FUJI SOFT INCORPORATED

9749

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Index

Summary

A major, independent IT solutions vendor established in 1970. Aiming to further improve long-term profitability, while also focusing on human resource investment and work-style reforms

1. Company outline and business description

FUJI SOFT INCORPORATED <9749> (hereafter, also "the Company") is a major, independent IT solutions vendor established in May 1970. It has its roots in FUJI SOFTWARE LABORATORY, Ltd., which was established in his home by Mr. Hiroshi Nozawa, the Company's current Chairman and Representative Director, and two other employees. Today, nearly half a century after this establishment, the Group has grown to consist of more than 16,000 employees (as of June 30, 2019) in 28 consolidated subsidiaries, 2 equity-method non-consolidated subsidiaries, and 2 equity-method affiliates.

The Company has three reporting segments; the SI (systems integration) Business, the Facility Business, and Other Businesses. In the mainstay SI Business, it provides a diverse solutions menu, centered on the development of embedded / control software and operations software. The Facility Business entails rentals of office buildings, and Other Businesses includes a BPO (business process outsourcing) services business, a contract center business, and a regenerative medicine business.

2. Its core competencies are "technological capabilities + proposal capabilities"

The Company considers that the reasons why it is chosen by customers are its "high-level technological capabilities and proposal capabilities that continue to evolve every day." It is highly confident in its core competencies, of "technological capabilities and proposal capabilities," that it demonstrates in aspects such as its advanced technological expertise acquired through the development of embedded / control software that requires extremely high levels of precision, such as for vehicles and semiconductor manufacturing equipment; systems construction capabilities cultivated through the solutions it has provided to a wide range of industries; and its ability to provide flexible proposals as an independent solutions provider.

3. While strengthening the financial structure, has renewed its record-high sales from their peak before the economic downturn precipitated by the Lehman Brothers bankruptcy for two consecutive periods

The Company's sales peaked before the economic downturn precipitated by the Lehman Brothers bankruptcy (FY3/06), but it set a new record high for sales in FY12/17 and then achieved double-digit sales growth in FY12/18 as well. So while it actually took more than 10 years to renew its peak sales, the Company can be highly evaluated on the point that during that time, it not only recovered flow profits, it also worked to strengthen its financial structure and growth potential.

Specifically, the Company achieved major improvements for the representative financial indicators, including that the equity ratio rose from 47.3% at the end of FY3/06 to 54.5% at the end of FY12/19 1H, and the current ratio increased from 96.4% to 192.6%. On the other hand, due to the significant increase in the recruitment of new graduates from FY12/15 onwards, the number of consolidated employees increased by 1.7 times in the same period, from 9,415 people to 16,012 people. The percentage of certified technicians on a stand-alone basis (the percentage of certified specialists and certified project managers, based on the Company system, to the total number of employees) also had risen from 22.8% at the end of FY12/14 to 27.5% at the end of FY6/19. From this, it can be understood that growth potential as seen from the aspect of human resources has been enhanced both in terms of quantity and quality.

4. Near-term results are strong, and the Company's commitment to enhancing corporate value is evident from its announcement of an increase in its interim dividend, the first since FY3/13.

For FY12/19 2Q (cumulative) consolidated results, the Company reported net sales of ¥113,556mn, up 12.8% YoY, operating income of ¥6,693mn, up 26.7%, ordinary income of ¥6,825mn, up 19.5%, and profit attributable to owners of parent of ¥3,736mn, up 12.6%. The sales and profits increased by double digits.

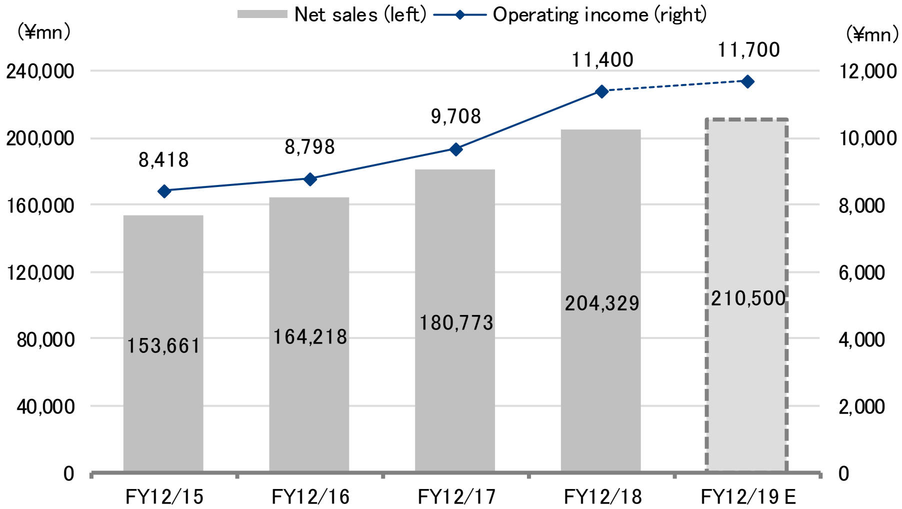
Seen in comparison to the initial corporate plan announced in February 2019, these results outpaced targets for 2Q (cumulative), with net sales at 109.6%, operating income at 125.1%, ordinary income at 121.9% and profit attributable to owners of parent at 118.6% of plan, respectively. In terms of rate of progress toward forecasted full-year results (net sales of ¥210,500mn, operating income of ¥11,700mn, ordinary income of ¥12,200mn and profit attributable to owners of parent of ¥6,700mn), the Company performed at its highest pace since FY14/12, with net sales at 53.9%, operating income at 57.2%, ordinary income at 55.9% and profit attributable to owners of parent at 55.8% of forecast, respectively.

Despite these strong results, the Company chose to leave its full-year forecast unchanged, citing a shifting macro environment, including worsening trade friction between the U.S. and China. Meanwhile, along with announcing its 2Q results, the Company also announced an increase in dividend (from ¥38/share to ¥40/share), its first increase in the interim dividend since FY13/3. This was both a response to its short-term results and an indication of the Company's commitment to enhancing corporate value.

Key Points

- A major, independent IT solutions vendor established in 1970. Its active investment in human resources and complementary M&A strategy are proving successful, and it has exceeded the ¥100bn barrier for net sales. At the end of June 2019, it had more than 16,000 consolidated employees.
- Its core competencies are "technological capabilities and proposal capabilities," as seen in its abundant track record and corporate philosophy. Results stagnated for a period after the economic downturn precipitated by the Lehman Brothers bankruptcy, but it has strengthened its financial structure and growth potential and is accelerating "Challenges and Creation" while aiming to be an innovative corporate group.
- In its FY12/19 2Q results (cumulative), the Company secured double-digit increases in sales and profit, and the rate of progress toward its planned full-year results is at its highest pace since FY12/14. Its announcement of the first increase in its interim dividend since FY3/13 was both a response to its short-term results and an indication of the Company's commitment to enhancing corporate value.

Results trends



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

Company overview

Based on its corporate motto of "Challenge and Creation," achieved net sales in excess of ¥100bn through organic growth and a complementary M&A strategy, while remaining independent

The Company is a major, independent IT solutions vendor established in May 1970. It has its roots in FUJI SOFTWARE LABORATORY, Ltd., which was established in his home by Mr. Hiroshi Nozawa, the Company's current Chairman and Representative Director, who at that time was a teacher in a computer vocational school and started a business focusing on the prospects for the computer industry with two other employees who he had previously been his students. Today, nearly half a century after this establishment, the Group has grown to consist of more than 16,000 employees in 28 consolidated subsidiaries (of which, 4 are listed companies), 2 equity-method non-consolidated subsidiaries, and 2 equity-method affiliates.

