# Medical System Network

4350 Tokyo Stock Exchange First Section

Company Research and Analysis Report
FISCO Ltd.
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## ■Aiming for record-high profits in FY3/14 by expanding the number of pharmacies supplied

Medical System Network has two main businesses. The one is dispensing pharmacy business and the other is "pharmaceutical network business" which provides an efficient pharmaceutical ordering system for small and medium-sized pharmacies, both its own and independent pharmacies. This system allows pharmacies to outsource operations with pharmaceutical wholesalers such as ordering, price negotiation, and payment. The pharmaceutical network business has been growing, and the company offers this system to more than 1,000 pharmacies. At the same time, the pharmacy business is expanding, in part, through mergers and acquisitions. Thus, the company targets consolidated sales of ¥300bn in 10 years the fiscal year to March 2024, i.e., FY3/24.

In FY3/13, the company's consolidated sales grew by 11.9% year-on-year (y-o-y) to ¥54,827mn, due to an increase in the number of member pharmacies in the network business and to greater sales by the company's pharmacies, reflecting the opening of new pharmacies and mergers and acquisitions. However, consolidated operating profit dropped by 16.2% y-o-y to ¥2,046mn, because sales and profits generated by the company's pharmacies in operation for more than a year declined and the company incurred costs to integrate acquired pharmacies. FY3/12 included only six months because the company changed its fiscal year to end in March that term, having previously ended in September. However, the rates of change in FY3/13 results cited above and hereafter are relative to results in the year through March 2012.

For FY3/14, the company forecasts a 15.2% y-o-y rise in consolidated sales to ¥63,164mn and an 18.8% upturn in consolidated operating profit to ¥2,432mn. It plans to expand the number of member pharmacies by 217, making the total 1,250, and it foresees a sales recovery by its pharmacies in operation for more than a year and contributions by acquired pharmacies. It also plans to reduce indirect costs by consolidating its pharmacy subsidiaries.

There are about 54,000 pharmacy companies in Japan, of which, about 40,000 are small or medium-sized. Small and medium-sized pharmacies can improve their profitability by procuring their supplies through the network system of Medical System Network, and no other company in Japan offers a similar service. Thus, the company's network business has substantial growth potential. In the pharmacy business, the company plans to continue its strategy of dominating the Greater Tokyo, Aichi Prefecture, and Kyoto-Osaka-Kobe areas, partly through M&A. Through this strategy, it intends to increase its sales and profits steadily over the medium-to-long term.

## ■Check Points

- Company's business model is a system for distributing drugs from wholesalers to pharmacies efficiently
- Sales grew by double digits y-o-y in FY3/13 because the company opened and acquired new pharmacies
- Through aggressive M&A, the company plans to generate sales of ¥300bn in 10 years

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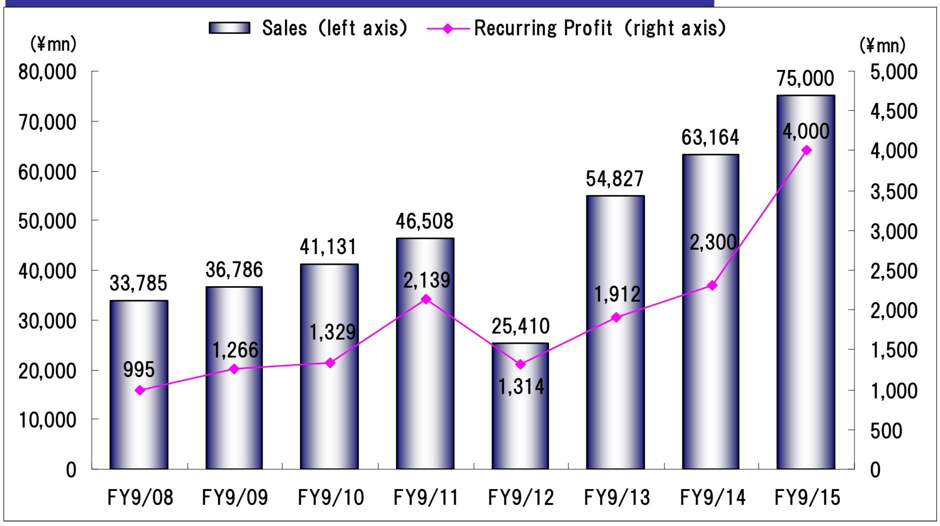
**Consolidated Sales and Recurring Profit (¥mn), FY9/08-FY3/15E**




Note: Due to a change of fiscal year, the term to March 2012 contained six months of operations

# ■Company Outline

## Established to provide a system for efficiently distributing drugs from wholesalers to pharmacies

### (1) History

The company was founded in September 1999 in Sapporo, Japan by current president Tajiri, current vice president Okinaka and current senior managing director Akino to rationalize the administration of pharmacies and to efficiently distribute pharmaceuticals. Mr. Tajiri had previously worked at a pharmaceutical wholesaling company, Mr. Okinaka had worked system development company, and Mr. Akino had worked at a pharmacy. The three pooled their respective expertise to establish a new business model for the systematic distribution of drugs from wholesalers to pharmacies.

The company's mission is to contribute to a higher quality of life for people in the community by building a high-quality medical infrastructure. As Japan's society ages, medical costs grow. Through its network business, which connects drug wholesalers with pharmacies, the company tries to offer an efficient distribution system, thereby supporting the managers of pharmacies and slowing the growth of medical costs. Through its pharmacy business, the company aims to provide high-grade pharmacies, thereby supporting the health of communities.

■Company Outline

Before the diffusion of the Internet, Japanese pharmacies placed orders for drugs and medical supplies with wholesalers and paid for them by telephone or facsimile machine. This was a cumbersome and costly process. Medical System Network developed a system enabling it to act as an agent for all steps of ordering and paying for these supplies, including inventory control and price negotiation, for a network of pharmacies. In its first year, the company handled only about ¥3bn of orders, but by March 2002, the company was large enough to register its shares on the JASDAQ Japan market (today the shares are listed on the First Section of the Tokyo Stock Exchange). In December 2002, the company bought Pharmaholdings, which runs the pharmacy business, and Nihon Leben, which leases property and operates medical facilities, and made both wholly owned subsidiaries. As the company gained public recognition, its business growth accelerated, and by FY3/13, it handled about ¥94.8bn of orders for pharmaceuticals and other medical supplies.

In 2003, Medical System Network entered a strategic business agreement with Mitsui & Co. (8031) in the field of pharmaceuticals. In February 2005, it established subsidiary MM Net to develop the network business on Japan' s main island of Honshu, and in October 2005, the company embarked on mergers and acquisitions on a significant scale, boosting its consolidated sales to ¥30bn annually. In 2007, Medical System Network bought Hokkaido Hiclips (now called SMO Medisys) and embarked on the business of supporting clinical trials at medical institutions. In following years, the company expanded its pharmacy business through aggressive M&A, and by the end of FY3/13, this business operated 269 pharmacies.

