Kita no Tatsujin Corporation KK

2930

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Index

Summary

Achieved major increases in sales and profits in FY2/19 1H

Kita no Tatsujin Corporation KK <2930> (hereafter, also "the Company") conducts an e-commerce (EC) business for online sales of health foods and cosmetics to general consumers. On the J North Farm website, which is its original brand, it focuses on the development and sales of products that specialize in supporting bodily problems, such as constipation, atopy, and acne. In particular, KAITEKI OLIGO, which uses oligosaccharide as a raw material, has been driving the Company's growth. Meanwhile, new products are growing significantly, including EYE KIRARA, which has become a new pillar of earnings, and along with with the business expansion, the sales mix has improved. Due to the strengthening of the customer acquisition system and the growth in new products, the percentage of sales from skin care products (cosmetics) is increasing compared to in the past, when sales were centered on health foods, and it is considered that the Company has entered a new growth phase.

In FY2/19 1H, net sales increased 88.0% year on year (YoY) to ¥3,950mn and operating profit rose 146.9% to ¥953mn, for major increases in sales and profits. However, although net sales greatly exceeded their forecast, profits trended below forecast due to a special factor. For sales, in addition to the strong performance of the main product, KAITEKI OLIGO, sales of the products launched in the last one or two years have been growing significantly. Continuing on from the previous fiscal year, the growth is being driven by the Company's success in acquiring new customers (and accumulating regular-purchase members) through actively investing in advertising, and at the end of August 2018, the number of members had risen to surpass 210,000 (compared to about 170,000 members at the end of the previous fiscal year). On the other hand, profits rose thanks to the higher sales, despite the significant increase in SG&A expenses due to the active investment in advertising and other expenses. However, the reason why profits were below forecast was that some advertising expenses that did not generate profits increased due to operating errors on the launch of the Company's own advertising system*. Therefore, there have been no structural changes to the Company's profitability, while it seems that it will once again work on reforming operations from November 2018.

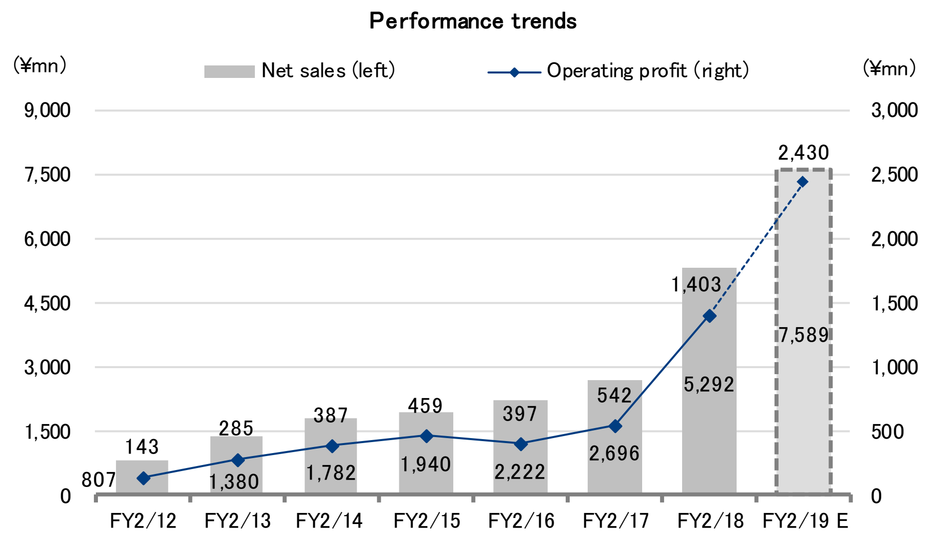
* The Company developed in-house an advertising management system that systemizes the expertise in managing advertisements held by individuals, with the aims of increasing the optimization speed of advertisements and acquiring new members by targeting new groups.

The Company has left unchanged its initial forecasts for FY2/19, which are for major increases in sales and profits, with net sales to increase 43.4% YoY to ¥7,589mn and operating profit to rise 73.1% to ¥2,430mn. The same as in 1H, it is expected that the growth will be driven by the active investment in advertising, mainly for the top-ranking products. In addition, it also intends to work on improving the performances of those products that have not been performing sufficiently well up to the present time. In profits also, while the large-scale investment in advertising is expected to continue, the Company is still expected to realize a major increase in operating profit from the effects of the higher sales and the measures to reduce costs, so the operating margin is also forecast to improve to a level of above 30%, to 32.0% (26.5% in the previous fiscal year). It seems that it is planning to release a number of products, in addition to the 2 new products released in 1H.

The Company's growth strategy is the same as up to the present time; namely, to realize stable growth by aiming to have the top products in niche markets through utilizing its overwhelming product appeal in product fields in which it is easy for customers to feel their effects for their health, beauty, and other concerns, and therefore for which it is easy to obtain repeat sales. The Company is accelerating the pace of growth through actively investing in advertising, and in the near future it has in sight achieving its targets of net sales of ¥10bn and operating profit of ¥3bn (operating margin of 30.0%). Going forward, as the next growth stage it has set targets of net sales of ¥30bn and operating profit of ¥10bn, and it seems that is aiming to achieve them by 5 years' time. At FISCO, we consider that, in addition to the sustainable growth of the main products, the key to achieving further growth will be developing a large number of products that are top in their niche market with a sales scale of ¥300mn to ¥1bn. Going forward, we will be focusing on the following 6 points; 1) the state of the development of new products and their contributions to earnings, 2) the strengthening of the customer acquisition system and its effects, 3) the progress made in reducing costs, including in overseas production, 4) the fully fledged business development in Asia, 5) the investment strategy that utilizes its solid financial base (particularly M&A), and 6) the acquisition of new channels.

