

Daikoku Denki Co., Ltd.

6430

Tokyo Stock Exchange First Section and Nagoya Stock Exchange First Section

4-Feb.-2021

FISCO Ltd. Analyst

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FISCO Ltd.

<https://www.fisco.co.jp>

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Summary

In 1H FY3/21, sales and profits both declined significantly due to the coronavirus pandemic, but these results had been expected. The Company will aim for a 2H recovery in earnings alongside the market rejuvenation, and will maintain a ¥40 per share annual dividend

1. Business overview

Daikoku Denki Co., Ltd. <6430> (hereafter, “the Company”) has two main businesses: one that develops, manufactures and sells computer systems for pachinko (Japanese slot machines) parlors and halls, and the other that develops, produces and sells display and control units for pachinko and pachislot machines. The Company holds the leading market share, approximately 35%, of the Japanese market for hall computers, reflecting an information management method that is the de facto standard for the industry. Furthermore, the industry’s leading membership-based information provision service Daikoku Denki Strategic Information System (DK-SIS) to support the operations of pachinko hall associations forms a network of 3,348 pachinko halls and supports the Company’s business foundation.

Japan’s pachinko market has been shrinking over the years. In response, the Company has been working to reform its businesses over the medium to long term. Reforms include developing a next-generation hall computer and shifting to a business model more reliant on services that provide recurring revenue. However, with the series of revisions to regulations (including controlled ball payouts, measures against gambling addiction, and replacement with machines complying with the new regulations) having brought the industry to a major turning point, earnings right now remain difficult due to the impact of future uncertainty, along with the impact of the coronavirus pandemic. Meanwhile in June 2019, the Company released the AI hall computer “X (Kai),” the first of its kind in the industry, as it started in earnest on its efforts targeting future business expansion. Toward a new era with machines complying with the new regulations, the Company is aiming to increase its market share and boost profitability while helping hall operators improve efficiency and save labor.

2. Overview of 1H FY3/21 results

In 1H FY3/21, both sales and profits declined significantly, with sales falling 40.7% year on year (YoY) to ¥11,060mn and an operating loss of ¥224mn (compared to operating income of ¥1,302mn in the previous fiscal year). However, these results were within the expected range. In the midst of the pandemic, the environment for pachinko parlor management became increasingly challenging due to the request for business suspensions, shortened operating hours, etc., and the sharp decline in appetite for and postponement of capital investment resulted in sluggish performance in the Information System Segment. In the Control System Segment, sales of new titles by game machine manufacturers were postponed due to the impacts of the coronavirus. With this backdrop, sales of display units, control units, and parts all fell. In terms of profits, the Company posted an operating loss in conjunction with the sharp decline in sales, but the magnitude of the operating loss was lower than forecast as a result of the postponement of R&D costs, decline in venue costs as a result of holding exhibitions online, and Company-wide efforts to reduce expenses.

Summary

3. FY3/21 forecast

The Company's forecast for FY3/21 is for a decrease in sales and profits, with net sales of ¥28,000mn (-15.0% YoY) and operating income of ¥400mn (-72.1%). However, it is necessary to keep in mind that this earnings forecast involves more earnings being booked in 2H. Net sales are expected to decline significantly in 1H due to the impacts of the coronavirus pandemic and the associated cooling of investment appetite. However, the Company expects the market environment to normalize gradually during 2H and net sales to recover. In particular, it seems to think that the replacement of machines with those that comply with new pachinko industry standards ("play time") (details are below) will contribute to the revitalization of the market. In terms of profits, the Company is forecasting a profit for the full fiscal year, but a significant decline from the previous fiscal year is expected.

4. Future strategic direction

In the Company's view, regulatory revisions and other changes in conditions surrounding the pachinko industry will, in the medium to long term, represent a good opportunity for the industry to evolve into one that enjoys even wider public support. The Company's policies are focused particularly on expanding market share with its industry-first AI hall computer "X (Kai)" and other next-generation products, as well as on creating new value through its data analytics and planning and development capabilities, which will contribute to industry growth while also leading to improved growth and profitability for the Company itself. In the medium- to long-term view, we at FISCO are also keeping a close watch on the Company's efforts to revitalize the industry as a whole, and its M&A action both in and outside the industry.

Key Points

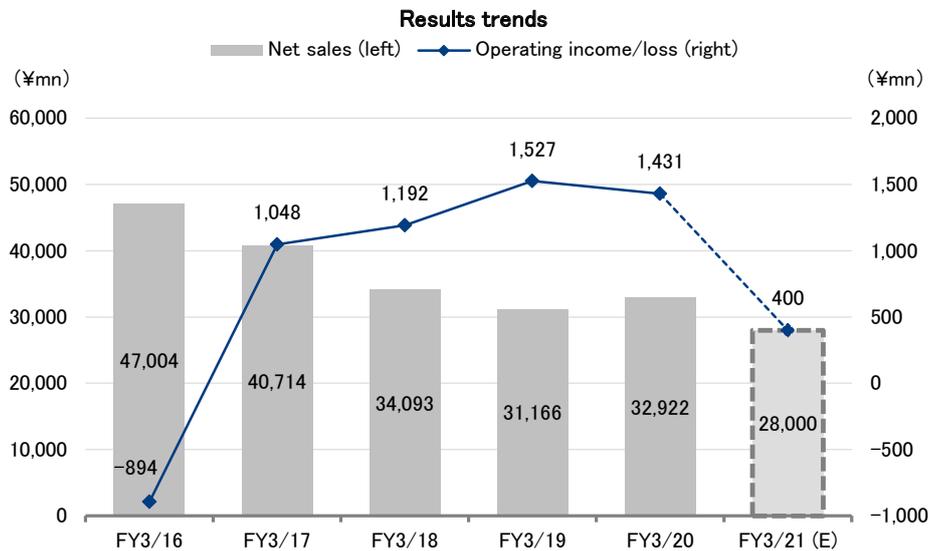
- Amid the continued challenging industry environment and the impacts of the coronavirus, 1H FY3/21 sales and profits declined significantly, but the results were within expectations
- Forecasting a decline in both sales and profits for the full year in FY3/21, but aiming for a recovery in 2H. Will also maintain an annual dividend of ¥40 per share
- The current recovery trend in hall business conditions seems to have plateaued, but expecting the market to be rejuvenated in conjunction with the replacement of machines with "play time" machine models
- Toward a new era with machines complying with the new regulations, the Company aims to increase its market share and improve profitability by helping pachinko halls improve their operating efficiency and save labor, as well as by providing new value leveraging data

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Summary



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

Description of businesses

Focuses on hall computers and peripheral equipment for pachinko halls. Aims to further expand its top market share in the industry by promoting the industry's first AI hall computer

While emphasizing development, production and sales of computer systems for pachinko halls, the Company also develops, manufactures and sells display and control units for pachinko and pachislot machines.

