COMPANY RESEARCH AND ANALYSIS REPORT

DYNAM JAPAN HOLDINGS

06889

Hong Kong Stock Exchange

25-Dec.-2019

FISCO Ltd. Analyst

Hiroyuki Asakawa

FISCO Ltd.

http://www.fisco.co.jp

Index

Summary

Steadily advancing in preparations for an approaching major industry reorganization era despite ongoing difficult business conditions

DYNAM JAPAN HOLDINGS Co., Ltd. (HK06889; hereinafter, the Company) is one of Japan's top operators of pachinko halls with the largest number of halls operated. Its strength and characteristics lie in low-cost operations based on the "chain store theory." In addition, the Company is a pioneer as the first in its industry to be listed on a stock market, aided by recognition of its high-quality management with implementation of a customer-first approach, information disclosure, compliance management, and other measures.

1. Achieving revenue and profit gains in a difficult environment by shifting to pachislot machine and rigorously conducting low-cost operations

The Company reported higher revenue and profits in FY3/20 1H with ¥73,970mn in revenue (+0.5% YoY), ¥14,042mn in operating profit (+14.5%), and ¥13,150mn in profit before income taxes (+6.0%). While the pachinko operating rate dropped in a difficult business environment, pachislot operating rate remained upbeat and the Company boosted income by bolstering the shift to pachislot machines. Gross margin increased too. These trends supported a slight YoY gain in FY3/20 1H revenue. In expenses, machine costs rose due to deployment of pachislot machines, but the Company worked to reduce other hall operating expenses and achieved an increase in operating profit.

2. Longer-term growth strategy unchanged though putting priority on response to 2018 regulations, prepared for higher costs

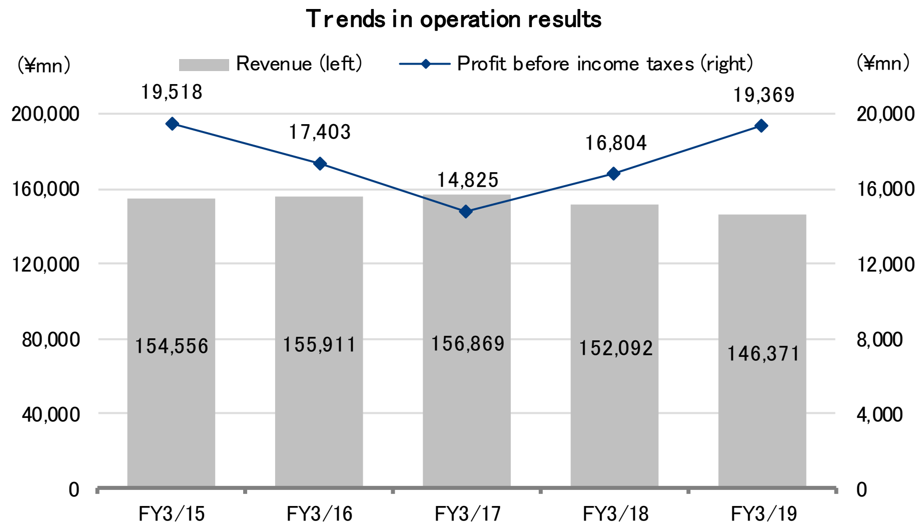
The longer-term strategy aims for growth driven by increase in hall volume and expansion of customer traffic at existing halls. This stance has not changed at all from previously. However, the Company currently needs to implement a planned response that addresses new regulations on the ball output rate introduced in February 2018. The new regulations require pachinko halls to replace all amusement machines with models that comply with the 2018 regulations by January 31, 2021 and hence are likely to temporarily result in a steep rise in machine costs and heavily pressure earnings. The Company has a very large number of locations at 449 halls for the entire group and thus faces an estimated rise in machine costs of roughly ¥20bn versus the regular year. While it needs to absorb this amount over two years in FY3/20 and FY3/21, a substantial portion might slip into FY3/21 and this could lead to a temporary steep decline in profit. Nevertheless, the Company is prepared to handle the cost upswing thanks to cutbacks in interest-bearing debt and reinforcement of profitability over the past few years.

3. Possibility of 2018 regulation response causing industry reorganization, growth opportunity for the Company with competitiveness advantages

The 2018 regulations might also trigger industry reorganization. Higher costs associated with replacement of existing machines pose a major burden for the Company, but we think it should be capable of restoring profit growth from FY3/22 and recouping these costs. Among industry peers, however, we expect numerous cases in which owners opt against remaining in business. With its advantage in low-cost operations, the Company is likely to steadily realize survivor upside in this environment. The Company is also smoothly ramping up airplane leasing business that it fully launched in FY3/20 as a new business. It secured two leasing contracts through October 2019 and expects to finalize additional contracts during FY3/20. We believe it is obtaining internal rate of return (IRR), the return evaluation yardstick, in the 5-6% range as anticipated.

Key Points

- Making steady progress in dealing with 2018 regulations and still retains wherewithal for an era of major industry reorganization
- Ramping up the airplane leasing business and already completed two leasing contracts by November 2019
- Possibility of entering a new growth phase driven by survivor upside from FY3/22



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

Company profile

Expanded business scope by implementing innovative measures premised on "chain story theory", first pachinko hall operator to list shares

1. History

The Company was founded as Sawa Shoji Co., Ltd. in 1967 by Yohei Sato, the father of Yoji Sato, a current senior corporate advisor. When the founder passed away in 1970, his eldest son, Yoji, who was then aged 24 and working at The Daiei, Inc., took over the business, and steadily expanded operations.

The Company was a pioneer in the pachinko hall industry by acting on new initiatives ahead of peers, including hiring new university graduates, opening suburban halls and low-cost halls, forming a labor union, and spreading low-fee ball rental nationwide. Yoji Sato's leadership was an important factor in the Company's adoption of a progressive corporate culture. He joined Daiei due to interest in the chain store theory that was still a novel concept in Japan. Since succeeding his father, who was the founder, he managed the Company, and expanded business by consistently applying the chain store theory to pachinko hall operations. The chain store theory is the source of low-cost operations, the Company's largest strength.