Key Points

- Achieved major increases in sales and profits in FY2/19 1H, including by actively investing in advertising and strengthening the customer acquisition system
- Increasing the scope of member attributes, including to middle-aged and elderly men, alongside the growth of the new products
- Has left unchanged the forecasts for FY2/19 full year (which are for the high growth to continue)
- Has in sight net sales of ¥10bn and operating profit of ¥3bn, and in the near future will enter a new growth stage targeting net sales of ¥30bn and operating profit of ¥10bn



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

Company profile

Conducts an e-commerce business through J North Farm, its original brand

1. Business description

The Company conducts online sales of health foods and cosmetics to general consumers. On the J North Farm website, which is its original brand, it focuses on the development and sales of products that specialize in supporting bodily problems, such as constipation, atopy, and acne. In particular, KAITEKI OLIGO, which uses oligosaccharide as a raw material, has been driving the Company's growth. At the end of August 2018, it is estimated that it had more than 210,000 members. Based on the major increase in members from the previous fiscal year (FY2/18) alongside the dramatic growth in results, it appears that the upward trend in member numbers is continuing. In addition to KAITEKI OLIGO, which has been its main product since its establishment, sales of the Company's new products are growing significantly, including EYE KIRARA, which has become a new earnings pillar.

KAITEKI OLIGO is a highly pure, high quality health food (that is effective for constipation) created by compounding several types of oligosaccharide, including sugar beet produced in Hokkaido, as the main ingredient. In addition, the Company handles 28 other products (as of the end of August 2018), such as EYE KIRARA, which is a cream to improve bags under the eyes; CLEAR NAIL SHOT α, which is a penetrating, specialized nail care product that contributes to beautiful and healthy nails; and HYALO DEEP PATCH, which concentrates and replenishes moisture by using micro-sized needles of hyaluronic acid to reach the deep parts of fine wrinkles around the eyes.

Product overview (in order of launch)

Item	Description
KAITEKI OLIGO	A health food independently formulated by the Company using as ingredients many high-purity crystal oligosaccharides (raffinose) extracted and purified from sugar beet produced in Hokkaido, and also six other types of highly pure oligosaccharide
KOJUKAN	The Company's first food with functional claims, with low-molecular weight lychee polyphenol as the main ingredient, to which is added ingredients including hyaluronic acid, vitamin C and L-citrulline
MINNANO HADAJUNTO ~ ATO CARE TYPE ~	A moisturizing-care product that is 100% derived from plants, with the main ingredient being sugars made from sugar beet produced in Hokkaido
KAITEKI DOKA SLIM CHA	A health food formulated using a unique blend of natural herbs developed by thoroughly studying the peristaltic motion of the intestines
20NEN HOIPPU	A facial cleanser to improve facial skin dullness that uses a proprietary manufacturing method called direct flame pot kneading and that adds whey to the ingredients as the moisturizing compound
MINNANO HADAJUNTO ~ CLEAR TYPE ~	An acne-prevention skin care product coated with plant oils, including lavender and peppermint, and which uses sugars made from sugar beet produced in Hokkaido as the main ingredient
EZOSHIKI SU-SU-CHA	A health food independently developed by the Company which blends three types of tea leaves in a perfect balance—bamboo grass that has been used as a herbal remedy in Hokkaido since the olden days, red perilla, and tencha (tea leaves) of the rose family. The product suppresses allergy symptoms, including sneezing, runny nose, and nasal congestion
KITANO DAICHINO YUMESHIZUKU	A new concept of a resting support drink, whose main ingredients are extracts that include rest-inducing compounds extracted using proprietary technologies from asparagus produced in Hokkaido
ZUKI SHIRAZUNO MI	A health food formulated from feverfew, giant knotweed, and bittern (magnesium chloride)
MINNANO HADAJUN LOTION	A lotion formulated from humidity-retention components, such as lipidurea, squalene, and ceramide, and whose main ingredient is sugars made from sugar beet produced in Hokkaido
MINNANO HADAJUNBURO	A moisture-sealing, moisture-care bath additive formulated from sugars made from sugar beet produced in Hokkaido, and also other ingredients including extracts from natural deposits at hot springs and sea buckthorn.
EYE KIRARA	A cream that improves bags under the eyes. It is formulated from ingredients including MGA, which is one type of vitamin C-derivative that supports collagen, and plant oils rich in natural vitamin K that help to make the blood flow smoothly
CLEAR FOOT VEIL	A barrier-type foot care product for use specifically by people with constantly itchy feet
NO ! NO ! SMELL !	A medicated deodorant foot cream that addresses existing issues with foot odor while also treating skin conditions to make it difficult for odor to reappear.
KUROUMEBIYORI	A health food that leads to a life without concerns through normalizing the body and protecting it from the inside
CLEAR NAIL SHOT α	A penetrating, specialized nail care product that deeply penetrates the nail to the source of problems, which leads to beautiful and healthy nails
CARE NANO PACK	A sleeping pack that leads to tightened pores that do not stand out
HYALO DEEP PATCH	A premium, night-care product, in which micro-sized needles of hyaluronic acid reach the deep parts of the fine wrinkles around the eyes, concentrating and replenishing moisture
MAYME WHITE 60	A fast-acting skin whitening cream that leads to ideal whitening in 60 seconds with rapid-action whitening and a deep-layer approach
LUMINAPEEL	A hand peeling gel developed to solve problems with aging hands that are susceptible to UV-related damage
WRINKY FLAT	A fast-acting, anti-wrinkle beauty gel that stretches wrinkles and leads to younger looking skin in just one minute after it is applied
LID KIRARA	A beauty gel exclusively for the upper eyelids that returns skin to its original condition by thoroughly tightening the upper-eyelid skin. It has a fast-acting effect with the skin tightening immediately after application, and a continuity effect, with the foundation being raised by its continuous use
BUILD MAKE 24	A hybrid protein formulated from 1,750 mg of HMB per single serving that focuses on making body conditioning extremely efficient
RESHINE PATCH	A "patch" pinpoint-type approach sheet that provides directly focused care for accumulated UV damage
RIMO SAVON	A laundry detergent that coats clothing fibers in the Company's proprietary coating compound with each wash, which makes it difficult for pet hairs to stick to clothes, and if they do stick, enables them to be easily removed. The Company's first product to be classified in miscellaneous goods
HANDPURENA	A care cream for aging hands, with a concentrated approach to hand skin that makes the skin feel soft when it is used

