COMPANY RESEARCH AND ANALYSIS REPORT

USEN-NEXT HOLDINGS Co., Ltd.

9418

Tokyo Stock Exchange First Section

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Summary

Highly profitable and high growth company with robust cash flow on a real basis

USEN-NEXT HOLDINGS Co., Ltd. <9418> (referred to below as “the Company”) delivers music distribution service, its founding business, and a full range of solutions used in running stores and other facilities, including cash registers, communications environments, automated payment machines, front management systems, and electricity to restaurants and other retailers, hotels, hospitals, and other businesses. The Company also provides “U-NEXT,” a flat-rate video distribution service to consumers. USEN and U-NEXT reintegrated in December 2017. The integration aims to smoothly direct cash from the cash-cow music distribution business to high-growth businesses, such as store operation solutions, and mutually utilize their strengths, including music and video content, network infrastructure, and customer bases, at a higher level, and collaborating in their respective sales channels. The ultimate goal is to maximize sales per customer through creating group synergies by cross-selling the mainstay products of group companies.

The Company has six business segments: store services, communications, business systems, content distribution, energy, and media. The store services provides music distribution services to restaurants and other stores, manages music copyrights, and provides store IoT and other store operation solution services. The energy and media provide such customers with sales of electricity and gas, as well as services like “Hitosara” that use media to help attract customers. The communications provides communication lines to facilities and mobile communication (MVNO) services to individuals, as well as agent sales of Internet services provided by communications service providers. The business systems provides automated payment machines and front desk management systems to hotels, hospitals, and golf courses, among other users. The content distribution distributes video, e-books, and other digital content to individuals.

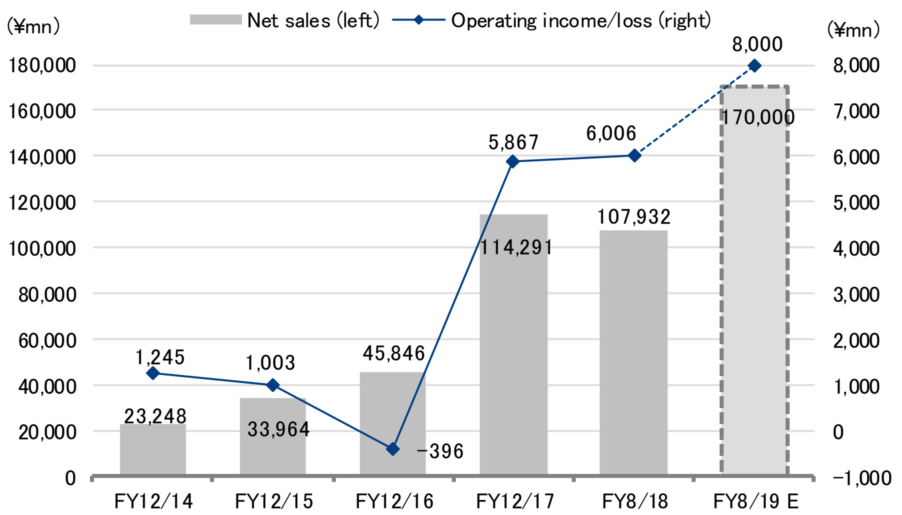
The Company’s advance to an integrated holding structure significantly broadened business scope and possibilities. It formulated the medium-term management plan “NEXT for 2024” in this context. Core strategies are 1) fully leverage customer assets and build a stable income base, 2) further reinforce cash-cow business and aggressively invest created funds into growth areas, 3) improve productivity and raise business efficiency through revisions to the work environment, 4) optimize the financial balance, and 5) make sustainable growth investments and provide continuous shareholder return. Based on these efforts, it hopes to reach ¥270bn in net sales, ¥13bn in operating profit, and high-quality balanced finances by FY8/24. It hence aims to maintain net sales, EBITDA, and capital outlays in accordance with the plan and focus on ROE, which is considered to be the most important management indicator, and its component factors as benchmarks.

In 1H FY8/19, the Company reported ¥83,574mn in net sales, ¥3,942mn in operating profit, and ¥1,775mn in net profit attributable to parent shareholders. We think it made healthy progress toward full-year guidance at 50-60% levels. Acquisition of peer CANSYSTEM Co., Ltd. as a consolidated subsidiary established an overwhelming position in the music distribution service market. The Company’s FY8/19 guidance calls for ¥170,000mn in net sales, ¥8,000mn in operating profit, and ¥3,000mn in net profit attributable to parent shareholders. We believe it is within reach of these targets in light of likely income additions from further contract build-up. If the Company attains goals in “NEXT for 2024,” it would realize average double-digit profit CAGR. While it assumes low operating margin in “NEXT for 2024,” this reflects the impacts of roughly ¥3bn in goodwill amortization annually and low-margin energy business. Profitability adjusted for these items is fairly high. In other words, the Company is actually a highly profitable and high growth company with robust cash flow. We think the price-to-cash flow ratio is a very effective way of assessing the Company.

Key Points

- Headed for a stage of fully leveraging management integration synergies
- "NEXT for 2024" targets ¥13bn in FY8/24 operating profit
- Possesses robust cash flow as well as strong earnings and growth potential

Results trends



Note: The December 2017 management integration of U-NEXT and USEN resulted in an eight-month fiscal year for FY8/18. For USEN, the FY12/17 fiscal period covered the nine-month period (March 2017–November 2017), while FY12/18 covers the nine-month period from December 2017 through August 2018. For FY12/16 and earlier periods, the figures are for U-NEXT prior to the integration.
Source: Prepared by FISCO from the Company's financial results

Company profile

Targeting synergies through reintegration

1. Company profile

The Company is a holding company that provides music distribution services (the founding business), a flat-rate video distribution service, and store and facility assistance tools and solutions via subsidiaries to commercial, retail, and other customer sites. It was established as a holding company through the management integration of former U-NEXT and USEN. The integration aims to create group synergies from cross-selling mainstay products of group companies by mutually utilizing their strengths, including music and video content, network infrastructure, and customer bases, at a higher level, and collaborating in their respective sales channels. It also aims to realize dynamic growth strategies as a new corporate group possessing abilities in IoT, AI, and other next-generation technologies. Furthermore, the merger should result in higher operational efficiency by reducing overlapping costs incurred by individual group companies through consolidation of group functions.

