

Digital Arts Inc.

2326 Tokyo Stock Exchange
 First Section

14-Jul.-16

Important disclosures
 and disclaimers appear
 at the end of this document.

FISCO Ltd. Analyst
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* Filtering software is a software product with a function for dividing Internet sites into those that can be viewed and those that cannot be viewed based on user settings. While anti-virus software protects PCs, smartphones, and other devices from the danger of virus infections, filtering software protects users against unintended exposure to dangers of the Internet.

■ Holds a top market share for web filtering software; Entering a new growth stage

Digital Arts <2326> is a manufacturer of information security products that plans, develops, and sells Internet security software, particularly web filtering* and email filtering products. It handles from product planning and development to sales and support on its own and has established operations to promptly address the needs of corporate and individual customers, including quick provision of support, software version updates, and web filtering databases. Digital Arts has become the top domestic supplier of web filtering software thanks to favorable response to its provision of one of the largest domestic web filtering databases, a key component of filtering products, and technology capabilities that enabled it to acquire patent approval in 27 countries and regions.

Digital Arts reported FY3/16 consolidated results with all-time high sales and profits, including ¥4,000mn in net sales (+17.6% YoY), ¥1,006mn in operating profit (+16.4%), and ¥545mn in net profit attributable to owners of parent (+2.8%). While it aggressively engaged in overseas upfront investment, primary drivers were upbeat sales of mainstay i-FILTER for Business software to corporate and public-sector customers and healthy activity for the FinalCode product in Japan. The low growth rate in net profit reflected setbacks from forex valuation losses and a rise in tax costs related to upfront investments.

Digital Arts guides for double-digit sales and profit gains in FY3/17 with net sales at ¥4,600mn (+15.0% YoY), operating profit at ¥1,400mn (+39.1%), and net profit attributable to owners of parent at ¥870mn (+59.5%). It factors in upfront investments for overseas business (¥450mn), similar to FY3/16. However, it projects continuation of robust domestic business, including higher orders from large companies in the corporate market and the prospect of growing demand in the public-sector market considering the policy presented by the Ministry of Internal Affairs & Communications for strengthening information security measures.

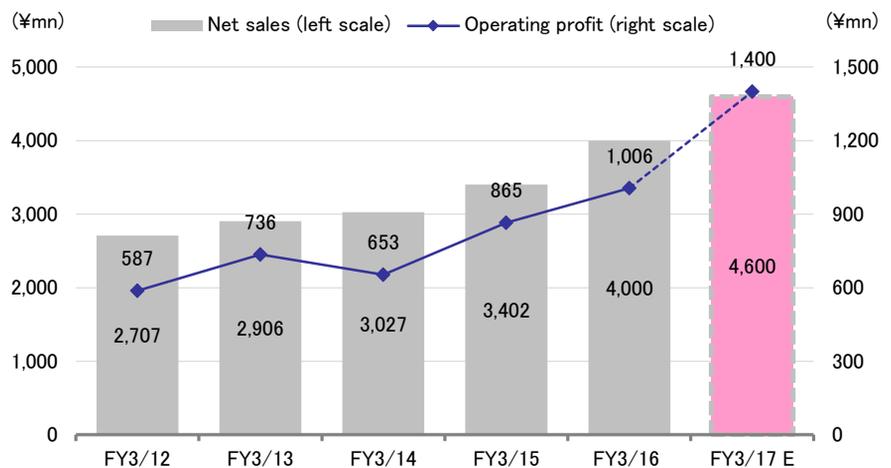
We think the FY3/17 plan is conservative and offers upside room in light of 1) the company's tendency to disclose conservative values in period-start guidance, 2) healthy progress developing business with large companies through alliances with products from other companies in the corporate market, and 3) the existence of deals greatly exceeding the budget for the FinalCode business in Japan. We believe Digital Arts is entering a new growth stage, due to larger deal sizes and progress developing corporate business aided by alliances with third-party products and FinalCode proposals, and will be paying close attention to the orders trend for FinalCode in Japan and abroad.

For shareholder returns, Digital Arts adheres to a core policy of obtaining retained profits, while sustaining a stable dividend, with the aim of securing investment funds to bolster the business foundation and prepare for wider adoption of web filtering software based on an outlook for rapid market expansion. It uses a target dividend payout ratio of about 30% of consolidated net profit attributable to owners of parent. The FY3/17 plan targets a ¥20 dividend (¥10 interim dividend) that works out to a 32.0% dividend payout ratio.

■ Check Point

- Reached all-time high sales and profits in FY3/16
- Making progress in development of new large corporate customers by bolstering consulting capabilities with the establishment of a consulting subsidiary
- Successfully obtained US orders in FY3/16 and is confident about expansion of overseas business in FY3/17

Results Trends



■ Company Overview and History

Security software manufacturer with a top share in the web filtering market

(1) Company overview

Digital Arts is a security software manufacturer that plans, develops, and sells Internet security software and appliance products for companies and individuals. It has created information security solutions, such as web filtering and email filtering that prevent dangers related to Internet access ahead of time and file encryption and tracking solutions that protect important information contained in files, based on a corporate policy of “contributing to a more convenient, more comfortable, and safer Internet life” and supplied these products to corporate, public-sector (government ministries and agencies and schools), and household markets. It handles from product planning and development to sales and support on its own and has established operations to promptly address the needs of customers, including quick provision of support, software version updates, and web filtering databases. Digital Arts promotes security products for the Internet, mail, and files as a core business and has become the top domestic supplier of web filtering software thanks to favorable response to its provision of one of the largest domestic web filtering databases, a key component of filtering products, and technology capabilities that enabled it to acquire patent approval in 27 countries and regions.