As a pioneer in the development of hall computers, which assist in the management of pachinko halls, and holder of the top market share in the Japanese market, the Company won halls' trust and satisfied pachinko players by proposing a management method which puts emphasis on data management, introducing innovative peripheral equipment for its hall computers and providing the industry's leading membership-based information provision service.

The Company's hall computers are utilized at 3,434 halls (35.6% share) and 1,867,000 game machines are installed (44.5% share).

The Company's two main businesses are the Information System Segment and Control System Segment, but the Information System Segment provided 74.2% of its net sales (1H FY3/21 results) and has been the main source of stable profit in the past few years.

Description of businesses

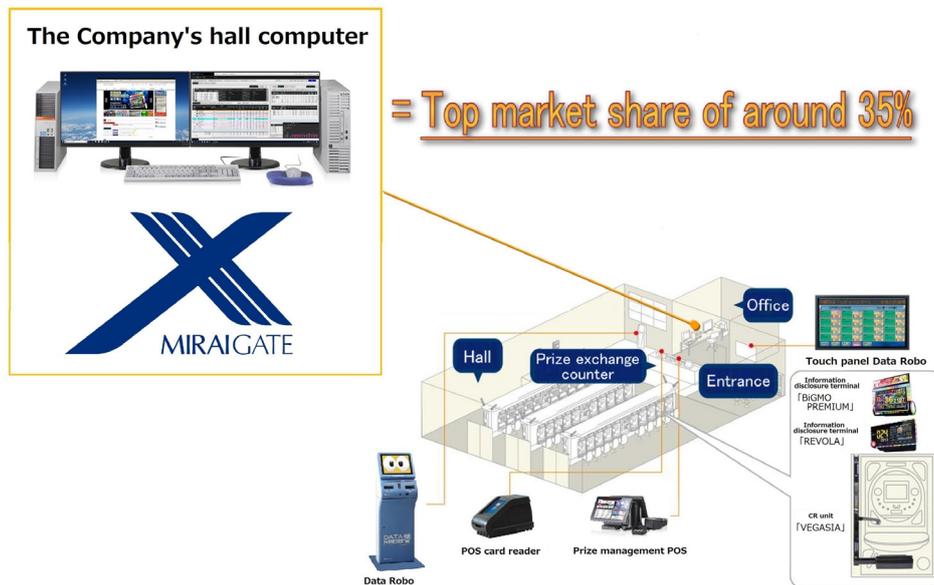
1. Information System Segment

The Information System Segment offers a complete line of information equipment and services necessary to support operational management at pachinko halls. It sells hall computers, which are the core of the system used at pachinko halls, and peripheral equipment, such as prize management and information disclosure systems. The segment also offers hall management support services through information equipment and the membership-based information provision service DK-SIS, which is the leading service in Japan that provides strategic information about associated halls.

Hall computers are the core systems for supporting pachinko hall operations. These computers display the operating conditions and sales of each machine in a hall. These computers are supported by peripheral equipment, such as prize management and information disclosure systems. They also serve as the foundation of the membership-based information provision service. Introducing a hall computer provides the advantage that peripheral equipment and support services can be sold as a package deal. The Company has been aiming to transition to a business model that provides recurring revenue by collecting membership fees such as its after-sales management support services and information provision service in addition to information equipment sales.

In June 2019, the Company released industry-first AI hall computer “X (Kai),” its first launch in 12 years since the release of the hall computer “CII”. Based on the concept of a “hall computer that teaches,” the main feature of this AI hall computer is that it will guide pachinko hall operators to the optimal solutions by utilizing the Company’s big data and having AI automatically analyze the data. By helping pachinko hall operators improve their operating efficiency and save labor, it aims to expand its market share and increase its profitability.

Hall computers and main peripheral equipment



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

Description of businesses

2. Control System Segment

The Control System Segment produces and sells displays and control units, as well as components used for pachinko and pachislot machines for game machine manufacturers. Applying the knowledge obtained from analyzing data from pachinko machines as a hall computer manufacturer for many years, the segment serves as a development partner for the content as well, moving beyond the scope of a machine manufacturer by proposing specs based on the trends of popular models and acquiring copyrights for popular characters. In particular, from 2H FY3/21, the Company plans to leverage the hardware and software technologies it has cultivated to advance bundled contract development of pachislot machines and expand the business domain of the products it sells, thereby ramping up the pachislot business in earnest.

■ Company strengths

Track record of creating new opportunities for the industry and provides added value for hall management in various aspects

1. Growth model based on market expansion through innovation

Since its establishment, the Company has consistently planned and developed new categories of goods and services, thereby cultivating the pachinko market and achieving growth. It has not just developed machines with superior functions but emphasized the importance of data management and the necessity for information disclosure. Thus, it has been able to provide added value to various aspects of pachinko hall management.

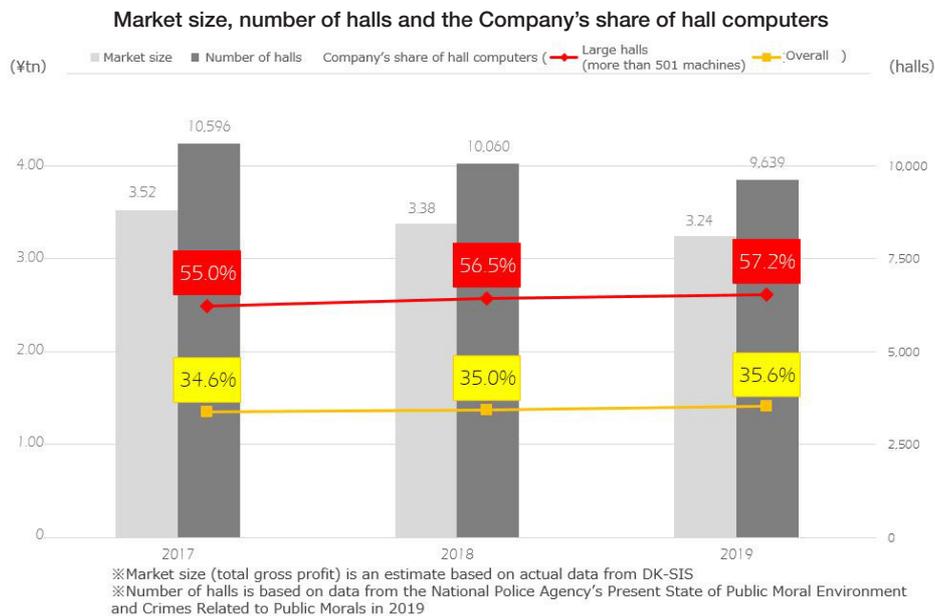
Launched in 1974, the Company's first hall computer enabled the managers of pachinko halls to introduce a hall management method based on data management. Previously, pachinko halls accumulated only basic data, but with the introduction of hall computers, data-based hall management became the de facto standard. In subsequent years, the Company has been consecutively introducing industry-first information equipment with revolutionary functions in the pachinko industry. One such piece of equipment was the Data Robo terminal, which provides information about different models of pachinko and pachislot machines to the players of these machines. This equipment has increased the satisfaction of pachinko players and the efficiency of pachinko hall management, and hereby improved the profitability of pachinko halls.

