Medical System Network
4350 Tokyo Stock Exchange
First Section

8-Jul.-14

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Aiming for greater profit growth by expanding its two main businesses: Pharmaceutical Network Business and Dispensing Pharmacy Operation.

Medical System Network has two main businesses, business support for small and medium-sized independent dispensing pharmacies and operating its own dispensing pharmacies. The company calls the former business "Pharmaceutical Network Business" (PNB) and it works mainly as an intermediary between pharmaceutical wholesalers and pharmacies or medical institutions to facilitate efficient distribution. PNB has been growing, and at the end of the fiscal year to March 2014, i.e., FY3/14, it served 1,163 pharmacies. At the same time, the pharmacy operation business is expanding, in part, through mergers and acquisitions, such as the acquisition of Total Medical Service Co. in November 2013. Thus, the company targets consolidated sales of ¥300bn in the fiscal year to March 2024, i.e., FY3/24.

In FY3/14, the company's consolidated sales grew by 20.7% year-on-year (y-o-y), but its operating profit increased by only 2.2% because the pharmacy operation business, after lengthy negotiations with pharmaceutical wholesalers, had to pay ¥588mn more than planned for drugs received from wholesalers over the past two years.

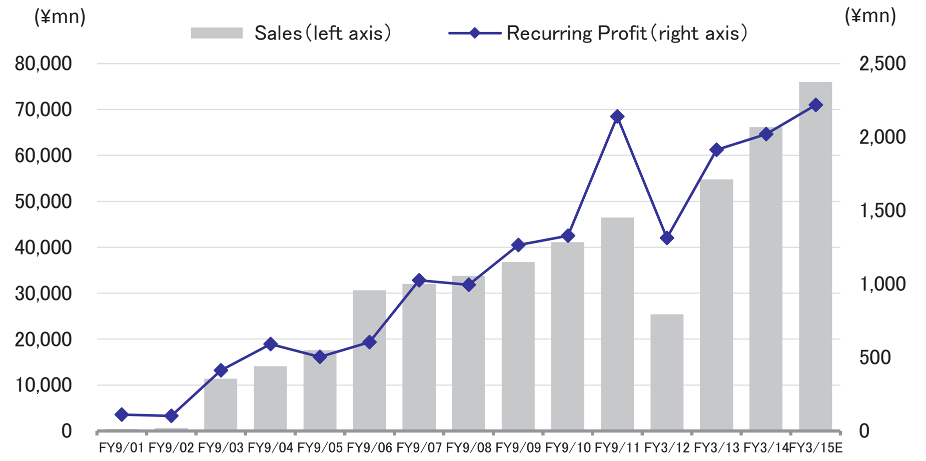
For FY3/15, the company forecasts a 14.9% y-o-y rise in consolidated sales and a 15.0% upturn in consolidated operating profit. It foresees little sales and profit growth in PNB because it expects some of its customers to withdraw from the network. However, it projects strong sales and profit growth in its pharmacy operation business, reflecting the opening of new pharmacies and the acquisition of other pharmacy companies, even though it sees a ¥166mn profit fall in this business as a result of the latest changes in official drug prices, which took effect from April 1, 2014.

The market for Japanese pharmacies is becoming severely competitive as larger pharmacy companies gain market share. However, Medical System Network is likely to continue to grow by offering its two main businesses. As the proportion of Japan's population that is 75 years old or older is increasing rapidly, the company intends to aggressively develop the business of homes for the elderly that offer special services. In so doing, it will adhere to its founding purpose of "contributing to a higher quality of life by building a high-quality medical infrastructure" and continue to grow.

Check Point

- Company aims for record-high sales, operating profit and recurring profit in FY3/15
- Profits in the pharmacy operation business continue to grow, reflecting more transactions in generic drugs and in the treatment of patients at home
- Medium-to-long-term growth scenario remains unchanged; by improving its organization, the company should resume strong growths both in sales and profit.