Promoting digitalization and diversification from the founding business of music distribution

2. History

Mototada Uno founded USEN in 1961 as Osaka Yusen Broadcasting and subsequently built a wired broadcast network nationwide. When Yasuhide Uno took over as President in 1998, he promoted store assistance services and broadband service using the Company's existing customer base and infrastructure, and pursued diversification and digitalization, including video distribution, electronic books, and other content provision services. U's Broad Communications (now, U-NEXT), a broadband service provider that was established as a spin-off from U's Marketing, a USEN subsidiary, took over the TV paid video distribution service and sales agent business for personal optical lines and other communication lines through a corporate split-off from USEN in December 2010. In December 2017, the Company decided to reintegrate USEN and U-NEXT in order to more effectively leverage the group's strengths, such as the customer base, sales channels, and store assistance know-how of both companies.

Business overview

Operates six businesses with emphasis on B-to-B business and recurring income business

1. Business segments

The Company has six business segments: store services, communications, business systems, content distribution, energy, and media. Its mainly uses a B-to-B format. The store services provides music distribution services to restaurants and other stores, engages in sales and installation of distribution equipment, manages music copyrights, and provides store IoT and other store operation solution services. The energy and media provide such customers with sales of electricity and gas, as well as services like "Hitosara" that use media to help attract customers. The communications provides communication lines to facilities and mobile communication (MVNO) services to individuals, as well as agent sales of Internet services provided by communications providers, along with other services. The business systems provides automated payment machines and front desk management systems to hotels, hospitals, and other customers. The content distribution distributes video, e-books, and other digital content to individuals. The Company mainly utilizes a recurring income model of collecting monthly fees.

Provision of relaxation and efficiency to stores and facilities

2. Business description

(1) Store services

The store services is divided into the music distribution business and the store operation solutions business. The music distribution business has been operating for more than 50 years, and provides the "USEN" service for broadcasting music and information to stores and facilities nationwide with a content range of specialty channels (such as J-POP and Western music) to request channels. Stores comprise the vast majority of customers, with restaurants, retailers, beauty salons, and health clinics accounting for a high percentage of users. Chain store users range from national chains to chains focused on local areas. Naturally, the Company properly handles copyright issues for all of the music it supplies. Users rent service tuners from the Company, and the tuners utilize dedicated coaxial cable, communications satellite, or Internet line infrastructure as appropriate for the tuner installation environment. The group has extensive support operations with 150 branches nationwide, 1,000 salespeople, and 750 engineers. This gives it the ability to cover services from installations to aftercare. We think the deep-rooted popularity of this service makes sense with its robust music lineup, quality, and support capabilities and provision of CD players and other hardware, continuous software purchase costs, song selection, and time-consuming copyright processing at a monthly fee of ¥4,000-5,000. This business has a strong customer base of over 750,000 users and generates steady sales and an overwhelming share of more than 90% in store and facility background music (these levels include 130,000 customers, just over ¥5bn in sales, and ¥400mn in operating profit from CANSYSTEM, the No.2 firm in music distribution service to business sites acquired as a wholly owned subsidiary in October 2018). Profitability is high too, and this business generates cash that supports the group strategy.

In store operation solutions, the Company supplies solutions service related to store operations to business sites with a range from business launch assistance to building the business environment and promoting sales. The shift to IT has progressed in the retail and service sectors in recent years, and this trend has made the business environment even more challenging for smaller and very-small stores. To help such stores, the Company provides service with one-stop delivery of cutting-edge equipment and systems that they find it difficult to deploy on their own. Main offerings are tablet POS register "U Regi," tenant comprehensive insurance for business operators "Omise-no-Anshin Hoken," store cashless payment solution "USEN PAYGATE," store app creation service "UPLink," and facility Wi-Fi service "USEN SPOT." This business is growing because of its strong popularity.

(2) Communications

The communications provides "USEN GATE 02," an ICT solution for businesses, "USEN Hikari," a broadband Internet line for businesses, "U-mobile," an MVNO service for individuals, and "U-NEXT Hikari 01," a broadband Internet line for individuals. The ICT business sells a variety of ICT products and services, including "USEN GATE 02" Internet line, dedicated lines, and other corporate network services, cloud services from Google, Cybozu Inc. <4776> and others, data communications and mobile device management (MDM) services, and data center services. The Company was the first provider worldwide to offer Internet connection service from optical fiber and has provided services to more than 40,000 companies in the constantly changing and advancing ICT industry. We think the breadth of the service lineup is an important strength in this business. The business handles all network environment-related needs while offering an integrated contact point that provides a high level of convenience.

(3) Business systems

Subsidiary ALMEX INC. handles the business systems. This business supplies automated payment machines and lodging facility management systems to business hotels, city hotels, and leisure hotels, automated payment machines and automated patient check-in machines to general hospitals and other medical institutions, and automated payment machines and check-in machines to golf courses. It also sells ordering terminals and operating systems to restaurants. While automated payment machines might seem like a market segment that would be dominated by large electric equipment manufacturers, ALMEX holds very high market shares in Japan, at 85% for leisure hotels, 65% for business hotels, 65% for large medical institutions, and 70% for golf courses. As a fabless manufacturer, it develops, sells, and provides maintenance for equipment and systems. ALMEX hence has the culture of a manufacturer, which makes it a different presence within the group. However, like the group's other businesses, ALMEX also incorporates a concept of providing hospitality to the customers of facilities installing its equipment and this is an important differentiating factor.

(4) Content distribution

U-NEXT provides video distribution (video-on-demand; VOD) service. This service charges a monthly fee to individuals for viewing access by television, PC, smartphone, or other devices of video content and television, electronic book content, and music content. It offers unlimited viewing of video content (over 90,000 items) and pay-per-view access to new works. It is also the only major service that carries adult content. The overwhelming victory by TSUTAYA Co., Ltd. over US-based major Blockbuster LLC, which entered Japan, during the growth years in rental videos, highlights the importance of adult content in expanding content demand. The Company charges ¥1,990 per month. While this may seem expensive at first glance, it is actually fairly reasonable considering robust content with more than 140,000 items, support for four users per account, and an allocation of ¥1,200 in points each month that enables effectively free access to the latest pay items within the point range. These features support strong growth potential despite extensive competition with massive service firms Amazon Prime Video, Netflix, and others.

(5) Energy

In the energy business, the Company sells high- and low-voltage electricity and city gas to stores and retail facilities located outside of partner Tokyo Electric Power Company Holdings, Inc.'s <9501> service territory, and also offers consulting services such as proposals of energy-conservation measures. Even though this business was just recently launched in September 2016 following the liberalization of electricity sales, the Company has attracted strong interest and is rapidly increasing the number of subscribers by promoting low prices to its deep customer base. The Company's service always obtains spread because it resells electricity supplied on a wholesale basis from Tokyo Electric Power Company Holdings, in contrast to new power firms that could incur negative margin due to seasonal fluctuation and other temporary risks because of differences in power supply operations, but its margin is extremely low.