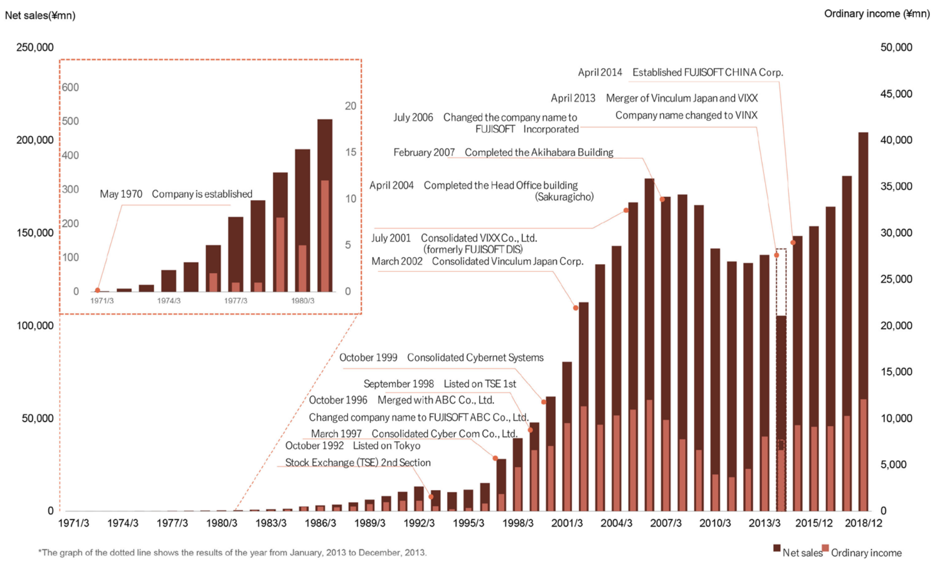
Even while achieving rapid development in terms of size, the Company, in accordance with its basic philosophy of "Being a corporate group that is more useful for society, makes customers more happy, and that is more considerate to the Earth, and that provides 'relaxed and worthwhile' work environments," has consistently conducted the enlightened management that its founder aimed for to contribute to society through business, and it aims to formulize the knowledge expressed by its corporate philosophy, such as through the Group's corporate charter and the systems to have executives and employees understand it.

The Company has three reporting segments; the SI Business (systems construction and products and services), the Facility Business, and Other Businesses. In the mainstay SI Business, it provides a diverse solutions menu, centered on the development of embedded / control software and operations software. The Facility Business entails rentals of office buildings, and Other Businesses includes a BPO service business, a contract center business, and a regenerative medicine business. Although the entry into the regenerative medicine business appears at first glance to be an entry into an unrelated business area, it can be said to be a typical example of business creation based on its corporate philosophy.

At the time it was established, the Company's business was founded on the dispatch of computer operators. Subsequently, it entered-into the software development and systems construction businesses and achieved rapid development supported by the explosive expansion of the computer industry. But what should not be overlooked as a factor behind this growth is the founder Chairman Nozawa's conviction that the time of the computer society had arrived, and while bearing a considerable risk, the Company actively invested in recruiting and training engineers and pursued a complementary M&A strategy to incorporate into itself the technologies and customer bases it did not have.

Even as the computer society has become a reality and the Japanese IT services market has expanded in scale to be worth more than ¥5 trillion, the major IT services companies with sales of more than ¥100bn are comprised almost entirely of manufacturers (such as Fujitsu Ltd. <6702>), user-related companies (such as NTT DATA Corporation <9613>), trading companies (such as SCSK Corporation <9719>), and overseas-related companies (such as IBM Japan, Ltd.). Including the Company, there are only three so-called independent companies. It has become one of groups with over ¥100bn in net sales in FY3/02, but on looking at the number of employees to achieve this, of 3,426 people on a stand-alone basis and 6,353 on a consolidated basis, we can see that its business expansion has been supported by its active recruitment of human resources and training of engineers since its establishment. Also, in 1996, it merged with ABC Co., Ltd., which has strengths in finance-related operations systems, and subsequently also, it made consolidated subsidiaries of Cybernet Systems Co., Ltd., <4312> which has its origins in an overseas company in 1999, and Vinculum Japan Corp. (currently VINX Co., Ltd.), whose main business is distribution-related business systems, in 2002. In such ways, the Company has advanced an M&A strategy to incorporate into itself the technologies and customer bases to supplement its strengths in embedded /control software development. It is considered that it would not have been able to exceed net sales of ¥100bn solely from riding the favorable external wave, but that its bold decision making has also been vital to achieving this.

Since its establishment in May 1970, the Company's size has expanded dramatically



Source: From the Company's 2019 FACT BOOK

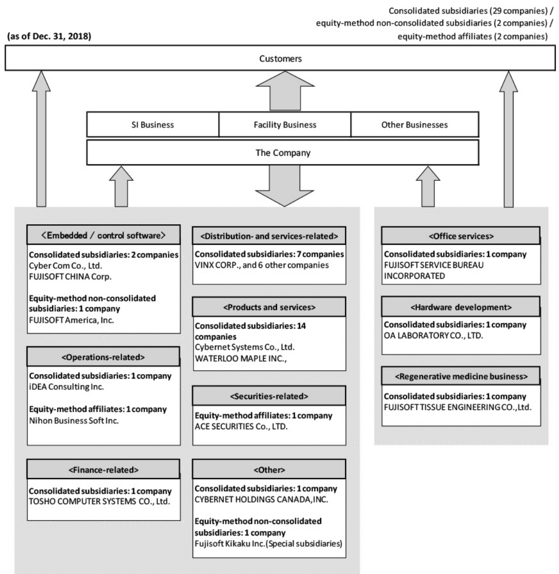
With "technological capabilities and proposal capabilities" as its core competencies, the Company is aiming to be a CSV-style innovative corporate group

The Company considers that the reasons why it is chosen by customers are its "high-level technological capabilities and proposal capabilities that continue to evolve every day." It is highly confident in its core competencies, of "technological capabilities and proposal capabilities," that it demonstrates in aspects such as its advanced technological expertise acquire through the development of embedded / control software that requires extremely high levels of precision, including for vehicles and semiconductor manufacturing equipment; its systems construction capabilities cultivated through the solutions it has provided to a wide range of industries; its ability to provide flexible proposals as an independent solutions provider; and its construction of a network of bases close to customers (43 bases in Japan + a global network). Also, the Company believes that its important mission is for its various business activities to lead to the development of society, alongside sustainable growth and the creation of corporate value in the medium to long term. As its medium-term policy, it is aiming to be "an innovative corporate group that connects the development of ICT to the improvement of value for customers."

What can be read from the messages disseminated by the Company would seem to be "its conviction in the effectiveness and potential of utilizing ICT and its sense of mission to progress this," and having a "customer-oriented and CSV-type (a company that increases enterprise value through social contributions via its businesses) management policy." Of course, corporate activities will have CSV-type aspects to a greater or lesser extent, even if the company itself is unaware of this. But in the Company's case, the fact that the founder's strong intentions, based on the corporate motto of "Challenge and Creation," have been incorporated into its corporate culture, is worthy of note.

One of the Company's unique initiatives as a CSV-type company is the All Japan Robot-Sumo Tournament, which it has held continuously since 1990 and which has grown to become Japan's largest robot competition. It started with the aim of providing a place to experience the enjoyment of building things and to improve technologies through building robots. But it is currently recognized to be an excellent example of support for developing human resources through manufacturing; for example, since a section for high school students established in 1993, the National Association of Principals of Technical Senior High Schools has joined the operation, and the organizations including the Ministry of Education, Culture, Sports, Science and Technology, and METI are also known as the sponsors as well.

Business structural diagram



Source: From the Company's securities report

Business overview

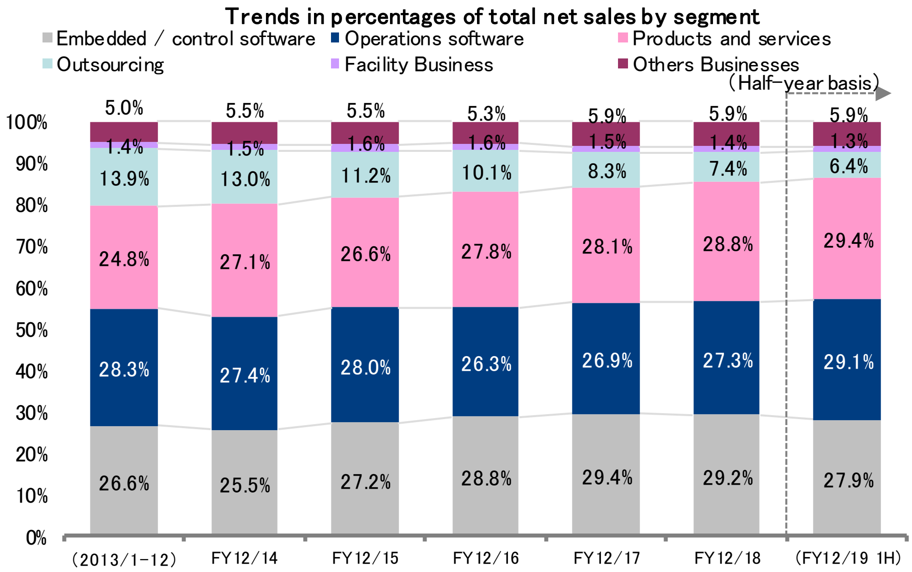
Offering varied and unique ICT services and products

The Company has three reporting segments; the SI Business, the Facility Business, and the Other Businesses. The mainstay SI Business is broadly divided into systems construction, and products and services. Further, systems construction is subdivided into embedded / control software and operations software, while products and services are subdivided into narrowly defined products and services, and outsourcing. Also, the Facility Business entails rentals of office building, while Other Businesses includes a BPO service business, a contract center business, and a regenerative medicine business.