Source: Prepared by FISCO from securities reports and press releases

The Company itself does not have production bases for its products and it mainly consigns production to its OEM partners. On the other hand, at the end of August 2015 it established a Taiwan branch office as a base for strengthening online sales in local markets in Asia.

2. History

The Company was established in May 2002 as Hokkaido dot See Oh dot Jay Pee KK by current President and Managing Director Katsuhisa Kinoshita (in March 2009, the Company name was changed to the current name of Kita no Tatsujin Corporation KK). However, the history of its establishment goes back to May 2000, when Mr. Kinoshita, who had worked at Recruit Holdings <6098>, aimed to expand the e-commerce market and launched the EC website “hokkaidou.co.jp.,Ltd.,” which marked the start of online sales of specially produced Hokkaido foods.

The first turning point was in July 2007 when, with the aim of differentiating itself in a situation of an increasing number of competing EC websites, the Company established the Kaiteki Friend Club site (currently, J North Farm) as a site for comprehensive sales of health and beauty products. In addition, in September of the same year, it established Hokkaido Wakeari Ichiba as a website specializing in outlet (non-standard product) food sales. In particular, Hokkaido Wakeari Ichiba, which was rare among websites at that time, was featured on many mass media outlets, garnering a lot of attention. However, as this business was comparatively easy to imitate, the more that it attracted attention, the more that competition intensified.

The second turning point was when the Company decided to compete by using overwhelming superior product quality and functions that other companies could not easily imitate. It transferred management of the hokkaidou.co.jp. and Hokkaido Wakeari Ichiba businesses, and at the same time, pivoted to the development and sales of health and beauty products through the Company’s own brand, J North Farm. During this period, KAITEKI OLIGO became a hit product, and it has been driving growth at the same time as the Company has worked to steadily expand the base of regular-purchase members. In May 2012, it was listed on the Sapporo Securities Exchange (SSE) Ambitious market, and then in March 2013, its listing was upgraded to the SSE’s main market. Moreover, in November 2014, it was additionally listed on the Tokyo Stock Exchange (TSE) Second Section, and then on November 24, 2015, its listing was upgraded to the TSE First Section. So it achieved an upgrade to a new listing market for four consecutive years.

In FY2/16, the Company began creating and maintaining a business foundation toward accelerating growth, including establishing the Taiwan branch office (the end of August 2015) and strengthening various measures, such as for its products-development structure.

Meanwhile, in terms of external evaluations of the Company, in September 2015 in EY Entrepreneurs of the Year Japan*1, which is a part of an international scheme to recognize entrepreneurship, Mr. Kinoshita was elected as the representative of the Hokkaido block. In February 2017, Mr. Kinoshita was awarded the Special E-Commerce Promotion Award at the Japan Venture Awards 2017*2 hosted by the Organization for Small & Medium Enterprises and Regional Innovation, JAPAN (sponsors: The Small and Medium Enterprises Agency, METI, etc.)

*1 An international awards system that honors the efforts and achievements of entrepreneurs who take on challenges in new business areas. In Japan, it started in 2001 as EY Entrepreneurs of the Year Japan, and each year it honors entrepreneurs selected from all over the country.
*2 A system that honors managers in high-minded venture companies that conduct businesses that are innovative, that have high growth potential, and that contribute to the revitalization of regions.