Consolidated Sales and Recurring Profit (¥mn)



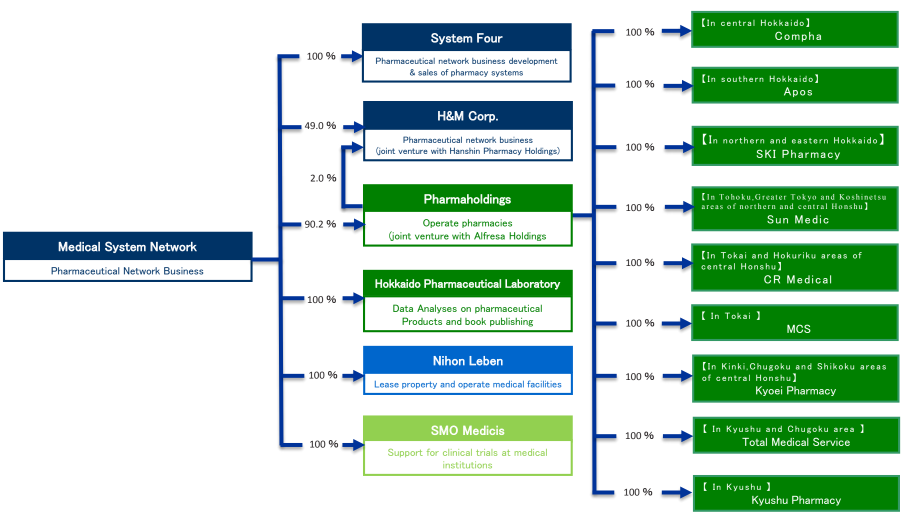
Note:Due to a change of fiscal year, the term to March 2012 contained six months of operations

Businesses Outline

Pharmaceutical Network Business and Dispensing Pharmacy Operation as two core sources of profit

Having PNB and Dispensing Pharmacy Operation as two main businesses, Medical System Network also operates medical facility services (including property leasing), meal supply and support for clinical trials at medical institutions. PNB is conducted by Medical System Network and subsidiaries System Four and H&M, while the pharmacy operation business is conducted by subsidiary Pharmaholdings, its subsidiaries and subsidiary Hokkaido Pharmaceutical Laboratory (see diagram below).

Organization Chart of Medical System Network Group as of May 1, 2014



The subsidiaries of Pharmaholdings operated 336 stores, including OTC drug stores and one care plan center (home care support office)

Source: Company

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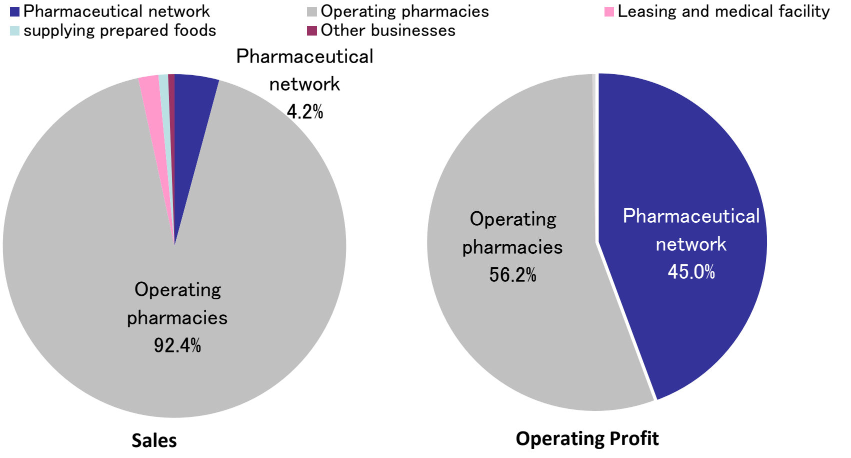
As detailed in the pie charts below, in FY3/14, the operation of pharmacies provided 92.4% of total consolidated sales before the elimination of intra-business sales, while PNB supplied 4.2%, leasing provided about 2%, and the supply of prepared foods and other businesses accounted for about 1.0% each. However, the operation of pharmacies provided 56.2% of total operating profit before the elimination of profit from intra-business sales and unallocated corporate costs, while pharmaceutical network provided 45.0%. The operating profit margin is by far the highest in PNB.