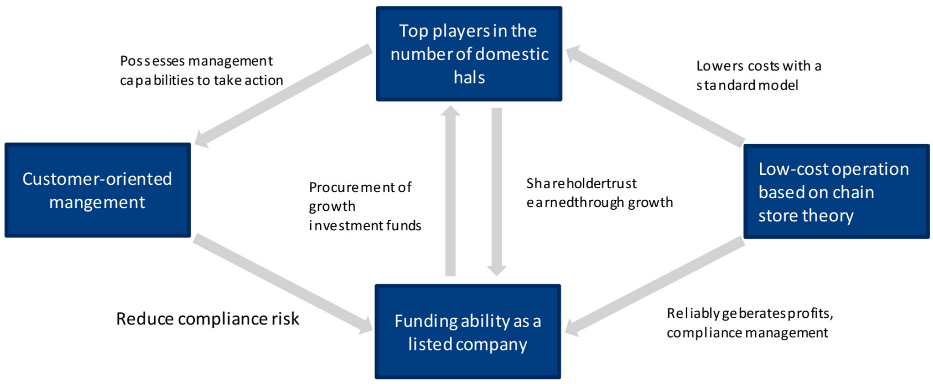
His logical approach rooted in the chain store theory took hold as the corporate culture and served as a fundamental force lifting the Company to the position of being the top company in the industry. The Company also moved quickly in embracing the most important concepts for modern management of a customer-first approach, information disclosure, and compliance, providing a foundation for its listing on the Hong Kong Stock Exchange in August 2012.

Established a robust management foundation that leverages four strengths, differentiates itself from other companies

2. DYNAM JAPAN HOLDINGS Group's features and strengths

We focus on four points as the Company's attributes and strengths – 1) top player in terms of the number of halls in Japan, 2) low-cost operations, 3) customer-oriented management, and 4) fund-raising capabilities. Importantly these strengths are mutually interactive. We think it is difficult for other companies to realize the same combined strength seen at the Company.

Relationship among the four strengths of the Dynam Japan Holdings Group



Source: Prepared by FISCO from interviews

(1) Top group with 449 halls in Japan

The Company is the domestic leader with 449 group halls (as of the end of September 2019). While it is not possible to make precise comparisons due to differences in compilation timing, we estimate that the Company's domestic shares for hall volume and machine installations are both at mid 4% ranges.

The Company's large number of halls provides it with economies of scale that appear in new hall openings, renovations, amusement machine purchases, prize procurement, logistics, and other areas. Benefits in amusement machine purchases and hall operations, which account for a large portion of expenses, are particularly important. The large number of halls obviously means ownership of a high volume of pachinko and pachislot machines and stronger buying power toward amusement equipment manufacturers. The Company also develops and deploys private-brand machines and realizes economies of scale in this respect too. Furthermore, it has built operations that attract more customers and lower costs by leveraging its large hall network to move models among halls.

(2) Low-cost operations based on the chain store theory

Low-cost operations are a vital source of the Company's competitiveness. Our understanding is that this aspect is tremendous support in enabling the Company to secure the feasibility and effectiveness of various measures, including the growth strategy.

The chain store theory provides the theoretical backdrop as a pillar to low-cost operations. Costs of personnel and machines constitute a large portion of the total cost of operating a pachinko hall. Yet it takes more than just direct cost cutbacks. The Company is succeeding with low-cost operations as an overall group by deploying hall designs and hall operating systems (such as ball counters at each machine) that facilitate operations with a small number of employees and by standardizing new halls. The chain store theory plays an important role in a variety of ways and is enabling low-cost operations for the Group.

The Company is the industry leader in Japan, as mentioned earlier, with 449 halls. Aggressive hall network expansion supports this position, but the driving force of low-cost operation know-how has been an essential enabler. Hall network expansion has created a virtuous cycle of cost reductions through economies of scale that has put the Company in its strong position. We think the customer-oriented management explained below is an outcrop from low-cost operations as well.

The history section explained the background to the Company's utilization of the chain store theory in its management. The Company established the Pachinko Chain Store Association (PCSA), an industry group, with peers who have a similar view, and this entity has been researching application of the chain store theory to pachinko hall management. PCSA activities have not only contributed to strengthening the business foundation of industry peers, but also played a major role in the Company's expansion with the addition of Yume Corporation to the Group.

(3) Implementing management from a customer perspective

The Company advocates a customer-first approach as one of its five business policies and has been practicing it. This stands out because we think few peers who promote a similar policy are actually seeing actions through.

Among the Company's business policies, we have a favorable view of a) low ball rental fees and b) operations that do not rely on gambling appeal. These are also key words for understanding the Company's business policy and growth strategy

a) Low ball rental fee operations

Pachinko is a game that is played with rented balls. The fee for renting balls (halls lend the balls) had been ¥4 per ball. Low ball rental fee operations take a cheaper approach that lowers the fee to ¥1 or ¥2. Customers can rent more balls for the same amount, extending their playing time in accordance with the additional balls. The Company's low ball rental fee machines account for 72.4% of pachinko machines (47.4% for the overall industry) and 57.5% of pachislot machines (21.8% for the overall industry), substantially exceeding industry averages (as of the end of September 2019).

Data shows that halls offering low ball rental fees have attracted more customers than halls charging higher fees. Yet it takes substantial company wherewithal to adopt this type of strategy as margin declines at halls with low ball rental fees see weaker revenue than halls charging higher fees without much difference in operating costs. A measure to offset this aspect is growth through expansion of hall numbers. The Company has followed this path.

b) Operations that do not rely on gambling appeal

The Company does not position models with strong gambling appeal as a central strategy. Pachinko machines range from ones with high probability of major wins to ones with low probability. Machines with lower probability give a larger number of balls in a major win and are preferred by pachinko fans. Many pachinko halls hence attract customers by operating halls with a high ratio of machines that have low major-win probability (in other words, machines with strong gambling features).

However, authorities introduced regulations to curtail gambling appeal in FY3/17, lifting the lowest probability threshold from 1/400 to 1/320. The industry removed 1/400 machines by December 2016. Regulations on gambling appeal address the addiction issue and authorities applied new rules in February 2018. These changes are eroding the pachinko hall management style of attracting customers with gambling.

The Company, meanwhile, has a lower ratio of gambling-type machines than the industry and conversely the share of machines with the lowest gambling features at 1/100 probability is 20 percentage points higher than the industry average. While the Company cannot avoid an impact from stricter gambling appeal regulations, we think the negative impact is relatively minor due to its existing pursuit of operations that do not rely on gambling appeal.

(4) Fund-raising capabilities that leverage strength as a listed company

The Company became the first in the pachinko hall industry to list its shares with its IPO on the Hong Kong Stock Exchange in 2012. Only three companies, including the Company, out of the pachinko hall industry's roughly 3,000 companies are listed on stock markets as of the end of September, 2019. The industry is projected to face realignment going forward. An important point for a buyer in this environment is obviously whether it has fund-raising capabilities. The Company capitalized on its strength as a listed company to acquire Yume Corporation in November 2015 through a stock swap for all of its shares. We anticipate very strong benefits for the Company as a listed company in non-M&A areas too because of the likely need for a variety of funds in the future for hall investment, new business development and other initiatives.

