. In addition to this, the Company plans to make approximately ¥60bn in regular investments for a total of ¥160bn. Given that over the past four years, the Company made investments of roughly ¥50bn and did not make any M&A deals, this scale of investment would be a very aggressive step. However, owing to changes in the market environment, the Company expects to see more M&A activity and believes it will be able to invest ¥100bn in M&A and alliance deals.

The Company will target companies that have customer bases in its mainstay business areas (Gas, CATV, and Information and Communications). The Medium-term management plan also identifies increasing cross sales as an important mission and the Company will therefore pursue a strategy of developing its businesses by pursuing M&A and alliances with companies that have businesses compatible with its existing life services businesses. Base on this aggressive investment strategy, the Company aims to double sales and roughly double operating profit and net income attributable to owners of the parent over four years.

2. Targets for management indicators

Targets for topline growth are a 90% increase in sales to ¥339.3bn in FY03/21, an 80% increase in operating profit to ¥22.5bn, and 60% increase in net income attributable to owners of the parent income to ¥11.5bn. The Company also plans to increase customer numbers by at least 70% to over 4.32mn at end-FY03/21. In order to invest ¥100bn in M&A and alliances and make additional capital investments of ¥60bn, the Company plans to raise interest-bearing debt to ¥120bn, roughly 2.2x the end-FY3/17 level. The Company plans to consider multiple ways to finance this debt including zero-coupon convertible bonds. The Company will continue to pursue management focused on capital efficiency, targeting an interest-bearing debt/EBITDA ratio of 2.8x, an equity ratio of 31.6%, and ROE of 13%.

Regarding the investment of ¥100bn, the company will pursue M&A yielding ROI (Operating profit before goodwill amortization ÷ amount invested) of approximately 8%.

Financial targets in Innovation Plan 2020

(¥bn)

	FY3/17 results	FY3/18 targets	FY3/19 targets	FY3/20 targets	FY3/21	
					Targets	Vs. FY3/17
Net sales	178.6	189.4	202.0	224.4	339.3	1.9x
Operating profit	12.8	11.4	14.0	16.2	22.5	1.8x
Net income attributable to owners of the parent	7.3	6.4	7.9	8.7	11.5	1.6x
Total assets	161.1	169.8	173.8	191.2	283.4	1.8x
Interest-bearing debt/EBITDA ratio (x)	2.0	2.4	2.2	2.0	2.8	
Equity ratio (%)	34.5	33.9	35.6	34.9	31.6	
ROE (%)	15.2	11.1	12.8	13.0	13.0	
Number of customers (million contracts)	2.56	2.88	2.99	3.72	Over 4.32	1.7x

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

M&A investment and impact on earnings (by FY3/21)

(¥bn)

	Total planned M&A
Investment	100.0
Net sales	116.9
Operating profit before goodwill amortization	8.4
ROI (operating profit basis)	8.4%
Goodwill amortization	4.0

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

3. Main initiatives

(1) Establish section specializing in M&A

As a means to achieve its goals, the Company plans to establish a Group M&A Section specializing in aggressively pursuing M&A. This section will be responsible for screening and executing investments and moving ahead with business integrations following acquisitions. Responsibilities will include collaborating with M&A specialists to gather information and searching for future M&A targets by strengthening ties with venture capital firms and buyout funds.

We expect intensification of competition resulting from the liberalization of the city gas retail market and investments by CATV companies to prepare for 4K and 8K broadcasting to result in small- and medium-sized companies without sufficient operational capabilities to increasingly be absorbed into larger corporate groups. We think the coming four years will present Tokai Holdings, which is developing multiple life services businesses, with opportunities to expand its customer base and earnings through M&A.

The Company's strategy is to use M&A to combine its life services with new related products and services to achieve synergies through cross selling. Candidates for these new products and services include fields such as foods, sports, medical care, education and childcare, and next-generation agriculture. The Company plans to target venture companies that are using IT to efficiently build customer bases and companies that already have customer bases.

(2) Targeting 20% of customers with multiple service contracts

In FY3/17, only 7% of customers had multiple service contracts. In line with the Company’s TLC concept, raising this rate is an important management priority. Securing multiple contracts with the same customer not only discourages contract cancellations, it also bring down customer acquisition and maintenance costs, thereby improving margins. The Company aims to bring the ratio of customers with multiple service contracts to 20% during the period covered by the new Medium-term management plan.

In order to increase this ratio, the Company had already been offering “set discounts” to customers subscribing to multiple services and, from April 2017, it adopted a more active sales approach. For example, each business is given cross selling targets and incentives are offered for businesses that reach these targets, thereby increasing sales motivation. The Company plans to focus these efforts on highly compatible businesses. For example, owing to the high compatibility between the gas and CATV businesses, the Company will try to sell combined LP gas and CATV packages to newly built residential complexes. This is expected to increase the appeal of the Company’s services and make customer acquisition easier. Because there are no other LP gas companies in Japan providing multiple services, we see this as one of Tokai Holdings’ strengths.