In May 2013, Medical System Network dissolved its equity and business alliance with Mitsui & Co., took full ownership of subsidiary MM Net Corp., and concluded a business agreement with FamilyMart (8028), a leading Japanese operator of convenience stores. The company is now considering the addition of convenience stores to its pharmacies. In July 2013, the company took a 51% stake in H&M Co., a joint venture established with Hanshin Pharmacy Co. for the cooperative purchase and distribution of pharmaceuticals.

| Date | Company History |
|---|---|
| Sep-99 | Established in Chuo Ward, Sapporo, Japan to rationalize the administration of medical institutions and efficiently distribute pharmaceuticals. |
| Jul-01 | Purchased System Four Co., which engaged in the network distribution of pharmaceuticals, making it a wholly owned subsidiary. |
| Mar-02 | Registered shares on the NASDAQ Japan market (now just the NASDAQ market) of the Osaka Securities Exchange. |
| Dec-02 | Bought Pharmaholdings, which runs the pharmacy business, and Nihon Leben, which leases property |
| | and operates medical facilities, and made both wholly owned subsidiaries. |
| Jul-03 | Entered a broad agreement in the field of pharmaceuticals with Mitsui & Co. |
| Feb-05 | Established MM Net to develop the network business on Japan' s main island of Honshu, taking a 51% stake, while Mitsui & Co. took a 49% stake. |
| Oct-05 | Pharmaholdings bought all of Kyoei Pharmacy Co., Sun Medic Co., and Sun Medics Japan Co. |
| Mar-07 | Bought all of Hokkaido Hiclips (now called SMO Medisys), which engaged in the business of supporting clinical trials at medical institutions. |
| Sep-08 | Listed shares on the Second Section of the Tokyo Stock Exchange. |
| | Entered a business agreement with Alfresa Holdings for the joint operation of pharmacies, the managerial support of pharmacies, |
| | and the improvement of the customary distribution of pharmaceuticals. |
| Jun-10 | Listed shares on the First Section of the Tokyo Stock Exchange |
| Nov-11 | Pharmaholdings bought all of Saeki Pharmacy Co. (now Kyushu Pharmacy Co.) |
| Apr-12 | Pharmaholdings bought all of Apo Pharmacy Co., Tomioka Pharmacy Co., and M and Three Co. |
| Aug-12 | Pharmaholdings bought all of Toen Co. |
| Nov-12 | Pharmaholdings bought all of MSC Co. Pharmaholdings entered an agreement with Hanshin Pharmacy Co. |
| | to jointly purchase and distribute pharmaceuticals, train employees, procure medical equipment and supplies, |
| | dispose of obsolete inventories, and undertake related businesses. |
| Feb-13 | Pharmaholdings bought all of Satsuki Pharmacy Co. |
| May-13 | Pharmaholdings bought all of Sun Pharmacy Co. |
| | Medical System Network concluded a business agreement with FamilyMart, |
| | terminated its equity and business agreement with Mitsui & Co., and took full ownership of subsidiary MM Net Corp. |

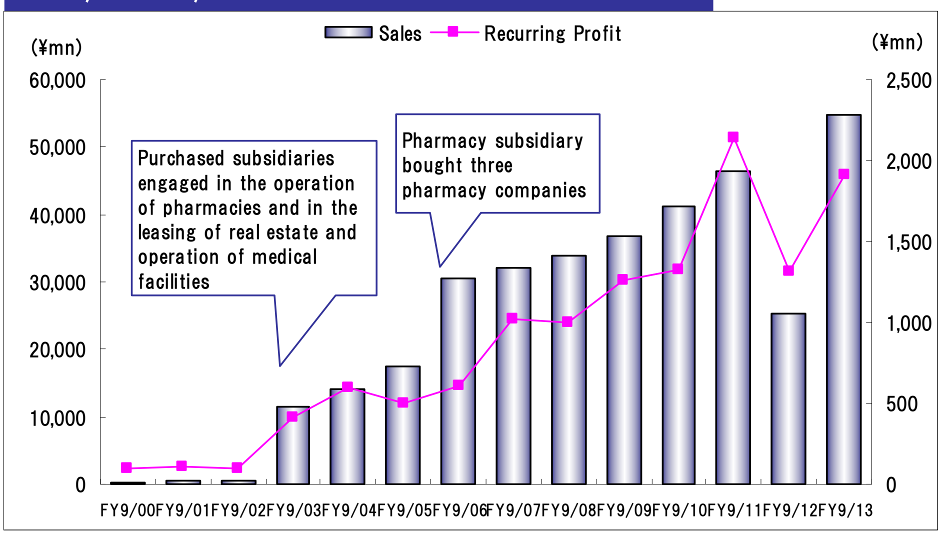
■Company Outline

At the end of FY3/13, the top three shareholders of Medical System Network were its three founders, who are representative directors. The fourth largest shareholder was Mitsui & Co. However, when Medical System Network scrapped its tie with Mitsui & Co. in May 2013, it bought back all of the shares held by Mitsui & Co.

**Ownership Ratios of Top Four Shareholders at the end of March 2013**

| Shareholder | Ownership Ratio (%) |
|---|---|
| Inao Tajiri | 12.78 |
| Yasuyuki Okinaka | 9.47 |
| Jiro Akino | 8.47 |
| Mitsui & Co. | 8.00 |

Consolidated Sales and Recurring Profit (¥mn), FY9/00-FY3/13




Note: Due to a change of fiscal year, the term to March 2012 contained six months of operations

## Main businesses are dispensing pharmacy business and pharmaceutical network business

### (2) Businesses

Medical System Network has two main businesses, dispensing pharmacy business and pharmaceutical network business. It also leases property and operates medical facilities related to its two main businesses, and in its other business segments, it supports clinical trials at medical institutions. The network business is conducted by Medical System Network and subsidiaries System Four and MM Net, while the other businesses are conducted by subsidiaries (see table below).

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■Company Outline

As detailed in the table below, the sales weighting of the company's businesses has changed little over the past five fiscal periods. The operation of pharmacies provides about 93% of total consolidated sales each year, while pharmaceutical network business supplies 4-5%, leasing provides about 2%, and other businesses account for less than 1%. However, the operation of pharmacies provides about 60% of total operating profit, while pharmaceutical network business provides 30-40%. The operating profit margin is by far the highest in the pharmaceutical network business.

### Consolidated Subsidiaries of Medical System Network

| Subsidiary | Ownership ratio (%) | Business |
|---|---|---|
| System Four | 100.0 | Pharmaceutical network business |
| MM Net Corp | 51.0 | Pharmaceutical network business (made a wholly owned subsidiary in May 2013, integrated with Medical System Network in July 2013. |
| Pharmaholdings | 90.2 | Operate pharmacies (joint venture with Alfresa Holdings) |
| Compha | 100.0 | Operate pharmacies in central Hokkaido |
| Apos | 100.0 | Operate pharmacies in southern Hokkaido |
| SKI Pharmacy | 100.0 | Operate pharmacies in northern and eastern Hokkaido |
| Sun Medic | 100.0 | Operate pharmacies in Tohoku, Greater Tokyo and Koshinetsu areas of northern and central Honshu |
| Apo Pharmacy | 100.0 | Operate pharmacies in Greater Tokyo |
| Tomioka Pharmacy | 100.0 | Operate pharmacies in Greater Tokyo |
| MSC | 100.0 | Operate pharmacies in Greater Tokyo |
| CR Medical | 100.0 | Operate pharmacies in Tokai and Hokuriku areas of central Honshu |
| Kyoei Pharmacy | 100.0 | Operate pharmacies in Kinki, Chugoku and Shikoku areas of central Honshu |
| Sun Pharmacy | 100.0 | Operate pharmacies in Chugoku area of central Honshu |
| Kyushu Pharmacy | 100.0 | Operate pharmacies in Kyushu and Okinawa |
| Hokkaido Pharmaceutical Laboratory | 100.0 | Pharmacy business (train pharmacists) |
| Nihon Leben | 100.0 | Leasing of property and operation of medical facilities |
| SMO Medisys | 100.0 | Other businesses (supporting clinical trials at medical institutions) |