Segment breakdown

Segment name	Breakdown
SI Business	
Systems construction	
Embedded / control software	
Machine control systems	Embedded / control software such as FA, OA, digital home appliances
Automotive-related	Automotive-related embedded / control software
Mobile-related	Embedded / control software for mobile devices, etc.
Social infrastructure-related	Embedded / control software for communication control (switches, routers, etc.), base stations, aerospace and defense, etc.,
Operations software	
Financial industry	Operations software for financial companies (life insurance, credit cards, securities companies, banks, etc.)
Distribution and services	Operations software for distribution-related companies (retail, wholesale, trading companies, real estate, construction industry, etc.)
Manufacturing industry	Operations software for manufacturing
Other operations-related	Operations software that does not correspond to the above fields
Products and services	
Products and services	Products and services of the FUJISOFT Group and of other companies based on strategic partnerships
Outsourcing	Data center business, systems maintenance operations, etc.
Facility Business	Sales related to the real estate rentals business
Other Businesses	Office services, hardware development, regenerative medicine business

Source: From the Company's results briefing material



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

1. Mainstay embedded/control software

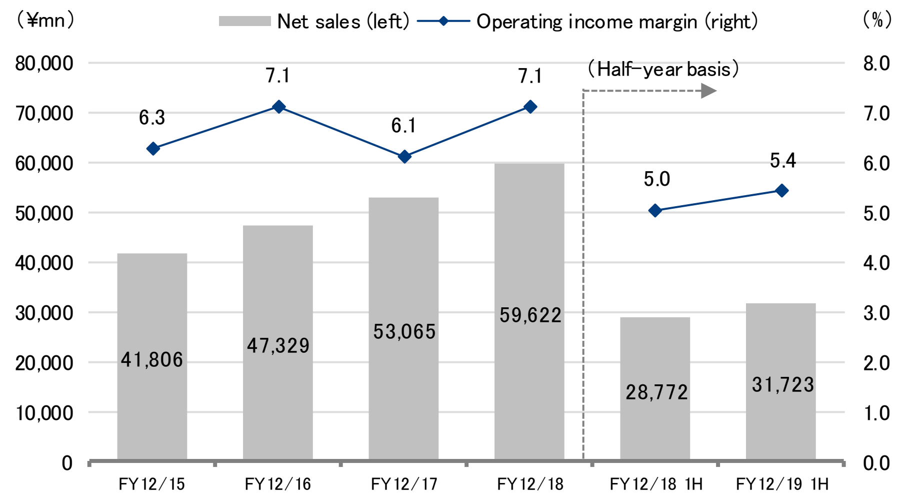
Embedded / control software, which belongs to the systems construction category in the SI Business, accounted for 29.2% of Company-wide sales (FY12/18) and 37.2% of operating income, and its segment profit margin was also the highest within the SI Business.

Embedded / control software is software that runs on a microcomputer or other device, embedded into the device to provide specific functions. The Company's technologies are used in a variety of products and devices, including vehicles and mobile phones, home appliances such as TVs and air conditioners, office automation (OA) equipment including printers, robots and semiconductor manufacturing device production equipment, infrastructure equipment such as traffic lights, and medical equipment like CT and MRI.

The Company has accumulated top-class results in Japan in this area, and it has strengths in FA and other machine control systems and automotive-related. If limited to vehicles installations, in practical terms it delivers products to every vehicle manufactured in Japan, and it has the top share of the domestic market.

Developments in the productivity revolution through CASE (Connected, Autonomous, Shared/Service, Electric), AI and robots in the automotive industry are currently proving advantageous for the Company. In 1H FY12/19 it achieved double-digit growth in sales and profit, with its backlog of orders accumulating steadily to rise 17.0% YoY for the end of 1H, a 7.8% increase over the end of the previous fiscal year. Note that while segment profit margin declined to 5.4% from the 7.1% recorded in FY12/18 due to the impact of large-scale hiring of new graduates and other factors, it improved by 0.4 points when compared to the same period in the previous fiscal year, and does not need to be viewed as a problem.

Trends in embedded / control software net sales and operating income margin



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

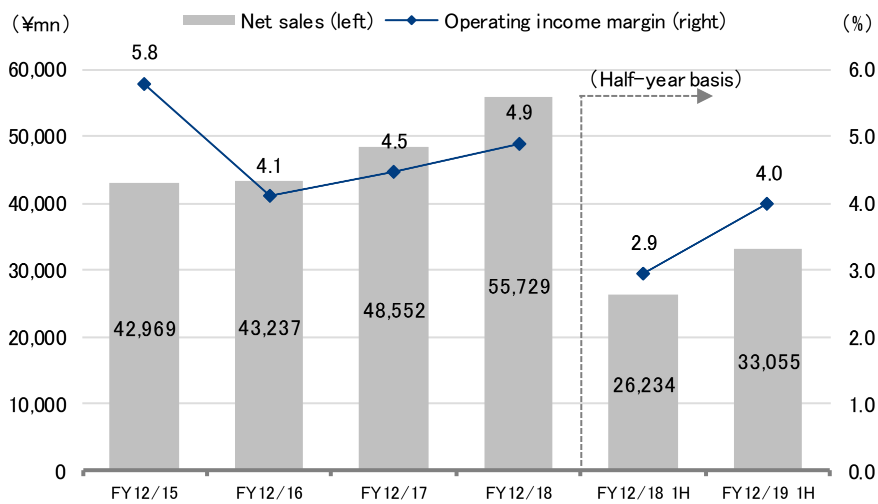
2. The operations software profitability is recovering

Operations software, part of the system construction category in the SI Business, is a major pillar of earnings, contributing 27.3% of Company-wide net sales (FY12/18) and 23.9% of operating income. Sales stopped growing in FY12/16, but subsequently, the growth rate has exceeded that of overall Company-wide results for two consecutive years, while segment profit margin is also recovering. The Company continued to maintain its strong performance in 1H FY12/19 as well, primarily in solutions for manufacturing, internet services and non-bank financial institutions, and, at its group companies, for the distribution and service industries. Net sales increased 26.0% YoY, while profit increased 70.4%, with the backlog of orders rising at a high pace, up 29.9% year on year as of the end of 1H FY12/19, and 16.0% over the end of the previous fiscal year. Note that while segment profit margin declined to 4.0% from the 4.9% recorded in FY12/18 due to the impact of large-scale hiring of new graduates and other factors, it improved significantly by 1.1 points when compared to the same period in the previous fiscal year, substantially continuing the recovery of recent years.

In this area, in addition to organic business growth, the complementary M&A strategy is proving successful, and the Company has established a system that is able to provide a one-stop service, from consulting through to development, systems construction, and support, for various solutions, such as for backbone systems like store and ordering systems and production, sales, inventory, and accounting systems, and also information systems and online services. It provides these solutions to a wide range of industries, including distribution, financial, services, manufacturing, online businesses, social infrastructure, education, medicine, and public institutions.