Breakdown by Business of Consolidated Sales and Operating Profit in FY3/14



Note: Operating profit before the deduction of unallocated corporate costs and other minor adjustments.

Pharmaceutical Network Business serves more than 1,000 pharmacies in 43 prefectures throughout Japan

○Pharmaceutical Network Business (PNB)

The model for the pharmaceutical supply or network business is as an intermediary between pharmaceutical wholesalers and pharmacies or medical institutions to facilitate efficient distribution. This was the original business of Medical System Network. It is now conducted by Medical System Network and subsidiaries System Four and H&M. The business acts as an agent for daily supply chain management for its network of customer pharmacies. It also disposes of obsolete inventories through its dead stock exchange service, and supports the training of pharmacists and fund raising.

The services provided by PNB are outlined in the diagram below. The supply chain management service facilitates daily order placement, payments and inventory control, and negotiates prices for the goods ordered. Using the company's order entry system (O/E system), small and medium-sized pharmacies can 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.

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.

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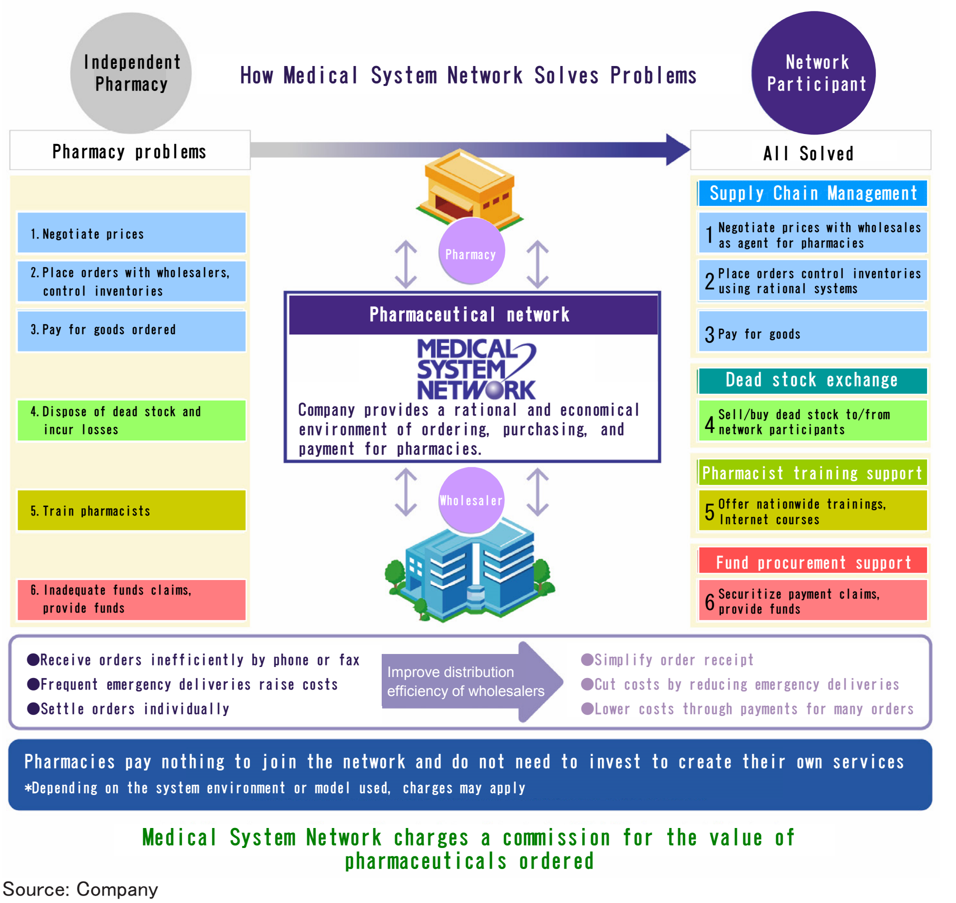
Outline of Pharmaceutical Supply (Network) Business



Source: Company

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 raising 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 raising support service pays pharmacies in one month from the date of dispensing pharmaceuticals.