Results trends

Achieved higher revenue and profit, despite continued decline in the number of pachinko customers, by shifting to pachislot machines and implementing other income improvement measures and effectively utilizing hall operating expenses

● **Summary of FY3/20 1H results**

(1) Summary of consolidated results

The Company reported gains in revenue and profits in FY3/20 1H with revenue at ¥73,970mn (+0.5% YoY), operating profit at ¥14,042mn (+14.5%), profit before income taxes at ¥13,150mn (+6.0%), and net profit attributable to owners of the Company at ¥8,691mn (+4.2%).

Summary of FY3/20 1H results

(¥mn)

	FY3/19			FY3/20		
	1H	2H	Full-year	1H	YoY	Change
Ball rental fee revenue	386,840	382,017	768,857	379,269	-2.0%	-7,571
Cost of prizes	313,257	309,229	622,486	305,299	-2.5%	-7,958
Revenue	73,583	72,788	146,371	73,970	0.5%	387
Total expenses	61,315	65,714	127,029	59,928	-2.3%	-1,387
Operating profit	12,268	7,074	19,342	14,042	14.5%	1,774
Profit before income taxes	12,411	6,958	19,369	13,150	6.0%	739
Net profit attributable to owners of the Company	8,340	4,256	12,596	8,691	4.2%	351
EBITDA	18,049	13,087	31,136	19,638	8.8%	1,589

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

Ball rental fee revenue, which corresponds to gross revenue, dropped 2.0% YoY (¥7,571mn) to ¥379,269mn in FY3/20 1H. The Company has worked to acquire revenue amid decline in the pachinko playing population and sustained contraction of the market through localized customer recruitment efforts that address characteristics of individual halls (such as location conditions and customer attributes). In FY3/20 1H, the Company took further steps to attract more customers by shifting from pachinko to pachislot machines and increasing pachislot machine space in response to healthier demand from pachislot fans than in pachinko business. However, it was unable to completely offset the impact of decline in pachinko customer volume and ball rental fee revenue fell 2.0% YoY as noted above.

Prize issuance value, which reflects unit costs, meanwhile, declined 2.5% YoY (¥7,958mn) to ¥305,299mn. The difference between ball rental fee revenue and prize issuance value is gross profit and represents net sales (revenue). As mentioned earlier, revenue increased 0.5% YoY (¥387mn) in FY3/20 1H.

The percentage of revenue to ball rental fee revenue is gross margin. In FY3/20 1H, the Company's gross margin improved by 0.5pt YoY to 19.5%. Gross margin is the inverse of the payout rate to customers (percentage of prize issuance value to rental ball income), and when this value is too high, it might lead to customer losses. Since past trends show gross margin in the 18% range to 19% range, we think the FY3/20 1H result was within the normal range.

In expenses, meanwhile, total expenses fell 2.3% YoY (¥1,387mn) to ¥59,298mn. Machine costs rose mainly on reinforcement of pachislot machine purchases aimed at boosting earnings, though other hall costs (advertising and promotional costs, personnel costs, etc.) declined thanks to emphasis on efficient spending and decrease in depreciation costs. The Company's application of new lease accounting standards under IFRS adopted in FY3/20 1H lowered real estate costs in operating expenses. Operating profit climbed 14.5% (¥1,774mn) to ¥14,042mn with support from these trends.

Application of new lease accounting standards reduced rent expenses on real estate booked in operating expenses, but interest related to leased assets must be booked in financial costs. In FY3/20 1H, the Company booked ¥957mn as interest on leased assets. Profit before income taxes, which reflects these financial balances, increased 6.0% YoY (¥739mn) to ¥13,150mn.

As a result of applying the new lease accounting standards, profit before income taxes has a more accurate depiction of actual earnings than operating profit for FY3/20 1H when comparing against the previous year. Since profit before income taxes improved 6.0% YoY in FY3/20 1H, we think the rise in this year's earnings occurred on a real basis too, not only because of the change in accounting policy. We expect operating profit to return to accurate depiction of profits for analysis and assessment in FY3/21 due to comparison using the same accounting standards.

Impact of new lease accounting standards on the income statement

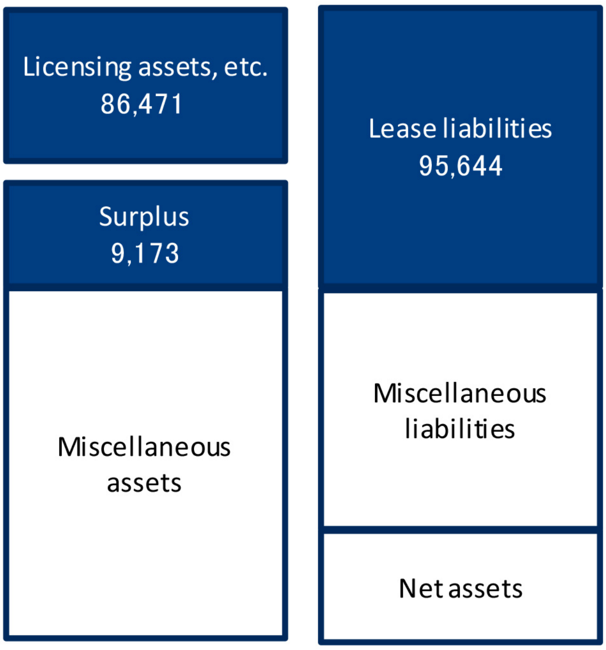
(¥mn)

Factors	Costs	FY3/19 1H	FY3/20 1H	Changes	Remark
Operating expenses	Rent expenses on real estate	6,331	87	-6,244	
	Licensing assets amortization value	-	5,120	5,120	
	Total	6,331	5,207	-1,124	Factors boosting operating profit
Operating profit		12,268	14,042	1,774	¥1,124mn impact from application of new lease accounting standards
Financial expenses	Interest on leased assets	-	957	957	Factors pressuring profit before income taxes
Profit before income taxes		12,411	13,150	739	

Source: Prepared by FISCO from the Company's materials, interviews

The new lease accounting standards heavily affect the balance sheet (statement of financial position) too. For the real estate contracts leased for halls, the Company must separately record total future rent expenses as licensing assets, the present value (obtained by applying a discount calculation of total future rent expenses) as lease liabilities, and the portion related to discount processing as a surplus.

Impacts on licensing assets, lease liabilities, and surplus in new lease accounting standards



Note: These values are current as of the end of FY3/20 1H.
Source: Prepared by FISCO from the Company's materials, interviews

Impacts at the end of FY3/20 1H were ¥86,741mn in licensing assets, ¥95,644mn in lease liabilities, and -¥9,173mn in surplus, and this sharply expanded the balance sheet. While actual impacts are fairly minor, these changes nominally lowered the capital ratio by a hefty amount from 76.5% at the end of FY3/19 to 49.2% at the end of FY3/20 1H. We think caution is necessary because this clearly does not accurately reflect the Company's situation. We estimate that the Company's capital ratio using the previous standard (not applying new lease accounting standard) was 76.7% at the end of FY3/20 1H, an improvement compared to a half year earlier.