In the operations software area, which is positioned as the main battlefield in the domestic IT services market, there have been structural changes in the market that could prove to be disadvantageous to the existing players, including 1) the shift from on-premises (operating IT systems, such as servers, through equipment installed within a company) to the use of cloud services, and 2), the evolution from “defensive IT (mainly to improve work efficiency) to offensive IT (mainly to create businesses).” Within this situation, the Company, based on a spirit of seeing “changes as opportunities,” has clearly set-out and is implementing an approach of strengthening the development of outsourcing through actively investing in human resources. Further, it makes management decisions in accordance with the Company motto, of “Challenge and Creation,” and we will be paying attention to developments in the future.

Trends in operations software net sales and operating income margin



Source: Prepared by FISCO from the Company’s results briefing material

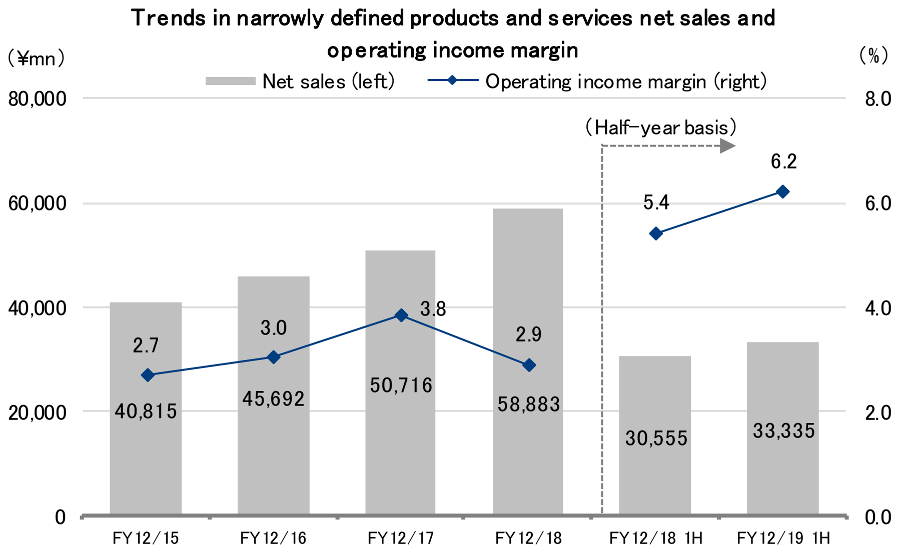
3. Narrowly defined products and services see significant improvement in profitability

In the SI Business, products and services are subdivided into narrowly defined products and services, and outsourcing. Narrowly defined products and services provide 28.8% of total net sales (FY12/18) and 14.9% of operating income.

While the percentage of total net sales has risen in each of the last three years, the overall segment profit margin was below the Company-wide level. This is because the majority of the segment's net sales are from product sales and others whose profit margins are low. Practically all of remaining sales come equally from Company products and the license business. Note that sales increased and profits decreased in FY12/18, while the large drop in profit margin was a temporary movement caused primarily by an increase in upfront investment to strengthen product quality. In fact, 1H FY12/19 saw an increase of 9.1% YoY in net sales and 24.8% YoY in profit, while improvements in profitability and other factors at subsidiary Cybernet Systems helped bring segment profit margin to 6.2%, an improvement both year on year and over FY12/18. The backlog of orders at the end of 1H FY12/19 rose 11.5% YoY, increasing significantly by 31.5% over the end of FY12/18, strong performance that can be expected to continue in 2H FY12/19.

Narrowly defined products and services are comprised of 1) the Company's own products (including moreNOTE, a paperless system; Mirai School Station, a comprehensive education solution for the information society; smartBYOD, a tool for utilizing employees' personal smartphones and other devices for a company's operations; and PALRO, a communication robot); 2) the license business (Microsoft products, AWS, VMware, etc.); 3) product sales, etc. (PCs, servers, etc.). Looking at the YoY percentage increase in sales in 1H 12/19, sales of the Company's own products increased 2% (versus 7% in FY12/18), while license business sales were up 29% (versus 26%) and product sales, etc. grew 3% (versus 17%); the license business showed particular strength. While special demand in advance of the ending of support for Windows 7 (on January 14, 2020) helped to push up sales in the license business, generally speaking it is possible that stability in the business has increased thanks to the growing shift to a subscription model for ICT products—a business model in which fees are collected based on length of use, rather than via one-time software sales—including Office 365 and various cloud services. Note that sales of support for deployment of licensed products is recorded in the Company's own products, apparently enabling it to secure high profit margins.

One of the Company's strengths is that, as an independent SIer, it is able to construct systems flexibly without being tied to specific hardware, but launching proprietary products, including hardware such as the communication robot PALRO, seems to pose unique challenges. The strategy of working to create new added value through the Company's own products that are infused with its core competencies, of "technological capabilities and proposal capabilities," acts in accordance with its corporate moto, of "Challenge and Creation." But we shall be paying close attention to the high profitability the Company is seeking for after the upfront investment phase.

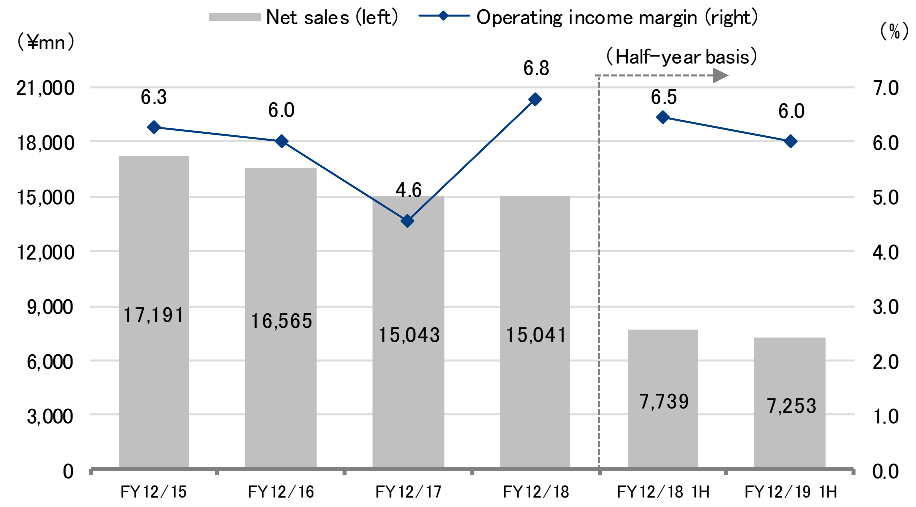


Source: Prepared by FISCO from the Company's results briefing material

4. Outsourcing continues competition with cloud services

Outsourcing provides various services, including data centers and systems operations and maintenance, contributing 7.4% of total net sales (FY12/18) and 9.0% of operating income. Segment operating profit margin rose 6.8% in FY12/18 due to a decrease in data center repair costs, which had increased in FY12/17. The declining trend in sales in recent years is mainly due to a decrease in ongoing projects for distribution and services, sales of which fell 6.3% in 1H FY12/19, with a 12.9% drop in profits. The pickup in order backlog as of the end of 1H FY12/19 (up 7.9% YoY, up 21.6% versus the end of the previous fiscal year) was primarily due to a recovery in systems operations and maintenance, while the data center business continues to search for a bottom in the face of serious competition from cloud services offered by other companies.

Trends in outsourcing net sales and operating income margin

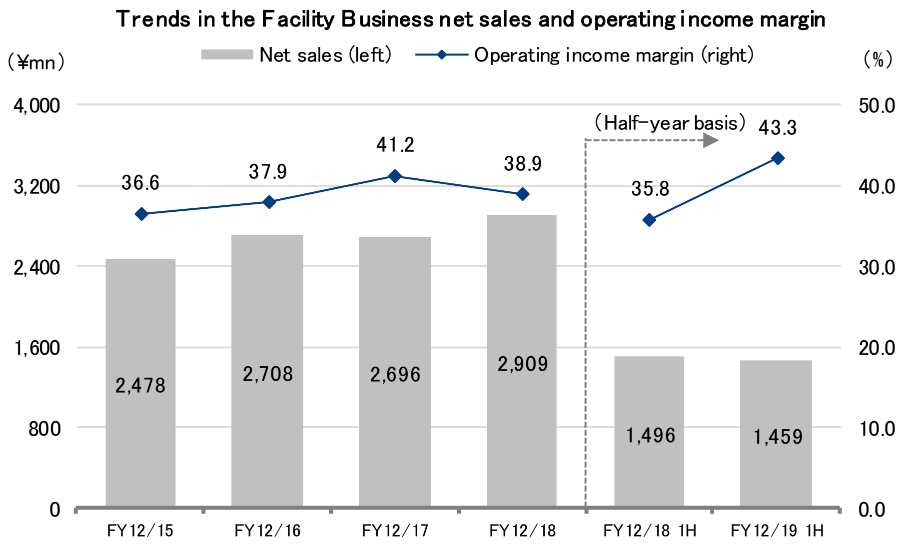


Source: Prepared by FISCO from the Company's results briefing material

5. The Facility Business has high earnings

The Facility Business, which obtains rental income from the office buildings the Company owns, provides 1.4% of total net sales (FY12/18) and 9.9% of operating income, with a high segment profit margin of 38.9%. While sales fell 2.4% in 1H FY12/19, profits rose 17.9%, providing stable support for the Company's profit level. Note that segment profit margin improved further, rising by 7.5 points YoY, to 43.3%, and by 4.4 points compared to FY12/18.