PNB 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 FY3/14, the pharmaceutical network business had 1,163 companies, institutions or pharmacies in its customer network, including 27 hospitals or medical institutions, as detailed in the table below. Almost half of its customers were 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. In November 2013, this business bought Total Medical Service Co., which has many pharmacies in Kyushu. Thus, the business now serves 43 of Japan's 47 prefectures or metropolitan districts.

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.

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Number of Customers in the Pharmaceutical Network Business at the end of FY9/10 – FY3/15E

Classification	FY9/10	FY9/11	FY3/12	FY3/13	FY3/14	FY3/15E
External customers	393	526	631	764	842	–
Group pharmacies	204	214	223	269	321	–
Total	597	740	854	1,033	1,163	1,400

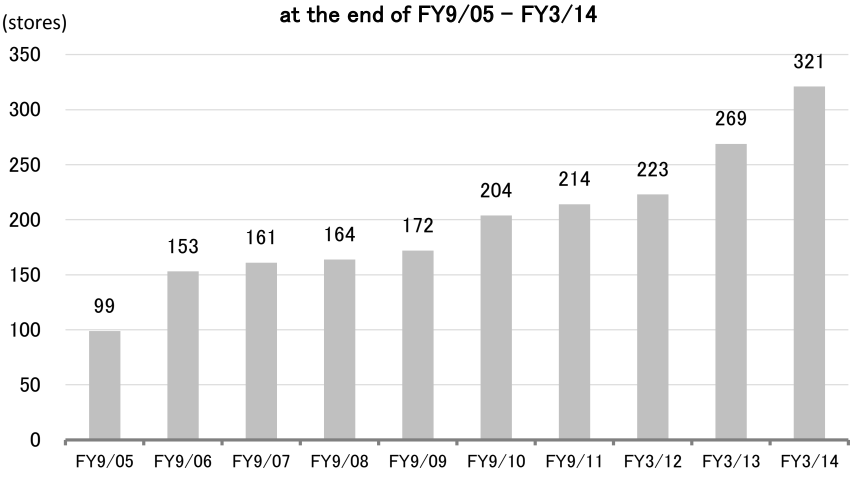
Geographical breakdown	FY9/10	FY9/11	FY3/12	FY3/13	FY3/14	FY3/15E
Hokkaido	188	180	197	212	216	–
Tohoku	28	31	63	80	91	–
Kanto – Koshinetsu	194	202	214	270	298	–
Tokai – Hokuriku	28	79	96	138	160	–
Kinki	85	150	150	178	187	–
Chugoku – Shikoku	48	55	70	77	87	–
Kyushu – Okinawa	26	43	64	78	124	–
Total	597	740	854	1,033	1,163	1,400

Increased the number of pharmacies in operation to more than 300 through M&A

○Pharmacy Operation Business

Pharmaholdings, a subsidiary of the company, functions as holding company for the nine group entities which manage "Nanohana pharmacies", the dispensing pharmacy operation business of the group (as of the end of FY3/14). 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. The pharmacy operation business has been increasing the number of pharmacies it operates, partly through M&A. At the end of 3/14, this business operated 321 pharmacies, 12 OTC drugstores and one care plan center. Of the pharmacies, 110, or 34%, were in Hokkaido. 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.

Number of Pharmacies Operated by the Pharmacy Operation Business at the end of FY9/05 – FY3/14



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Operates medical facilities, such as medical malls, and homes for the elderly which offer various health services

○Leasing and Medical Facility Business

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 starting a medical practice and operates medical malls, where many medical specialties are offered on a single floor of a building, medical buildings housing numerous clinics, and homes for the elderly which offer various health services.

○Meal Supply Business

In November 2013, Medical System Network acquired Total Medical Service Co. and made it a subsidiary. As of the end of FY3/14, two subsidiaries of Total Medical Service Co. supplied meals to medical institutions and welfare facilities.