(2) History

Representative Director Toshio Dogu* founded Digital Arts in June 1995 with the primary aim of developing and selling Internet-related application software. While it developed and sold Internet software tools in the company’s initial years, it developed Japan’s first web filtering software in August 1998 and started collecting information on problematic sites. It released the i-FILTER School Edition for schools in July 2000 and the i-FILTER Business Edition for companies in January 2001. It steadily expanded business by adding features to these products and broadening the product line-up. Digital Arts listed its shares on the Osaka Stock Exchange NASDAQ Japan market (now: Tokyo Stock Exchange JASDAQ (Growth)) in September 2002, its 7th year after being established. (It subsequently moved the listing to TSE-2 in February 2012 and TSE-1 in March 2013).

* He joined Shin Nihon Kohan Corporation (now, Forval Corporation <8275>) in 1988 and held a sales position. He then worked in programming at MacroSystem Co. and handled business planning for education and entertainment at TDK Core Ltd. (now, Nippon Columbia <6791>). He became Representative Director and President at Digital Arts in October 1997.

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*1 This service provides continuous information monitoring from Internet-based entries and other sources. It searches domestic web sites using key words specified by customers as the search criteria and gives customers URLs that contain information that meets the search criteria.

*2 This service lets companies and households create a cloud with their own PC and supports management of document files, video, music, and photo files, and other electronic data as well as access control and data transfers among multiple devices, including smartphones and tablets, in a high-speed and secure environment, using the Polkast application for building original clouds in the global market.

Digital Arts began NET iScope Internet monitoring service as a corporate risk management tool in May 2000*1, and this business steadily expanded thereafter. However, it decided that it lacked sufficient resources to expand the business further alongside of the mainstay security business and sold the NET iScope business to Gala <4777> in September 2004. Digital Arts thus concentrated resources in filtering software. It acquired IQS' Co., Ltd., which mainly operates a web filtering software business, as a wholly owned subsidiary in March 2005 with the aim of supplementing mutual business resources and expanding customer bases. This move sought to strengthen the security business.

Digital Arts began sales of m-FILTER email filtering software in February 2007 and broadened its business scale. It started selling the D-SPA secure proxy appliance in November 2010 and launched FinalCode in June 2010, putting in place today's product line-up.

Digital Arts formed a business alliance with US-based Polkast LLC*2 and established Polkast Japan in order to expand service in Japan in May 2013, but it concluded that it would be difficult to provide service with high customer satisfaction and dissolved the business alliance and liquidated Polkast Japan in July 2015.

Meanwhile, it founded FinalCode, Inc. in the US in April 2014 with goals of promoting a new concept of security measures worldwide and expanding sales of FinalCode in North America. It established Digital Arts Asia Pacific Pte. Ltd. in Singapore in November 2015 and renamed it FinalCode Asia Pacific Pte. Ltd. in February 2016. It also renamed UK-based Digital Arts Europe Ltd. (founded in April 2011) as FinalCode Europe Limited. Digital Arts is working on operations for overseas sales of FinalCode. Furthermore, it founded Digital Arts Consulting Inc. in April 2016 to focus on management strategy and IT strategy consulting businesses and help recruit major corporate customers in Japan.

History

Date	Overview
June 1995	Founded Digital Arts in Tokyo (Minato-ku) with ¥10mn in capital in June 1995 with the primary aim of developing and selling Internet-related application software
August 1998	Developed Japan's first web filtering software and started collecting information on problematic sites
May 2000	Began NET iScope Internet monitoring service
September 2002	Listed shares on the Osaka Stock Exchange NASDAQ Japan market (now, Tokyo Stock Exchange JASDAQ (Growth) market)
September 2004	Sold the NET iScope Internet monitoring service business and shifted to concentrating resources in filtering software.
February 2005	Gained approval for a "patent on Internet access control including filtering" in 22 countries (it had rights for this patent in 27 countries as of 31 March, 2015)
March 2005	Acquired all shares in IQS' Co., Ltd. (now a consolidated subsidiary)
December 2010	Moved its share listing to Osaka Stock Exchange JASDAQ (Standard) (now, Tokyo Stock Exchange JASDAQ (Standard))
April 2011	Established Digital Arts America, Inc. as a US subsidiary
April 2011	Established Digital Arts Europe Ltd. as a UK subsidiary (renamed as FinalCode Europe Limited in February 2016)
February 2012	Listed shares on the Tokyo Stock Exchange Second Section
May 2012	Delisted shares from Osaka Stock Exchange JASDAQ (Standard) (now, Tokyo Stock Exchange JASDAQ (Standard))
June 2012	Established Digital Arts Investment, Inc. as a US subsidiary
March 2013	Change its share listing to the Tokyo Stock Exchange First Section
May 2013	Established Polkast Japan and formed a business alliance with US-based Polkast LLC
June 2013	Formed a strategic business alliance and conducted a business transfer with NRI Secure Technologies, Ltd.
April 2014	Established FinalCode, Inc. as a US subsidiary
January 2015	Ended the business alliance with US-based Polkast LLC
July 2015	Liquidated Polkast Japan
November 2015	Established Digital Arts Asia Pacific Pte., Ltd. in Singapore in November 2015 and renamed it FinalCode Asia Pacific Pte., Ltd. in February 2016
April 2016	Established Digital Arts Consulting Inc.

Source: FISCO Ltd. from negotiable securities reports, the Digital Arts web page, and other materials

Mainly supplies security products for the web, email, and files

The Digital Arts group consists of Digital Arts and six subsidiaries. It includes three consolidated subsidiaries (as of end-March 2016) – IQS' Co., Ltd., FinalCode Inc., and FinalCode Asia Pacific Pte. Ltd. Other key subsidiaries besides these three firms are Digital Arts Consulting Inc. established in April 2016 and FinalCode Europe Limited, a strategic subsidiary for Europe.