In June 2019, the Company released the industry's first AI hall computer, "X (Kai)." This AI hall computer will greatly help pachinko hall operations, for which shortage of manpower is an issue, by improving operating efficiency and reducing necessary labor by having AI automatically analyze big data that the Company possesses.

Company strengths

2. Strong network of pachinko halls

Another advantage the Company has is its membership-based information provision service, DK-SIS. This service creates an information network connecting the Company and member pachinko halls, and processes and analyzes the daily operational information of pachinko halls recorded by hall computers and gives feedback to hall managers to help their operations. It enables the managers to conduct effective hall operation utilizing valuable external information, including nationwide pachinko machine information and operational data broken down by machine model. At the same time, this strong network made up of members also supports the Company's business foundation. Additionally, it occupies an industry think-tank role, contributing to improving the Company's brand as a leading company, and is utilized in strategic proposals and sales activities to game machine manufacturers. Membership totaled 3,348 halls at the end of September 2020 with 1.47mn managed machines (35.1% share in managed machines). While member volume has peaked amid a recent decline in overall pachinko halls, DK-SIS enjoys a large share in managed machines, mainly at large sites.

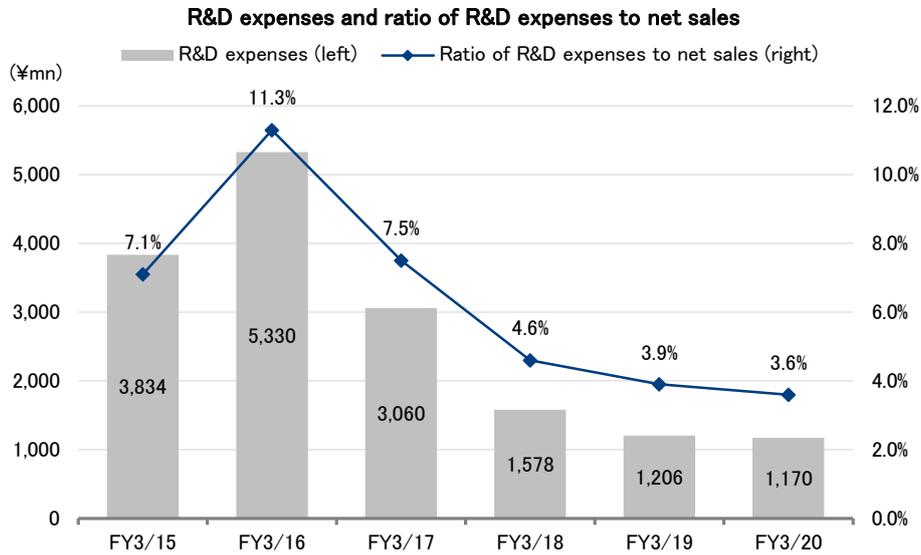


Source: Prepared by FISCO from the Company's results briefing materials

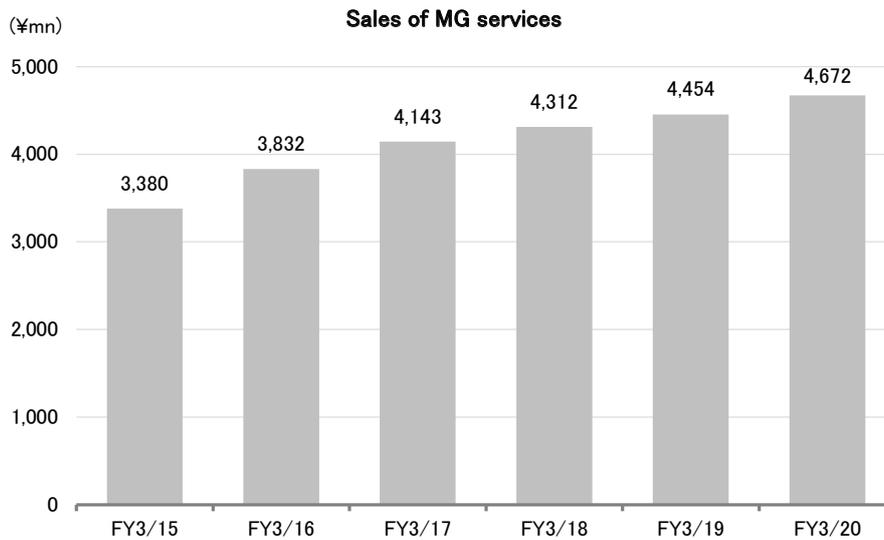
3. Stable profit base that supports investment for the future

The Company's main source of competitiveness is its proactive upfront investment eyeing future growth, including its R&D expenses. Over the past few years, it has developed unique pachislot machines, a next-generation hall computer (and peripheral equipment), and other products to drive its sales and profit growth hereafter. The stable revenue stream provided by the high-margin Information System Segment makes this investment possible. In particular, management support services (MG services) promoted by the Company as a recurring revenue business model have grown and enabled funding of R&D at a high level while maintaining stable segment income, and investment risk has been limited. The Company's ability to balance large profits from its existing businesses with heavy investment in businesses for future growth allows it to produce value on a continuing basis. Since FY3/18, R&D expenses have continuously been on the decline because of a lull in major investment in the next-generation hall computer, etc. Going forward, the Company intends to proactively invest its R&D expenses in fields including data analysis features related to AI hall computer "X (Kai)," which has already been introduced in the market.