### Consolidated Subsidiaries of Medical System Network

| | FY9/09 | FY9/10 | FY9/11 | FY9/12 | FY9/13 |
|---|---|---|---|---|---|
| Sales | | | | | |
| Pharmaceutical Network Business | 1,496 | 1,622 | 2,126 | 1,348 | 2,650 |
| Pharmacy Operation Business | 35,391 | 39,645 | 44,641 | 24,273 | 52,581 |
| Leasing and Medical Facility Business | 905 | 912 | 987 | 509 | 1,122 |
| Other Businesses | 294 | 257 | 225 | 131 | 252 |
| Internal sales | ▲ 1302 | ▲ 1306 | ▲ 1473 | ▲ 852 | ▲ 1779 |
| Total | 36,786 | 41,131 | 46,508 | 25,410 | 54,827 |
| Operating profit | | | | | |
| Pharmaceutical Network Business | 730 | 789 | 997 | 596 | 1,221 |
| Pharmacy Operation Business | 1,360 | 1,426 | 2,032 | 1,233 | 1,766 |
| Leasing and Medical Facility Business | 50 | 63 | 136 | 65 | 111 |
| Other Businesses | 16 | ▲ 22 | ▲ 18 | 5 | 4 |
| Company-wide operating costs | ▲ 719 | ▲ 729 | ▲ 884 | ▲ 542 | ▲ 1,057 |
| Total | 1,440 | 1,528 | 2,262 | 1,357 | 2,046 |
| Operating profit margin (%) | | | | | |
| Pharmaceutical Network Business | 48.8 | 48.7 | 46.9 | 44.2 | 46.1 |
| Pharmacy Operation Business | 3.8 | 3.6 | 4.6 | 5.1 | 3.4 |
| Leasing and Medical Facility Business | 5.6 | 7.0 | 13.8 | 12.8 | 9.9 |
| Other Businesses | 5.7 | -8.7 | -8.3 | 4.1 | 1.9 |
| Total | 3.9 | 3.7 | 4.9 | 5.3 | 3.7 |

■Company Outline

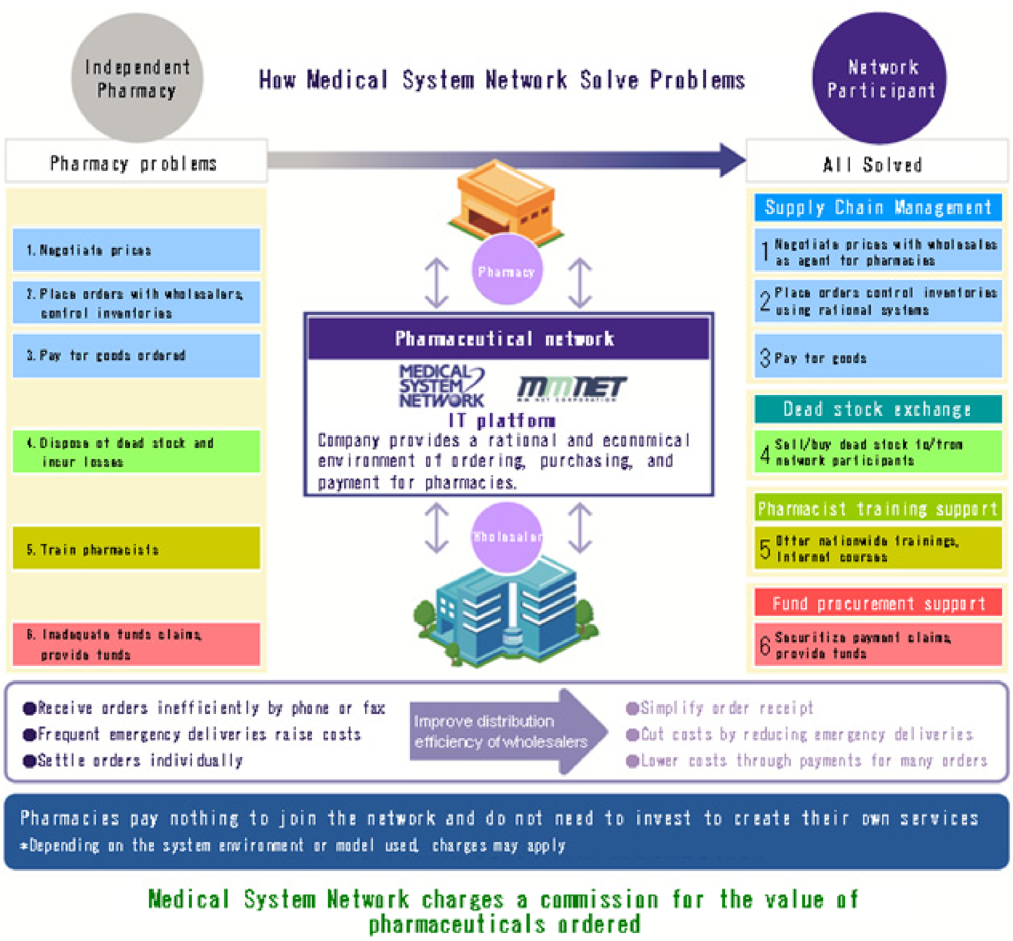
## Supporting the efficient distribution of pharmaceuticals from wholesalers to pharmacies

### Pharmaceutical Network Business

The model for the pharmaceutical network business is as an intermediary between pharmaceutical wholesalers and pharmacies to facilitate efficient distribution. This was the original business of Medical System Network. It is now conducted by Medical System Network and the two subsidiaries identified above. The company acts as an agent for daily supply chain management for its member pharmacies. It also disposes of obsolete inventories through its dead stock exchange service, supports the training of pharmacists and fund procurement.

The services provided by the pharmaceutical network business are outlined in the diagrams below. The supply chain management service facilitates order placement, payments, and inventory control, and negotiates prices for the goods ordered. Before the company offered this service, small and medium-sized pharmacies ordered and paid for their goods through a cumbersome, costly process. Using the company ' s order entry system (O/E system), these pharmacies can now handle these processes efficiently through the Internet, raising productivity. Furthermore, they can purchase pharmaceuticals more cheaply than before because Medical System Network can negotiate lower prices for bulk orders than individual pharmacies can negotiate.

**Pharmaceutical Network Business**




Source: Company

■Company Outline

The dead stock exchange service allows customer pharmacies to both rid themselves of unsold goods and acquire some needed goods cheaply by buying and selling from each other. Using this service, the pharmacies can lower their losses from disposing of unsold inventories.

The pharmacist training support service provides nationwide concentrated training sessions 30-40 times per month to raise the skills of pharmacists. It also provides e-learning lessons. The fund procurement support service securitizes the payment claims of pharmacies and provides funds to the pharmacies a month or more faster than the usual payment process does. Normally, this process takes about two months, but the fund procurement support service pays pharmacies in a month or less from the date of dispensing pharmaceuticals.

The pharmaceutical network business also develops, sells and maintains the Pharmacy Ace pharmaceutical order receipt computer system, the company's pharmaceutical order entry system, and peripheral equipment for both systems. It also sells equipment, fixtures and fittings used to prepare and dispense pharmaceuticals.

Most of the customers for the pharmaceutical network business of Medical System Network are pharmacy companies with 20 or fewer pharmacies or proprietor pharmacies.