Statement of financial position using the previous standard (non-application of new lease accounting standards)

(¥mn)

	End-FY3/19 (previous standards)	End-FY3/20 1H			Remark
		New lease accounting standards (1)	Previous standards (2)	Change (1 - 2)	
Total assets	185,332	274,532	188,061	86,471	Licensing assets ¥80,530mn, Lease assets ¥6,358mn
Total liabilities	43,532	139,432	43,788	95,644	Lease liabilities ¥95,644mn
Share capital	15,000	15,000	15,000	-	
Surplus, etc.	126,800	120,100	129,273	-9,173	Revision to the surplus due to the application of new lease accounting standards
Total equity	141,800	135,100	144,273	-9,173	
Liabilities and net worth	185,332	274,532	188,061	86,471	
Capital ratio	76.5%	49.2%	76.7%	-	

Source: Prepared by FISCO from the Company's materials

(2) Situation at DYNAM Co., Ltd.

DYNAM, the group's core company, posted higher revenue and profits in FY3/20 1H at ¥69,082mn in revenue (+0.7% YoY), ¥10,788mn in operating profit (+7.7%), ¥11,400mn in ordinary profit (+8.5%), and ¥7,664mn in net profit (+9.3%).

During FY3/20 1H, pachinko revenue fell YoY due to continued decline in customer volume, while pachislot revenue increased with a boost from the release of popular models. Vending machine sales and other revenue improved too. Total revenue climbed by ¥499mn YoY.

In profits, machine costs were higher YoY because of the deployment of popular pachislot machines, but hall operation costs besides machines, such as advertising and promotional costs and personnel costs, declined. Total operating expenses hence contracted by ¥275mn, and operating profit rose by ¥774mn.

DYNAM's management situation

(¥mn)

	FY3/19 1H	FY3/20 1H	YoY growth rate	YoY	Summary
Revenue	68,581	69,082	0.7%	501	
Operating profit	10,014	10,788	7.7%	774	
Ordinary profit	10,505	11,400	8.5%	895	
Net profit	7,012	7,664	9.3%	652	
KPIs					
No. of halls	406	405	-0.2%	-1	Closed the Sakata Izumi (Yamagata) hall
Pachinko machine operating rate	43.3%	42.2%	-	-1.1pt	+10.4pt vs. rival halls
Pachislot machine operating rate	40.0%	39.2%	-	-0.8pt	+5.5pt vs. rival halls
No. of machines	187,667	188,765	0.6%	1,098	Installed machine share 4.4% (P-1, 112 units; S+ 2,210 units)
No. of private-brand machines	7,785	11,393	46.3%	3,608	Installation ratio 8.5%

Source: Prepared by FISCO from the Company's materials

Looking at operating rates among KPIs, the pachinko rate was down by 1.1pt YoY and the pachislot operating rate remained resilient with a decline of just 0.8pt despite a significant increase in installed volume. The Company deployed popular models and expanded pachislot space to capitalize on a rise in customer traffic in response to hit models. It implements low ball rental fee operations, the core sales and differentiation strategy, in pachislot business (low medal rental fee operations for pachislot) as well and switched from ¥5 rental to ¥10 rental to meet customer needs.

In the hall network, the Company closed one hall (Sakata Izumi hall in Yamagata) in FY3/20 1H and had a total of 405 halls at the end of September 2019. This closure occurred due to circumstances on the property owner side, and the Company plans to open a new hall nearby in FY3/20 2H and expects to be back at 406 halls at the end of March 2020. The pachinko hall industry must completely replace existing models with new models that comply with new regulations to restrict ball output in order to diminish gambling features. In the midst of the transition period, downside outweighs benefits of opening new halls through organic launches or acquisitions because of the burden of deploying new models. DYNAM therefore is also taking a cautious stance on new openings until the end of January 2021 when the transition to new regulations has ended.

Medium- to long-term growth strategy and current initiatives

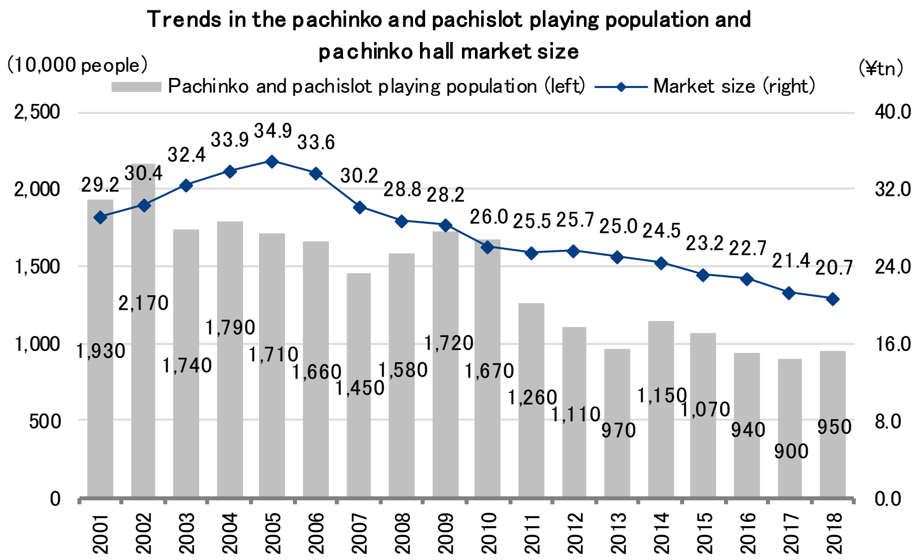
The Company's business largely consists of its core pachinko hall business and new businesses. At this point, pachinko hall business occupies a very large percentage of overall income and contributions from new businesses are extremely limited. In a few years from now, however, the Company aims to raise the contribution from new business income (and particularly profits) to a noticeable level. We hence think it is very important to understand where things currently stand in new businesses too, not only pachinko hall business.