Positioning of Digital Arts and Consolidated Subsidiary Businesses

Company	Main business content	Consolidated
Digital Arts	Plans, develops, and sells Internet security software and appliance products	-
IQS' Co., Ltd.	Develops and sells Internet security software	o
FinalCode, Inc.	Plans, develops, and sells FinalCode (file encryption and tracking solution) products	o
FinalCode Asia Pacific Pte. Ltd.	Sells FinalCode (file encryption and tracking solution) products in Asia	o
FinalCode Europe Limited	Sells FinalCode (file encryption and tracking solution) products in Europe	-
Digital Arts Consulting Inc*	Operates management strategy and IT strategy consulting businesses	-

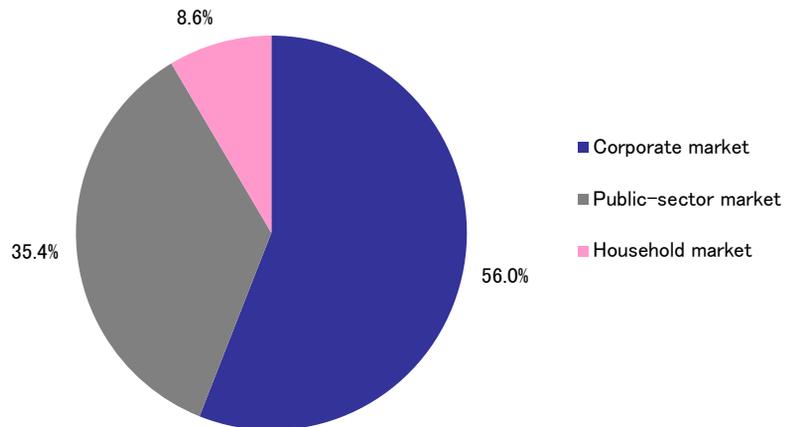
Note 1: The o mark in column indicates companies that were consolidated subsidiaries as of end-March 2016

Note 2: Established Digital Arts Consulting on April 1, 2016

Source: FISCO Ltd. from Digital Arts' negotiable securities reports and press releases

The Company's operations are security services for general corporations, government agencies, and individuals, involving planning, development, sales and so forth of web filtering software, email filtering software, and file encryption and tracking solutions. It only discloses information about the security business segment; however, it discloses information about the status of each user market. The sales composition by market for FY3/16 was corporate 56%, public-sector 35.4%, and household 8.6%.

Sales Ratios by Market (FY3/16)



Products developed and sold by Digital Arts can be broadly grouped into three categories – 1) web security products, 2) email security products, and 3) file security products. Digital Arts sells products directly (in response to requests from its web site) and through sales agents and retailers. Major sales agents, such as SoftBank Commerce & Service Corp., Daiwabo Information System Co., Ltd. (subsidiary of Daiwabo Holdings Co., Ltd. <9912>), SIOS Technology Corp. <3744>, and Uchida Yoko Co., Ltd., handle the bulk of sales to corporate and public-sector customers.



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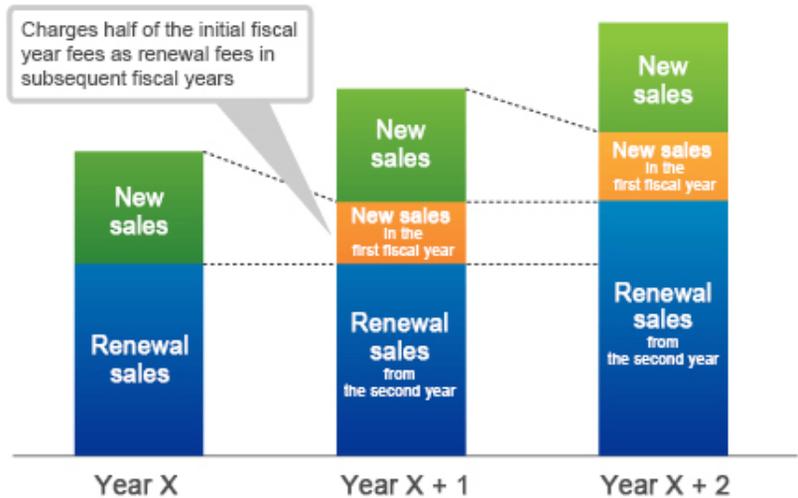
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(1) Web security products (web filtering software)

These are software products with a function for dividing Internet sites into those that can be viewed and those that cannot be viewed based on user settings. The company’s main offerings are i-FILTER for Business, i-FILTER Browser & Cloud, and D-SPA for corporate and public-sector customers, and i-FILTER for Consumers, marketed to household customers. It has installed products at over 7,300 corporate and public-sector sites and more than 31,000 schools nationwide in the school and educational institution business.

The business model provides stable recurring revenue because software customers pay a software usage fee (software license and maintenance fees) in the first fiscal year of installing the software and then pay half of the amount paid in the first fiscal year each year from the second year. Digital Arts books software development costs with a portion that goes under expenses and a portion recognized as an asset and subsequently amortized. Its profit is the difference between these amounts and sales.

Sales Booking Image



Next, we review features of the main products.

a) i-FILTER for Business

The i-FILTER for Business Ver. 9, the latest offering, achieves effective control and visualization to counter information leaks caused by shadow IT*1, a new security issue, for web usage, including cloud-based web application services. Digital Arts also started selling a collaborative option with FireEye, Inc., which leads the industry in supplying products and services that combat advanced cyber attacks. This product makes it possible for customers to stop leaks of confidential information due to multi-faceted high-level attacks, including zero-day attacks that aim for weaknesses in software*2 and targeted attacks that focus on certain companies and individuals with the goal of stealing confidential information.

b) i-FILTER Browser & Cloud

This is web filtering software for smart devices that curtails private usage and prevents information leaks by supporting centralized control of multiple operating systems that range from smart devices equipped with Android and iOS (iPhone, iPad, and others) to notebook PCs and other Windows terminals.

c) D-SPA

This is a “domestic” proxy appliance product that realizes centralization, visualization, and improved efficiency for web accesses and serves as a platform for web filtering, HTTP virus scans, and security solutions.