Company strengths



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



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

Industry environment

Uncertainty remains for the time being due to the replacement of machines with those complying with the new regulations and the coronavirus pandemic, but in the medium term it is a good opportunity for transformation

Japan's pachinko industry has been experiencing a challenging environment over the past few years, reflecting the decline in the overall number of pachinko players, a trend toward playing games with low rental costs for balls, increases in Japan's consumption tax, and other factors. The self-regulatory action taken by the industry in 2015 (tightening restrictions on both pachinko and pachislot machines with strong gambling elements) left the whole industry in a slump in 2016 as it started to grapple with the problem of collecting and removing all pachinko machines that may perform differently from certified standards. Since the official announcement on September 4, 2017 of the Regulations Regarding the Certification of Game Machines and Examination of Models (enforced on February 1, 2018; hereafter, "new regulations")*, the situation has remained in a state of flux due to a pessimistic view and uncertainty toward the industry. As for pachislot machines in particular, the certification of mainstay models with strong gambling elements which had been the breadwinners for the management of pachinko halls had expired at the end of December 2019 (deadlines for removal), and this will have a considerable impact on pachinko halls' business. This, combined with the impacts of the coronavirus pandemic (business suspensions, shortened operating hours, etc.) since the start of 2020, has made the future outlook increasingly uncertain.

* Among the new regulations are restrictions on the maximum number of balls that can be paid out and clearly defined standards for "controlled machines." However, although more than two years have passed since the enforcement of the new regulations, there is still a large number of machines conforming to the previous regulations that continue to operate. Pachinko hall operators are worried that their earnings will decline and they will be faced with difficult decisions about the timing of equipment replacement and other matters. This has likely prolonged their diminished investment appetite (cautious stance).

On the other hand, the deadline for completely removing machines conforming to the previous regulations was extended for one year (until the end of January 2022) due to the coronavirus pandemic, and the replacement of machines with those complying with the new regulations*¹ is expected to progress gradually in stages. Game machines with new game features ("play time," etc.)*² will be released based on the revisions to the Criteria for Interpretation of Technological Standards enacted in January 2020, and the associated establishment of internal regulations of the Japan Pachinko Machine Industry Association. With this, there are hopes that the market will be revitalized by the demand for replacement of game machines. In addition, as machines conforming to the previous regulations are removed and machines complying with the new regulations are introduced to the market in the future, it is believed that investment (to draw in customers) as pachinko halls compete to survive will be sparked, and it is also expected that the efforts to save labor will be activated to resolve the labor shortage in the operation of pachinko halls and that there will also be investments made to address the move to eliminate smoking in pachinko halls as a part of the Health Promotion Law that went into full effect in April 2020.

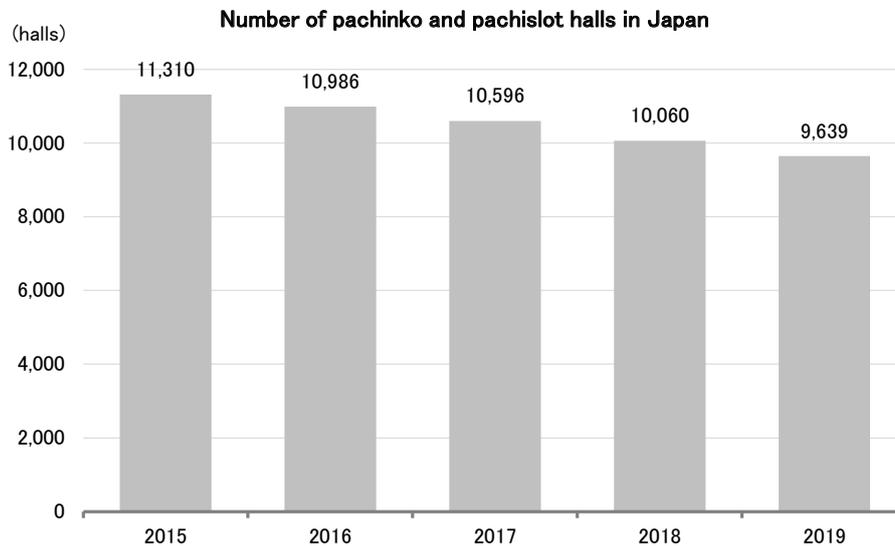
*¹ According to Company estimates, the rate of deployment of machines complying with the new regulations as of the end of October 2020 was about 51% for pachinko and about 34% for pachislot. Deployment for pachislot, where earnings from type-6 machines are weak, is particularly slow.

*² "Play time" is a system (rescue measure) whereby the machine enters a shortened time mode (a function that efficiently rotates balls without reducing the number of balls up to a certain number of times) if the player does not have a big win in a specified number of rotations during normal play (low probability). With the recent industry regulations, new functions such as "play time" have been added, and the breadth of game features of game machines has expanded significantly.

Industry environment

According to surveys by the National Police Agency, the number of pachinko halls in Japan declined at an average annual rate of 3.0% from 2011 to 2019. In particular, there is a noticeable decline in new hall openings due to the impact of the new regulations and other factors. In the end of December 2019, the number of halls was 9,639 (-421 YoY), and the Company served 3,434 of these halls (35.6% share). Its customer halls are often high-end, large pachinko halls that are the top performers in their respective local markets, which exceed the market average in size*. Average game machine volume per store is 544 machines, surpassing the average at other companies (375 machines) by about 45%. The customer base hence is fairly resilient to economic fluctuations and possesses healthy investment resources. As the Company moves toward a new era with machines complying with the new regulations, we expect an excellent opportunity for it to expand business once investment appetites recover, mainly at large halls.

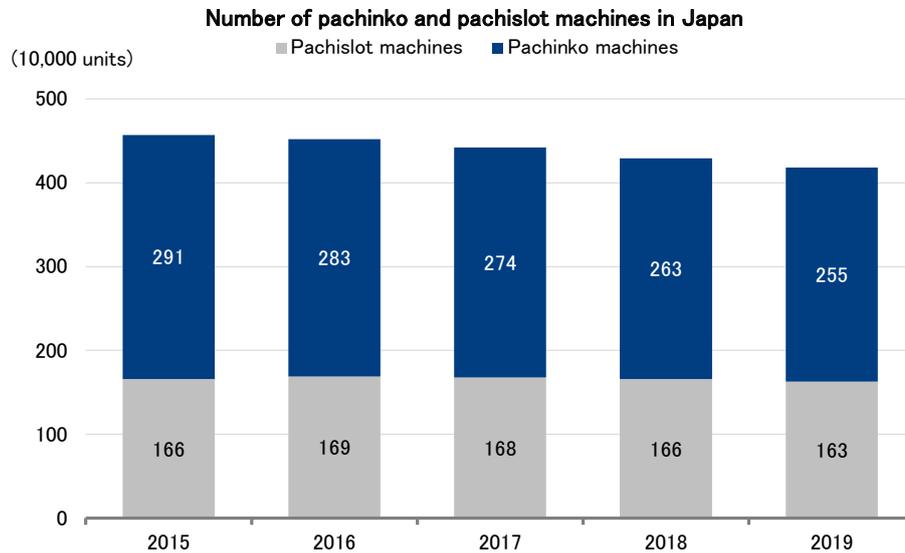
* The Company holds a roughly 55.3% share in mid-sized to large halls (501 to 1,000 machines) and around 72.3% in large halls (1,001 or more machines). Its market presence is higher at large halls.