Smooth progress in responding to 2018 regulations, retains wherewithal for an era of major reorganization in the industry

1. Growth strategy and initiatives in the pachinko hall business

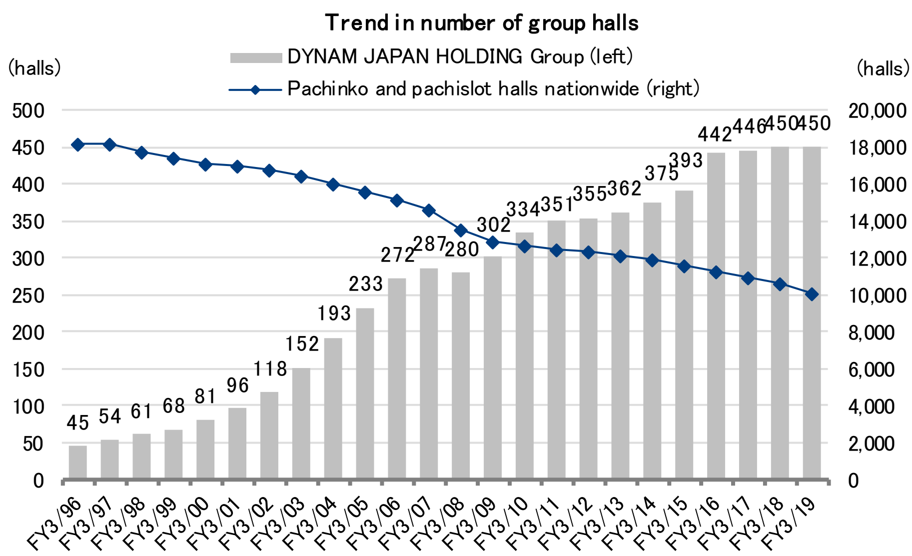
(1) Overview of the business environment and growth strategy

The pachinko market continues to experience a long-term shrinkage trend. According to "White Paper on Leisure" by the Japan Productivity Center, While Japan's pachinko and pachislot playing population rebounded by about 500,000 people (5.6%) to 9.5mn people in 2018, from 9.5mn people in the previous year, the pachinko hall market (total ball rental fee revenue) fell 3.3% YoY to ¥20.7tn.



Source: Prepared by FISCO from the Japan Productivity Center's "White Paper on Leisure"

The number of pachinko and pachislot halls has been steadily trending lower too amid these conditions. Hall volume dropped by 536 halls (5.1%) to 10,060 halls at the end of 2018 (according to National Police Agency research). The Company, meanwhile, sustained group hall volume at 449 halls (the end of FY3/20 1H), the same level as the end of FY3/19.

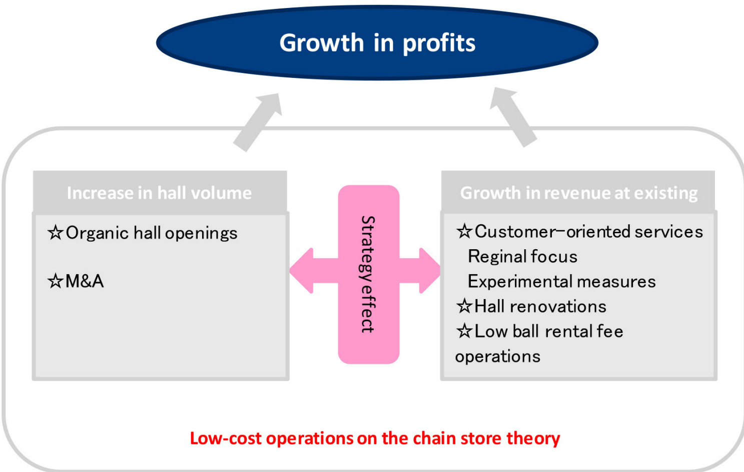


Source: Prepared by FISCO from the Company's materials and National Police Agency materials

The Company has adhered to a consistent growth strategy in the pachinko hall business of pursuing growth along two tracks – through increase in hall volume and expansion of customer traffic at existing halls. While its choices for increasing hall volume are organic (self) openings and acquisitions, we think organic openings are more efficient due to the Company's strength in low-cost operations. In acquisitions, we expect the Company to assess each opportunity individually and proceed in cases that offer clear benefits.

For the growth in revenue at existing halls, the Company focuses on securing customer traffic, more than average spend. This approach fits with the Company's strategy of getting pachinko to take hold as a leisure activity for spending time. While the Company has steadfastly worked to attract more customers through localized measures that leverage characteristics of individual halls as explained in the section on results trends, customer traffic growth has been fluctuating due to strong headwinds confronting the entire industry.

Image of the two-pronged growth strategy – increase in hall volume and growth in revenue at existing halls



Source: Prepared by FISCO from Company materials

(2) Response to 2018 regulations

We looked at conditions facing the pachinko hall industry and the Company above and in addition to the customer factors explained earlier, regulation factors are strongly affecting pachinko hall business.

New industry regulations for ball output rates and ball output volume took effect in February 2018 (below, referred to as "2018 regulations"). These regulations mainly consist of 1) limiting the maximum ball output rate to about two-thirds of the current level and 2) restricting ball output volume for a major win to two-thirds of the current level (see our report issued on December 25, 2018 for details on 2018 regulations).

We expect a very large impact by 2018 regulations on pachinko hall management. Besides, the impact on customer draw from decline in gambling content, the need to replace existing all amusement machines with a new type that complies with 2018 regulations has even larger implications. For example, a hall that operates 400 machines requires an investment of ¥140mn to replace all 400 machines (assuming ¥350,000 per new machine and calculated as ¥350,000 x 400 machines). It requires ¥14bn if there are 100 halls like these.

The industry has a three-year transition period to comply with 2018 regulations. This period allows continued use of amusement machines based on previous regulations in the three years from February 1, 2018 to January 31, 2021 if approval is obtained. Many pachinko hall operators, including the Company, have selected this option and are currently operating halls with a mix of former-regulation machines and new-type machines based on 2018 regulations. However, we think the rollout rate of new-type machines is still very low because of weaker appeal to consumers with stricter ball output regulations.

With just under a year and a half left in the transition period (FY3/20-21 in terms of fiscal years), pachinko hall operators must make a major decision about whether to invest heavily in order to continue hall operations from February 2021 or give up and close operations. This situation is truly opening the door to major reorganization of the industry.

The Company has implemented low-cost operations based on the chain store theory, and this is its biggest strength. Amusement machine replacement costs are not insignificant for the Company as well. However, we believe it has sufficient resources and wherewithal.

In funding, the Company had a net-cash position of ¥43,501mn at the end of FY3/20 1H with ¥48,140mn in cash and deposits and ¥4,639mn in interest-bearing debt. We think it is capable of procuring sufficient funds from external sources with this healthy cash on hand and a 49.2% capital ratio (as of the end of FY3/20 1H; effectively 76.7% excluding the impact of new lease accounting standards applied from FY3/20).

A more important issue is how it recoups (or whether it can recoup) funds used to replace amusement machines. On this point, we think the Company is capable of steadily recouping and repaying its replacement costs by leveraging robust hall profitability supported by low-cost operations. We review these details in the outlook section. The Company spends about ¥20bn a year on machine costs in a typical year. Since the final deadline (January 31, 2021) is fixed for the 2018 regulations, machine spending is likely to reach higher levels than normal in FY3/20 and FY3/21. We roughly estimate the additional portion (exceeding normal outlays) at ¥20bn over the two years. This is equal to the Company's current annual operating profit, and we thus think it is possible to recoup amusement machine replacement costs.