*1Shadow IT refers to use of personal PCs, smartphones, and tablets and cloud services, file transfer services, and other services for business without obtaining approval from the company. It creates risks of loss, theft, and information leaks similar to the “bring your own device” (BYOD) model (employees bring personal information terminals to the company to conduct work).

*2Attacks targeting software weaknesses (security holes) capitalize on the time that it takes from discovering the weakness to provision of fix programs by the developer.

*3Targeted attacks refer to cyber attacks with a clear purpose, such as improperly obtaining information or money or obstructing business, aimed at a specific organization or person.



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d) i-FILTER for Consumers

Digital Arts supplies products for home use under the “i-FILTER for Consumers” brand. Key products are “i-FILTER for multi-devices” service that runs on all Windows, iOS, and Android devices, PC service, game player service, and smartphone, tablet, and music player service. This series supports a wide range of devices.

Products are installed as a standard feature on PCs supplied by major firms and are also available from over 160 Internet service providers nationwide in Japan, and are officially adopted in major game machine (including Nintendo’s <7974> 3DS and Wii and Sony’s <6758> PlayStation and PSP), TV, and mobile terminal services.

(2) Email security products (email filtering software)

This software is capable of controlling email transmission and reception based on user settings. Main products are m-FILTER and m-FILTER MailAdviser. Digital Arts has installed products at over 1,800 entities, including companies and public ministries and agencies. Customers pay a software licensing fee in the first fiscal year and then pay maintenance fees from the second year.

a) m-FILTER

This product realizes diverse and reliable measures to prevent mistaken mail transmissions, such as holding transmissions going out of the company for a certain amount of time and blocking transmissions that lack approval from a superior.

b) m-FILTER MailAdviser

This is a client-type software that prevents mistaken mail transmissions by giving on-the-spot “notices” to email senders.

(3) File security products (file encryption and tracking solutions)

This is a password-less encryption service that can track and remotely control electronic files. The main product is FinalCode, and it has been installed at roughly 300 companies. It costs ¥2,000 per month per person for the low-cost version and ¥3,600 per month for the ordinary version (annual contract).

Key features are 1) a file encryption and tracking solution that encrypts important files, tracks usage, and facilitates remote deletion (file encryption software), 2) absence of risk of indirect information leaks to a third party through a transfer (secondary leak) because of file encryption for a specified user group, and 3) an ability to easily recover (eliminate) important encrypted files, which had been impossible in the past, through active revision of rights after distribution.

■ Strengths and Business Risks

Integrated provision from development to support, built one of the largest domestic web filtering databases

(1) Strengths

We think an important strength is the integrated operation from development to support. Digital Arts handles from collection of information for the core web filtering database to product planning, development, sales, and support directly in an integrated manner as a specialty developer of filtering software in Japan. This stance enables it to properly grasp customer needs and quickly reflect them in development activities. It also helps in creation of differentiating factors, such as advanced product performance and ease of use. Digital Arts hence has captured a large share in the filtering software market and realizes high customer satisfaction with a repeat rate of 95% or more.

The “Comparative Survey of Web Filtering Product Quality” prepared by Veriserve Corporation <3724> shows i-FILTER at a much higher average blocking rate in tests of 10 major categories (such as pornography and adult sites, bulletin boards, and games) at 96.3% versus 66.7% for the No.2 product. We think this outcome confirms the very high efficacy of the Web filtering database, which is also one Japan’s largest, visually assessed and compiled by an expert team based on proprietary collection technology* and rating standards.

* ZBRAIN is a proprietary filtering technology, and Digital Arts has received patent rights in 27 countries and regions, including Japan, the US, Asia, and Europe.

We see establishment of a stable income base using a business model of recurring revenue as an important strength too. As noted above, web filtering uses a business model with recurring revenue by charging a renewal fee (half of the value of the first fiscal year) from the second year in order to sustain usage after the first year. This model provides a stable income source.

Primary rivals are US-based Blue Coat Systems Inc., Alps System Integration (ALSI;*), and Trend Micro <4704>. Cultural differences serve as an entry barrier for major foreign companies, and these firms have not sufficiently addressed the Japanese market. Furthermore, Digital Arts constantly provides the latest and highly precise database as explained earlier, and this aids in differentiation from other companies and sustaining a high market share.

(2) Business risks

Two major business risks are high reliance on sales agents and human resource outflow and recruiting and training personnel.

The majority of group products are sold to customers through sales agents. Group sales hence might fluctuate substantially based on sales conditions at major sales agents and changes in the management environment, such as corporate M&A and bankruptcies. Sales agents also carry products that are rivals, and there is a possibility of agents handling rival products prior to the company's products. Reliance on the top three sales agents (SoftBank Commerce & Service, Daiwabo Information System, and Sios Technology) in FY3/16 was 46.7%.

The information security market is faring well, and we expect further expansion of demand for cyber security measures and personal data protection measures due to regulatory advances with the Basic Law on Cyber Security, My Number Law, and Revised Personal Information Protection Law. Digital Arts, which has the leading market share, is currently in an upbeat environment, given these conditions, in which it can obtain more business if it has the personnel. Therefore, if an outflow of personnel occurred, it could have a major impact on business results. We think recruitment and training of personnel is an important issue from the standpoint of longer-term growth.