(6) Media

The core product in the media is "Hitosara," a gourmet restaurant information website that helps restaurants attract customers. The site focuses on chefs (Hito) and food (Sara). By narrowing its scope to relatively high-end restaurants, it differentiates itself from rival sites. "Hitosara" has established a solid market position. In income, it added transaction fees for on-the-spot reservations to the existing advertising revenue business model. It started operating "SAVOR JAPAN," a multi-lingual version of "Hitosara" that targets foreigners visiting Japan, as an inbound strategy. The media business also offers "WeColle," a wedding media that targets women who are beginning to think about marriage using a four-pronged strategy (free magazine, Internet, events, and salons) and as well as "bangs," a web magazine for finding hair and other stylists.

Medium-term management plan

Seeks to maximize enterprise value by raising productivity via work style reforms

1. Brand slogan and management strategy

The Company significantly broadened business areas and possibilities with the integration and formation of a holding company framework. Meanwhile, it faces increasingly complex and diverse social issues due to dramatic changes in the business environment, including rapid inroads by new technologies and decline in the working population. Given these conditions, the Company advocates "Brighten the future" as its group brand slogan with the aim of continuously being a corporate group that society counts on and requires. It believes that promotion of "Work Style Innovation" reform is vital to realizing a new work style in which employees act independently and earnestly and utilizing their capabilities contributes to corporate activities in a natural way. This is what it takes to steadily supply products and services supported by many people. The Company's longer-term business strategy seeks to maximize group synergies with emphasis on enhanced productivity via work style reforms and improve growth potential and profitability while creating new services in order to make effective use of customer assets and strengthen sales in focus area. Through work style reforms, the Company aims to quickly identify needs and business opportunities in fast-changing technology and social environments and enlist IT capabilities, such as IoT and AI. It hopes to achieve income growth through fast decision-making and pursue maximize shareholder and enterprise value.

Aiming for ¥13bn in FY8/24 operating profit

2. "NEXT for 2024" medium-term management plan

The Company formulated "NEXT for 2024," a medium-term management plan starting in FY8/20, in the context of this approach. Core strategies are 1) fully leverage customer assets and build a stable income base, 2) further reinforce cash-cow business and aggressively invest created funds into growth areas, 3) improve productivity and raise business efficiency through revisions to the work environment, 4) optimize the financial balance, and 5) make sustainable growth investments and provide continuous shareholder return. Based on these efforts, it hopes to reach ¥270bn in net sales, ¥13bn in operating profit, and high-quality balanced finances by FY8/24. It also wants to raise the dividend payout ratio from an anticipated 10% in FY8/19 to 30% at some point. It hence aims to maintain net sales, EBITDA, and capital outlays in accordance with the plan and focus on ROE, which is considered to be the most important management indicator, and its component factors as benchmarks.

Numerical goals in NEXT for 2024

(Unit : million yen)	FY08/2019	FY08/2022	Growth ratio (vs. FY08/2019)	FY08/2024	Growth ratio (vs. FY08/2019)
Net sales	170,000	**230,000**	135.3%	**270,000**	158.8%
Operating Income	8,000	**10,000**	125.0%	**13,000**	162.5%
Ordinary Income	6,500	**9,000**	138.5%	**12,000**	184.6%
Net Income	3,000	**4,500**	150.0%	**6,500**	216.7%
EBITDA	18,000	**20,000**	111.0%	**23,500**	130.2%
EBITDA-CAPEX	10,000	**10,000**	100.3%	**13,500**	135.3%
ROE	20%	**15%**	▲5%	**15%**	▲5%
Equity ratio	15%	**20%**	+5%	**30%**	+15%
Leverage ratio	4.0	**3.0**	▲1.0	**2.5**	▲1.5
Debt equity ratio	4.0	**2.0**	▲2.0	**1.5**	▲2.5
Payout ratio	10%	**10%~30%**	-	**10%~30%**	-

Source: The Company's medium-term management plan briefing materials

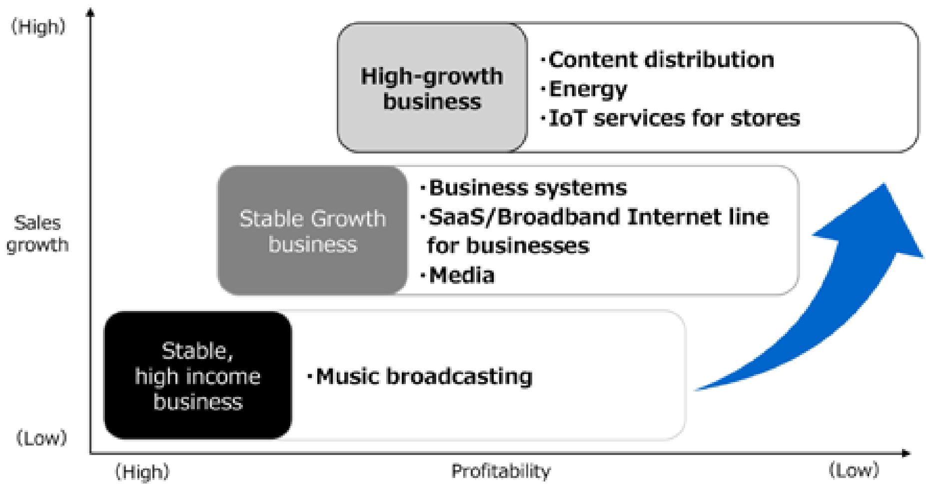
Clarification of the business portfolio

3. Group medium-term management vision

Looking at the integration aim more closely, the Company hopes to utilize funds from the music distribution business, which lacks growth potential on its own but is an excellent cash cow, in the store services built around the founding music business, in other areas of business. It also wants to maximize sales per customer for the reinforced customer base following the addition of CANSYSTEM to the group through provision of sales and technology assistance that had been broken up among companies and businesses thus far, service integration and improved efficiency, enhanced cross-selling of services and products in a growth phase, and upselling by individual customers (lifting the average customer sales price). Store services business customers include retail and public facilities, and shifts in usage purpose, type of usage, and users related to changes in the social environment have been going beyond adjustments at facilities. The Company intends to support facility responses to aging, cashless payments, increase in inbound activity, and other trends.