○Other Businesses

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

■ Business Trends

Two main businesses supported increases in sales, operating profit and recurring profit

(1) FY3/14 Results

On May 2, 2014, Medical System Network announced its results for FY3/14. Consolidated sales increased by 20.7% y-o-y to ¥66,181mn, consolidated operating profit rose by 2.2% to ¥2,091mn, and recurring profit grew by 5.6% to ¥2,019mn, but net profit dropped by 11.6% to ¥668mn. Sales were slightly larger than the company had forecast, but profits were lower than projected, mainly because, following negotiations with drug wholesalers, the company had to pay ¥588mn more than budgeted for its drugs purchased the past two years. The increment was recorded in the company's cost of goods sold.

Consolidated Results (¥mn) in FY3/13 - FY3/14

	FY3/13		FY3/14				
	results	vs. sales	initial Co. f	results	vs. sales	y-o-y	vs. initial Co. f
Sales	54,827	100.0%	63,164	66,181	100.0%	20.7%	4.8%
Cost of goods sold	35,415	64.6%	-	43,444	65.6%	22.7%	-
SGA costs	17,365	31.7%	-	20,645	31.2%	18.9%	-
Operating profit	2,046	3.7%	2,432	2,091	3.2%	2.2%	-14.0%
Recurring profit	1,912	3.5%	2,300	2,019	3.1%	5.6%	-12.2%
Net extraordinary losses	-5	-	-	-249	-	-	-
Net profit	756	1.4%	826	668	1.0%	-11.6%	-19.1%

In the pharmaceutical network business, operating profit increased by ¥253mn y-o-y in FY3/14 as a result of increased transactions for customers of more than a year. In the pharmacy operation business, despite a huge increase in the cost of drugs purchased over the past two years, operating profit increased by ¥73mn y-o-y due to an increase in profit from pharmacies in operation for more than a year and due to the impact of acquisitions. In the leasing and medical facility business, operating profit declined by ¥150mn y-o-y because its depreciation expense rose due to the May 2013 opening of the Wisteria Kiyota nursing home offering advanced services and due to the cost of strengthening the work force. The business of supplying meals suffered an operating loss of ¥12mn because of an increase in the cost of foods.

Factors (¥mn) Contributing to Operating Profit Increase in FY3/14

Business/other factor	change	Business/other factor	change
Pharmacy operation	73	Pharmaceutical network	253
		Leasing/medical facility operation	-150
Additional cost of drugs purchased in the past two years	-588	Prepared food supply	-12
Pharmacies in operation for more than one year	138	Other operations	5
Pharmacies opened or purchased in FY3/13	198	Adjustments	-125
Pharmacies opened in FY3/14	-103		
Pharmacies bought in FY3/14 (exc. Total Med. Service)	82		
Total Medical Service Co.	157		
Pharmacies closed in FY3/14	65		
Head office cost	-7		
Drop in cost of employee stock ownership plan	41		
Other factors	90	Total	44

Net profit declined y-o-y in FY3/14 because the company declared a number of extraordinary losses, including a ¥193mn impairment loss on pharmacies and some other assets and a ¥167mn retirement allowance.

Results by business are discussed in greater detail below.