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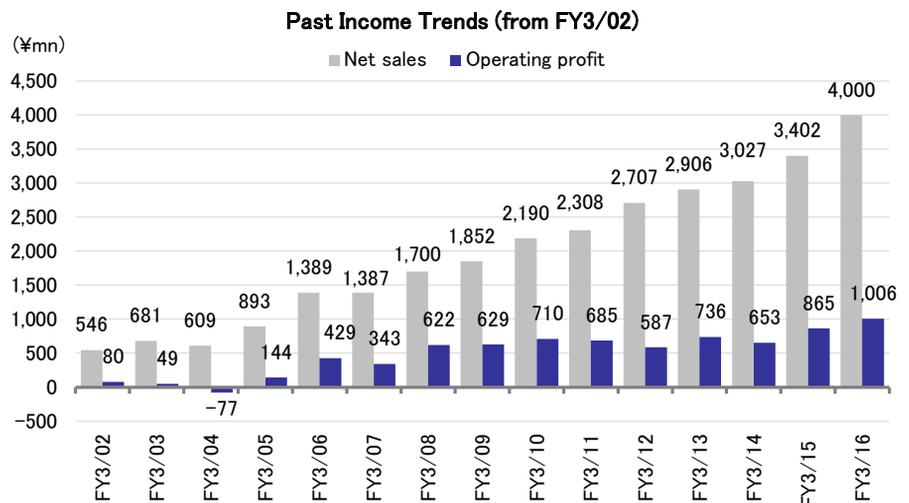
* Consolidated subsidiary of Alps Electric <6770> that offers manufacturing and distribution solutions, security solutions, and firmware solutions.

■ Performance Trends

Continuing a trend of income expansion with reinforcement of the product lineup

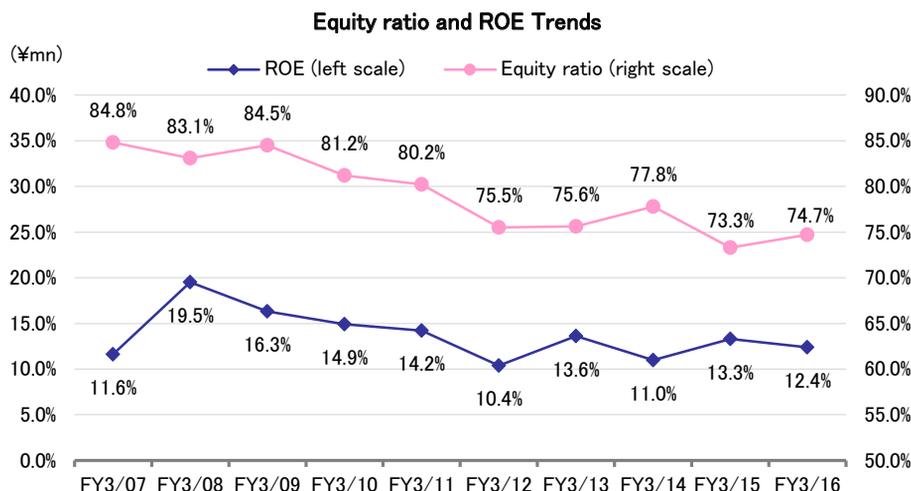
● Past results

A review of past results clarifies consistent expansion of sales along with broadening of the product lineup. Profits largely expand in line with sales growth other than the two dip phases: 1) FY3/03 to FY3/04 under pressure from listing-related costs, added personnel to expand businesses, and investment cutbacks at schools and local government entities and 2) FY3/11 to FY3/12 affected by heavy use of sales promotion costs aimed at expansion of the household market.



Source: FISCO Ltd. based on negotiable securities reports (Digital Arts)

Looking at the balance sheet, we see steady build-up of net assets supported by the stable earnings model with recurring revenue. This is enabling Digital Arts to sustain the equity ratio at over 70%, giving it healthy financial standing.



Note: Consolidated for the equity ratio from FY3/05 and for ROE from FY3/06

Achieving all-time high profits thanks to upbeat corporate and public-sector business

●FY3/16 results

(1) Review of the results

Digital Arts reported FY3/16 consolidated results with all-time high sales and profits, including ¥4,000mn in net sales (+17.6% YoY), ¥1,006mn in operating profit (+16.4%), and ¥545mn in net profit attributable to owners of parent (+2.8%). Net sales and operating profit achieved double-digit gains.

Overview of FY3/16 Consolidated Results

(unit: ¥mn)

	FY3/15		Period-start guidance	Updated guidance*	FY3/16			
	Actual	Ratio to sales			Actual	Ratio to sales	YoY change	Versus updated guidance*
Net sales	3,402	-	3,800	3,950	4,000	-	17.6%	1.3%
Cost of sales	974	28.6%	-	900	926	23.1%	-5.0%	2.9%
Gross profit	2,428	71.4%	-	3,050	3,074	76.9%	26.6%	0.8%
SG&A expenses	1,562	45.9%	-	2,050	2,067	51.7%	32.3%	0.9%
Operating profit	865	25.4%	910	1,000	1,006	25.2%	16.4%	0.7%
Recurring profit	910	26.8%	910	1,003	994	24.9%	9.2%	-0.9%
Net profit attributable to owners of parent	531	15.6%	548	577	545	13.6%	2.8%	-5.4%

Note: Digital Arts raised guidance values on October 29, 2015

Source: FISCO Ltd. from earnings presentation materials

Sales rose faster than in previous years with gains of 17.9% in the corporate market and 24.4% in the public-sector market amid stronger interest in targeted attacks and measures designed to prevent internal leaks of confidential information. By product, Digital Arts expanded mainstay i-FILTER for Business and posted upbeat FinalCode sales in Japan, driving the sharp sales increase.