To deal with this challenge, the Company regrouped the business portfolio into three categories as part of the integration, such as cash-cow stable high income businesses with a robust customer base, stable growth businesses continuing growth as they address stable needs, and high growth businesses with potential as a future income source. For the Company's business segments, music distribution business is a stable high income business, business systems, SaaS and line businesses, and media are stable growth businesses, and content distribution, energy, and store IoT business are high growth businesses. While video distribution, which is growing as a service that caters to individuals, holds a somewhat unusual position in the group, it might broaden into a cross-selling service in a 5G era. The Company also needs to revise its management framework from a top-down approach to a bottom-up stance as an environment that fosters many new services and products while engaging in cross-selling efforts. Work style reforms occupy an important position in the strategy for this reason too. The Company is introducing super-flex time and telework programs and also promoting free addresses and expansion of free space for better communication as office reforms. It has already deployed some measures, and employee engagement and productivity are rising. These policies appear to be having a positive impact on new graduate hiring too.

Business portfolio



Source: The Company's medium-term management plan briefing materials

Numerical goals seem attainable when viewed by individual businesses

4. Growth strategy by segment

The Company set ambitious goals for FY8/24 net sales and operating profit at roughly 1.6x increases from FY8/19 targets. It counts on energy business and content distribution to drive net sales and forecasts two-fold and four-fold gains in communications and content distribution respectively (albeit with support from large denominators) and realization of substantial profitability in energy business. Viewed at the business level, many of these areas are already ramping up and these goals, which seemed ambitious, are relatively attainable.

Segment net sales numerical goals in the NEXT for 2024 plan

(Unit : million yen)	FY08/2019	FY08/2022	Growth ratio (vs. FY08/2019)	FY08/2024	Growth ratio (vs. FY08/2019)
Store services	48,500	**53,000**	109.3%	**57,000**	117.5%
Exclude individual service	46,500	**51,500**	110.8%	**56,000**	120.4%
Music distribution for individuals	2,000	**1,500**	75.0%	**1,000**	50.0%
Communications	35,000	**41,500**	118.6%	**49,500**	141.4%
Business systems	19,500	**21,500**	110.3%	**23,500**	120.5%
Content distribution	32,000	**46,000**	143.8%	**52,000**	162.5%
Energy	32,000	**65,000**	203.1%	**85,000**	265.6%
Media	5,000	**6,000**	120.0%	**6,500**	130.0%
Adjustment (*)	▲2,000	**▲3,000**	-	**▲3,500**	-

*Sales deduction for inter-segment transactions
Source: The Company's medium-term management plan briefing materials

Segment operating profit numerical goals in the NEXT for 2024 plan

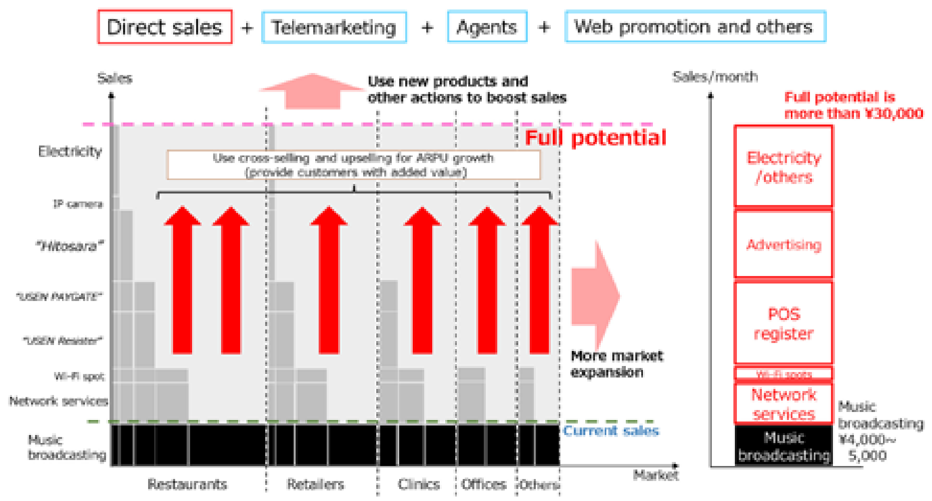
(Unit : million yen)	FY08/2019	FY08/2022	Growth ratio (vs. FY08/2019)	FY08/2024	Growth ratio (vs. FY08/2019)
Store services	8,000	7,000	87.5%	7,200	90.0%
Exclude individual service	6,000	6,500	108.3%	7,000	116.7%
Project cost (*1)	0	▲500	-	▲600	-
Music distribution for individuals	2,000	1,000	50.0%	800	40.0%
Communications	2,800	4,500	160.7%	6,000	214.3%
Business systems	3,400	3,500	102.9%	4,000	117.6%
Content distribution	500	1,000	200.0%	2,000	400.0%
Energy	▲500	500	-	1,000	-
Media	300	400	133.3%	500	166.7%
Adjustment (*2)	▲6,500	▲6,900	-	▲7,700	-

*1 Up-front expenditures for capturing synergies between CANSYSTEM, which joined the USEN-NEXT Group in Oct. 2018, and the music distribution service. After completing these activities in FY08/2024, expect profit contribution of ¥850mn (cost saving of ¥250mn and absence of ¥600mn of up-front expenditures) starting in FY08/2025.
*2 Major components of the adjustment are head office expenses and goodwill amortization and eliminations of inter-segment transactions
Source: The Company's medium-term management plan briefing materials

(1) Store services

In store services, the Company targets ¥57bn in FY8/24 net sales (+17.5% versus FY8/19 guidance) and ¥7.2bn in operating profit (-10.0%). It plans to expand the solution services lineup for its robust music distribution customer base with 750,000 customers targeting key store services except for music distribution to individuals. Sales policy calls for wider transaction opportunities through utilization of a more complex structure of sales channels that adds telemarketing, distributors, and the Internet, as benefits of the merger, to existing direct sales and reduction of transaction costs. With this support, the Company should be capable of further upselling on development of new services and products to the full potential of ¥30,000 or more from music distribution service (¥4,000-5,000 average customer price) plus cross selling of Wi-Fi spots, "U Regi" (POS registers), anti-crime cloud cameras, "USEN PAYGATE" with e-money support, advertising, insurance, electricity, and other services.

Stable growth through cross-selling activity



Source: The Company's medium-term management plan briefing materials

While it is obviously not realistic to expect all locations to reach the full potential considering various industry, business, and store characteristics, we think 20.4% increase in net sales for store services, excluding music distribution to individuals, over five years driven by upselling is a reasonable target. In earnings, the Company only projects 16.7% increase in operating profit for store services, excluding music distribution to individuals, during the same period because it includes negative effect from separate project measures. Project measures refer to projects that pursue cost synergies with CANSYSTEM by eliminating double costs for satellites and electric pole. However, the Company anticipates upfront merger costs prior to realizing synergies after the NEXT for 2024 plan. The strategy for music distribution to individuals focuses on halting cancellations without having to allocate funds since the Company does not expect growth in this business.