At the end of FY3/13, the pharmaceutical network business had 1,033 companies, institutions or pharmacies in its customer network, including 24 hospitals or medical institutions, as detailed in the table below. Thus, the company has achieved its goal since founding of offering this business to 1,000 customers. The company had customers in 43 prefectures and administrative areas of Japan, with almost half in Hokkaido and the Greater Tokyo (Kanto) and Koshinetsu areas of Honshu. The Kinki area (Greater Osaka) had the next largest number of customers, followed by the Tokai and Hokuriku areas.

Most of the sales generated by the pharmaceutical network business come from the sale of systems to network customers and from commissions on orders placed through the company's order entry system.

**Number of Customers in the Network for the Pharmaceutical Network Business at the end of FY9/10-FY3/13**

| | FY9/10 | FY9/11 | FY9/12 | FY9/13 |
|---|---|---|---|---|
| External customers | 393 | 526 | 631 | 764 |
| Group pharmacies | 204 | 214 | 223 | 269 |
| Total | 597 | 740 | 854 | 1,033 |
| Geographical breakdown | | | | |
| Hokkaido | 188 | 180 | 197 | 212 |
| Tohoku | 28 | 31 | 63 | 80 |
| Kanto - Koshinetsu | 194 | 202 | 214 | 270 |
| Tokai - Hokuriku | 28 | 79 | 96 | 138 |
| Kinki | 85 | 150 | 150 | 178 |
| Chugoku - Shikoku | 48 | 55 | 70 | 77 |
| Kyushu - Okinawa | 26 | 43 | 64 | 78 |
| Total | 597 | 740 | 854 | 1,033 |

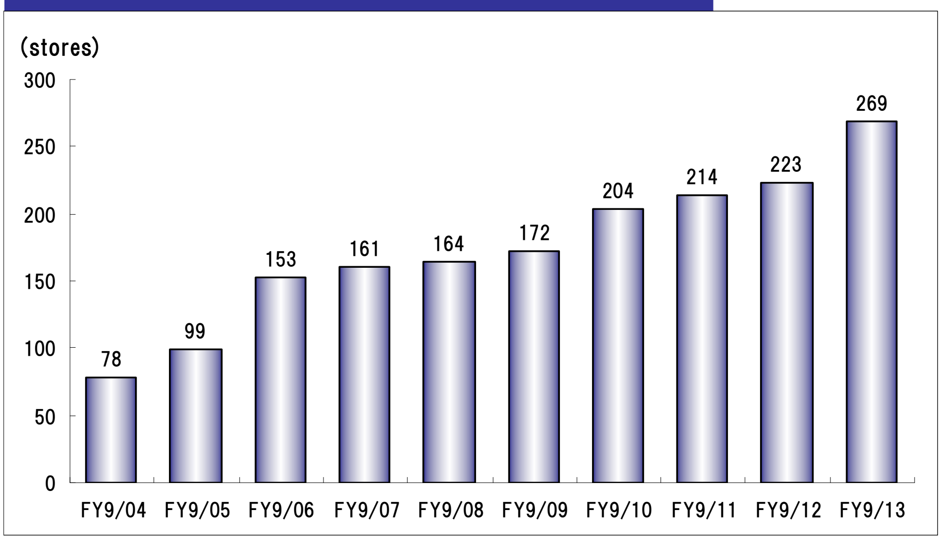
■Company Outline

## Increasing the number of pharmacies in operation, in part, through M&A

### Pharmacy Operation Business

The company's Nanohana pharmacies were operated by 12 subsidiaries of subsidiary Pharmaholdings as of the end of FY3/13. These pharmacies are trying to change from a simple chain of pharmaceutical dispensaries into pharmacies that offer a range of services to improve the health of local inhabitants. Hokkaido Pharmaceutical Laboratory, another subsidiary of Medical System Network, educates and trains pharmacists and other pharmacy workers, both for group pharmacies and for independent pharmacies. The pharmacy operation business has been increasing the number of pharmacies it operates, partly through M&A. At the end of 3/13, this business operated 269 pharmacies.

Number of Pharmacies Operated by the Pharmacy Operation Business at the end of FY9/04-FY3/13




## Providing leasing and medical facility business in its subsidiary

### Leasing and Medical Facility

Medical System Network subsidiary Nihon Leben primarily develops land sites on which to build group pharmacies and leases and insures buildings for medical services. It also offers consulting service about medical practice and operates medical malls where many medical specialties are offered on a single floor of a building, medical buildings where many clinics gathers in one building, and homes for the elderly which offer various health services.

### Other Businesses

Medical System Network subsidiary SMO Medisys signs contracts with medical institutions conducting clinical trials to support these trials.

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# ■Business Trends

## Sales grew by double digits y-o-y, due to the opening and purchase of new pharmacies

### (1) FY3/13 Results

On May 2, 2013, Medical System Network announced its results for FY3/13. Consolidated sales increased by 11.9% y-o-y to ¥54,827mn, but consolidated operating profit fell by 16.2% to ¥2,046mn, recurring profit declined by 18.3% to ¥1,912mn, and net profit dropped by 24.9% to ¥756mn.

Sales in the pharmaceutical network business grew, as did sales in the pharmacy operation business, the latter supported by the opening of new and purchased pharmacies. However, sales and profits from pharmacies in operation for more than a year declined y-o-y, the costs of opening new pharmacies increased, and the company incurred additional costs to integrate purchased pharmacies into its operations. For these reasons, profits weakened.

**Consolidated Results (¥mn) in FY3/13**

| | FY3/12 (4/11-3/12) | FY3/13 (4/12-3/13) | Rate of change |
|---|---|---|---|
| Sales | 48,977 | 54,827 | 11.9% |
| Operating profit | 2,443 | 2,046 | ▲16.2% |
| Recurring profit | 2,340 | 1,912 | ▲18.3% |
| Net profit | 1,007 | 756 | ▲24.9% |

**Factors (¥mn) Contributing to Operating Profit Decline in FY3/13**

| Business/other factor | Change | Business/other factor | Change |
|---|---|---|---|
| Pharmacy Operation Business | ▲ 304 | Pharmaceutical Network Business | △ 118 |
| (Pharmacies in operation | ▲ 224) | Leasing and Medical Facility Business | ▲ 16 |
| (Pharmacies opened or purchased in previous year) | △ 164) | Other Businesses | △ 4 |
| (Pharmacies opened in FY3/13 | ▲ 245) | Cost of introducing an employee stock option plan | ▲ 61 |
| (Pharmacies bought in FY3/13 | △ 284) | Increase in taxes paid | ▲ 64 |
| (Pharmacies closed in FY3/13 | ▲ 14) | Company-wide expenses | ▲ 74 |
| (Cost of integrating purchased pharmacies | ▲ 153) | **Total** | ▲ 396 |
| (Other business costs | ▲ 36) | | |
| (Cost of hiring new personnel | ▲ 80) | | |