(3) Initiatives for growth in revenue at existing halls

The Company's efforts to generate income on a daily basis are obviously important too, along with major themes of industry reorganization and regulation compliance. The main initiative in this area during FY3/20 1H was strengthening pachislot machines.

For pachinko machines, while deployment of new-type machines based on the 2018 regulations has begun as explained above, manufacturer releases are proceeding slowly and the industry has not seen hit models yet in this category. Although pachislot machines also face regulations on gambling features and the industry needs to remove models with strong gambling attributes by the end of January 2021, just as with pachinko machines, the pachislot category has delivered some hits and customer traffic interested in enjoying pachislot machines is growing.

In light of these conditions, the Company lowered the purchase costs on pachinko machines (YoY) and raised purchase value of pachislot machines. It also adjusted space allocation at halls to shift from pachinko machines to pachislot machines (increasing installation space for pachislot machines).

Amusement machine purchase costs results in FY3/20 1H

(¥mn)

	FY3/19 1H	FY3/20 1H	Change
Amusement machine purchase costs	11,348	13,174	1,826
Pachinko purchase costs	8,802	7,688	-1,114
Pachislot purchase costs	1,465	4,341	2,876
Other expenses	1,081	1,145	64

Source: Prepared by FISCO from Company materials

The Company revised rental medal fee as well. While maintaining the framework of strengthening low medal rental fee operations throughout the hall network, it changes the rental medal fee from ¥5 to ¥10 to meet customer needs.

Thanks to these measures, pachislot revenue in FY3/20 1H climbed by 7.8% YoY (¥2,029mn) to ¥27,989mn. While pachislot popularity and related shift to pachislot business is an industry-wide trend, the industry growth rate was just 1.9% and the Company's strong result stood out. Pachislot machine installation volume rose 3.9% YoY in FY3/20 1H. We attribute faster growth in pachislot revenue than installation volume for the increase in revenue per pachislot machine.

Pachislot revenue (FY3/20 1H result)

(¥mn)

Factors	Parties	FY3/19 1H	FY3/20 1H	Change
Pachislot revenue	Overall market	328,709	334,951	1.9%
	DYNAM Group	25,960	27,989	7.8%
Pachislot machine installation volume (units)	DYNAM Group	60,990	63,376	3.9%

Source: Prepared by FISCO from Company materials

The Company expects these conditions to continue and has adopted a policy of planned increases in the pachislot machine installation ratio from FY3/20 2H. Its pachislot ratio was 30.1% at the end of September 2019, trailing the 39.5% industry level by about 10%. We agree with the decision to raise the pachislot ratio in light of this situation and expect a strong effect too.

(4) View of increasing hall volume

Development of the hall network, the other component of the Company's growth strategy, is likely to be dormant for the time being. We expect this stance in both organic openings and acquisitions.

The Company has adopted a passive stance toward development of the hall network because of the 2018 regulations. This takes into account challenges for opening new halls at this point because of a market supply shortage in new machines that meet the new regulations and the prospect of losing to rival halls due to not having arranged procurement of former-regulation machines that remain popular with customers. However, these former-type machines ultimately must be replaced with new-type machines. This means spending on amusement machine replacement before it is possible to recoup initial investments if the Company adds new halls now. Opening halls hence currently does not make economic sense. The same situation applies to acquiring halls.

We therefore do not expect the Company to resume development of the hall network again until at least February 2021. We think it is necessary to see how the industry landscape changes with arrival of the deadline for 2018 regulations and assess this impact.

This stance is very rational and makes sense to us. We think industry peers have decided essentially the same thing. Given these conditions, we believe acquisition energy, and particularly business sale needs, are building up in the pachinko hall industry. Total absence of buyers has probably increased psychological pressure on sellers. We expect these needs to spike once activity resumes from February 2021 and refer to this situation as arrival of a major industry reorganization era.

Full-fledged start of airplane leasing business Completed leasing contracts and transfers for two deals as of November 2019

2. Progress made in airplane leasing business

The Company announced its entry into the airplane leasing business as a new business in fall 2018. (Refer to our report issued on December 25, 2018 for details.)

The detailed scheme is establishment of a wholly owned subsidiary, rather than forming a syndicate and recruiting other investors, and having the subject subsidiary engage in airplane leasing business on its own. In line with this policy, the Company established Dynam Aviation Ireland Limited (DAIL) with full ownership in December 2018 (roughly ¥100mn in capital, March fiscal year). Ireland strongly supports airplane leasing businesses and has set a low corporate tax rate. As a result, 14 of the world's top 15 aircraft leasing companies (based on aircraft volume) have sites in Ireland. The Company followed this pattern.

As the business model, it plans to mainly lease mid-sized "narrow model" planes, a segment with high transaction activity, including the Boeing 737-model series and the Airbus A319, A320, and A321 models. This category greatly outweighs other plane sizes in the number of planes in operation by airlines and orders and order backlogs of airplane firms and truly holds the position of a "volume zone." By focusing on this segment, the Company aims to ensure market liquidity and reduce business risk. The Company plans to purchase about 20 used planes (from among these models) over the next three years and lease them to airlines worldwide.

The Company intends to invest ¥90bn to purchase the 20 planes with a planned breakdown of ¥30bn in self funding and ¥60bn from external procurement (mainly non-recourse loans). It has already transferred ¥10bn of its own funds for the first fiscal year and started the leasing business.

As progress thus far, the Company completed its first leasing contract and transfer in July 2019 and the second transfer in October. It is leasing two airplanes as of November 2019 and appears to be making steady progress in other deals.

The first deal is with Vueling Airlines, a Spanish LCC, and the second deal is with Indigo, India's largest LCC. The contract terms and anticipated profitability in these deals is generally on track with the Company's plan. We think the business is off to a smooth start in profitability. Deal income in leasing business is determined through finalization of three main aspects – initial purchase price, lease fee income during the lease period, and selling price after the lease finishes. The industry uses internal rate of return (IRR) to measure investment return because of these characteristics. We believe the Company has realized the IRR it anticipated in the first two deals (estimated at about 5-6% based on recent interest rate conditions).

We expect airplane leasing business to reach an annual profit contribution of about a few billion yen once it has accumulated 20 planes as planned and establish a noticeable presence in the Company's overall earnings.

Beginning deployment of video slot machines in casinos Currently in test operation, waiting for results

3. Progress in the video slot machine business for casinos

The Company has been working on the planning and development of mass-market video slot machines for the Macau casino market as a new business. The development concept is a straightforward approach of time-consumption games that incorporates pachinko elements.