Pharmaceutical orders exceeded ¥100bn, lifting commissions and profitability

○Pharmaceutical Network Business

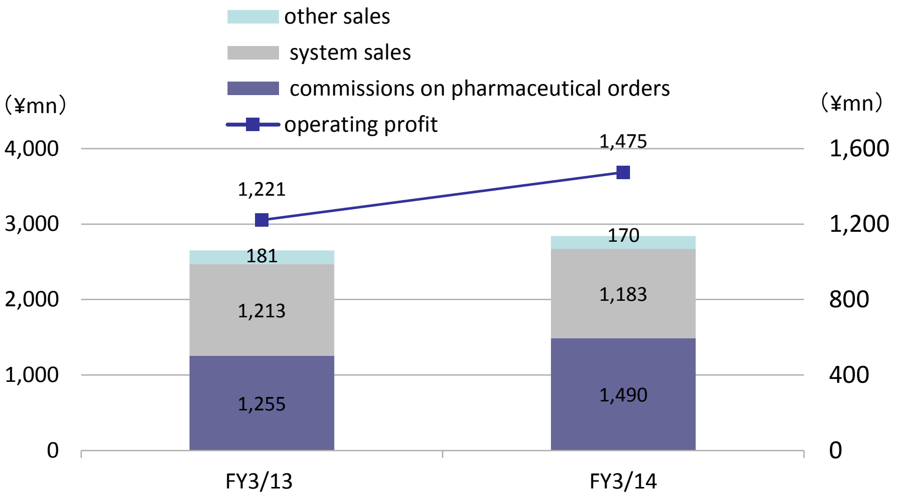
Sales in the pharmaceutical network business rose by 7.3% y-o-y in FY3/14 to ¥2,843mn and operating profit advanced by 20.7% to ¥1,475mn. The operating profit margin increased to 51.9% in FY3/14 from 46.1% in FY3/13. Sales and profit growth was propelled by an increase in commissions on the placement of pharmaceutical orders, which carry high profit margins.

The number of customers under the network increased by 130 to 1,163. The company had originally planned to expand this network to 1,250. It failed to meet this target mainly because of prolonged price negotiations with drug wholesalers. Until these prices had been fixed, potential customers could not gauge their savings from becoming customers.

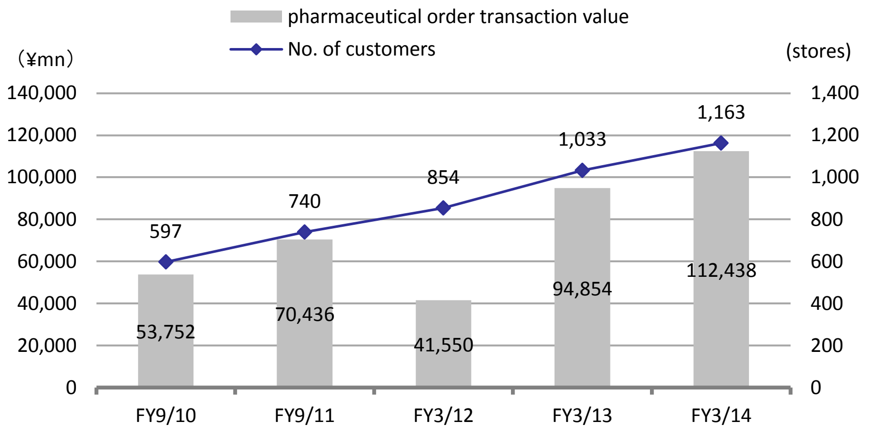
Drug orders received from customers served for more than one year increased by 18.5% y-o-y in FY3/14 to ¥112,438mn. With a transaction value exceeding ¥100bn per year, the company has become one of the leading members of its industry. Commissions received for filling these orders grew by 18.7% y-o-y to ¥1,490mn.

Sales of systems declined by 2.5% y-o-y in FY3/14 to ¥1,183mn because the number of new customers increased less than it had in FY3/13, and system sales are made mainly to new customers.

Sales and Operating Profit in the Pharmaceutical Network Business(¥mn)



Number of Customers and Pharmaceutical Order Transaction Value in the Pharmaceutical Network Business