Store services

* Estimates for FY08/2019 = 100
Source: The Company's medium-term management plan briefing materials

(2) Communications

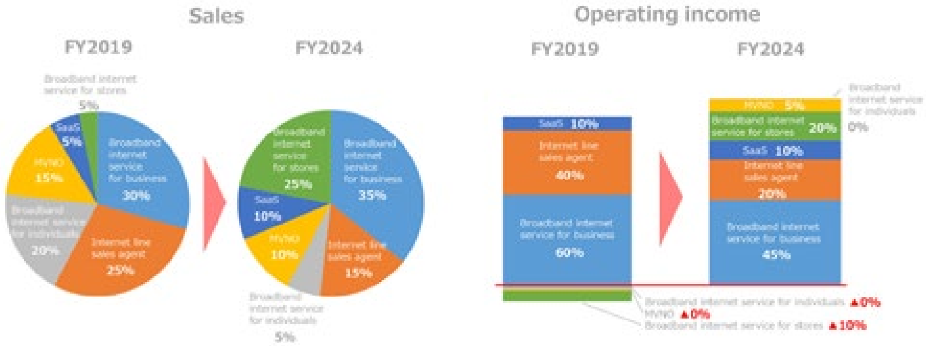
In communications, the Company targets ¥49.5bn in FY8/24 net sales (+41.4% versus FY8/19 guidance) and ¥6bn in operating profit (2.1-fold increase). It possesses a solid foundation in corporate optical line business that delivers stable growth and hopes to drive gains with its own lines (optical collaboration) for business facilities and SaaS business. In corporate optical line business, it conducts procurement sales of its own lines obtained from NTT through "wholesale" optical access service (optical collaboration) directly to users, rather than the past approach of arranging contracts for NTT to deliver service to users as a sales agent. In income, this approach has shifted the model from one-time income when contracts are closed to recurring income with sales and other equipment costs and modest monthly usage fees due to supplying its own lines (optical collaboration). Although it takes some time to recoup acquisition costs, there is a lengthy period of profit creation after going past the breakeven point. The Company can also lower acquisition costs through cross selling. While the one-time model was "lucrative" in past years, it has become a difficult business now due to system changes, strong offensives by major carriers, and increase in the number of rivals. More than half of the Company's customer base offers opportunities because the service targets customers that have not deployed IoT at stores yet.

Shift from one-time income to recurring business

Source: The Company's medium-term management plan briefing materials

Additionally, the Company targets stable income by selling option services to its customer base. Demand should steadily expand in SaaS business due to growing deployments on heightened need for work style reforms (better efficiency and cost savings) at stores and companies against a backdrop of manpower shortages and other challenges. In MVNO (mobile virtual network operator) business, which supplies cheaper smartphone service, to individuals and other customers, the Company hopes to generate larger income contributions through provision of mobile service using a channel tuner as an MVNE (mobile virtual network enabler).

Segment composition in Communications



Source: The Company's medium-term management plan briefing materials

(3) Business systems

In business systems, the Company targets ¥23.5bn in FY8/24 net sales (+20.5% versus FY8/19 guidance) and ¥4bn in operating profit (+17.6%). Leveraging its top share in automated payment machines at hotels, golf courses, and hospitals, the Company plans to pursue business at white spaces that it has not addressed much up to now, such as capsule hotels, private rental lodgings, guest houses, clinics, and care facilities. New services include smart Pay and software applications. The Company also hopes to broaden beyond one-time sales of automated payment machines and other equipment by reinforcing application fees and other recurring income, including applications for lodging facility use and lodging parties based on expansion of hotel mission-critical system sales and software sales along with sales of "Sma-paTERMINAL," the next-generation hospital reception machine.

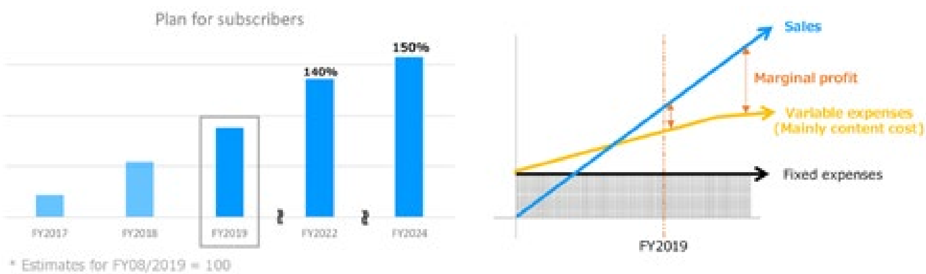
Changes in the sales structure in business systems

Source: The Company's medium-term management plan briefing materials

(4) Content distribution

In content distribution, the Company targets ¥52bn in FY8/24 net sales (+62.5% versus FY8/19 guidance) and ¥2bn in operating profit (four-fold increase). VOD (Video on Demand) is receiving a tailwind from recent attention, and the Company is steadily increasing users. While it is not as well known as fast-growing major firms Amazon <AMZN> and Netflix <NFLH>, the service is highly comprehensive with a large lineup of unlimited content and new releases and also provides excellent quality. Satisfaction greatly exceeds rivals. We think the Company's service has secured a unique and attractive position in the VOD market. However, it has not reached the stage of accelerated earnings growth because of increased marketing costs and contracts that do not incorporate decline in content costs. While it needs to coordinate with content holders, the Company wants to capitalize on its overwhelming economies of scale to improve terms to contracts that boost marginal profit ratio after surpassing a certain sales level.