Note: △ is increase in profit, ▲ for decrease in profit

## Pharmacy operation business added 46 pharmacies, contributing to sales growth

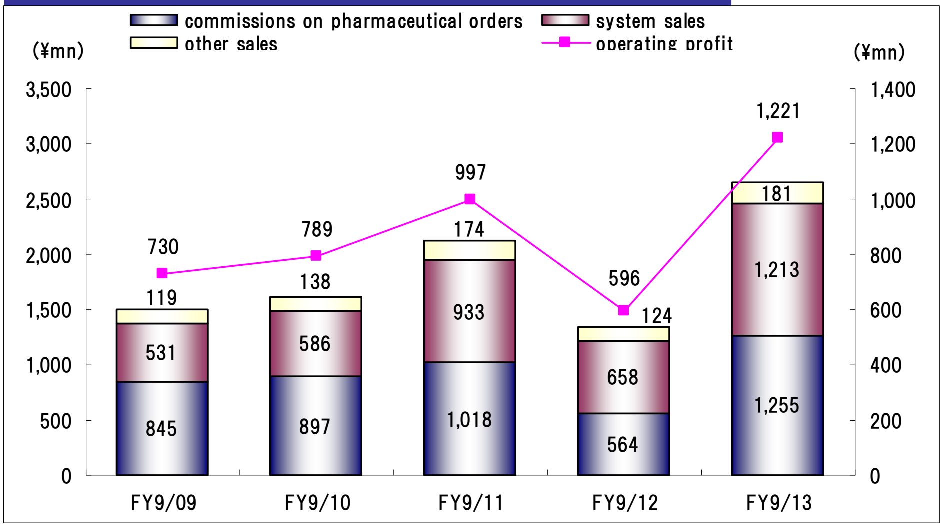
### The FY3/13 results by Business

### Pharmaceutical Network Business

Sales in the pharmaceutical network business rose by 8.7% y-o-y in FY3/13 to ¥2,650mn and operating profit advanced by 10.8% to ¥1,221mn. The members increased by 179 to 1,033, including 24 hospitals or medical institutions. This increase supported the growth of system sales and commissions from the placement of pharmaceutical orders.

■Business Trends

Sales and Operating Profit (¥mn) in the Pharmaceutical Network Business, FY9/09-FY3/13

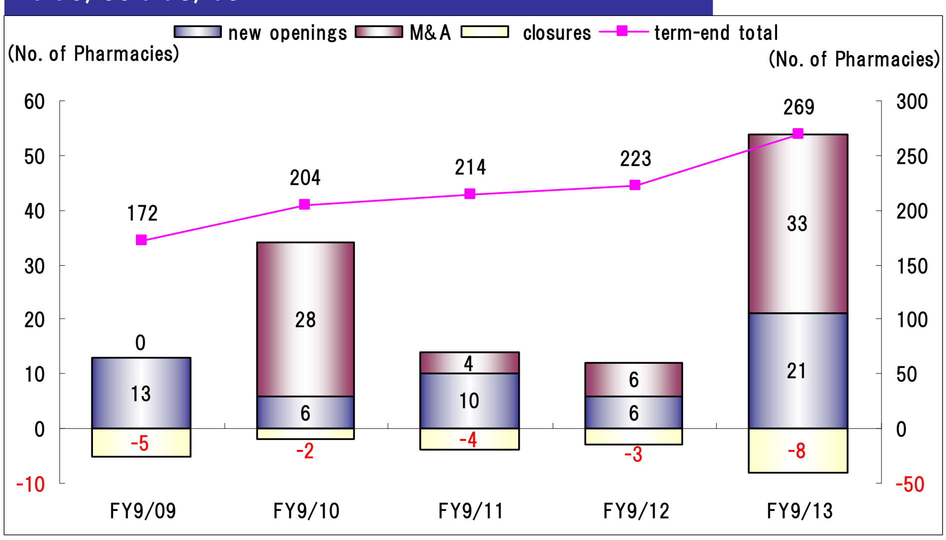



Note: Due to a change of fiscal year, the term to March 2012 contained six months of operations

**Pharmacy Operation Business**

In the pharmacy operation business, sales grew by 12.1% y-o-y in FY3/13 to ¥52,581mn, but operating profit declined by 20.1% to ¥1,766mn. During FY3/13, the business opened 21 new pharmacies and acquired six new subsidiaries with a total of 31 pharmacies. The business also bought two other pharmacies. On the other hand, it closed seven pharmacies and converted one pharmacy into a over-the-counter (OTC) drugstore. Therefore, it increased the number of pharmacies in operation by 46, bringing the total to 269 at the end of the fiscal year. This increase supported sales growth.

Changes in the Number of Pharmacies in Operation, FY9/09-FY3/13

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■Business Trends

As noted previously, profits in the pharmacy operation business fell for several reasons. Sales and profits from pharmacies in operation for more than a year decreased because official drug prices, i.e., prices paid by health insurance companies, were lowered in April 2012 and because the number of prescriptions filled declined, reducing sales per pharmacy. Furthermore, the cost of opening new pharmacies increased, as did the cost of integrating acquired pharmacies and personnel costs.

The table below shows a breakdown of the sales generated in 4/11-3/12 and in FY3/13 by pharmacies in operation for more than a year. The number of prescriptions filled by these pharmacies declined by 1.7% y-o-y in FY3/13, probably because the hospital doctors staffing changed and the number of patients making bulk purchases of inexpensive generic drugs increased.

The technical fee (pharmacist fee) per prescription paid by pharmacies in operation for more than a year rose by 1.6% y-o-y in FY3/13, reflecting an increase in the weighting of generic drugs in the number of prescriptions filled to 27.7%. To control the increase in medical costs in Japan, the Ministry of Health, Labor and Welfare is promoting the greater use of generic drugs. To encourage pharmacists to dispense more generic drugs, the ministry allows an increase in the technical fee per prescription when the weighting of generic drug prescriptions exceeds a certain level. As the weighting of generic drug prescriptions rose, an increasing number and proportion of pharmacies raised their technical fees. Although this weighing rose at Medical System Network's pharmacies in operation for more than a year in FY3/13, it was slightly lower than the 28% average weighting for pharmacies in Japan. The average price of pharmaceuticals declined by several percentage points in FY3/13 due to the cuts in official prices, but because patients bought larger quantities of pharmaceuticals per prescription in FY3/13, the average prescription price at Medical System Network's pharmacies in operation for more than a year decreased by few points y-o-y.

**Breakdown of Sales Generated in 4/11-3/12 and in FY3/13 by Pharmacies in Operation for More than a Year**

| Pharmacies in Operation | FY3/12 | FY3/13 | Change |
|---|---|---|---|
| No. of prescriptions filled (thousand) | 4,580,450 | 4,503,702 | ▲ 1.7 |
| Average prescription price (¥) | 9,421 | 9,453 | 0.3 |
| Technical fee per prescription (¥) | 2,177 | 2,212 | 1.6 |
| Pharmaceutical revenue per prescription (¥) | 7,244 | 7,240 | ▲ 0.0 |
| Pharmaceutical sales (¥mn) | 43,153 | 42,572 | ▲ 1.3 |