More recently, aspects such as the Company's profitability and growth potential have been positively evaluated in the media on a number of occasions. For example, in the Asia version of Forbes, the U.S. economic magazine, it was selected among "Asia's 200 Best Under A Billion," which are its selection of 200 excellent companies with sales of less than U.S.$1 billion in the Asian Pacific region (second time since the August 2014 issue). On August 7, 2018, it was selected as a constituent stock of the JPX-Nikkei Mid and Small Cap Index* (applied on August 31, 2018).

* A stock index jointly calculated by Tokyo Stock Exchange Inc. and Nikkei Inc. JPX Nikkei Index 400 introduces the concept of selecting companies that have high investment appeal to investors as its constituent stocks. The JPX-Nikkei Mid and Small Cap Index applies the same concept to select mid and small cap stocks of companies that efficiently utilize capital and conduct management with investors in mind. In addition, the index aims to spread and promote the awareness of investment appeal to a wide range of companies (from the TSE website).

Company features

Strengths include regularly purchased products with high customer satisfaction and effective marketing

1. Overwhelmingly strong product appeal

The reason for the Company's growth so far is because it has used the overwhelming appeal of its products to expand its base of highly loyal customers. It has launched a series of hit products by specializing in providing consumers with support for the body-related problems that they find most concerning, and at the same time, by maximizing customer satisfaction through a product-development concept that prioritizes quality above all and that provides thorough follow-up services. Although they do not stand out in comparison to the major growth of the results of the top-ranking products, including KAITEKI OLIGO, each of the products are supported by long-term demand and positioned as the top product in their respective niche market. These products have also won numerous awards*, mainly in the food field, such as by Monde Selection, an international rating organization that reviews the quality of products. These awards which can be said to indicate the strength of the Company's product capabilities.

* In Monde Selection 2018, all of the Company's products that were evaluated won awards. In particular, KAITEKI OLIGO won the Grand Gold Award for the seventh consecutive year, MINNANO HADAJUNTO ~ ATO CARE TYPE ~ won it for the sixth consecutive year, and MINNANO HADAJUNTO ~ CLEAR TYPE ~ for the fourth consecutive year. Also, 20NEN HOIPPU won the Gold Award for the sixth consecutive year, EYE KIRARA for the third consecutive year, and HYALO DEEP PATCH for the second consecutive year. In addition, 2 products launched in the previous period, WRINKY FLAT and BUILD MAKE 24, won the Gold Award for the first time, while 4 products–CLEAR FOOT VEIL, MAYME WHITE 60, LUMINAPEEL, and LID KIRARA–won the Silver Award.

The key to creating hit products that are supported by consumers is highly accurate test marketing. From among the many candidates, it selects those whose effects are easily experienced and that are likely to be purchased repeatedly. In addition, its consistent policy has been to only launch a product that is highly likely to sell well based on the results of a monitor survey of a prototype product.

2. Stability from regular purchases

The same as other EC businesses, the Company has a growth model in which the expansion of the membership base drives results. But in the case of the Company, in addition to the fact that the products are premised on their continuous use, its customer base is composed of highly loyal members who suffer from pressing problems. Therefore, a feature of its business is that the rate of regular purchases is high, which gives it management stability. In the future also, it intends to continue with a strategy of aiming for multiple products that are top of their niche market, not to pursue an explosive growth in results (a boom) that tends to be temporary, and rather to steadily capture long-term demand in each of these respective markets at the same time as aiming to achieve stable results growth by diversifying risk.

3. Effective marketing methods

Another feature of the Company is a marketing method using detailed data analysis. After conducting multiple types of sales tests at each stage, such as for markets, products, advertisements, and webpages, and comparing and analyzing the results, it finds the definite “winning pattern” and only then starts fully fledged sales. Particularly with regards to advertising investment, an important policy for an EC business is that it directly links it to sales, but the Company judges this only after measuring the advertisement-investment effects for each media up to the level of customers’ lifetime value. Therefore, even if member numbers and net sales are expected to temporarily increase due to investments in advertising, that investment may be foregone depending on assumptions for retention rate after the fact. Amidst this background is the Company’s approach of thoroughly prioritizing profits, and it also reflects its high profit margin.

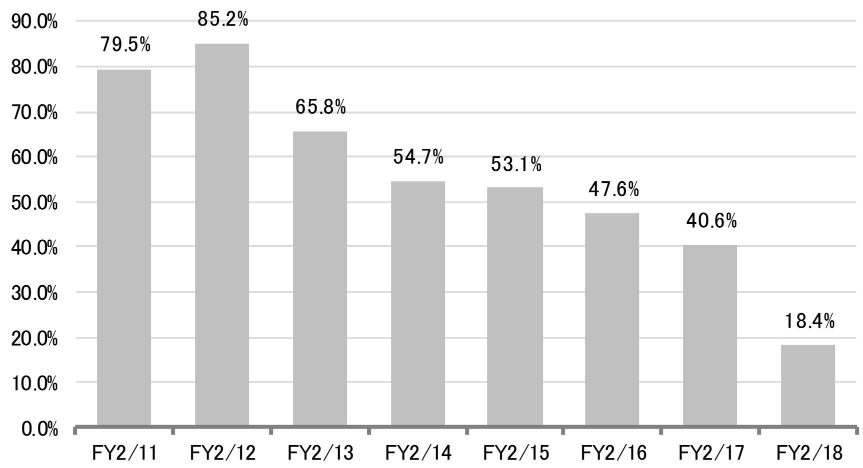
Financial highlights

Realizing business expansion with a good balance through the growth of the new earnings pillars