Source: Prepared by FISCO from the National Police Agency's Present State of Public Moral Environment and Crimes Related to Public Morals in 2019

Meanwhile, although the number of game machines is on a downward trend (the decline in pachinko machines is particularly striking), the number of machines per hall is increasing, indicating that halls are becoming larger. As discussed above, larger pachinko halls that command economies of scale are the Company's main segment, therefore this trend should benefit the Company with its ability to realize robust investment return through advanced functionality and added value.

Industry environment



Source: Prepared by FISCO from the National Police Agency's Present State of Public Moral Environment and Crimes Related to Public Morals in 2019

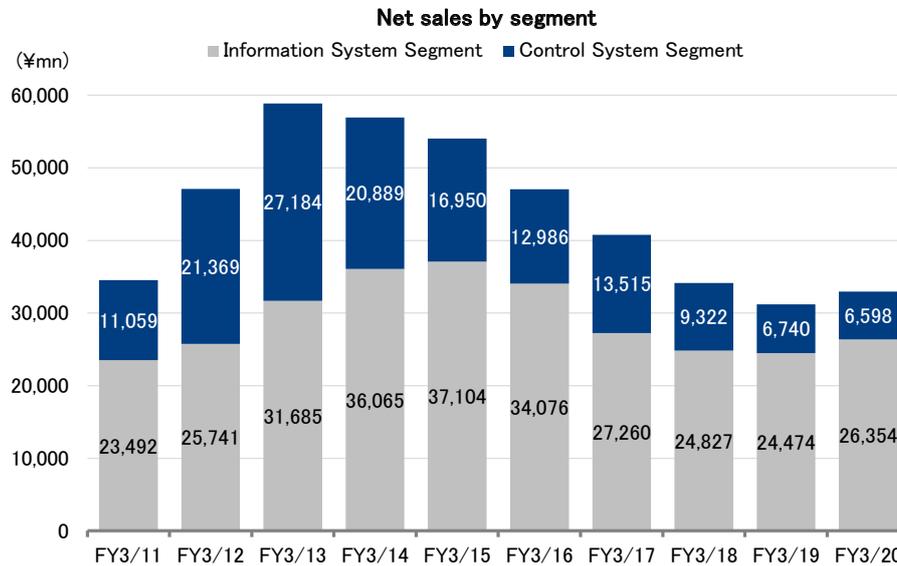
Financial results trends

As the industry enters a period of transition, earnings have been on a downward curve, but the Company is establishing a foundation for sustainable growth eyeing the future

1. Performance over the past fiscal years

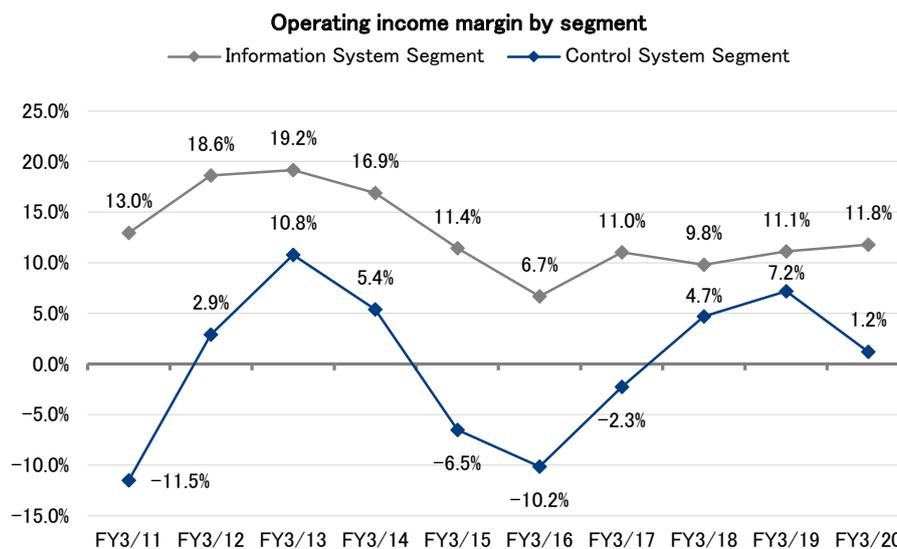
Looking back at past results, the Company's sales shrank YoY because of restrained consumer spending and the impact of the Great East Japan Earthquake in FY3/11. Its results rebounded afterwards, even though the pachinko industry continued to contract. This recovery was mainly led by the Information System Segment, which holds high market shares for its products. Net sales in this segment reached consecutive record highs from FY3/13 to FY3/15, supporting the Company's overall performance. However, net sales have been weak since FY3/16 due to the impacts of negative factors in the industry (self-regulatory action, collecting and removing of machines, and uncertainty related to new regulations), as well as the impacts of the coronavirus pandemic and other factors since the start of 2020.

Financial results trends



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

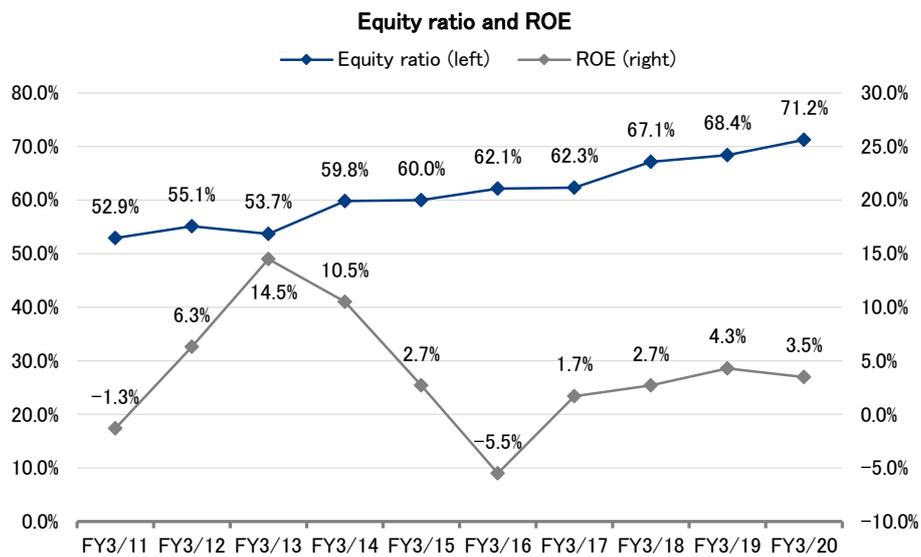
The Information System Segment has become the source of profits, and has maintained high profit margins as the Company's performance recovered. Reflecting increasing investment in R&D for next-generation products from FY3/14 to FY3/17, profit margins have declined, but considering the size of the investment, margins are still high. However, although R&D for next-generation products has run its course for the meantime since FY3/18, profit margins have not completely returned to the previous high levels due to factors including the stagnation in net sales. Meanwhile, steady progress in the conversion to a recurring revenue business model, including growth in MG services, has been supporting income.