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* This is an option for collaboration with the Web Security NX/CM series from FireEye, the industry leader in provision of defense measures against “unknown web threats.” The NX/CM series is a Threat Analytics Platform (TAP) that defends against web-based attacks that pass through single-function and next-generation (NGFW) firewalls, IPS, anti-virus software, and web gateways without detection

Cost of sales dropped ¥48mn YoY to ¥926mn, despite the sales expansion, on a decline in amortization costs due to finishing amortization for past major development activity in FY3/15. Gross margin hence rose 5.5ppt YoY to 76.9%. SG&A expenses, meanwhile, climbed ¥505mn owing to higher spending related to full-fledged operations at subsidiary FinalCode Inc., upfront investments to establish overseas sites, and increased costs for the 20th anniversary event and other initiatives, and this lifted the SG&A expenses ratio by 5.8ppt to 51.7%. While operating profit had a double-digit gain, operating margin slipped 0.2ppt to 25.2%. Low net profit growth stemmed from forex losses booked under non-operating income and higher tax and other costs burden due to upfront investments.

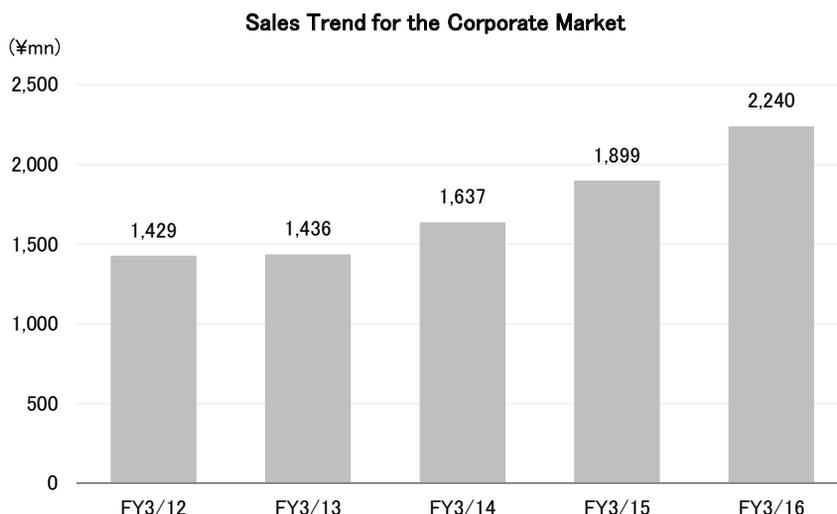
Net sales and operating profit both exceeded upward-revised guidance from October 29, 2015 (¥3,950mn in sales, ¥1,000mn in operating profit, and ¥577mn in net profit). Net profit, on the other hand, missed period-start guidance too because of ¥20mn in forex losses and larger tax costs related to upfront investments by the US subsidiary than anticipated.

(2) Trends by market segment

a) Corporate market

Sales to the corporate market grew 17.9% YoY to ¥2,240mn, surpassing ¥2,000mn for the first time. Digital Arts steadily expanded business with mainstay i-FILTER for Business sales as well as acquisition of major new deals thanks to the collaborative effect of m-FILTER and D-SPA working with FireEye* and other products from third parties. Sales climbed 13.8% for i-FILTER for Business and 15.0% for m-FILTER. D-SPA sales increased by a robust 39.6%.

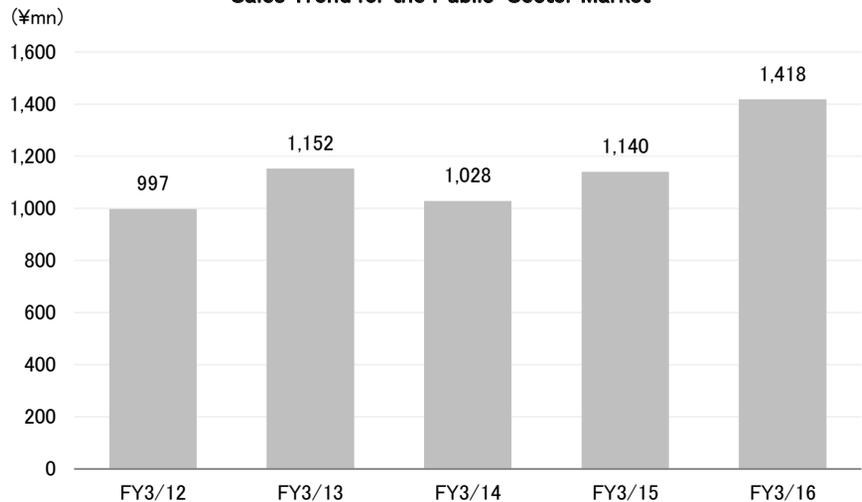
Digital Arts expanded domestic sales of FinalCode, a strategic product, by 3.5-fold YoY due to progress in installations at companies taking quick action on security measures amid a series of incidents with leaks of important information. Overseas FinalCode, meanwhile, only booked sales of a few hundred thousand yen and missed the ¥34mn target, but acquired 14 contracts (five local firms and nine Japan-affiliated firms) and made progress with overseas branding.



b) Public-sector market

Sales to the public-sector market increased 24.4% YoY to ¥1,418mn, an upbeat outcome that significantly outpaced FY3/15's 10.8% result. Mainstay i-FILTER for Business had a healthy 22.9% gain, and FinalCode sales expanded by a sharp 13.5 times. Other products achieved upbeat sales advances too with m-FILTER up 5.8% and D-SPA up 42.8%.