1. Trends in past results

Looking back on the Company’s past results, they have grown alongside the increase in the number of regular-purchase members, while the growth since FY2/13 has been particularly large. This was because up to that time the results’ dependence on KAITEKI OLIGO had been high, but from then on, the Minna no Hadajuntou series and 20NEN HOIPPU became established as new main products. Also, from FY2/17, the contributions of the new products, such as EYE KIRARA, were added to the results. Therefore, it can be said that in the last few years, the Company’s results have expanded significantly from the growth of the new earnings pillars while reducing the extent of its reliance on KAITEKI OLIGO.

Trend in the extent of the reliance on Kaiteki Oligo



Source: Prepared by FISCO from Company materials

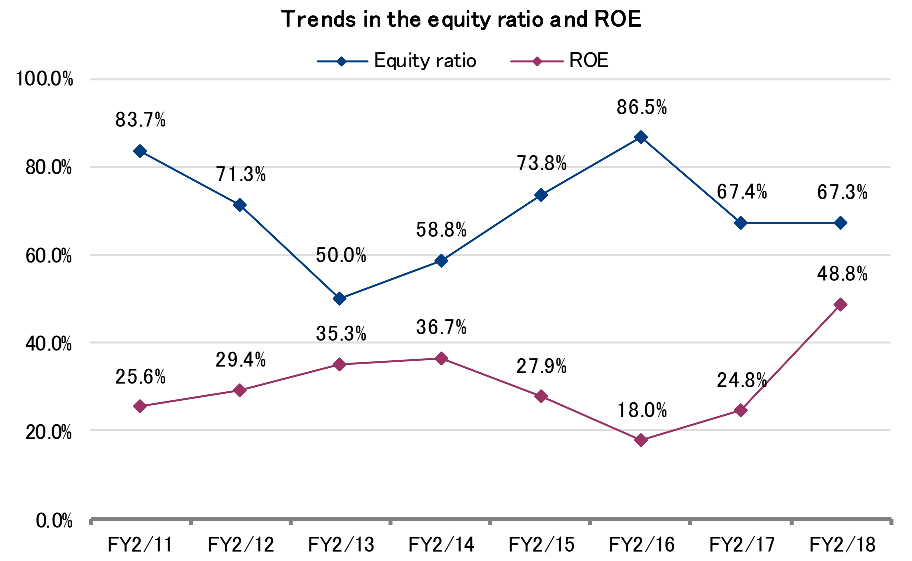
In terms of profits also, alongside the increase in net sales, the operating margin rose to a high level of above 25% due to the effective investment in advertising. The operating margin fell temporarily in FY2/16, but this was due to factors including upfront investment with an eye to the future*.

* In addition to actively investing in advertising and publicity expenses, these included operating expenses, such as personnel expenses to strengthen the organization, and outsourcing expenses.

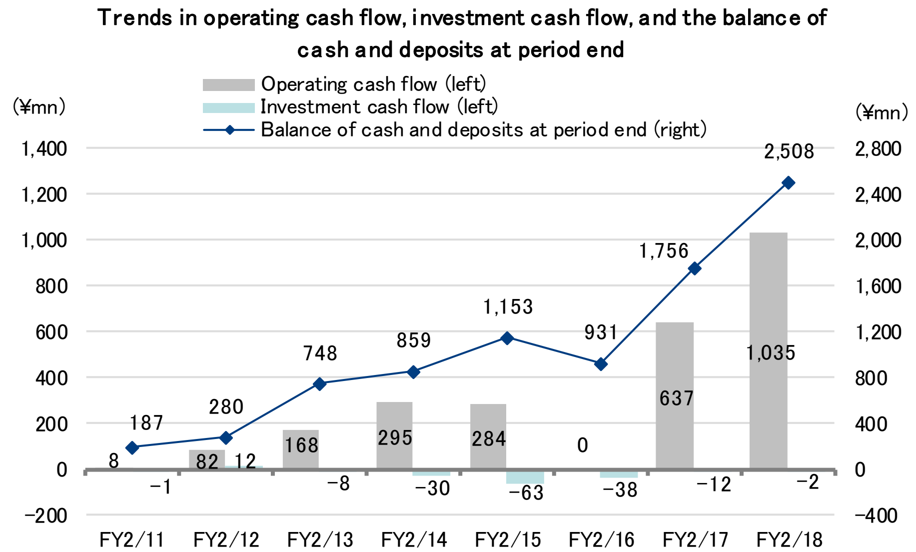
Meanwhile, the equity ratio, which is an indicator of the financial stability, declined to as low as 50.0% in FY2/13 due to an increase in interest-bearing debt to prepare for upfront investment for future growth. However, by FY2/16 it had recovered to the high level of 86.5% through a capital increase from a public offering and the accumulation of retained earnings. Although it once again fell in FY2/17 to 67.4% in order to secure liquidity from cash on hand through long-term borrowing, there are no concerns about the stability of the Company's financial base. In addition, ROE (return on equity), which is an indicator of capital efficiency, temporarily declined in FY2/16, including due to the impairment treatment of a subsidiary*. But it continues to trend at a high level, supported by the Company's high profitability, and its financial condition can be evaluated as being excellent.