The Company worked on development of this video slot machine jointly with WEIKE GAMING TECHNOLOGY (S) PTE. LTD. (below, WEIKE), which holds a license for manufacturing and selling casino machines in Macau. In progress thus far, this business ultimately acquired a permit from the Macau government entity on May 3, 2019, concluded a sales contract with a Macau casino operator in September 2019, and actually started deploying video slot machines in casinos from November 30.

Development of casino video slot machines – timeline

Time	Activity category	Initiative content
March 2019	Development	Received suitability notification from BMM (casino machine inspection entity) for the first model
May 2019	Development	Acquired DICJ (Macau government entity) approval for the first model
May 2019	Sales	Exhibited at G2E Asia (Asia's largest gaming and entertainment trade show)
September 2019	Sales	Concluded a contract with the Macau casino operators
October 2019	Development	Expanded approved models to three systems
November 2019	Sales	Deployed video slot machines at the Macau casino and started operation

Source: Prepared by FISCO from Company materials

This is a test deployment and only constitutes about 30 units. We expect a sharp rise in volume purchased by casino operators if it takes hold as a "profitable machine" based on popularity and utilization.

While the video slot machine business is proceeding smoothly thus far, we think it needs more time to realize full-fledged profit contributions. One reason is the necessity of going through a test period prior to deployment. It is also still unclear whether or not the current model becomes popular. Even more time might be required to realize a hit.

We think a revenue-sharing contract with the casino operator would be an ideal business model, but this is also likely to take some time because of various regulations. In any case, the most important point is realizing a "profitable machine" with the new product and we intend to closely monitor utilization and sales conditions for the first machine.

Business outlook

Possibility of a roughly ¥20bn increase in costs for replacing machines that meet 2018 regulations

1. FY3/20 and FY3/21 outlook

Since the Company does not disclose forecasts, we review key points and perspectives for projections.

(1) Revenue analysis

Revenue, which corresponds to net sales, rose 0.5% YoY in FY3/20 1H, but we are not optimistic about prospects in FY3/20 2H. It is the value obtained after deducting prize issuance cost from ball rental fee revenue (gross sales). Ball rental fee revenue dropped 2.0% YoY in FY3/20 1H mainly due to pressure from decline in pachinko playing customer volume.

Recent pachislot popularity, meanwhile, is likely to continue in FY3/20 2H. The Company intends to strengthen the shift to pachislot business in response, similar to FY3/20 1H.

With this external environment, we expect revenue (net sales) to be flat to slightly higher again in FY3/20 2H. Our outlook takes into account correlation of revenue to the payback ratio to customers, as explained above, and hence the ability to secure revenue gains, even with modest fluctuation in ball rental fee revenue, by using the payback ratio as a buffer.

(2) Profit analysis

Operating profit is more challenging than revenue. While main dynamics are essentially the same as covered in previous report (June 25, 2019), we review key points below.

The Company proved in FY3/20 1H results that it is capable of reaching baseline values in operating profit and EBITDA (operating profit + depreciation costs and other non-capital costs) even in the current tough business environment. It obviously did not attain these levels just on their own and harnessed various adjustments and efforts in top-line growth and cost control. These adjustments and efforts capitalize on the Company's strength of having the largest domestic hall network (405 DYNAM halls, 449 total group halls; as of the end of September 2019). With very few rivals able to copy the Company, we think the gap between the Company and peers is widening further due to difficult conditions.

Even the Company might temporarily encounter heavy downward pressure on earnings in FY3/20-21 because of the issue of replacement to new-type machines that comply with 2018 regulations.

The Company needs to remove 173,000 existing amusement machines and replace them with new-type machines over two years in FY3/20 and FY3/21 to comply with 2018 regulations, as explained above. We estimate total spending on machines at about ¥60bn during this period for a mix of new and used machines. Looking at the past years, the Company has booked about ¥20bn annually in machine expenses. The ¥60bn budget needed to replace all amusement machines over the next two years exceeds the ¥40bn normally spent on machines in a two-year span by ¥20bn. While the Company could absorb this much cost increase if revenue expands at a healthy pace, these extra costs are likely to directly pressure earnings (reduction factor) in current conditions.

While the Company needs to spend the extra ¥20bn in FY3/20 and FY3/21, it is difficult to accurately forecast allocation by individual years. We think the Company itself has not decided yet because it is likely to calibrate the timing and volume of machine purchases based on the timing of new-type machine releases by manufacturers and popularity levels.

We think the prospect is low, but the Company might even replace all former-type models during FY3/21. In this scenario, the above-mentioned ¥20bn in extra costs would be concentrated in FY3/21 and weigh heavily on earnings in the subject fiscal year and lower operating profit to breakeven. Consideration should be given to this worst-case scenario from an investor perspective.

Focus is on whether it returns to the earnings level from FY3/19 and earlier years after completing replacement of amusement machines

2. Outlook for earnings from FY3/22

Since the deadline for replacement to amusement machines that comply with the new regulations is January 31, 2021, we expect restoration of business conditions similar to FY3/19 before introduction of the new regulations in FY3/22.

However, it is still uncertain at this point whether the Company can restore earnings on par with the FY3/19 level (¥20bn in operating profit, ¥30bn in EBITDA). Our “uncertainty” reflects the possibility of losing core fans due to diminished pachinko appeal with the stricter ball output regulations and the possibility of accelerated decline in Japan’s pachinko playing population as the average age of pachinko enthusiasts generally rises.

At this point, while we think the probability of returning to the FY3/19 level in FY3/22 results is more than half, even if conditions emerge that prevent a full recovery by earnings as described above, this situation could be seen as a major opportunity from a different angle. If this happened, it implies heavy impact on almost all companies in the pachinko industry and could thereby result in a steady stream of exits from the market. As the leading company, we believe this could be the start of a new growth story driven by survivor benefits and restore a growth trajectory.