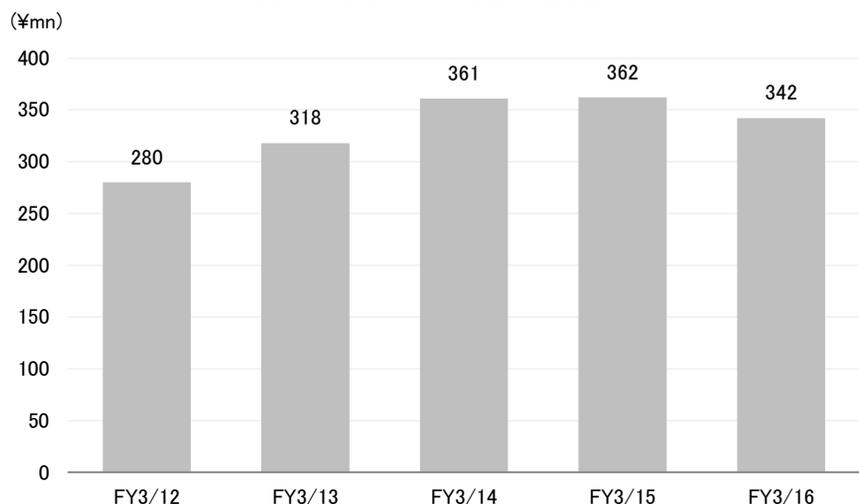
Sales Trend for the Public-Sector Market



c) Household market

Sales to the household market fell 5.6% YoY to ¥342mn mainly on a steep decline in domestic PC shipment volume, though held firm on an overall basis. PC-version i-FILTER for Consumers sales were down 28.1% due to a hefty drop in domestic PC shipments. Mobile-version sales, meanwhile, expanded 41.6% because of upbeat sales of “i-FILTER for multiple devices” that can use multiple OS with a single serial ID. Game machine and TV version sales also increased at a robust pace with a 29.3% gain thanks to healthy build-up of sales for Nintendo’s New Nintendo 3DS™ portable game player released in the previous fiscal year.

Sales Trend for the Household Market



Sustaining an equity ratio of over 70%

(3) Financial situation

Gross assets rose ¥384mn from the end of the previous fiscal year to ¥6,133mn at end-FY3/16. Current assets were up ¥184mn owing to increases in cash and deposits and accounts receivables accompanying business expansion. Fixed assets gained ¥199mn due to additions to intangible fixed assets and investment securities.

Liabilities grew ¥40mn to ¥1,491mn because of higher prepaid amounts from unearned maintenance revenue and higher unpaid corporate taxes. Net assets expanded ¥344mn from the end of FY3/15 to ¥4,642mn due to a rise in surplus profit from booking net profit attributable to owners of parent.

For cash flow, cash and equivalents rose ¥369mn from the end of the previous fiscal year to ¥2,443mn. Cash flow from operations had a net surplus of ¥1,027mn because of booking ¥998mn in net profit prior to taxes and adjustments and ¥503mn in amortization costs. Cash flow from investing activities had a net deficit of ¥441mn because of acquiring intangible fixed assets worth ¥515mn and buying ¥104mn in investment securities. Cash flow from finance activities reported a net deficit of ¥187mn due to ¥221mn in dividend payments and other items.

Looking at management indicators, the equity ratio, which reflects financial health, climbed to 74.7% and the current ratio increased to 294.4% and stayed at a high level. ROE and operating margin, which indicate profitability, slightly declined under pressure from upfront investments, though remained in good shape at strong levels.

Balance Sheet, Cash Flow Statement, and Management Indicators

(unit: ¥mn)

	FY3/15	FY3/16	Change in value	Reasons for the change
Current assets	4,077	4,262	184	Cash and deposits +269, accounts receivables +149, and securities -199
Fixed assets	1,671	1,871	199	Intangible fixed assets +59, investments and other assets +158
Net assets	5,749	6,133	384	
Current liabilities	1,408	1,448	39	Prepaid amounts +45
Fixed liabilities	42	43	1	
Liabilities (total)	1,451	1,491	40	
Net assets	4,297	4,642	344	Surplus profit +323
Liabilities and net assets (total)	5,749	6,133	384	
Cash flow from operating activities	1,355	1,027		
Cash flow from investing activities	-848	-441		
Cash flow from financial activities	-119	-187		
Period-end balance of cash and equivalents	2,074	2,443		
Management indicators				
<Health>				
Current ratio	289.5%	294.4%		
Equity ratio	73.3%	74.7%		
<Profitability>				
ROE	13.3%	12.4%		
ROA	17.1%	16.7%		
Operating margin	25.4%	25.2%		

Source: FISCO Ltd. from earnings materials (abbreviated statements)

Conservative guidance, possible upside

(4) Outlook for FY3/17

Digital Arts guides for net sales at ¥4,600mn (+15.0% YoY), operating profit at ¥1,400mn (+39.1%), and net profit attributable to owners of parent at ¥870mn (+59.5%) in FY3/17. It factors in upfront investments for overseas business (¥450mn), but expects to secure double-digit sales and profit gains thanks to an offsetting impact from upbeat domestic business driven by expansion of corporate and public-sector areas.

Overview of FY3/17 Guidance

(unit: ¥mn)

	FY3/16		FY3/17		
	Actual	Ratio to sales	Guidance	Ratio to sales	YoY change
Net sales	4,000	-	4,600	-	15.0%
Cost of sales	926	23.1%	947	20.6%	2.4%
Gross profit	3,074	76.9%	3,652	79.4%	18.8%
SG&A expenses	2,067	51.7%	2,252	49.0%	9.0%
Operating profit	1,006	25.2%	1,400	30.4%	39.1%
Recurring profit	994	24.9%	1,400	30.4%	40.8%
Net profit attributable to owners of parent	545	13.6%	870	18.9%	59.5%

Source: Materials supplied by Digital Arts at the earnings briefing



Digital Arts Inc.

2326 Tokyo Stock Exchange
First Section

14-Jul.-16

*1 Fundamental measures include enhancing security for municipalities (local government information system resilience enhancement model) and consolidating Internet connection points by individual prefectures and strengthening monitoring functions (local government information security cloud). The government hopes to utilize these measures to enhance security.