* Impairment treatment was conducted for the Company's shares for Order Cosme Japan Co., Ltd., which is its wholly owned (non-consolidated) subsidiary, due to a divergence with the initial business plan.

For the cash flow situation also, a feature of the Company's business is that a large amount of capital investment is not required and investment cash flow falls within the range of its abundant operating cash flow, so the balance of cash and cash equivalents at the end of the period has accumulated significantly. In FY2/16, operating cash flow declined, but this was due to inventory investment alongside the growth in net sales, in addition to investment in advertising and publicity expenses and upfront investment with an eye to the future. In FY2/17, it returned to a being greatly positive due to the recovery of inventory investment. Going forward, it seems that an issue will be how the Company will use its solid financial base and abundant operating cash flow to realize further growth.



Source: Prepared by FISCO from Company materials



Source: Prepared by FISCO from Company materials

2. FY2/19 1H financial highlights

In FY2/19 1H, sales and profits increased significantly, with net sales rising 88.0% YoY to ¥3,950mn, operating profit growing 146.9% to ¥953mn, ordinary profit climbing 147.1% to ¥954mn, and net profit increasing 149.0% to ¥663mn. However, while net sales greatly exceeded their forecast, profits were below forecast due to a temporary, special factor (operating errors following the launch of the in-house advertising system).

In net sales, sales of the products launched in the last one or two years grew significantly, in addition to the solid performance of the main product, KAITEKI OLIGO. Sales of the other products also trended strongly, supported by the continuous demand, despite the restrictions on the advertising budget and sales personnel, and the depth of the Company's earnings structure can be said to have increased. Through the growth in sales of the new products, the percentage of total sales from skin care products is increasing compared to in the past, when sales were centered on health foods, and the lineup of the top-ranking products has also changed greatly.

In addition, the reason why net sales exceeded its forecast is that, the same as in the previous fiscal year, the Company succeeded in acquiring new customers (and accumulating regular-purchase members) through actively investing in advertising, mainly for its top-ranking products. At the end of August 2018, the number of members had risen to surpass 210,000 (compared to around 170,000 at the end of the previous fiscal year).

Profits rose due to the higher sales, despite the significant increase in SG&A expenses due to the active investment in advertising and other expenses. However, the reason why profits were below forecast was that, as previously stated, some advertising expenses that did not generate profits increased due to operating errors on the launch of the Company's in-house advertising system in June 2018. Therefore, there have been no structural changes to the Company's profitability. It seems that it will work on reforming operations from November 2018.

For the Company's financial condition, total assets were up 8.0% on the end of the previous fiscal year to ¥3,758mn, mainly due to the increase in cash and deposits. The equity ratio also rose to 69.3% (compared to 67.3% at the end of the previous fiscal year), because shareholders' equity increased 11.1% YoY to ¥2,605mn due to the accumulation of retained earnings.

FY2/19 1H financial highlights

(¥mn)

	FY2/18 1H		FY2/19 1H		Change	
	Results	% of total	Results	% of total		%
Net sales	2,101		3,950		1,849	88.0%
Cost of sales	398	19.0%	866	21.9%	468	117.5%
SG&A expenses	1,310	62.4%	2,127	53.8%	817	62.3%
Operating profit	386	18.4%	953	24.1%	567	146.9%
Ordinary profit	386	18.4%	954	24.1%	568	147.1%
Net profit	266	12.7%	663	16.8%	397	149.0%

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

Topics

Released 2 new products and also worked to strengthen the customer acquisition system

1. Track record in releasing new products

In FY2/19 1H, the Company released 2 products. Specifically, it released RIMO SAVON (on April 11, 2018), which is a laundry detergent that coats the clothing fibers in the Company's proprietary coating compound with each wash, which makes it difficult for pet hairs to stick to clothes, and if they do stick, enables them to be easily removed, and 2) HANDPURENA (on June 14, 2018), which is a care cream for aging hands, with a concentrated approach to hand skin that makes the skin feel soft when it is used. It seems that both products have made steady starts, while 1) is the Company's first product to be classified in miscellaneous goods.

2. Strengthening the customer acquisition system

Continuing on from the previous fiscal period, the Company has greatly increased the number of personnel in its customer acquisition department* toward strengthening its customer acquisition system. In particular, for listing advertising, it has deployed full-time staff in order to achieve further growth, and it has also strengthened advertising design, and through such measures it is realizing an increase in the number of newly acquired customers.

* Overall, the number of employees increased by 22 on the end of the previous fiscal year. Within this number, a total of 12 employees, of 4 new graduates and 8 mid-career hires, were deployed to the customer acquisition department.