U-NEXT user volume trend (left) and
increase in marginal profit ratio through economies of scale (right)



* Estimates for FY08/2019 = 100
Source: The Company's medium-term management plan briefing materials

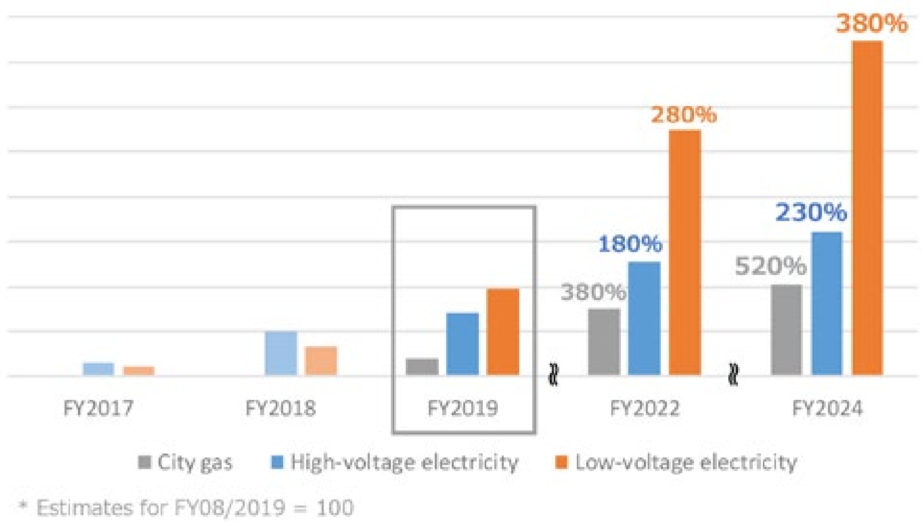
(5) Energy

In energy business, the Company targets ¥85bn in FY8/24 net sales (2.6-fold gain versus FY8/19 guidance) and ¥1bn in operating profit (reach profitability). Contract volume is rapidly growing simply because it enables use of electricity cheaply, gaining popularity. The Company sees this as a high growth business due to its role as a cross-selling hook, including an opportunity to make a sales approach to business facilities that have not required background music. However, it is likely to be a factor that lowers overall operating margin over the medium term because of the prospect of very large sales paired with low gross margin. Since the Company is putting more emphasis on sales of high-voltage electricity to large facilities, rather than low-voltage electricity with strong interest at ordinary business sites, it has an expert sales team of 100 people and books operating losses. Yet we think it is likely to achieve full-year profitability in FY8/21 because of anticipated negotiations to reduce procurement fees and rapid growth in customer volume.

Earnings plan for the energy business

Source: The Company's medium-term management plan briefing materials

Cumulative customer volume in the energy business



* Estimates for FY08/2019 = 100
Source: The Company's medium-term management plan briefing materials

(6) Media

In media, the Company targets ¥6.5bn in FY8/24 net sales (+30% versus FY8/19 guidance) and ¥500mn in operating profit (+66.7%). It hopes to achieve growth in line with changes in the gourmet site market. Due to shift in market structure from area and genre as search leads, flat rates for store listing fees, and Japanese people as the target to time and number of people as search leads, performance-based listing fees, and the growing foreigner segment as the target, the Company has switched to immediate reservations at the search lead, flat fee + performance as the listing fee, and multi-language support for the website. Both “Hitosara” and “SAVOR JAPAN” businesses seem to be expanding smoothly as a result. The Company wants to improve site clout and boost income with more “SAVOR JAPAN” listings that leverage collaboration with overseas media and inbound demand and through provision of immediate reservations from web pages.

Trends in important KPI

Source: The Company’s medium-term management plan briefing materials

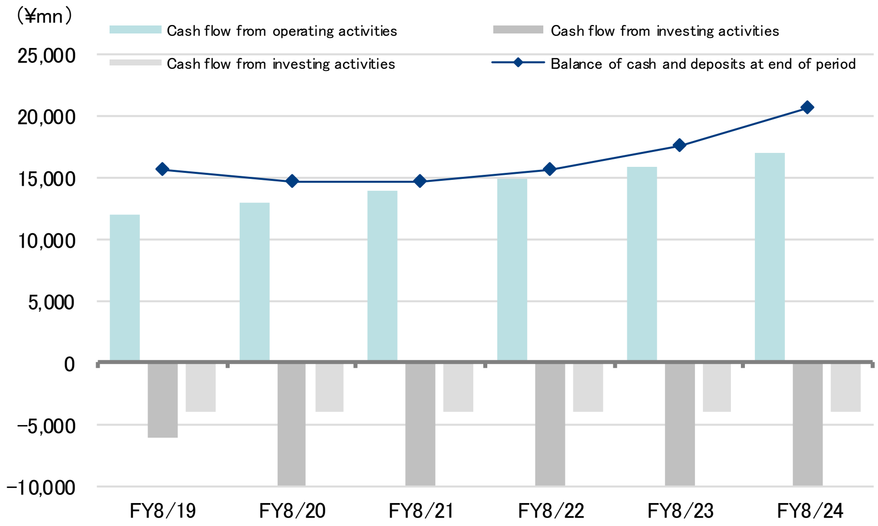
Utilizing abundant cash flow to fund the aggressive investment plan

5. Analysis of cash flows

The investment plan budgets ¥50bn over five years. The Company plans to mainly invest in store services for maintenance investment for its music distribution service, a stable high profit business, to prevent the service from breaking down. Also, it will invest in broadcast tuners and facilities. For business systems, it plans to invest in equipment and billing software as specified in the NEXT for 2024 plan. For content distribution, the Company will invest in software development, content server and distribution server to attain 2mn users. The Company has also budgeted ¥2bn in IT investments companywide for office reforms and integration aimed at raising productivity and ¥15bn in M&A and other growth investments. In growth investments, it wants to arrange initiatives with companies that possess synergistic technologies and digital start-ups.

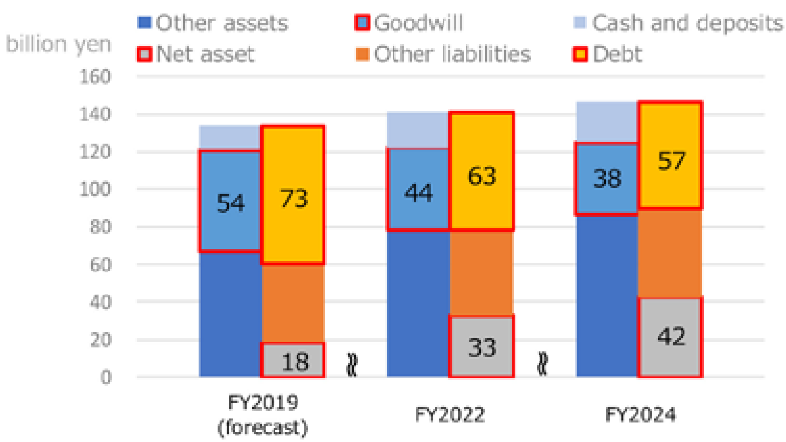
A rough cash-flow calculation indicates about ¥10bn in annual investment cash outflow from above-mentioned activities and ¥4bn in annual financial cash outflow from bank loan repayments and dividend payments. Operating cash inflow consists of net profit attributable to parent shareholders plus depreciation costs and goodwill amortization costs. Company targets for net profit attributable to parent shareholders are ¥3bn in FY8/19, ¥4.5bn in FY8/22, and ¥6.5bn in FY8/24. We also assume ¥3bn in annual goodwill amortization costs and about ¥7bn in annual depreciation costs. Resulting operating cash flow estimates are ¥12bn in FY8/19, ¥15bn in FY8/22, and ¥17bn in FY8/24. The only difference with the plan is ¥16bn cash flow in FY8/24. We hence expect the Company to have more than ¥20bn in cash and deposits at end-FY8/24 and considerable room to raise its dividend payout ratio to 30% with extensive cash holdings. Financial conditions are also improving as expected by the Company. Since goodwill amortization costs and other expenses without cash outlays weigh heavily on profits as shown above, we think the price-to-cash flow ratio is very effective as an indicator to assess the Company's enterprise value.