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

Financial results trends

In terms of financial indicators, the Company's equity ratio, a measure of financial stability, has been rising, reflecting the accumulation of retained earnings, reaching a high level of 71.2% in FY3/20. The current ratio, which indicates the ability to make payments in the short term, was 235.4% in FY3/20, mainly due to large holdings of cash and deposits, as the Company's robust financial base is a strength not only for business continuity, but also as a source for powering future growth. ROE, a measure of capital efficiency, has been low since FY3/15 due to a deterioration of net income. The Company suffered losses in FY3/15 due to the bankruptcy of a manufacturer customer and in FY3/16 due to the devaluation of parts and materials for its pachislot machines as industry restrictions were placed on risky machines.



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

1H FY3/21 earnings declined significantly due to the impacts of the coronavirus pandemic and other factors, but steady progress is being made towards reaching initial forecasts

2. Overview of 1H FY3/21 results

In 1H FY3/21, both sales and profits declined significantly due to the impacts of the coronavirus pandemic. Net sales declined 40.7% YoY to ¥11,060mn, while operating loss was ¥224mn (compared to operating income of ¥1,302mn in the previous fiscal year). Ordinary loss was ¥18mn (compared to ordinary income of ¥1,421mn), and net loss attributable to owners of the parent was ¥48mn (compared to net income of ¥912mn). The Company reported a loss on all profit lines. However, net sales were almost as forecast at the beginning of the fiscal year, and profit was actually higher than initially forecast.

Amid this challenging industry environment, along with the impacts of the coronavirus pandemic (business suspensions, shortened operating hours, etc.), the situation for the management of pachinko parlors has become increasingly adverse. This led to an extreme decline in the appetite for and postponement of capital investment, resulting in a significant slump in performance in the Information System Segment. In the Control System Segment, sales of new titles by game machine manufacturers were postponed due to the impacts of the coronavirus. With this backdrop, sales of display units, control units, and parts all fell.

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Financial results trends

In terms of profits, the Company posted an operating loss in conjunction with the large decline in sales, but the magnitude of the operating loss was lower than forecast as a result of the postponement of R&D costs, decline in venue costs due to holding exhibitions online, and Company-wide efforts to reduce expenses.

In terms of financial condition, equity declined 1.6% from the end of FY3/20 to ¥29,923mn due to the payment of dividends and posting of a net loss for the period. Meanwhile, total assets contracted 5.7% from the end of FY3/20 to ¥40,285mn, due to the decline in accounts receivable and depreciation expenses for property, plant and equipment and intangible assets. As a result, the equity ratio increased to 74.3% (compared to 71.2% at the end of FY3/20). Furthermore, cash on hand was approximately ¥15.0bn, and the current ratio was 266.2%, so there are no concerns about financial soundness.

Overview of 1H FY3/21

	1H FY3/20		1H FY3/21		Change		(¥mn)			
	Results	Ratio to sales	Results	Ratio to sales	% change	1H FY3/21		vs. forecast		
						Initial forecast	Ratio to sales	Achievement rate		
Net sales	18,643		11,060		-7,582	-40.7%	11,000		60	100.6%
Information System Segment	14,908	80.0%	8,206	74.2%	-6,702	-45.0%	8,500	77.3%	-293	96.5%
Control System Segment	3,750	20.1%	2,858	25.8%	-891	-23.8%	2,500	22.7%	358	114.3%
Adjustment	-15	-	-4	-	11	-	-	-	-	-
Gross profit	6,682	35.8%	4,332	39.2%	-2,350	-35.2%	4,050	36.8%	282	107.0%
SG&A expenses	5,379	28.9%	4,556	41.2%	-823	-15.3%	5,350	48.6%	-793	85.2%
Operating income (loss)	1,302	7.0%	-224	-2.0%	-1,527	-	-1,300	-	1,075	-
Information System Segment	2,309	15.5%	540	6.6%	-1,768	-76.6%	100	1.2%	440	540.4%
Control System Segment	-66	-	-5	-0.2%	60	-	-400	-	394	-
Adjustment	-940	-	-759	-	181	-19.3%	-1,000	-	240	-
Ordinary income (loss)	1,421	7.6%	-18	-0.2%	-1,439	-	-1,250	-	1,231	-
Net income (loss) attributable to owners of the parent	912	4.9%	-48	-0.4%	-961	-	-1,250	-	1,201	-
Depreciation	1,022		994		-28		987		7	

	End of FY3/20	End of 1H FY3/21	YoY	
				% change
Total assets	42,702	40,285	-2,416	-5.7%
Total equity	30,406	29,923	-482	-1.6%
Equity ratio	71.2%	74.3%	3.1pt	-

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

Financial results trends

The results by segment were as follows.

(1) Information System Segment

Net sales decreased 45.0% YoY to ¥8,206mn, while segment income dropped significantly by 76.6% YoY to ¥540mn. Although the Company focused efforts on introducing the AI hall computer “X (Kai)” (replacement for existing hall computers), sales of the latest related equipment and other efforts, the pachinko hall management environment has become increasingly adverse due to factors including business suspensions, shortened operating hours, and pachinko players refraining from playing due to the coronavirus pandemic. Amid this situation, net sales declined significantly due to the combination of the extreme drop in the appetite for and postponement of capital investment in conjunction with the one-year extension of the schedule for the removal of machines conforming to the previous regulations. In particular, the effects of the coronavirus pandemic were generally within the range of what was expected, but the extension of the schedule for the removal of machines appears to have had an impact that had not been expected. In addition, MG services, which had contributed to propping up earnings until now, decreased YoY due to temporary business suspensions, but even so their continued support of earnings should be appreciated*. Meanwhile, although segment profit declined due to the decline in sales, profit greatly exceeded the initial forecast as a result of exhibitions and seminars being held online, the use of mobile devices, and other cost-cutting initiatives.

* The commercial area analysis service “Market-SIS” (a part of MG services), which is a centerpiece of the Company’s strategy alongside the AI hall computer “X (Kai),” has steadily increased its share, with the number of halls it is posted in exceeding 3,000.