The cross-selling rate in Shizuoka Prefecture is roughly 16%. Looking at the breakdown by service in Shizuoka Prefecture, the cross-selling rate among city gas and CATV users is the highest at roughly 30% each, followed by LP gas at over 20%. Therefore, it is thought that developing these services in areas outside of Shizuoka Prefecture will be effective in improving the cross-selling rate to 20%.

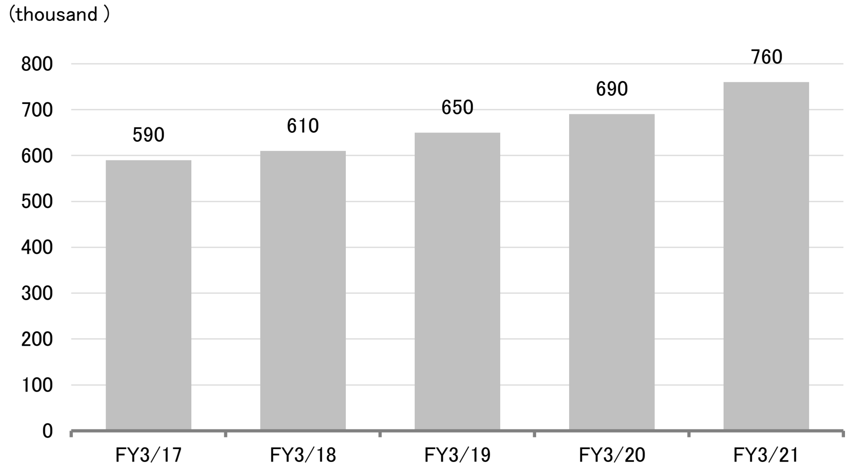
4. Major business initiatives

(1) LP gas business

The residential and commercial LP gas market is expected to shrink by roughly 7% over the next four years owing to population decline and more efficient energy-saving equipment. Small- and medium-sized operators are therefore expected to be pushed out or absorbed into larger corporate groups. This may present Tokai Holdings, the third largest company in the industry, with business opportunities.

In addition to developing businesses in areas where it already operates, starting in FY3/16, the Company began customer development in new geographical areas. Over the next four years, it plans to increase its numbers by 30% to 760,000. Of this increase, the Company plans to increase customer numbers in new areas nine fold, from 8,000 as of end-FY3/17 to 70,000. In addition to plans to expand into Mie Prefecture and Aichi Prefecture, (Aisai City), the Company is looking to expand its CATV business into Nagano Prefecture and Okayama Prefecture and its reception desk business into northern Kyushu. The Company is considering whether to expand in these areas by establishing its own sales offices or through M&A. Until it secures a certain number of customers in these new areas, it will delegate local partners to handle logistics.

Trends in LP gas customer numbers



Source: Prepared by FISCO from Company materials

(2) City gas business

The city gas retail market was liberalized in April 2017. Currently, competition with new market entrants is limited to large cities. Restructuring activity in the city gas market is currently relatively quiet compared with the situation that occurred in the electric power industry following liberalization. However, there are now 203 city gas business operators nationwide, but with the exception of the four largest companies, most are small- to medium-sized operators and, as the market gradually shrinks, we believe they may be absorbed in to the larger corporate groups.

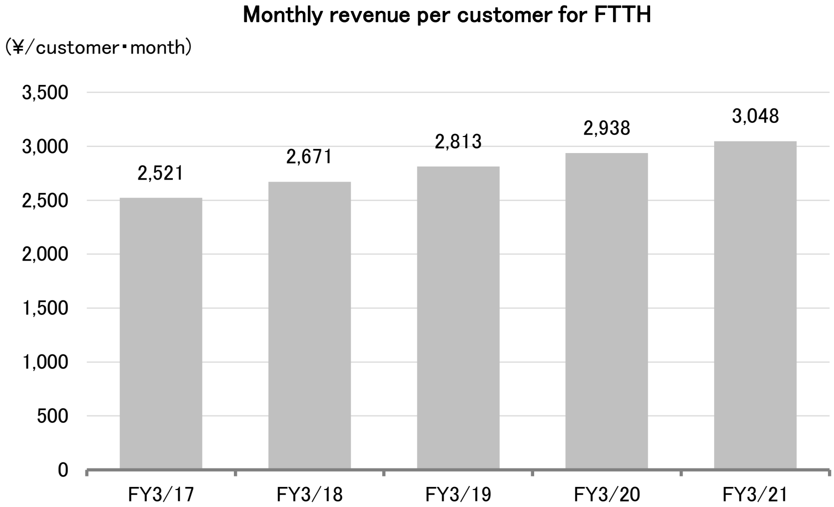
Amid this environment, the Company's strategy is to aggressively pursue M&A and alliances. It plans to increase its number of customers to 290,000, five times the level as of end-FY3/17 and raise operating profit by ¥230mn through investments in pipeline extensions and by capturing new commercial demand. The Company is considering expanding into all geographic areas of Japan, but would prefer to expand into areas where it can also market its other services. The Company is also developing a renovation business focused on plumbing (in the Building and Real Estate segment) and, with average sales of roughly ¥30,000 per customer, has strong capabilities compared with industry rivals. The Company plans to increase earnings in its renovations business by boosting customer numbers in its city gas business and targets a five-fold expansion of operating profit, from ¥50mn in FY3/17 to ¥250mn. We think M&A could go smoothly because companies acquired by Tokai Holdings could see sizable operational benefits. For example, most small- and medium-sized city gas providers do not offer additional products and services, so investment by the Company could enable them to do so.