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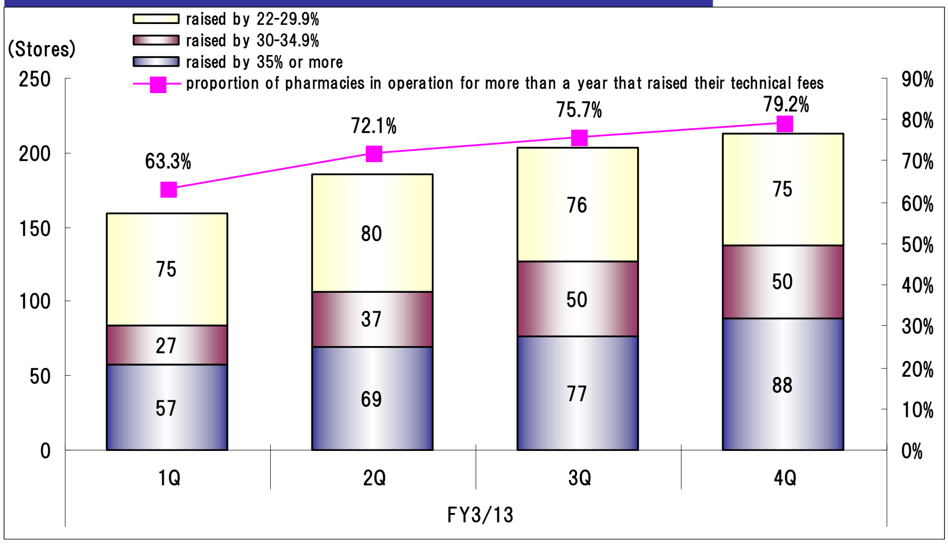
■Business Trends

Number of Pharmacies in Operation for more than a Year that Increased Their Technical Fee per Prescription in FY3/13




### Leasing and Medical Facility Business

Sales increased by 13.6% y-o-y to ¥1.122mn, but operating profit declined by 12.7% to ¥111mn. Revenue from real estate rental leasing increased, but the business invested heavily in its residence for the elderly offering medical services, Wisteria Kiyota, and hired more personnel. These costs depressed profits.

### Other Businesses

Sales in other businesses grew by 3.1% y-o-y in FY3/13 to ¥252mn and operating profit surged by 812% to ¥4mn. This is because SMO medisys contracted with many new medical institutions undertaking clinical tests and overhauled its sales organization, raising administrative efficiency.

## Projecting record-high operating and recurring profits

### (2) Company Forecasts for FY3/14

For FY3/14, Medical System Network forecasts a 15.2% y-o-y rise in sales to ¥63,164mn, an 18.8% upturn in operating profit to ¥2,432mn, a 20.3% increase in recurring profit to ¥2,300mn, and a 9.2% rise in net profit to ¥826mn. The operating and recurring profit forecasts would be record highs. The company’s projections for each business follow.

■Business Trends

### Pharmaceutical Network Business

For FY3/14, the company foresees a 5.7% rise in sales in the pharmaceutical network business to ¥2,802mn and a 7.3% increase in operating profit to ¥1,311mn. As detailed in the table below, the business plans to raise the number of customers in its network by 217 to 1,250 by the end of FY3/14. At the same time, it aims to extend its coverage to 47 prefectures and administrative areas of Japan, from 43 in FY3/13, leaving only four prefectures (Ibaraki, Toyama, Kochi and Tokushima) unserved. The company expects this business to handle ¥120bn of pharmaceutical orders in FY3/14, up 26.6% y-o-y.

**Number of Customers Planned for FY3/14 in Pharmaceutical Network Business**

| | FY3/13 | FY3/14E |
|---|---|---|
| Total | 1,033 | 1,250 |
| External customers | 764 | 940 |
| Group customers | 269 | 310 |

In May 2013, Medical System Network dissolved the equity alliance with Mitsui & Co. it had maintained since 2005 because the pharmaceutical supply business is now almost nation-wide, fulfilling the main purpose of the alliance. With this dissolution, Medical System Network bought Mitsui & Co.' s stake in MM Net Corp., making it a wholly owned subsidiary. On May 8, 2013, Medical System Network also bought back the 2.08mn of its shares that had been held by Mitsui & Co. for ¥1,131mn.

In July 2013, Medical System Network plans to establish a joint venture called H&M Co. with Hanshin Pharmacy Co., a large pharmacy company centered in the Greater Osaka area of Japan. Medical Supply Network will take a 51% stake in H&M, while Hanshin Pharmacy will take a 49% stake. The joint venture will purchase and distribute pharmaceuticals on behalf of both partners.

**Business Results (¥mn) of Hanshin Pharmacy Co., FY3/11-FY3/12**

| | FY3/11 | FY3/12 |
|---|---|---|
| Sales | 32,290 | 34,917 |
| Operating profit | 2,060 | 2,206 |
| Recurring profit | 2,039 | 2,219 |
| Net profit | 915 | 913 |
| Total assets | 13,785 | 15,803 |
| Equity | 1,725 | 2,621 |

■Business Trends

### Pharmacy Operation Business

For FY3/14, the company foresees a 15.5% rise in sales in the pharmacy operation business to ¥60,721mn and a 31.1% increase in operating profit to ¥2,316mn. By opening and acquiring new pharmacies, the business aims to add 41 pharmacies in FY3/14, bringing the total to 310. Most of these new pharmacies will be added in Greater Tokyo, Aichi Prefecture, and the Kyoto-Osaka-Kobe area, where the company is concentrating its pharmacies in a strategy to dominate the respective markets. To regain sales and profit growth at pharmacies in operation for more than a year, the business will try to improve customer satisfaction by introducing a floor concierge system and raising the generic drug weighting in sales volume to 30% or more per pharmacy, on average.

Medical System Network is also merging its pharmacy subsidiaries to lower its indirect costs. On April 1, 2013, it merged two subsidiaries serving Hokkaido, Compha and M and Three, making Compha the surviving entity. In July 2013, it plans to merge the main operations of four subsidiaries serving the Greater Tokyo area, Tomioka Pharmacy Co., Satsuki Pharmacy Co., MSC Co., and Apo Pharmacy Co., into Sun Medic Co.

To raise the efficiency of its information system management, Medical System Network plans to restrict the types of receipt computers used in its pharmacies to two. To date, many types of such computer have been used in its pharmacies.

### Leasing and Medical Facility and Other Businesses

For FY3/14, the company foresees a 13.7% rise in sales in the leasing and medical facility business to ¥1,276mn but a 91.7% decrease in operating profit to ¥9mn. Accompanying the full-scale operation of the Wisteria Kiyota residence for the elderly with medical services, the depreciation cost for this facility alone will increase by ¥96mn.

The company foresees no major changes in FY3/14 for its other businesses and projects a 4.5% rise in business sales to ¥263mn and a 113.8% rise in operating profit to ¥10mn.

Company Forecasts for FY3/14

| Sales | FY3/13 | FY3/14E | Change Ratio |
|---|---|---|---|
| Pharmaceutical Network | 2,650 | 2,802 | 5.7 |
| Pharmacy Operation | 52,581 | 60,721 | 15.5 |
| Leasing and Medical Facility | 1,122 | 1,276 | 13.7 |
| Other Businesses | 252 | 263 | 4.5 |
| Internal sales | ▲ 1,779 | ▲ 1,899 | - |
| Total | 54,827 | 63,164 | 15.2 |
| **Operating Profit** | | | |
| Pharmaceutical Network | 1,221 | 1,311 | 7.3 |
| Pharmacy Operation | 1,766 | 2,316 | 31.1 |
| Leasing and Medical Facility | 111 | 9 | ▲ 91.9 |
| Other Businesses | 4 | 10 | 113.8 |
| Company-wide operating costs | ▲1,057 | ▲1,215 | - |
| Total | 2,046 | 2,432 | 18.8 |
| **Operating profit margin (%)** | | | |
| Pharmaceutical Network | 46.1 | 46.8 | |
| Pharmacy Operation | 3.4 | 3.8 | |
| Leasing and Medical Facility | 9.9 | 0.7 | |
| Other Businesses | 1.9 | 3.8 | |
| Total | 3.7 | 3.9 | |

# ■Growth Strategy

## Aiming for annual sales of ¥300bn in 10 years by pursuing M&A aggressively

For FY3/15, the final year of Medical System Network's current medium-term plan, the company targets sales of ¥75bn, operating profit of ¥4.3bn, recurring profit of ¥4.0bn, and net profit of 2.0bn. These targets are based on the assumptions that the pharmaceutical supply business has 1,500 customers and the pharmacy operation business has 350 pharmacies by the end of FY3/15. Based on the current rates of growth in these two businesses, the company's assumptions and targets for FY3/15 appear reasonable.