According to the Company's securities report, there are four properties; the Yokohama Head Office (land-acquisition year: 2000, land and property book value: ¥11,399mn), the Akihabara Office (2005, ¥32,635mn), the Kinshicho Office (2000, ¥6,065mn) and the Monzen Nakacho Office (2003, ¥1,760mn).



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

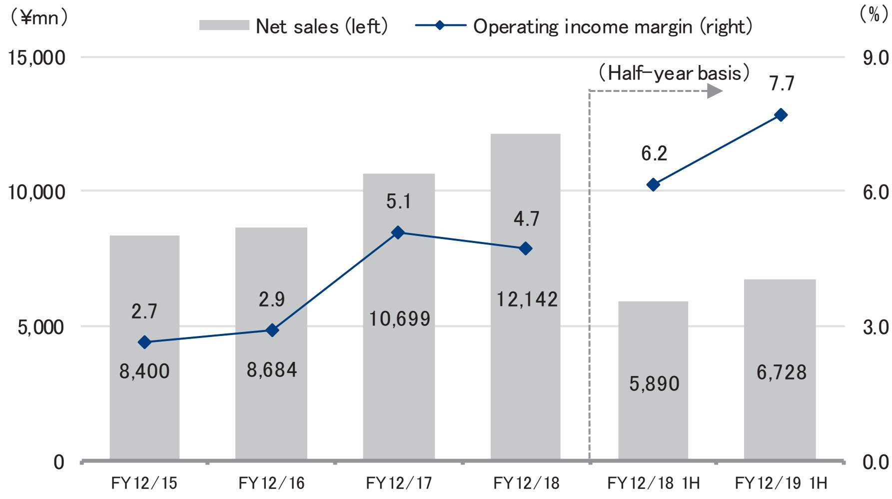
6. In the regenerative medicine business, which is included in Other Businesses, has successfully acquired certification for implanted regenerative cartilage

Other Businesses provides 5.9% of total net sales (FY12/18) and 5.0% of operating income. The higher sales and profits are primarily due to strong performance in the business process outsourcing (BPO) business, in which subsidiary FUJI SOFT SERVICE BUREAU INC. <6188> is involved, and in the contact center business. A similar trend continued in 1H FY12/19, with a 14.2% increase in net sales and a 43.3% rise in profits contributing to significant growth. Segment profit margin rose 1.5 points YoY to 7.7%, an increase of 3.0 points over FY12/18.

The regenerative medicine business began the "the cartilage and bone regenerative medicine donation course" at the University of Tokyo Hospital in November 2005, and in 2007, it was commissioned by the Japan Science and Technology Agency (since April 2015, it has been commissioned by the Japan Agency for Medical Research and Development). At first glance, the entry into this business would appear to be unconnected to the rest of the businesses, but it is also a "Challenge and Creation" business that focuses on the effectiveness of utilizing ICT in the medical field.

The Company received a technology transfer from the University of Tokyo and succeeded in researching and developing the world's first "implant-type regenerated cartilage" using autologous cells. In 2015, it conducted company trials to evaluate its efficacy and safety for patients with cleft lips and palates toward improving appearance and functions. Then in September 2018, it acquired a certificate of success for implant-type regenerative cartilage, and it is aiming to realize a production and sales business in 2019 and achieve sales of ¥4bn in 5 years' time.

Trends in the Other Businesses net sales and operating income margin

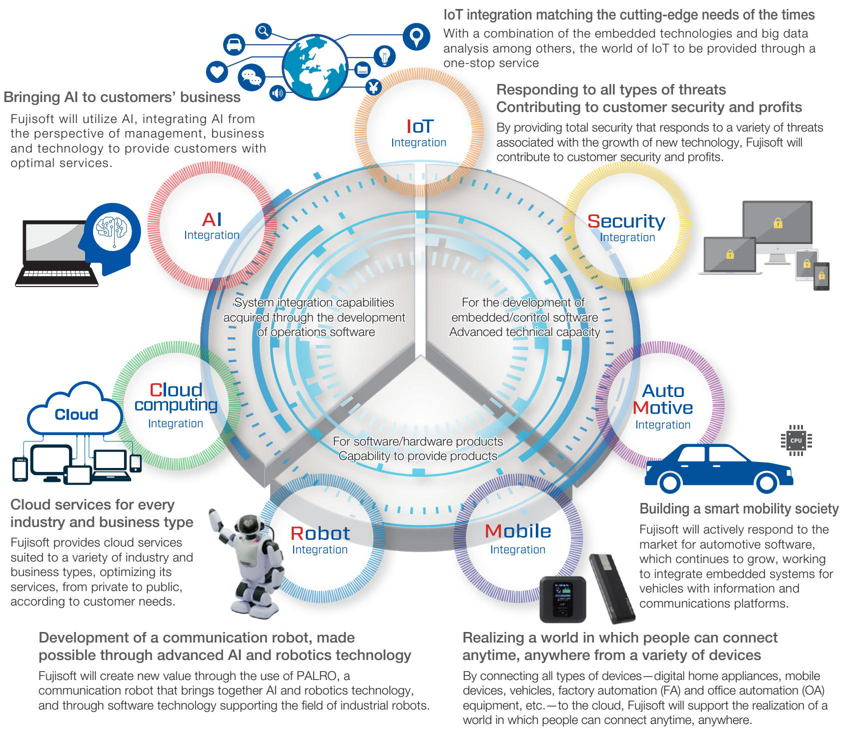


Source: Prepared by FISCO from the Company's results briefing material

7. Taking on the challenge in its business strategy of creating new products and businesses for AIS-CRM

The Company has set AIS-CRM (A: AI / I: IoT / S: Security / C: Cloud computing / R: Robot / M: Mobile & AutoMotive) to be a key technological area, and it is working to improve added value in this area. At first glance, it seems to be just a list of currently popular words, but the superordinate concept for AIS-CRM includes the Company's core competencies, so we can expect it to produce the seeds of new products and businesses.

Summary of AIS-CRM



Source: From the 2019 CSR Report

Results trends

With strengthened financial structure and upfront investments, record high operating income within sight

In FY12/17, net sales were ¥180,773mn, which was the first new record high for net sales in 11 years since their peak before the economic downturn precipitated by the Lehman Brothers bankruptcy (FY3/06, ¥179,505mn). Sales and profit increased by double digits in the FY12/18 results, with net sales rising 13.0% YoY to ¥204,329mn and operating income growing 17.4% to ¥11,400mn, and the Company has in its sights the previous record high operating income (FY3/06, ¥12,078mn). So while it took more than 10 years to renew the peak net sales, the Company can be highly evaluated on the point that during this time it not only recovered flow profits, it also worked to strengthen the financial structure and the growth potential.