(3) Broadband business

The Japanese broadband market is considered to be mature and we expect continued annual growth of roughly 2% going forward. Owing to the proliferation of low-cost smartphones, strong growth is expected in the MVNO market and the total number of contracts is expected to grow from 8.8mn to 19.5mn in four years. In this environment, the Company plans to continue with the shift of FTTH customers to Hikari Collaboration, thereby increasing sales per customer and achieving profit growth and also strengthening the LIBMO (MVNO service) it launched in February 2017.

The Company aims to raise the Hikari Collaboration ratio (Hikari Collaboration contracts ÷ FTTH contracts) from 50% in FY3/17 to 85% in four years. This would increase monthly revenue per customer to ¥3,048, roughly 21% higher than the FY3/17 level. The Company also aims to increase broadband services customer numbers by 1.7x to 1.34mn in four years.

The Company targets 140,000 LIBMO customers four years from now. LIBMO fees between ¥1,180 and ¥2,980 per customer per month for a data and audio plan. The Company's strategy is to increase sales per customer and make the service profitable by adding more services such as security and insurance features.



Source: Prepared by FISCO from Company materials

(4) CATV business

In the Japanese CATV industry, test broadcasting and commercialization of high-definition 4K and 8K technology has begun in the run-up to the 2020 Tokyo Olympics. However, fiber optic cable and other related devices are necessary for such broadcasts. As competition heats up, small- and medium-sized operators that cannot afford such capital investments are likely to be integrated into larger corporate groups so that they can receive the funding necessary to continue providing services. The Company believes this market environment proves it with business opportunities and plans to aggressively pursue M&A deals.

The Company plans to expand its business by offering services such as attractively priced 4K/Internet packages, disaster information services provided in cooperation with government agencies, provision of FTTH to areas without high-speed networks in cooperation with local governments, and construction of local broadband wireless access systems.

The Company targets CATV customer number growth from 733,000 (508,000 for broadcast services, 225,000 for communication services) as of end-FY3/17 to 823,000 in four years (530,000 and 285,000). However, depending on how M&A deals proceed, customer number could top 1mn. The Company plans to have acquisitions maintain their bands and independence in terms of program production. This stands in contrast to the largest player in the industry, which unifies all operations under the J:COM brand. In addition, we believe the Company's ability to provide a wide range of other products and services such as gas and water home delivery is appealing to M&A target companies. Several M&A deals have already been proposed and the Company is prepared to make deals. We believe the Company's actions in this area bear monitoring.

FY3/18 earnings outlook

Profit to decline temporarily in FY3/18 on upfront investments made to reach targets in Medium-term management plan

In FY3/18, the Company expects profit to decline, targeting net sales of ¥189,400mn (up 6.0% YoY), operating profit of ¥11,410mn (down 10.5%), recurring profit of ¥11,360mn (down 11.1%), and net income attributable to owners of the parent of ¥6,450mn (down 12.1%). This is because the Company plans to post one-time investment costs in FY3/18 in order to reach the targets in its Medium-term management plan.

Looking at factors expected to impact profit, the Company expects impacts of ¥1,100mn from sales growth in the Gas, CATV, and Information and Communications Service businesses, ¥1,100mn from expansion of the service area of the Gas business, ¥500mn from an increase in Sale promotion cost related to the launch of LIBMO, and ¥900mn from higher costs related to efforts to prevent contract cancellations. The Company expects end-FY3/18 customer numbers to increase by 320,000 YoY to 2.88mn. As the company has not closed an M&A deal since FY3/12 and new customer acquisitions have never topped 100,000 since then, we believe the Company is factoring in the impact of M&A into its forecast.