In addition, from June 2018, the analysis and management system to optimize advertisements (hereafter, the in-house advertising system) began operations. The Company had established a proprietary marketing method to effectively acquire new members while keeping down advertising expenses. However, as this marketing method was dependent on individual responses, the measures that utilized the Company's strengths to acquire new customers were limited to only a portion of products. Therefore, it is aiming to increase the optimization speed of advertisements and to acquire new members by targeting new groups through developing in-house an advertising management system that systemizes the expertise in managing advertisements held by individuals. However, as previously stated, some advertising expenses that did not generate profits increased due to operating errors on the launch of the in-house system. So the system's operations were temporarily suspended and advertising management was returned to how it was conducted previously. But subsequently, while aiming to resolve this problem, the Company further refined the system's functions and it became operational again from November 2018. If it performs as expected, it may produce results such as the improved performance of products that have not performed well up to the present time. In the future, through combining it with RPA (robotic process automation), the Company intends to progress measures to distribute, suspend, and change advertisements with high precision through a work automation system in which some work will be conducted by robots and that will operate 24 hours a day, 365 days a year.

3. Foods with functional claims

The Company has been responding to the Foods with Functional Claims System that came into effect in April 2015, and in May 2017, KOJUKAN (a supplement with low molecular weight lychee polyphenols) was accepted in this system as a food with functional claims. Also, in March 2018, oligosaccharide itself, which is the principal ingredient of KAITEKI OLIGO, the Company's main product, was certified as being eligible to apply for the Foods with Functional Claims System. So the Company is advancing to apply for this product also, and if the application goes smoothly, it is expected to be accepted around the spring of next year. It seems that it is also advancing preparations for applications for another two or three products.

Outlook

Outlook for FY2/19 is for the major growth to continue

The Company has left unchanged its initial forecasts for FY2/19, which are for major increases in sales and profits, with net sales to increase 43.4% YoY to ¥7,589mn, operating profit to rise 73.1% to ¥2,430mn, ordinary profit to grow 73.1% to ¥2,430mn, and net profit to climb 73.3% to ¥1,643mn.

The same as in 1H, the growth is expected to be driven by the active investment in advertising, particularly for the top-ranking products. Also, the Company intends to increase the accuracy of advertising investment through further strengthening its customer acquisition system, including from the operations of the in-house advertising system that was relaunched in November 2018, and also by working to improve the performance of products that have not performed sufficiently well up to the present time. It also plans to release a number of new products, in addition to the 2 new products released in 1H.

In profits also, while the large-scale investment in advertising is set to continue, operating profit is still expected to increase significantly from the effects of the higher sales and the measures to reduce costs. Therefore, the operating margin is also forecast to improve to a level above 30%, to 32.0% (26.5% in the previous fiscal year). Moreover, it seems that the Company intends to implement specific measures toward reducing costs in the future, including for the overseas development of production bases (production outsourcing partners).

At FISCO, we think it is highly likely the Company will achieve or even exceed its net sales forecast, for reasons including that net sales exceeded their forecast in 1H, that the new customers acquired in 1H will contribute to improving results as regular-purchase members, that it will continue its policy of strengthening customer acquisition through active investment in advertising in 2H also, and that the customer acquisition system is already in place. For the profits forecasts, although the results in 1H were below forecast, we think it can fully recover the shortfall from the growth in sales in 2H. However, because the member base is expanding greatly, such as due to the strengthening of the customer acquisition system, it cannot be denied that this will affect the policy judgement, of whether to prioritize profits or to prioritize advertising investment for growth. Therefore, it will be necessary to pay attention to developments in the future. In addition, the other points to focus on include the state of the in-house advertising system following its relaunch, and also the specific trends in the overseas business development (securing outsourcing partners) toward reducing costs.

FY2/19 forecast

(¥mn)

	FY2/18		FY2/19		Change	
	Results	% of total	Forecast	% of total	Amount	%
Net sales	5,292		7,589		2,296	43.4%
Operating profit	1,403	26.5%	2,430	32.0%	1,026	73.1%
Ordinary profit	1,403	26.5%	2,430	32.0%	1,026	73.1%
Net profit	948	17.9%	1,643	21.6%	694	73.3%

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

Growth strategy

Entered a new growth stage targeting net sales of ¥30bn

The Company does not publish specific medium-term management targets, but based on its policy of prioritizing profits above sales, basically it is pursuing a strategy of constantly releasing products every period following sufficient test marketing with the aim of them becoming the top in their niche market, and at the same time, steadily capturing demand through effectively investing in advertising and publicity expenses. The Company is succeeding in linking phased marketing to the acquisition of profits in the future through actively investing in advertising to acquire new members (and to accumulate regular-purchase members), which is accelerating the pace of growth. In the near future it has in sight achieving the targets of net sales of ¥10bn and operating profit of ¥3bn (operating margin 30.0%). Going forward, as the next growth stage it has set targets of net sales of ¥30bn and operating profit of ¥10bn, and it seems that is aiming to achieve them by 5 years' time.

At FISCO, we think that the Company is fully capable of achieving the targets for the near future, of net sales of ¥10bn and operating profit of ¥3bn, by the next fiscal period (FY2/20). In terms of the next targets of net sales of ¥30bn and operating profit of ¥10bn, if the timeframe is to achieve them by 5 years' time, then it is fully possible that it can achieve them even on a line extending from its current results. It seems that, in addition to the sustainable growth of the main products, the key to achieving further growth will be constantly releasing new products, of around 5 to 10 items a year, and from within them, developing a large number of them to be leading niche products with a sales scale of ¥300mn to ¥1bn.