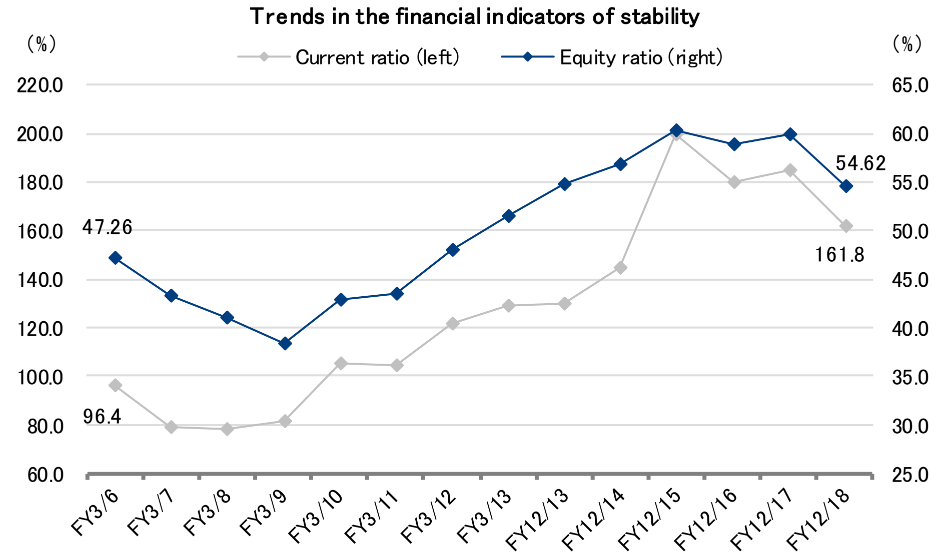
First, looking at the trends in the representative indicators showing the stability of the financial structure, the equity ratio rose trended from 47.3% at the end of FY3/06, 60.3% at the end of FY12/15, and 54.5% at the end of FY12/19 2Q, the current ratio trended from 96.4%, 199.7%, and 192.6%, respectively, and net interest bearing debt (interest bearing debt – cash and cash equivalents) trended from ¥21,285mn, ¥-479mn (excess cash), and ¥824mn, respectively, so every indicator has been greatly improving.

Also, due to the large-scale recruitment since FY12/15, the number of employees has increased by 1.7 times, from 9,415 people the end of FY3/06 to 16,012 people the end of FY12/19 2Q. On the other hand, looking at the percentage of certified technicians on a stand-alone basis (the percentage of certified specialists and certified project managers, based on the Company system, to the total number of employees), it had risen from 22.8% at the end of FY12/14 to 27.5% the end of FY6/19. So the Company has realized both large-scale recruitment and the early training and development of new and young human resources.

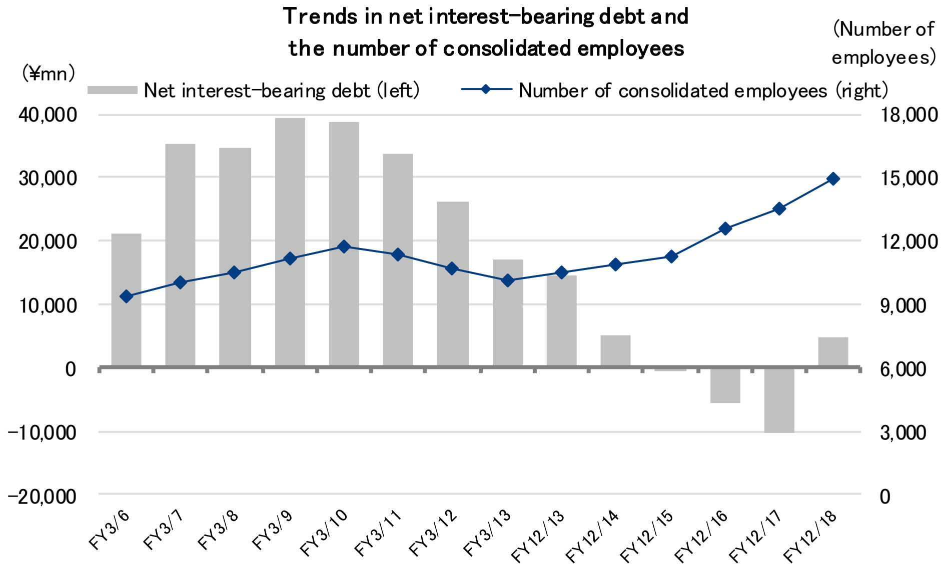
In addition, the capital investment amount increased from ¥3,028mn in F12/14 to ¥22,608mn in FY12/18, while R&D expenses also rose from ¥712mn to ¥945mn. So the Company has been expanding upfront investment, which together with its investment in human resources, indicates its intention to strengthen growth potential toward “Challenge and Creation.”

Looking here at the relationship between the financial indicators and the management strategy, in FY12/15, which is when the Company embarked on the large-scale recruitment and increased upfront investment, the equity ratio was around the 60% level, the current ratio had improved to nearly 200%, and net interest bearing debt had been reduced to a level of excess cash. This indicates that FY12/15 was when the Company realized a strong financial structure.

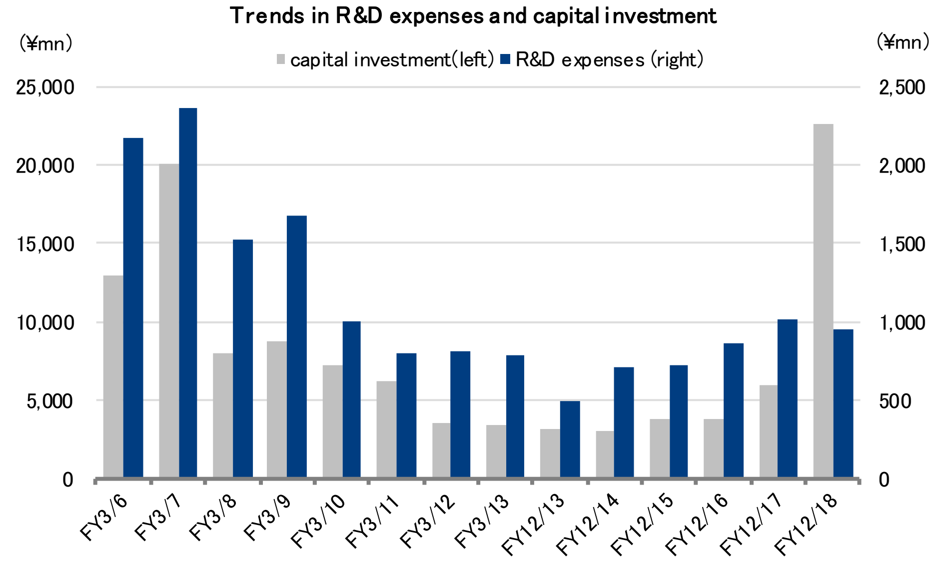
It can be said that the Company’s strengths include its ability to make and implement management decisions quickly through strong leadership, including that of its founder. It did not hesitate to change to “offensive management (actively conducting upfront investment)” precisely because it had progressed “defensive management (strengthening the financial structure)” during a phase of slumping results. So the Company can be highly evaluated for taking dispassionate management decisions that accurately reflect the changes to its business environment.



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



Source: Prepared by FISCO from the Company's securities report and results briefing material



Source: Prepared by FISCO from the Company's securities report and results briefing material

Simplified income statements

(¥mn)

	FY12/15	FY12/16	FY12/17	FY12/18	FY12/9 (E)
Net sales	153,661	164,218	180,773	204,329	210,500
YoY	3.5%	6.9%	10.1%	13.0%	3.0%
Cost of sales	117,552	126,024	138,708	156,808	-
YoY	3.3%	7.2%	10.1%	13.0%	-
Gross profit	36,109	38,193	42,065	47,520	-
YoY	4.2%	5.8%	10.1%	13.0%	-
Gross profit margin	23.5%	23.3%	23.3%	23.3%	-
SG&A expenses	27,691	29,394	32,357	36,119	-
YoY	5.1%	6.2%	10.1%	11.6%	-
SG&A expenses ratio	18.0%	17.9%	17.9%	17.7%	-
Operating income	8,418	8,798	9,708	11,400	11,700
YoY	1.4%	4.5%	10.3%	17.4%	2.6%
Operating margin	5.5%	5.4%	5.4%	5.6%	5.6%
Ordinary income	9,093	9,166	10,260	12,071	12,200
YoY	-1.9%	0.8%	11.9%	17.7%	1.1%
Profit attributable to owners of parent	4,922	5,042	5,797	6,516	6,700
YoY	1.0%	2.4%	15.0%	12.4%	2.8%