*2 US company that makes and sells computer virtualization software. It was acquired by EMC Corporation in January 2004.

Digital Arts explains that it can generate ¥4,500mn in sales through natural growth in existing products, excluding FinalCode, and obtain the remaining ¥100mn from initiatives with priority measures, including a) support for large corporate organizations, b) support for local government clouds, c) an increase in FinalCode domestic projects, d) overseas business, and e) consulting business. Below we review the five priority measures.

a) Support for large corporate organizations

Digital Arts plans to recruit new large corporate customers through provision of collaborative solutions with FireEye and other third-party products to defend against targeted attacks, just as in FY3/16.

b) Support for local government clouds

It intends to meet the security needs of local governments, in response to the Ministry of Internal Affairs & Communications' "policy for strengthening local government security"*1, through joint sales activities with VMware*2 and others.

c) Increase in FinalCode domestic projects

To increase FinalCode domestic projects, it plans to 1) assist in orders acquisition for priority deals with a new large-accounts team that specializes in dealing with major projects, 2) robustly promote sales of the local-government version in public-sector business, and 3) expand sales through existing partners.

d) Overseas business

Overseas strategies include build-up of local deals via partner recruitment and cultivation for the US, establishment of a sales network in Australia and New Zealand and distributor recruitment for Asia, and personnel hiring and organization building for Europe.

e) Consulting business

Digital Arts aims to address group-wide needs by selling its products to customers recruited by Digital Arts Consulting, which it established in April 2016, and building a route for provision of consulting services to its own customers.

Digital Arts forecasts a ¥600mn YoY rise in sales on gains in corporate and public-sector businesses and a boost from overseas market growth due to implementing these priority measures.

It also expects a 2.5ppt increase in gross margin to 79.4%, despite factoring in a 2.4% YoY expansion in costs of sales to ¥947mn due to utilization of outsourcing for development activities, thanks to reduction of amortization costs. While Digital Arts plans an 8.9% rise in SG&A expenses to ¥2,252mn, mainly because of personnel additions in Japan and abroad, it expects a 2.7ppt decline in the SG&A expenses ratio since the pace does not match anticipated sales growth. It hence guides for a 5.2ppt improvement in operating margin to 30.4%, moving above 30%.

We think guidance is conservative and see room for earnings upside because 1) Digital Arts typically uses conservative targets in the period-start plan, 2) efforts to recruit large companies in the corporate market through collaboration with FireEye and other third-party products are making healthy progress, 3) we expect strong demand for collaborative solutions with VMware and other partners from local governments ahead of the start of online interconnected network systems utilizing the My Number program from July 2017 in the public-sector market, 4) domestic FinalCode orders are at twice the budget level, and 5) overseas business is likely to benefit from ramp-up in Asia in addition to US activity.

■ Longer-Term Management Strategy

Entering a new growth stage

Digital Arts does not offer detailed numerical goals because it has not disclosed a medium-term business plan. However, it is targeting 50% recurring margin as a result of implementing a policy of “contributing to a more convenient, more comfortable, and safer Internet life.”

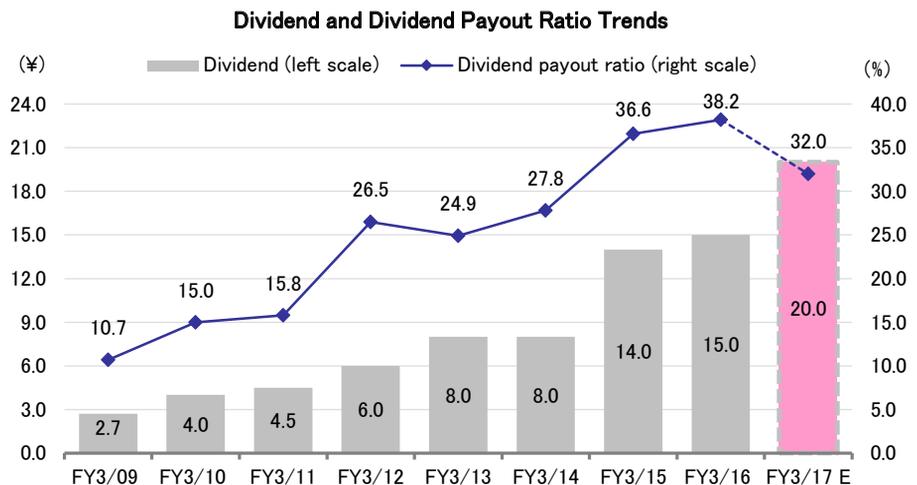
Its longer-term management strategy aims to expand sales through priority allocation of business resources to the security business, mainly driven by development and sales activities for web filtering software and email filtering software. It also plans to pursue reforms that help create profits by improving organizational efficiency and cutting spending and other costs.

We think Digital Arts is entering a new growth stage, based on larger deal size aided by collaboration with third-party products and FinalCode proposals and progress in recruitment of large corporate customers, and we will be closely monitoring the FinalCode orders trend in Japan and abroad.

■ Shareholder Returns

Continuing a stable dividend with a 30% payout ratio

Digital Arts adheres to a fundamental policy in shareholder returns of continuing a stable dividend while retaining profits to obtain investment funds needed to strengthen its business foundation and support wider use of web filtering software with the prospect of rapid market expansion. It targets a dividend payout ratio of roughly 30% of consolidated net profit. It intends to pay a ¥15 dividend for FY3/16 (38.2% payout ratio) and is aiming for ¥20, a 32.0% payout ratio, in FY3/17 (with a ¥10 interim dividend).



Note: Implemented a stock split of 1:100 shares on April 1, 2014

Source: FISCO Ltd. from earnings materials (abbreviated statements)

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