Regarding the operating status of pachinko halls (4 yen pachinko, 20 yen pachislot), although it was sluggish at around 50% YoY in April–May 2020 when the state of emergency was declared, it recovered thereafter, and has been around 80% since July. Although there is a sense that the recovery trend is plateauing at the moment, demand for replacement of game machines is expected to be energized going forward, as game machines with new game features (“play time,” etc.) are gradually introduced to the market and high-capacity pachinko machines begin to appear.

(2) Control System Segment

Net sales declined 23.8% YoY to ¥2,858mn, while segment loss was ¥5mn (compared with segment loss of ¥66mn in the previous fiscal year). Amid the coronavirus pandemic, sales of new titles by game machine manufacturers were postponed due to the impact of business suspensions, shortened operating hours, etc. With this backdrop, sales of display units, control units, and parts all fell. However, sales exceeded the forecasts due to the contribution of large orders. In terms of profits, although the decline in sales pushed earnings down, the magnitude of the loss contracted due to the postponement of R&D expenses and reduction in expenses. Currently, as restrictions on activity due to the coronavirus pandemic are gradually eased, game machine manufacturers are developing new game machines with “play time” and other features on a full-fledged basis. In line with this trend, the Company appears to be working to reallocate resources and review processes in order to minimize the impact on sales schedules.

3. Summary of 1H FY3/21

Based on the above and to summarize 1H FY3/21, the challenging industry environment combined with the impact of the coronavirus pandemic resulted in a continuation of weak operating results. To restate the current situation, there has not been a recovery in willingness to make capital investments in pachinko halls, nor significant progress in the shift to pachinko and pachislot machines that comply with the new regulations. Amid this, the Company has not been able to introduce the AI hall computer “X (Kai)” in earnest or sell the latest related equipment. However, if we look at the Company’s activities, it has been working towards market penetration of the AI hall computer “X (Kai)” and “Market-SIS” (commercial area analysis service), as well as promoting contracted development of pachislot machines. These efforts appear to be going well, so the groundwork laid by the Company can be seen as a positive heading into the future. In particular, at the MIRAIGATE 2020 Web Exhibition & Seminar discussed below, the number of participants was double that of a normal year, and the Company was able to confirm large potential demand for its services. Also, in the market there has been gradual progress with the development and introduction of “play time” machine models. These developments represent an opportunity for business expansion in the Company’s Information System Segment and Control System Segment, and we view the recovery of its operating results as only a matter of time.

■ Main activities

MIRAIGATE 2020 Web Exhibition & Seminar had twice the usual number of attendees, the Company confirmed large potential demand

1. Held the MIRAIGATE 2020 Web Exhibition & Seminar

Each year, through exhibitions and seminars at venues across Japan, the Company introduces new products and makes proposals useful for pachinko hall management. These events are important opportunities for the Company to engage in sales and build relationships. In 2020, MIRAIGATE 2020 Web Exhibition & Seminar was held online (September 1–15) for the first time due to the coronavirus pandemic, and the total number of attendees was 5,508, twice the usual number of attendees. It may be easy for people to participate online, and amid the continued challenging industry environment, it can be seen as an indication of the expectations and potential demand for the Company’s products and proposals. The Company proposed the industry’s new normal, under the themes of “play time,” “personnel and labor-saving,” and “with the coronavirus.” At the same time, it held a DK-SIS seminar to present a market analysis amid the coronavirus pandemic and propose methods for future business earnings recovery. In particular, regarding “play time,” which is the trump card for revitalizing the market, there appeared to be a lot of attention focused on corresponding functions installed in information disclosure devices such as BiGMO PREMIUM II (optimal data display function that enhances players’ sense of security, motivation to play, etc.) and the analytical capabilities of the AI hall computer “X (Kai).”

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Main activities

2. Proposals of new products in line with the times, such as combatting the coronavirus pandemic

The Company also released new products and services in line with the times one after another. These included measures to help halls prevent coronavirus infections*1, reduce personnel and save labor*2, and handle the prohibition of smoking in halls*3. These efforts have not only supported hall business management, but have also built a base for sales of information disclosure equipment and penetration of the AI hall computer “X (Kai).”

*1 To help prevent the spread of the coronavirus, the Company has added a function to call lamps to notify players of the machines that have been cleaned and disinfected and lights up the lamps for machines that need to be disinfected.

*2 The Company released wearable device WW-01 for hall staff to use. With a large LCD screen, it conveys various information, such as call notices from players, abnormalities or unauthorized access to game machine data, etc., via vibration and on-screen display for every instance.

*3 When leaving machines to smoke, players can use the seat-leaving operation on machines, such as the BiGMO PREMIUM, REVOLA and VEGASIA machines. They can smoke with peace of mind while keeping track of their smoking time on the “DiSMO” signage installed in the “Smoking Ark” smoking booth. Staff can respond quickly with an incoming voice notification from a game machine when a player has exceeded the smoking time limit.

Outlook

Based on the impacts of the coronavirus pandemic, expecting a decline in net sales and profit in 1H FY3/21, but anticipating a recovery trend in 2H

1. FY3/21 forecast

For FY3/21 results forecast, the Company has left its initial forecast unchanged projecting a decline in both sales and profits, with net sales of ¥28,000mn (-15.0% YoY), operating income of ¥400mn (-72.1%), ordinary income of ¥500mn (-70.1%), and net income attributable to owners of the parent of ¥300mn (-71.7%).

Net sales are expected to decline significantly in 1H due to the impacts of the coronavirus pandemic (business suspensions, shortened operating hours, etc.) and the associated cooling of investment appetite. However, the Company expects the market environment to gradually normalize during 2H, and looks for net sales to recover. In particular, it seems to think that the replacement of machines with those featuring “play time” will contribute to the revitalization of the market. Looking by segment, both the Information System Segment and Control System Segment are expected see large declines in 1H, but the Information System Segment will see a decline in sales for the entire year, while the Control System Segment will secure an increase in sales. In terms of profit, the Company expects to earn a full-year profit, but forecasts a large decline in profit compared to the previous fiscal year.

Furthermore, although its operating results have declined due to the impacts of the coronavirus pandemic, the Company thinks that results will bottom out in FY3/21 and then head towards a recovery.