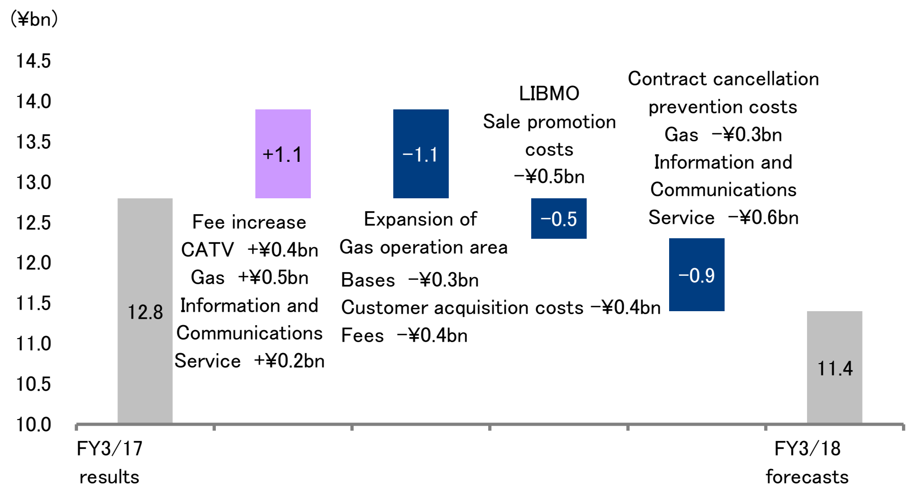
Outlook for the FY3/18 consolidated results

(¥mn)

	FY3/17	FY3/18			
	Results	Full-year forecast	YoY	1H forecast	YoY
Net sales	178,631	189,400	6.0%	86,000	4.6%
Operating profit	12,750	11,410	-10.5%	2,710	-38.5%
Recurring profit	12,775	11,360	-11.1%	2,650	-40.2%
Net profit attributable to owners of the parent	7,337	6,450	-12.1%	1,080	-54.7%

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

Factors expected to impact operating profit in FY3/18



Source: Prepared by FISCO from Company materials

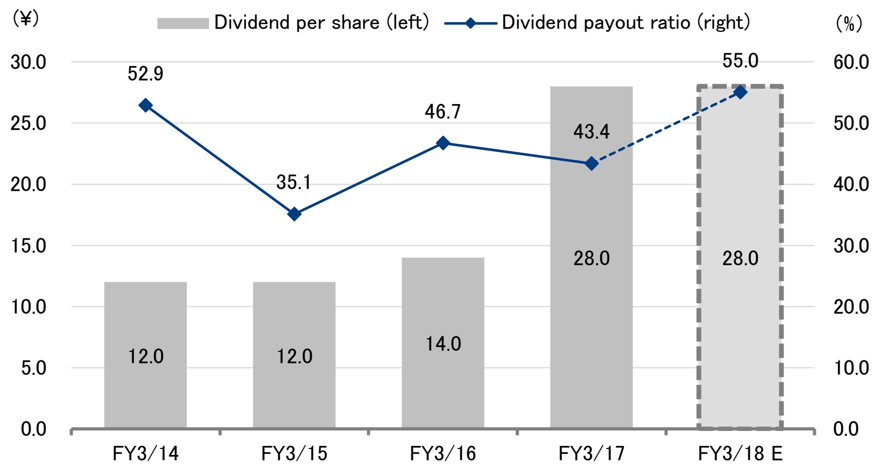
Shareholder return policy

To continue proactive shareholder return policy

The Company returns profits to shareholders by paying dividends, presenting shareholders with gifts, and also purchasing treasury shares depending on conditions. Its basic policy is to continuously pay a stable dividend and it targets a dividend payout ratio of 40% to 50%. For FY3/18, the Company plans to leave dividend distributions unchanged YoY at ¥28.0 per share (including the commemorative dividend of ¥6.0) but it will consider a dividend hike in FY3/19 if net income attributable to owners of the parent rises.

The Company presents gifts to shareholders at the end of September and March depending on the number of shares held. For each unit of shares (100 shares) held, shareholders can receive one of the following gifts: an Aqua product worth ¥1,900 (such as the Ulunom) “Fuji-no-Tennensui Sarari” (Mt. Fuji natural water), a QUO card worth ¥500, food coupons worth ¥1,000, or ¥1,000 worth of TLC Membership Service points. When including the gifts to shareholders in an estimate of the total investment yield per share unit from the current share price level (¥812 on May 12), it is in the range of 4% to 8% (depending on the selection of either a QUO card or an Aqua product as the gift).

Dividend per share and dividend payout ratio



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

Disclaimer