Cash flow forecasts



Source: Prepared by FISCO from interviews

Balance Sheet



Source: The Company's medium-term management plan briefing materials

Financial results trends

Expecting healthy results based on progress rates

1. FY8/19 2Q results

In 1H FY8/19, the Company reported ¥83,574mn in net sales, ¥3,942mn in operating profit, ¥3,378mn in ordinary profit, and ¥1,775mn in net profit attributable to parent shareholders. It does not provide YoY change rates because FY8/18 was an eight-month period (1 January to 31 August 2018) to alter the fiscal year. We think it made healthy progress toward full-year guidance at 50-60% levels.

FY8/19 2Q results

(¥mn, %)

	FY8/18 2Q (January - June, 2018)	% of net sales	FY8/19 2Q (September 2018 – February 2019)	% of net sales	Progress rate
Net sales	73,087	100.0	83,574	100.0	49.1
Gross profit	32,002	43.8	33,505	40.1	
SG&A expenses	26,802	36.7	29,562	35.4	
Operating income	5,200	7.1	3,942	4.7	49.2
Ordinary income	4,471	6.1	3,378	4.0	51.9
Profit attributable to owners of parent	2,595	3.6	1,775	2.1	59.1

Note: FY8/18 is eight months.
Source: Prepared by FISCO from the Company's financial results

Generally upbeat earnings progress in main businesses

2. FY8/19 2Q results by segment

Store services posted ¥23,029mn in net sales (47.5% progress) and ¥4,279mn in operating profit (53.5%). The Company added CANSYSTEM to the group and promoted expansion of business scope from “mainly music distribution” to “store comprehensive assistance services,” including reinforcement of the service lineup. Leading services are multifunction low-priced tablet POS register “U Regi,” self-order app “U Regi TTO” (an optional function for “U Regi”), self-ordering system for staff shortages and inbound response “U-Order,” store app creation service “UPLink,” business facility Wi-Fi service “USEN SPOT,” chain store Wi-Fi service “USEN SPOT Enterprise,” IP camera Viewla Series (easy connection and operation using a smartphone or other device), restaurant reservation service “USEN Reservation,” and card payment service “USEN PAYGATE.” Additionally, the Company started selling “Air Register for USEN” based on a business alliance with Recruit Lifestyle Co., Ltd. in February 2019. It began broadcasts of “music to encourage people to go home” in “Sound Design for OFFICE” background music service aimed to improve the work environment at offices and sells small-sum, short-term insurance to business facilities. In the CANSYSTEM business, it targets business portfolio changes and is making revisions to administrative costs and overlapping costs.

Communications reported ¥19,549mn in net sales (55.9% progress) and ¥1,440mn in operating profit (51.4%). Broadband Internet line sales agent business continued healthy new acquisition efforts mainly for smaller businesses, and the Company strengthened sales of network services, cloud services, and data center services under the “USEN GATE 02” brand in office ICT environment construction.

Business systems business booked ¥9,529mn in net sales (48.9% progress) and ¥1,591mn in operating profit (46.8%). The Company entered simplified lodgings as a new market with the release of the innto lodging management system for centralized management of guest room information at such sites and promoted mutual customer introductions between Japan and Taiwan through a business alliance with FunNow Ltd., which manages the FunNow store reservation site in Taiwan. In the hospital market, it started sales of "Sma-pa TERMINAL," a next-generation reception machine that integrates functions from medical reception to payments. It aims to improve convenience with reception and payment via a facial recognition system using AI, automated authentication of insurance certificates, and development of a smartphone app that synchronizes with "Sma-pa TERMINAL."

Contents distribution booked ¥15,736mn in net sales (49.2% progress) and ¥10mn in operating profit (2.0%). The Company continued to improve customer experience, expand contents, and develop the market amid stimulation of the VOD market driven by Amazon and Netflix. It also sustained high satisfaction and steadily increased subscribers by enhancing content, including movies, drama shows, animated programs, and other new and popular content. The AI concierge, an automated response service that runs 24 hours a day and 365 days a year, facilitates cost savings and high-quality responses through combination with manned answering by operators.

Energy business reported ¥14,098mn in net sales (44.1% progress) and a ¥306mn operating loss. The Company bolstered sales to business branches and retail facilities of mainly high-voltage and low-voltage electricity. It positions energy business as a high growth area and ramped up investment and sales activities, including formation of a dedicated sales division, as a future focus business. While it steadily increased subscribers, investments and upfront costs resulted in operating losses. The Company intends to sustain aggressive sales expansion efforts and realize early profitability. It is also accelerating sales activities for "USEN GAS," a newly launched city gas service.

Media booked ¥2,661mn in net sales (53.2% progress) and ¥136mn in operating profit (45.3%). "Hitosara" business retained a top domestic position in information volume, including chef listings, and "Hitosara" World enhanced local restaurant information recommended by chefs and thereby achieved differentiation from rivals. The Company began a service that gives points to users with the aim of raising awareness of its online immediate reservations. "SAVOR JAPAN," one of Japan's largest inbound gourmet sites, actively expanded not only English-speaking world users, but also users from Hong Kong and Taiwan. It also teamed up with Mafengwo, China's largest travel SNS media. In wedding business, the Company is promoting high-quality service that incorporates drone video.

Upfront costs initially toward realizing NEXT for 2024 goals

3. FY8/19 outlook

The Company's FY8/19 guidance calls for ¥170,000mn in net sales, ¥8,000mn in operating profit, ¥6,500mn in ordinary profit, and ¥3,000mn in net profit attributable to parent shareholders. While it does not give YoY changes because FY8/18 was an abnormal year with just eight months, we think these targets are sufficiently attainable in light of earnings progress at 50-60% in 1H and higher income from contract build-up. The Company is sustaining direct sales, but also strengthening sales operations through mutual use of sales channels such as telemarketing, web marketing, and distributor network channels with the aim of maximum utilization of the group's customer base, various products, and other business assets. It also aims to harness IoT, AI, and other new IT technologies to address rapid changes in technology and the social environment and quickly understand market needs and business opportunities. The Company is expanding sales channels for medium-term growth and revamping the business model in FY8/19 to support these activities and hence expects to incur larger upfront costs. The FY8/19 plan therefore sets anticipated operating margin at 4.7%, which is slightly less than the estimated average in the lower 5% range.