Medical System Network foresees further consolidation of Japan's pharmacy market and plans to take advantage of this trend to expand rapidly through M&A. Therefore, it anticipates annual sales of ¥300bn in 10 years. The prospects for its two main businesses are explained below.

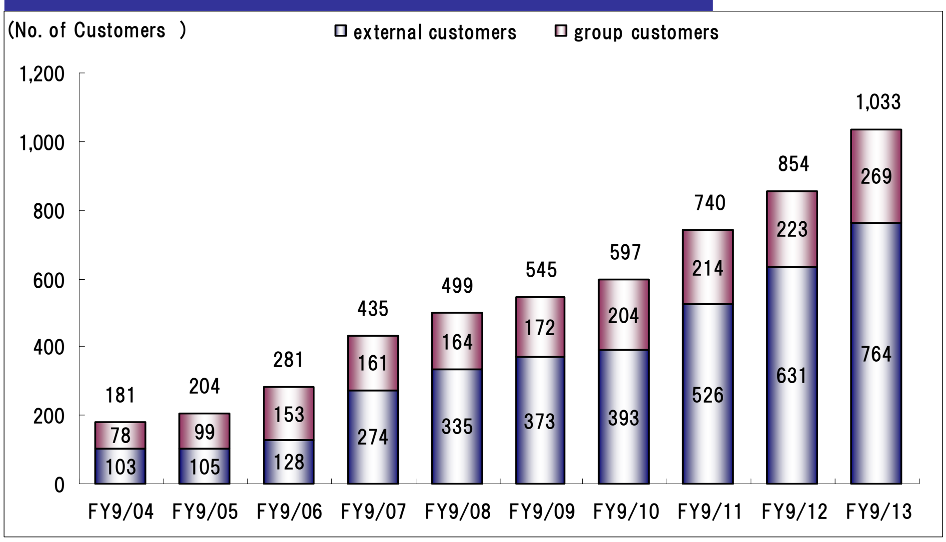
■Growth Strategy

## Profitability likely to improve as number of customers and order transaction amount increase

### Pharmaceutical Network Business

As detailed in the bar chart below, the number of external customers for the pharmaceutical network business has grown rapidly in recent years. There are two reasons for this growth. First, the business is unique in Japan – there are no competitors. Second, the operation of pharmacies has become more difficult because of increasing competition in the pharmacy industry; Drug prices have been cut and over-the-counter drugstores have begun to offer prescription drugs.

Number of Customers for the Pharmaceutical Network Business, FY9/04-FY3/13




The uniqueness of this business owe to the expertise in medical industry. The three senior executives of Medical System Network have respective expertise in pharmaceutical wholesaling, the operation of pharmacies, and systems development. With deep knowledge of the structure and commercial practices of each of these industries, the executives developed a network system that is so easy to use that no other company has been able to challenge it.

As mentioned above, pharmacies are hard-pressed to improve managerial efficiency. They can reduce their costs of goods ordered and their inventory losses using Medical System Network's network system. The reliability of this system is underscored by the fact that no customer has voluntarily terminated a contract for its use.

■Growth Strategy

There are about 54,000 pharmacy companies in Japan. Of these, about 90% are operating 20 or fewer pharmacies each. Many of these smaller pharmacy companies cannot afford to build their own supply chain management systems and would therefore benefit from using Medical System Network's network system. With slightly more than 1,000 customers, the pharmaceutical network business possesses great growth potential. The network system's reputation for reliability is growing, contributing to the growth of the number of customers.

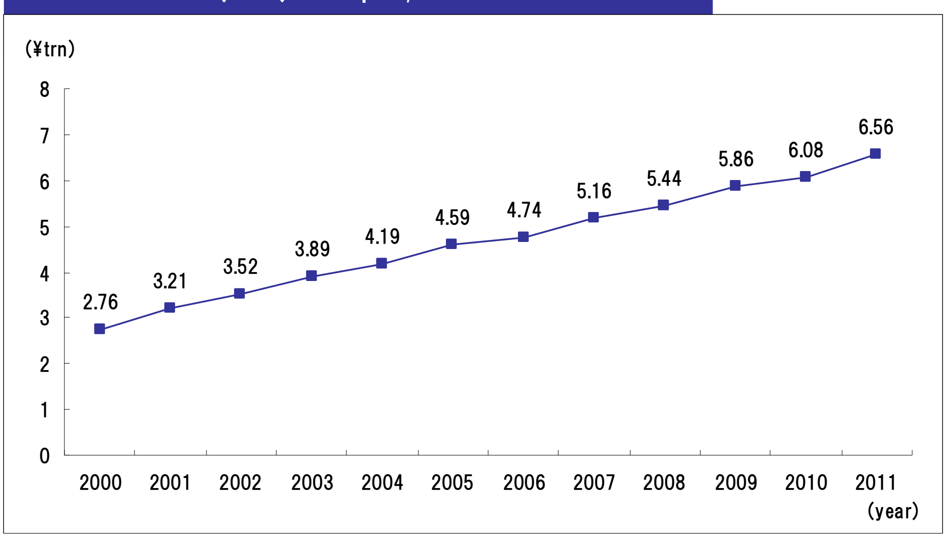
In addition, the pharmaceutical network business maintains an operating profit margin of more than 40% because its network system requires almost no support or renovation, so it provides a high marginal profit ratio. Therefore, as long as the business's commission rate on orders does not fall and its costs do not rise significantly, its profitability is likely to increase as its number of customers and order transaction amount continue to expand.

## May add convenience store function to pharmacies to differentiate them from competitors

### Pharmacy Operation Business

Reflecting the aging of Japanese society, the country's medical costs rose by an average annual rate of 8% from the country's fiscal year 2000, which ended in March 2001, to fiscal 2011, when they reached ¥6.56 trillion, according to the Ministry of Health, Labor and Welfare. At the same time, as noted above, most of Japan's pharmacy companies are small and unable to survive in an increasingly competitive market. Therefore, the pharmacy industry has been consolidating through M&A, and this trend is likely to continue because the average age of the operator of a pharmacy is 65, and many pharmacies lack successors for their operators.

Medical Costs (¥trn) in Japan, FY2000-2011



■Growth Strategy

Despite the trend of consolidation in Japan's pharmacy industry, the industry remains Japan's least concentrated industry. The industry leader, Ain Pharmaciez Inc., holds just over 2% of the market, and the top 10 companies in the industry hold an aggregate share of just over 10%. Thus, a pharmacy company that grows by aggressively merging or acquiring other pharmacy companies could emerge as the industry leader.

In May 2013, Medical System Network announced that it would cooperate with FamilyMart Inc. in developing pharmacies incorporating convenience store items. Through this action, Medical System Network's pharmacies would attempt to differentiate themselves from competitors in an increasingly competitive market. The company's pharmacies have an average floor space of about 30 tsubo (99 square meters). About 10-20 tsubo (33-66 square meters) of this floor space could be used to sell convenience store items. The company is now trying to determine what goods and services could be profitably offered in this space. If this business combination proves viable, Medical System Network and FamilyMart may market it to the more than 40,000 small and medium-sized pharmacies in Japan in the future.