Income statement

(¥mn)

	FY3/16	FY3/17	FY3/18	FY3/19	FY3/20 1H
Revenue	155,911	156,869	152,092	146,371	73,970
YoY change	0.9%	0.6%	-3.0%	-3.8%	0.5%
Hall operating expenses	138,326	142,142	136,727	128,024	61,134
YoY change	2.7%	2.8%	-3.8%	-6.4%	-2.1%
SG&A expenses	5,798	5,622	5,049	5,023	2,339
YoY change	6.3%	-3.0%	-10.2%	-0.5%	4.4%
Other income	8,184	9,224	9,458	8,971	4,451
Other expenses	1,805	2,430	2,425	2,953	906
Total expense	137,745	140,970	134,743	127,029	59,928
YoY change	1.9%	2.3%	-4.4%	-5.7%	-2.3%
Operating profit	18,166	15,899	17,349	19,342	14,042
YoY change	-6.1%	-12.5%	9.1%	11.5%	14.5%
Financial income	311	233	236	471	286
Financial expenses	1,074	1,307	781	444	1,178
Profit before income taxes	17,403	14,825	16,804	19,369	13,150
YoY	-10.8%	-14.8%	13.3%	15.3%	6.0%
Tax expenses	6,864	5,520	5,879	6,778	4,454
Net profit for the year	10,539	9,305	10,925	12,591	8,696
YoY	-6.4%	-11.7%	17.4%	15.2%	4.5%
Net profit attributable to owners of the Company	10,544	9,360	10,870	12,596	8,691
YoY	-6.7%	-11.2%	16.1%	15.9%	4.2%
EBITDA	30,494	28,469	29,524	31,136	19,638
YoY	-0.5%	-6.6%	3.7%	5.5%	8.8%
EPS (¥)	13.92	12.23	14.19	16.44	11.35
Dividend per share (¥)	13.00	12.00	12.00	12.00	6.00

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

Statement of financial position

(¥mn)

	End-FY3/16	End-FY3/17	End-FY3/18	End-FY3/19	End-FY3/20 1H
Current assets	43,240	63,072	53,145	59,875	61,441
Cash and cash equivalents	28,134	48,499	40,533	47,537	48,140
Trade receivables	459	563	469	614	580
Non-current assets	145,944	142,043	131,826	125,457	213,091
Property, plant and equipment	109,532	106,687	98,794	95,445	95,843
Licensing assets	-	-	-	-	80,530
Intangible assets	3,991	3,833	3,545	3,112	3,083
Total assets	189,184	205,115	184,971	185,332	274,532
Current liabilities	30,838	38,496	39,643	36,452	46,837
Trade and other payables	17,786	18,282	19,220	19,297	16,764
Borrowings	2,369	7,281	7,351	2,124	1,864
Lease liabilities	-	-	-	-	12,572
Non-current liabilities	25,727	29,738	7,813	7,080	92,595
Borrowings	18,394	22,768	1,221	502	2,775
Lease liabilities	-	-	-	-	83,312
Equity attributable to owners of the Company	132,645	136,953	137,532	141,821	135,115
Share capital	15,000	15,000	15,000	15,000	15,000
Capital reserve	12,883	12,741	12,741	12,741	12,741
Retained profits	110,253	112,403	114,106	115,204	109,856
Other component of equity	-5,202	-3,191	-4,315	-1,124	-2,482
Non-controlling interests	-26	-72	-17	-21	-15
Total equity	132,619	136,881	137,515	141,800	135,100
Liabilities and net worth	189,184	205,115	184,971	185,332	274,532

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

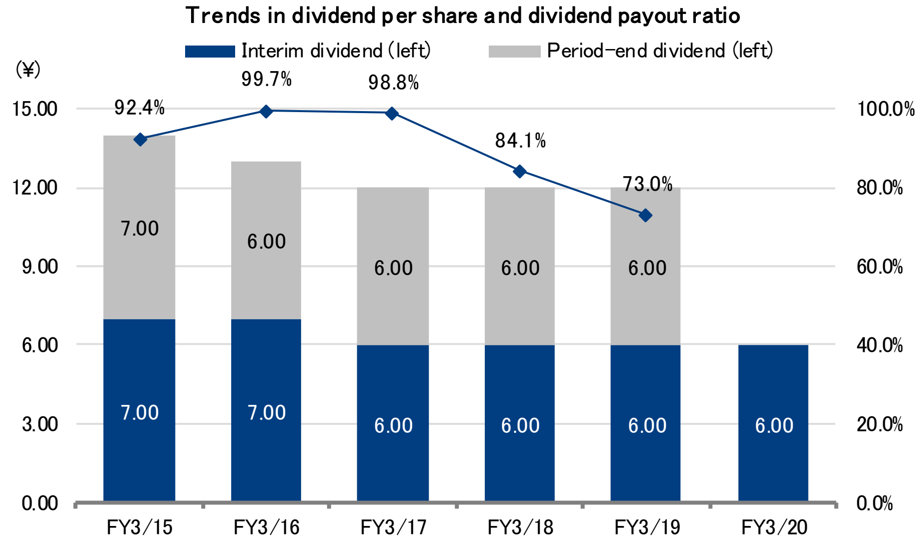
Returns to shareholders

Decided to pay a ¥6 dividend as the interim dividend in FY3/20 1H

The Company is highly conscious of the significance of returns to shareholders because it recognizes the importance of raising shareholder value in order to achieve sustainable growth. Based on this view, its policy is to pay stable dividends.

The Company decided to pay a ¥6 dividend as the interim dividend in FY3/20 1H with a total dividend of ¥4,596mn. This constitutes a 52.9% dividend payout ratio based on ¥8,691mn in FY3/20 1H net profit attributable to owners of the Company.

Returns to shareholders



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

CSR/ESG initiatives

Aiming to enhance long-term enterprise value as “regional infrastructure” in dealing with working style reforms, fostering and appointing women managers, and other important themes

1. CSR initiatives and enhancement of long-term enterprise value

As a listed company, the Company conducts compliance management in line with the laws and seeks to maximize profits. It also aims to build “regional infrastructure” (being a presence that is vital to local areas) and possesses strong CSR (corporate social responsibility) awareness.

Refer our report issued on December 25, 2018 for details. The Company conducts internal discussions and also interacts with external parties (other companies, local society, etc.) and engages in other activities to address social themes, such as work style reforms, training female managers, and efforts to prevent second-hand smoke. It aims to enhance long-term corporate value.

Disclosed an enhancing non-financial (ESG) information and provision of tools for dialogue with long-term investors

2. ESG activities

The Company made a major revision to the CSR section on its website on February 25, 2019. The Hong Kong Stock Exchange requires companies listed on the exchange to disclose ESG information since 2017, and listed companies are ramping up their disclosure of non-financial information. The Company's website also added to information disclosure on its views of and initiatives with the environment (E) and society (S) in light of the CSR activities reviewed above.

Pursuit of improvements in enterprise value from a long-term perspective, including ESG, is gaining recognition as a common theme among long-term investors and companies in an environment that encourages closer dialogue between investors and companies. We have a positive view of the Company's information disclosure on its website in an integrated report as evidence of its openness to dialogue with global long-term investors. The Company also disclosed an ESG report (ESG Report 2019) in August. We expect steady enhancement of tools for dialogue with long-term investors to broaden opportunities for appropriate assessment of the Company in the stock market.

Disclaimer

■ For inquiry, please contact: ■
FISCO Ltd.
5-11-9 Minami Aoyama, Minato-ku, Tokyo, Japan 107-0062
Phone: 03-5774-2443 (Financial information Dept.)
Email: support@fisco.co.jp