FY8/19 outlook

(¥mn, %)

	FY8/18	% of net sales	FY8/19 E	% of net sales	% of change
Net sales	107,932	100.0	170,000	100.0	-
Operating income	6,006	5.6	8,000	4.7	-
Ordinary income	5,012	4.6	6,500	3.8	-
Profit attributable to owners of parent	3,169	2.9	3,000	1.8	-

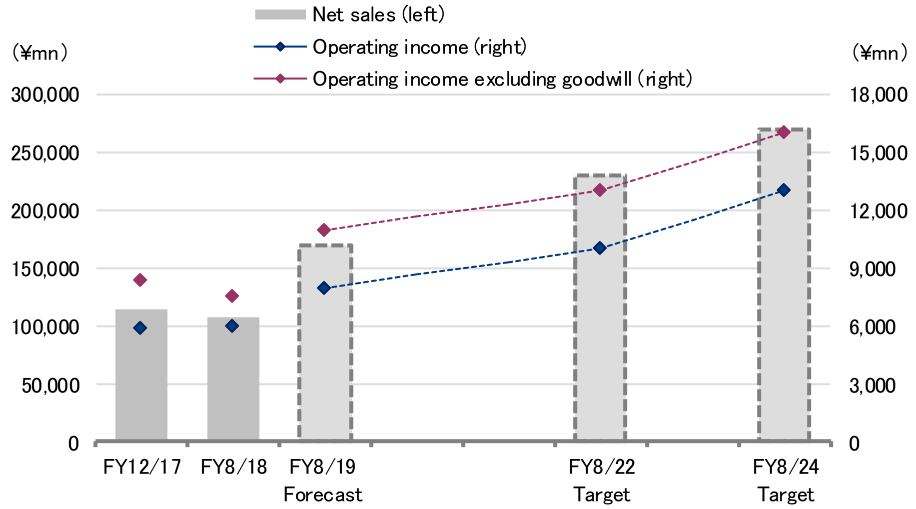
Note: FY8/18 is eight months.
Source: Prepared by FISCO from the Company's financial results

Likely to sustain high profits and growth over the medium term

4. Medium-term growth

We think the Company is sufficiently capable of attaining operating profit goals of ¥10bn in FY8/22 and ¥13bn in FY8/24 set in the medium-term plan NEXT for 2024. It needs robust double-digit annual average profit growth to reach these goals. In operating margin, however, the Company expects a weak level in the 4% range over the medium term because of roughly ¥3bn in annual goodwill amortization costs, upfront costs in FY8/19 and then structural reforms at CANSYSTEM, expansion of fast-growing (but low margin) energy business, and a shift in communications. Energy business, in particular, has low gross margin due to wholesale electricity business, and its downward pressure on overall profitability obviously reduces asset turnover too. However, we expect the Company to generate roughly 6% operating margin excluding energy business over the medium term and also robust operating margin prior to goodwill amortization costs, a key indicator of genuine profitability, of about 8% (excluding energy business). Given these points, we think the Company hopes to deliver strong profits in real terms and more than double-digit growth in NEXT for 2024.

Medium-term growth



Source: Prepared by FISCO from the Company's financial results and medium-term management plan briefing materials

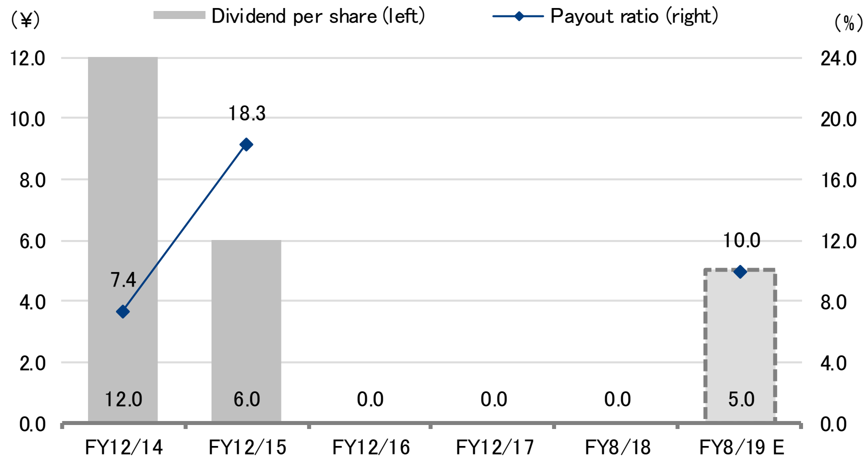
Shareholder return policy

Plans to restore the dividend

1. Dividend policy

The Company views profit compensation to shareholders as an important management policy and has adopted a basic policy of continuing stable dividends over the long term. While it had left FY8/19 interim and year-end dividends unresolved, it decided to revise its stance to zero interim dividend and a ¥5 period-end dividend comprehensively taking into account shareholder return, net profit targets, and other factors.

Trends in dividend per share and payout ratio



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

Benefit program that enables U-NEXT services to be used under favorable conditions

2. Shareholder benefit program

The Company provides a benefit program to shareholders who own one unit (100 shares) or more of its stock that consists of waiving the initial fee and usage fees for 90 days in the “U-NEXT” video distribution service. It also gives them 1,000 points that can be used in “U-NEXT” service (shareholders who are already members only receive the points). Furthermore, it waives the initial fee for mobile data communication service “U-mobile”’s calling plus plan and gives a ¥5,000 cash return via postal money order. Reception of these shareholder benefits requires registration through a dedicated URL.

Information security

Carefully managing security for work-style reforms

The Company is strengthening personal information protection capabilities and continues to implement educational programs. However, it cannot give a guarantee of complete protection and there is always risk of personal information leaks due to improper access from an external source, system trouble, insider crime, human mistakes, and management mistakes at outsourcing and service provision partners. Given these challenges, the Company manages the information system at a data center, employs a firewall, and continually assesses vulnerability in web applications as a more proactive information security effort. The Company allocates notebook PCs and smartphones to individuals as part of work-style reforms. It greatly reduces security risk by equipping notebook PCs with a security chip (TPM) and utilizing MDM in smartphones.

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