# ■Measures of Business Performance

## Taking advantage of low interest rates to boost profit growth through financial leverage

Important measures of business performance are shown at the bottom of the following summary balance sheet for Medical System Network. The company's equity ratio is just under 20%, and its debt-to-equity ratio exceeds 200%, so it is somewhat highly dependent on debt. This dependence reflects the company's use of borrowings to partially fund its aggressive M&A. The company's ROE remains above 10%, and its operating profit margin is stable at about 4%. These ratios are supported by the high profitability of the pharmaceutical network business and by the company's financial leverage, which is reasonable, given the very low interest rates in Japan.

The company is likely to maintain its current financial strategy, as it intends to continue to expand its pharmacy operation business through aggressive M&A.

■Measures of Business Performance

Summary Consolidated Balance Sheet (¥mn), FY9/10-FY3/13

| | FY9/10 | FY9/11 | FY9/12 | FY9/13 |
|---|---|---|---|---|
| Current assets | 8,071 | 7,786 | 8,901 | 8,271 |
| (Cash and deposits) | 1,792 | 1,329 | 2,072 | 2,091 |
| Tangible fixed assets | 6,752 | 9,162 | 9,975 | 11,471 |
| Intangible fixed assets | 5,210 | 4,982 | 5,040 | 8,263 |
| (Goodwill) | 5,099 | 4,900 | 4,968 | 8,176 |
| Total assets | 22,482 | 24,533 | 26,602 | 30,789 |
| Current liabilities | 9,409 | 10,800 | 12,693 | 14,375 |
| Fixed liabilities | 8,774 | 8,470 | 8,229 | 10,177 |
| (Interest-bearing debt) | 9,138 | 8,663 | 9,480 | 12,193 |
| Total liabilities | 18,184 | 19,270 | 20,923 | 24,553 |
| Total equity | 4,297 | 5,263 | 5,679 | 6,236 |
| Total liabilities & equity | 22,482 | 24,533 | 26,602 | 30,789 |
| (Ratios of financial security) | | | | |
| Current ratio | 85.8% | 72.1% | 70.1% | 57.5% |
| Equity ratio | 18.0% | 20.1% | 19.9% | 18.8% |
| Debt-to-equity ratio | 225.3% | 175.4% | 179.0% | 210.9% |
| (Ratios of profitability) | | | | |
| ROA | 6.8% | 9.2% | 5.1% | 6.6% |
| ROE | 11.7% | 20.3% | 9.8% | 13.1% |
| Operating profit margin | 3.7% | 4.9% | 5.3% | 3.7% |

# ■Shareholder Returns and Risk Factors

## Drugstores market share could rise to 10%, the company foresees little impact on its profits

The company's policy is to pay a stable dividend reflecting the company's profits, after securing funds to strengthen its financial condition, expand business, train employees and make other expenditures necessary for growth.

We foresee three possible risks to the company's profit growth.

・ Profits in the pharmacy operation business may be adversely affected by more cuts in official drug prices or changes in the method of payment for pharmaceuticals.

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■Shareholder Returns and Risk Factors

・ When Japan introduced a 3% consumption tax, it timed the introduction to coincide with cuts in official drug prices, so the net impact on the profits of pharmacies was modest. When the consumption tax was raised to 5%, the raise was again timed to minimize the impact. Japan plans to raise this tax in coming years. If these raises are again timed to coincide with cuts in official drug prices, their impact should be modest. However, if the tax is raised at a different time, the company's profits may be adversely affected.

・ More over-the-counter drugstores in Japan are incorporating prescription drug pharmacies. Currently, such drugstores account for about 2% of Japan's pharmacy market, and Medical System Network estimates that this ratio could rise to 10% in 10 years. Even if the ratio were to reach 10%, the company foresees little impact on its profits. However, if this ratio were to rise faster than the company projects, the company's profits could be adversely affected.

Consolidated Income Statement (¥mn), FY9/10 – FY3/14E

| | FY9/10 | FY9/11 | FY9/12 | FY9/13 | FY9/14E |
|---|---|---|---|---|---|
| Sales | 41,131 | 46,508 | 25,410 | 54,827 | 63,164 |
| (y-o-y growth) | 11.8 | 13.1 | - | 11.9 | 15.2 |
| Cost of goods sold | 27,060 | 30,291 | 16,450 | 35,415 | 41,010 |
| (Cost of goods sold ratio) | 65.8 | 65.1 | 64.7 | 64.6 | 64.9 |
| SGA cost | 12,542 | 13,954 | 7,602 | 17,365 | 19,722 |
| (SGA cost ratio) | 30.5 | 30.0 | 29.9 | 31.7 | 31.2 |
| Operating profit | 1,528 | 2,262 | 1,357 | 2,046 | 2,432 |
| (y-o-y growth) | 6.1 | 48.0 | - | ▲16.2 | 18.8 |
| (Operating profit margin) | 3.7 | 4.9 | 5.3 | 3.7 | 3.9 |
| Non-operating income | 51 | 100 | 81 | 149 | - |
| Non-operating expenses | 250 | 222 | 124 | 284 | - |
| Recurring profit | 1,329 | 2,139 | 1,314 | 1,912 | 2,300 |
| (y-o-y growth) | 5.0 | 61.0 | - | ▲18.3 | 20.3 |
| (Recurring profit margin) | 3.2 | 4.6 | 5.2 | 3.5 | 3.6 |
| Extraordinary profits | 0 | 110 | 24 | 59 | 0 |
| Extraordinary losses | 35 | 302 | 40 | 64 | 300 |
| Pretax profit | 1,294 | 1,948 | 1,298 | 1,907 | 2,000 |
| (y-o-y growth) | 12.8 | 50.5 | - | ▲12.5 | 4.9 |
| (Pretax profit margin) | 3.1 | 4.2 | 5.1 | 3.5 | 3.2 |
| Corporate taxes | 716 | 800 | 702 | 1,017 | |
| (Effective tax rate) | 55.3 | 41.1 | 54.1 | 53.4 | |
| Minority interest | 105 | 146 | 77 | 133 | |
| Net profit | 473 | 1,001 | 518 | 756 | 826 |
| (y-o-y growth) | 9.7 | 111.5 | - | ▲24.9 | 9.2 |
| (Net profit margin) | 1.2 | 2.2 | 2.0 | 1.4 | 1.3 |
| Number of shares outstanding (thousand) | 6,492 | 6,492 | 12,984 | 25,969 | 25,969 |
| EPS (¥) | 20.40 | 38.56 | 19.97 | 29.12 | 31.81 |
| DPS (¥) | 4.50 | 6.25 | 3.75 | 8.00 | 8.00 |
| BPS (¥) | 153.54 | 187.98 | 201.93 | 222.86 | - |
| CFS (¥) | 18.23 | 38.56 | 67.2 | 61.5 | - |
| Dividend payout ratio | 22.1 | 16.2 | 18.8 | 27.5 | 25.2 |

Note: Notes: 1) Due to a change of fiscal year, the term to March 2012 contained six months of operations
2) y-o-y rates of change in FY3/13 results are relative to results from April 2011 to March 2012
3) Per-share figures have been adjusted to reflect a two-for-one stock split in April 2012 and another two-for-one stock split in June 2012

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