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Outlook

FY3/21 forecast

	FY3/20		FY3/21		YoY change	
	Result	Ratio to sales	Forecast	Ratio to sales		% change
Net sales	32,922		28,000		-4,922	-15.0%
Information System Segment	26,354	80.0%	21,000	75.0%	-5,354	-20.3%
Control System Segment	6,598	20.0%	7,000	25.0%	401	6.1%
Adjustment	-31	-	-	-	-	-
Gross profit	12,040	36.6%	10,500	-	-1,540	-
SG&A expenses	10,608	32.2%	10,100	-	-508	-
Operating income	1,431	4.3%	400	1.4%	-1,031	-72.1%
Information System Segment	3,104	11.8%	1,700	8.1%	-1,404	-45.2%
Control System Segment	78	1.2%	600	8.6%	521	-
Adjustment	-1,751	-	-1,900	-	-148	-
Ordinary income	1,674	5.1%	500	1.8%	-1,174	-70.1%
Net income attributable to owners of the parent	1,061	3.2%	300	1.1%	-761	-71.7%
Depreciation	2,212		2,119		-93	
R&D expenses	1,170		753		-417	
Information System Segment	939		670		-269	
Control System Segment	230		83		-147	

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

2. FISCO analyst's opinion

FISCO's analyst believes that it will certainly not be easy to achieve the Company's sales forecasts, given the ongoing impacts of the coronavirus. The key point will be how much the movement to revitalize the market through "play time" and the contract development of pachislot machines, which will enter the market in earnest from 2H, will contribute to business results. Meanwhile, the FISCO analyst believes that the Company's profit forecast is achievable due to the support of MG services and the effect of cost reductions, even if one takes into consideration the portion of R&D expenses that were pushed back to 2H. Looking ahead to FY3/22 and beyond, assuming that the coronavirus will be coming under control and the market will have normalized, the pachinko hall industry will likely accelerate investment and M&A to survive, and industry reorganization and consolidation should proceed in a surge. We feel that this is likely to result in the Company reaching an important turning point. In particular, the biggest challenge in the industry is how to stop the escalating rate of player churn and bring back those who have refrained from playing due to the coronavirus. To this end, the role that the Company will play is massive, as it is important not only to introduce attractive game machines, but also to create an enjoyable environment for players as well as provide market analysis.

Future strategic direction

In addition to increasing market share with the AI hall computer “X (Kai),” the Company aims to generate new value utilizing its data analytics and planning and development capabilities

In the Company’s view, regulatory revisions and other changes in conditions surrounding the pachinko industry will, in the medium to long term, represent a good opportunity for the industry to evolve into one that enjoys even wider public support. The Company’s policies are focused particularly on expanding market share with its AI hall computer “X (Kai)” and other next-generation products, as well as creating new value through its data analytics and planning and development capabilities, which will contribute to industry growth while also leading to improved growth and profitability for the Company itself.

1. Information System Segment

While investment appetite in the pachinko market is expected to remain depressed for a little while longer and despite the fact that the deadline for the complete removal of machines conforming to the previous regulations was extended by one year, game machines with new game functions due to “play time” and other factors are expected to be released, and the Company’s strategy is to capture replacement demand. In particular, it will focus on AI hall computer “X (Kai)” proposals, and promote the replacement of existing hall computers, as well as introduce products equipped with various contents that are compatible with new game functions like “play time,” thereby contributing to improved earnings at pachinko halls. Furthermore, by promoting MG services (especially the commercial area analysis service “Market-SIS”), the Company will help pachinko hall operators increase competitiveness and save labor, thereby securing its own customers and stabilizing its own operating performance.

2. Control System Segment

In addition to the growing demand for reduced development costs for pachinko and pachislot machines, demand for new proposals to address future changes in the market environment is rising, and as planning capabilities have become increasingly important, the Company intends to closely coordinate the efforts of its Control System Segment and Information System Segment in order to further differentiate itself from competitors, assure rapid response to changes in the market environment, and raise operating efficiency. In particular, the Company will revise its development system, further improve operating efficiency, and use the hardware and software technologies it has cultivated over the years to advance bundled contract development of pachislot machines and expand the business domain of the products it sells (start the pachislot business in earnest), as well as utilize the Information System Segment’s DK-SIS data and Fan-SIS data to promote project proposals that generate new gaming value.

3. Strengthening the R&D system

On April 1, 2020, the Company established the R&D Department which will handle basic research on new technologies from a medium- to long-term perspective and investigate new businesses, along with other efforts. Aiming to support technologies that will lead to future business expansion, the department will construct a technology foundation in order to introduce AI technology and other cutting-edge technologies into the Company. The Company will work on promoting open innovation and accumulating technologies and building alliances with outside entities. In addition, the Business Development Office has been incorporated into the R&D Department, where it will continue to explore and conceive new business opportunities.

4. Points of focus for the FISCO analyst

Even though the pachinko industry is approaching a major turning point that renders the Company's surrounding profit conditions uncertain from a medium- to long-term perspective, the successful launch of AI hall computer "X (Kai)" aimed at future growth, in addition to its high-value-added next-generation products, will give it a major advantage over its competitors. In particular, we see the Company's MG services and value proposals leveraging its unique services and data analysis putting it in a strong position to meet the changing needs of the industry. Even assuming the pachinko market continues to contract for a while longer, we believe it will be possible for the Company to sustain growth with the help of a full-scale rollout of a high-value-added lineup of next-generation products that will capture replacement demand among existing pachinko hall operators. Additionally, polarization is likely to proceed further in the pachinko hall industry with firms with extensive capital resources surviving. These conditions are likely to work favorably for the Company in its efforts to increase market control with the AI hall computer "X (Kai)" and raise market share.

We believe that for the time being, it is necessary to cautiously assess net sales growth, which is readily affected by the external environment, but we should also focus on improvement in profitability through development of products and services that respond to changes in market conditions and expansion of MG services. From a medium- to long-term perspective, we also anticipate results from the Company's efforts to revitalize the industry as a whole, as it faces a new age with the complete transition to machines complying with the new regulations. We will also keep watch on the Company's efforts to engage directly with pachinko and pachislot players, amusement fans and new fan segments (including provision of member information via a smartphone app and initiatives that bring people to halls) as well as with pachinko halls and game machine manufacturers. Furthermore, as the Company completes a round of major investment in next-generation hall computers and begins collecting on that investment, we need to also monitor its M&A moves, including those outside the industry. Because the Company's expertise in utilizing data can be extended in other areas, we believe M&A will be an important strategy, both for securing a new source of profits and distributing risk.

Shareholder returns

Plans to continue to pay a ¥40 annual dividend in FY3/21, likely to have room to raise the dividend over the future accompanying profit growth

Although the Company is expecting a significant decline in profit due to the impacts of the coronavirus pandemic, it still plans to pay an annual dividend of ¥40 per share (¥10 interim, ¥30 year-end). Given the Company's policy of raising the dividend in line with earnings, we at FISCO feel there is room for dividend increases in the future as profits grow.

The Company had a system of awarding gifts to shareholders in order to make its shares more attractive to investors and encourage shareholders to keep their holdings over the medium to long term, but on August 7, 2020, it announced that this shareholder gifts system would be abolished. The Company has decided to emphasize dividends as a means of returning profits to shareholders.



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