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

Simplified balance sheets

(¥mn)

	End-FY12/15	End-FY12/16	End-FY12/17	End-FY12/18	2Q-FY12/19	Change
Current assets	55,032	67,350	72,457	77,315	84,274	6,959
Cash and deposits	12,784	19,134	18,851	22,554	23,274	720
Notes and accounts receivable - trade	31,485	36,727	40,288	44,456	45,851	1,395
Non-current assets	98,800	96,513	102,110	115,310	115,216	-94
Property, plant and equipment	67,013	65,796	65,220	82,356	81,872	-484
Intangible assets	6,273	5,949	6,821	4,738	4,599	-139
Investments and other assets	25,513	24,766	30,068	28,214	28,744	529
Total assets	153,833	163,863	174,568	192,625	199,491	6,865
Current liabilities	27,556	37,461	39,197	49,428	43,750	-5,678
Notes and accounts payable - trade	7,625	9,444	9,977	9,526	12,668	3,141
Short-term loans payable	3,967	9,410	8,464	16,207	6,171	-10,035
Non-current liabilities	22,197	17,400	16,959	23,526	33,002	9,476
Long-term loans payable	11,242	6,723	4,182	13,319	23,097	9,777
Total liabilities	49,754	54,861	56,156	72,955	76,753	3,798
Interest-bearing debt	15,210	16,134	12,647	29,527	29,268	-259
Total net assets	104,078	109,001	118,411	119,670	122,737	3,067

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

Simplifies cash flow statements

(¥mn)

	FY12/15	FY12/16	FY12/17	FY12/18	FY12/19 2Q cumulative
Net cash from operating activities (a)	7,595	9,530	9,244	11,192	7,639
Net cash from investing activities (b)	-549	-4,337	-4,524	-23,424	-2,576
Net cash from financing activities	-7,414	1,076	-4,462	-14,766	-1,116
Free cashflow (a)+(b)	7,045	5,192	4,720	-12,232	5,063
Cash and cash equivalents at end of period	15,688	21,790	22,157	24,587	28,444

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

Outlook

Expect the next step as effects of productivity improvement materialize with progress from aggressive investment and work-style reforms

1. Steady performance in FY12/19

For FY12/19 2Q (cumulative) consolidated results, the Company reported net sales of ¥113,556mn, up 12.8% YoY, operating income of ¥6,693mn, up 26.7%, ordinary income of ¥6,825mn, up 19.5%, and profit attributable to owners of parent of ¥3,736mn, up 12.6%. The sales and profits increased by double digits.

Seen in comparison to the initial Company plan announced in February 2019, these results reflect an achievement rate versus the FY12/19 2Q plan of 109.6% for net sales, 125.1% for operating income, 121.9% for ordinary income and 118.6% for profit attributable to owners of parent, respectively. Rate of progress toward forecasted full-year results (net sales of ¥210,500mn, operating income of ¥11,700mn, ordinary income of ¥12,200mn and profit attributable to owners of parent of ¥6,700mn) has continued to maintain a high pace since FY12/14, with net sales at 53.9%, operating income at 57.2%, ordinary income at 55.9% and profit attributable to owners of parent at 55.8%.

Despite these strong results, the Company chose to leave its full-year forecast unchanged, citing a shifting macro environment, including worsening trade friction between the U.S. and China. Meanwhile, along with announcing its 2Q results, the Company also announced an increase in dividend (from ¥38/share to ¥40/share), its first increase in the interim dividend since FY13/3. This was both a response to its short-term results and an indication of the Company's commitment to enhancing corporate value.

Because the current shifts in the macro environment are not limited to the business cycle, but is rooted in a shakeup of the traditional order of free trade and globalization, the situation will remain unpredictable. That said, the companies are betting their survival on strategic investments—including in the automotive-related CASE field, for FA-related IoT and investments involving the use of AI—meaning that despite the strong sense of uncertainty in the macro environment, it is highly likely we will see a considerable degree of downward rigidity demonstrated going forward.

The Company states that its basic policy for the return of profits is to achieve a stable, ongoing dividend, implemented with comprehensive consideration to strategic growth investment and the need to accommodate sudden changes in the economic environment and various unforeseen business risks. Given this, the unusual timing of the announcement of its dividend increase can be seen as containing two messages. The first—and this is strictly speculation—is that the Company is responding to its strong short-term results even as it senses a shift in the macro environment; the second message is that, even if the shift in the macro environment leads to worsening results, the Company aims to continue enhancing corporate value by boosting shareholder returns, etc.

In addition, the Company is preparing to mark a significant milestone with its 50th anniversary in May 2020. Even if the strong sense of uncertainty in the macro environment continues, part of the Company's efforts to continue enhancing corporate value are likely to involve standing firm on the basic policy noted earlier, while further evolving its shareholder returns. Looking at the previous year-end dividend for FY3/13, when an increase was announced at mid-term, the dividend was raised in phases, from an initial forecast of ¥10/share, to an interim forecast of ¥11/share, to an actual year-end dividend of ¥13/share, leading to an interim forecast for FY12/14 of ¥14/share. While this may be reading too much into the situation, the Company may have acted to increase its interim dividend as a means of increasing the degree of freedom it has in making dividend policy while avoiding a year-end-weighted dividend increase.

Results forecast

(¥mn, %)

	Net sales		Operating income		Ordinary income		Profit attributable to owners of parent		Net income per share (¥)
	Amount	% change	Amount	% change	Amount	% change	Amount	% change	
FY12/18	204,329	13.0%	11,400	17.4%	12,071	17.7%	6,516	12.4%	208.22
FY12/19 (E)	210,500	3.0%	11,700	2.6%	12,200	1.1%	6,700	2.8%	214.10
FY12/20 (E)	217,000	3.1%	12,000	2.6%	-	-	-	-	-

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

2. Productivity is improving from the focus on upfront investment and work-style reforms

On the one hand, the Company is focusing on investing in human resources, centered on the large-scale recruitment of new graduates, while on the other hand, it is assiduously implementing work-style reforms that are tailored to a variety of lifestyles, and providing support for these reforms, toward realizing "relaxed and worthwhile" working environments.

Specifically, based on the upgraded version of the Super Flex System, introduced in 1990 that had no core working hours, the Company introduced the Ultra Flex system (the Super Flex system + a system enabling acquisition of paid leave on units of 30 minutes without fixing the time period, and 'refresh time' of 10 minutes)," and working to establish a working environment for remote locations and also on the fully fledged management of a teleworking system for which all employees are eligible. As a result of these efforts, in 2018 (the totaling period was April to March), it achieved the following results; 1) the paid-leave acquisition rate: 72.9% (private-sector average, 51.1%; government target, 70% by 2020), 2) number of employees using the teleworking system: 5,930 in total, 3) number of employees taking child-care leave: 165, and 4) number of people working more than 80 hours of overtime a month: 0. It has also been positively evaluated and recognized by external organizations, including the Platinum Kurumin Certification based on the Act on Advancement of Measures to Support Raising Next-Generation Children (Minister of Health, Labour and Welfare), the highest rank of the Eruboshi Certification based on the Act on Promotion of Women's Participation and Advancement in the Workplace (Minister of Health, Labour and Welfare), Top Hundred Telework Pioneers (Ministry of Internal Affairs and Communications), Certified Health & Productivity Management Outstanding Organizations Recognition Program (Ministry of Economy, Trade and Industry), and a Kanagawa business that promotes the support of children and child raising (Kanagawa Prefecture).