Going forward, we will be focusing on the following 6 points; 1) the state of developing new products and their contributions to results, 2) the strengthening of the customer acquisition system and its effects, 3) the progress made in reducing costs, including in overseas production, 4) the fully fledged business development in Asia, 5) the M&A strategy, and 6) the acquisition of new channels. Particularly for 1) and 2), in addition to being the twin drivers of growth in the future, it is highly possible that they will further evolve. Conversely, 4) to 6) can be positioned as factors that will add to results. Especially with regards to 4), since the Company is prioritizing responding to the strong domestic demand, we cannot see any major progress for it at the present time. But if going forward, the Taiwan branch gets on track through the strengthening of its organizational aspects (such as personnel and advertising budget), and if the plan is also to enter the Chinese mainland and Southeast Asia, then it has enormous potential for the future. With regards to 5), it would target a company with a customer base through the EC online sales companies it is close to, but it currently seems to be at the stage of conducting a careful investigation, including for the management structure after M&A. For 6), there has been no change to the policy of prioritizing profitability. However, if the Company can acquire effective channels from among the various options, it can be expected to contribute greatly to results. Therefore, depending on the extent of the progress made in 4) to 6), it would seem possible that in 5 years' time, results will actually exceed the targets of net sales of ¥30bn and operating profit of ¥10bn (or they will be achieved ahead of schedule).

Shareholder returns

Plans to greatly increase the dividend in FY2/19 (to an annual dividend per share of ¥3.6)

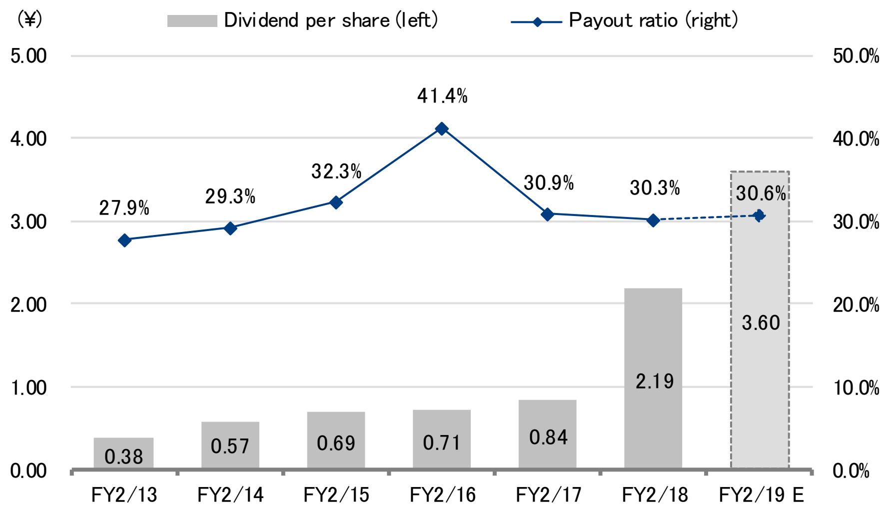
The Company's basic policy is to return profits to shareholders in accordance with its results, while also aiming to supplement retained earnings to strengthen its financial base. In FY2/18, after adjusting for the share splits*, it greatly increased the annual dividend per share to ¥2.19 (up ¥1.35 after adjusting for the share splits) from an interim dividend of ¥3.5 (¥0.59 after adjusting for the share splits), and a period-end dividend of ¥1.6 (dividend payout ratio, 30.3%).

* In order to improve the liquidity of its shares, the Company conducted 3 share splits; a two-for-one share split on April 1, 2017, a two-for-one share split on November 6, 2017, and a three-for-one share split on February 15, 2018. For the dividend amounts after adjusting for the share splits, fractions of less than one yen have been rounded up.

For FY2/19, the Company plans to increase the dividend per share by ¥1.41 to ¥3.6 (interim dividend ¥1.6, period-end dividend ¥2.0, dividend payout ratio 30.6%). It aims to stably pay dividends targeting a dividend payout ratio of 30% as the standard, but there remains plenty of room to increase the dividend in the future alongside the growth in profits.

In addition, based on a resolution in the Board of Directors meeting held on August 6, 2018, the Company has acquired treasury stock. From August 13, 2018, to September 3, 2018, it acquired a total of 700,000 shares (acquisition price, ¥384,432,000).

Trends in dividend per share and payout ratio



Note: The dividend per share amounts are after the adjustment for the following 6 share splits (fractions of less than one yen have been rounded up): February 9, 2013 (1:4); January 3, 2014 (1:2); June 1, 2015 (1:2); April 1, 2017 (1:2); November 6, 2017 (1:2), and February 15, 2018 (1:3).
Source: Prepared by FISCO from the Company's financial results

In addition, the Company has introduced a shareholder benefits program for shareholders registered on the last day of February of each year. Shareholders holding 1 or more unit of shares (100 shares) receive highly pure, high quality oligosaccharide KAITEKI OLIGO (150g, about a one-month supply), which is effective for improving intestinal flora (the gift is reviewed each period and may be changed).

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