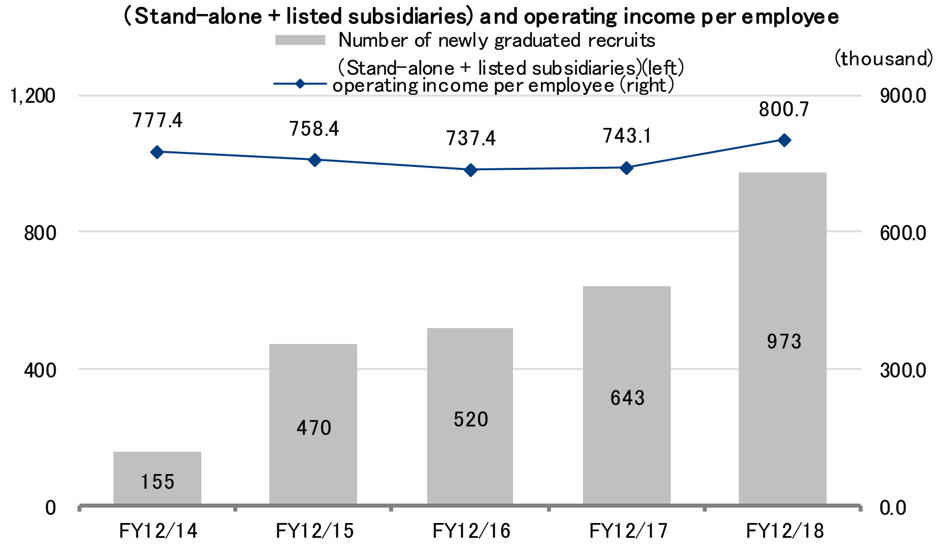
What we should pay attention to here is that the Company is realizing improvements to productivity through workstyle reforms even while providing labor-intensive IT services.

In the short term, work-style reforms, which will cause a reduction in the working hours of existing employees, and the large-scale recruitment of new graduates will lead directly to a dilution in the fighting strength of employees and an increase in upfront costs. So in many cases, these are factors keeping down the productivity indicator of operating income per employee (operating income / the average number of employees at the end of the period). In the case of the Company, in the two years after FY12/15, when it began the large-scale recruitment of new graduates while producing positive effects from work-style reforms, operating income per employee decreased but since FY12/17, it changed direction and has been increasing.

Specifically, when simply calculating the new graduate inclusion rate (the number of recruited new graduates/ the number of employees at the end of the previous year) has risen each year, from 1.5% in FY12/14, 4.3% in FY12/15, 4.6% in FY12/16, 5.1% in FY12/17, 7.2% in FY12/18. At the same time, progress was made in reducing overtime hours and increasing the number of employees taking paid leave. On the other hand, in FY12/18 operating income per employee increased 3.0% compared to FY12/14, to more than ¥800,000. The internal management indicator that the Company calls one-hour productivity improved by 1.16 times compared to FY12/16, which is when the record high operating income was achieved and operating income per employee was ¥1.35mn. So it would seem that, through implementing measures to utilize ICT and the continuous reviews of work forms and the work environment, the improvements to the work framework and the creation of workplaces that are "relaxing and worthwhile" is leading to improved productivity.

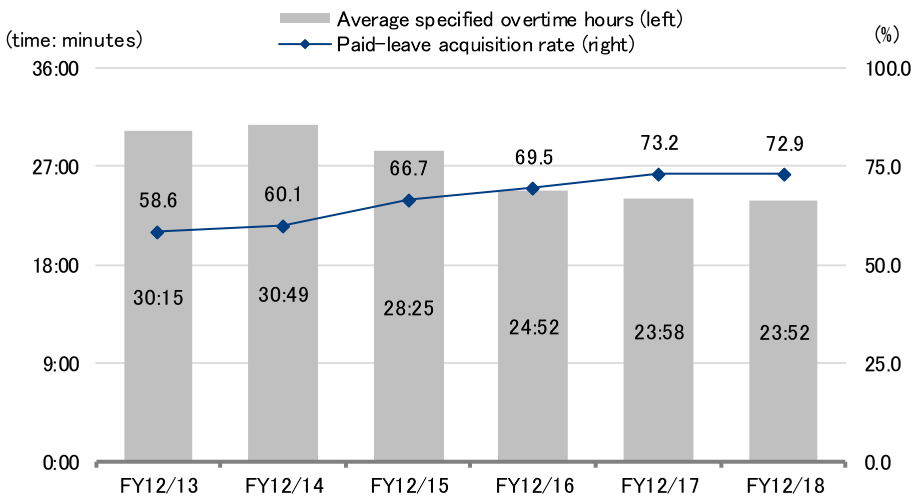
Going forward, there remains room to further reduce overtime and increase the number of people taking paid leave, while the new graduate inclusion rate is expected to peak-out. Therefore, the positive effects from improving hourly productivity will become easier to realize. We can have high expectations for the future of the Company, which is aiming to further improve profitability in the long term.

Trends in the number of newly graduated recruits
(Stand-alone + listed subsidiaries) and operating income per employee



Source: Prepared by FISCO from the Company's securities report and results briefing material

Trends in average specified overtime hours and
the paid-leave acquisition rate



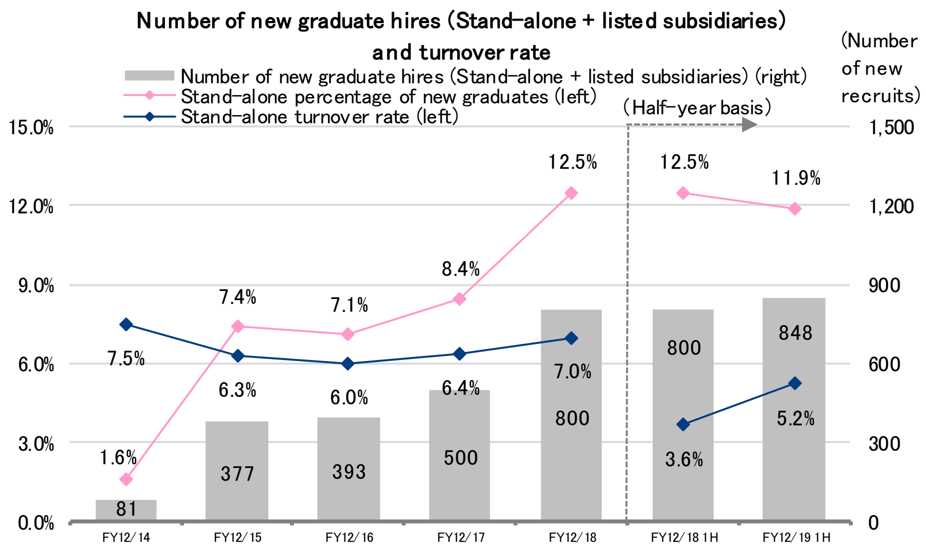
Note: calculated based on the April-to-March period.
Source: Prepared by FISCO from the Company's CSR report

3. Human resource investments beginning to progress from the acceleration stage to a groundwork-building cruising stage

Looked at on a stand-alone basis, which offers more detailed disclosure of the Company's human resource investment trends, signs of a shift can be seen in what had been a relatively stable turnover rate (annual number of retirees/ number of employees at previous year's end), even as the percentage of new college graduates in the Company's workforce jumped from 1.6% in FY12/14 to the 7% range in FY12/15 and beyond. Specifically, the turnover rate for FY12/18 was 7.0%, an increase of 0.6 points YoY, while the Company was forced to experience a 1.6 point YoY rise in turnover rate for IH FY12/19. One reason that might be pointed out is that the percentage of new college graduates rose suddenly in FY12/18, to 12.5% (a 4.1 point increase YoY, and remained high in 1H FY12/19 at 11.9%.

While the absolute turnover rate is itself not at a level that requires excessive concern, it is difficult to conceive that the Company is viewing the situation idly given its emphasis on human resource investment. In fact, the Company's per-graduate spending on recruitment training (recruitment training costs on a consolidated basis/number of new graduates hired by the Company alone plus its listed subsidiaries), which had been on a downward trend (from ¥1.95mn in 1H FY12/14 to ¥0.76mn in 1H FY12/18) even as it increased the number of new graduate hires, swung back in 1H FY12/19, to ¥0.91mn (a 19.3% increase YoY), and the Company has curbed the percentage of new college graduates, if only slightly (from 12.5% in FY12/18 to 11.9% in FY12/19). This may be a sign that the Company is beginning to reevaluate the balance between quantity and quality in its human resource investments, and may be making progress in shifting from an acceleration stage to a groundwork-building cruising stage

Generally speaking, once a company's human resource investments enter this cruising stage, the effect of increased productivity in boosting results can more easily come to the surface. FY12/20 is not only the final year of the three-year results forecast indicated by the Company in February 2018, but is also a milestone in that it marks the Company's 50th anniversary, all the more reason to expect the Company to come out with a message that sets the bar even higher.



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

Disclaimer

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