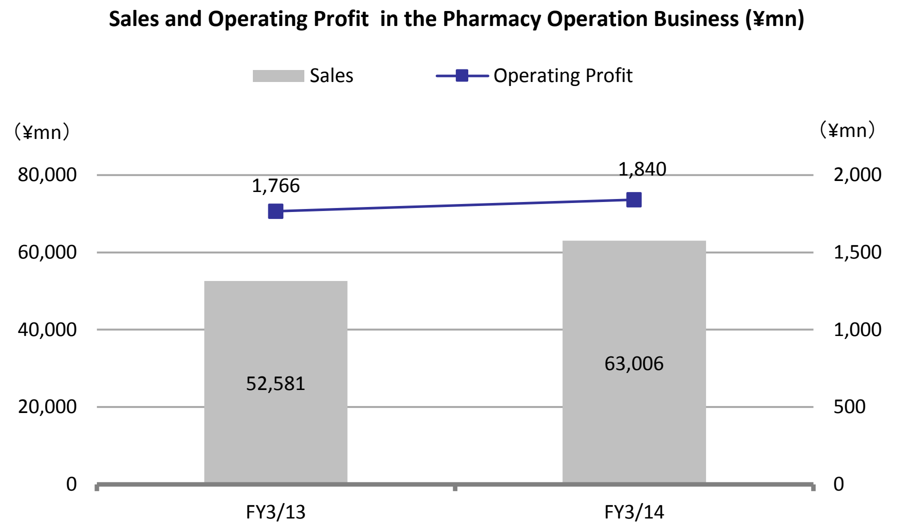


Note: Due to a change of fiscal year, the term to March 2012 contained six months of operations

Increase in the number of pharmacies and in the sales by pharmacies in operation for more than one year supported sales and profit growth

○Pharmacy Operation Business

In the pharmacy operation business, sales grew by 19.8% y-o-y in FY3/14 to ¥63,006mn and operating profit rose by 4.2% to ¥1,840mn. The operating profit margin declined to 2.9% in FY3/14 from 3.4% in FY3/13 because, as mentioned above, following negotiations with drug wholesalers, the business paid ¥588mn more than planned for drugs purchased the past two years. This expense was claimed as a cost of goods sold by the business in the final quarter of FY3/14. If the business had not been burdened by this cost, its operating profit margin would have risen to 3.9%. Sales by pharmacies in operation for more than one year increased, and indirect costs were reduced as a result of merging eight pharmacy subsidiaries.



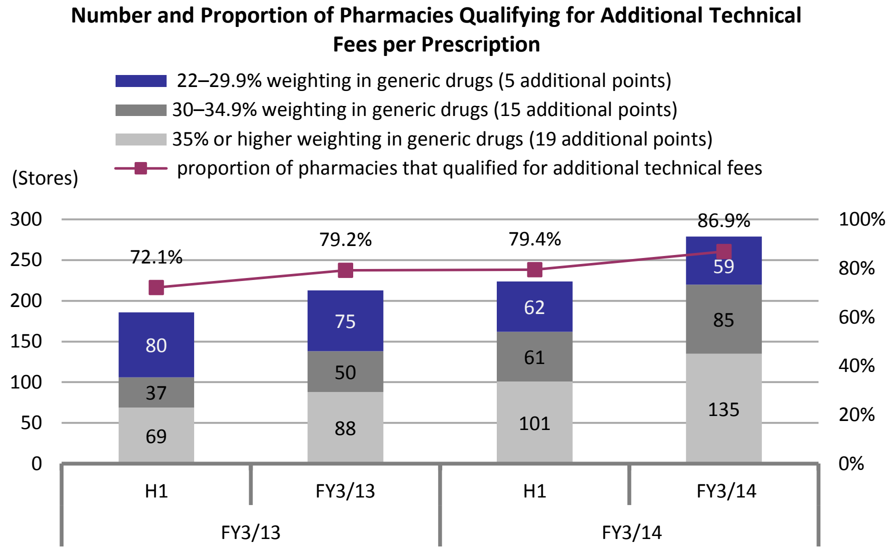
During FY3/14, the business opened 14 new pharmacies and acquired five new subsidiaries with a total of 44 pharmacies. The business also bought one other pharmacy. On the other hand, it closed seven pharmacies. Therefore, it increased the number of pharmacies in operation by 52, bringing the total to 321 at the end of the fiscal year, excluding one pharmacy that was temporarily closed. This increase supported sales growth. Of the five subsidiaries acquired in FY3/14, the largest was Total Medical Service Co. Bought in November 2013, this company operated 35 pharmacies, located mainly in northern Kyushu. Total Medical Service Co. added ¥157mn to the business's operating profit in FY3/14. With the purchase of Total Medical Service Co., the business also acquired ¥3,866mn of goodwill, which is being amortized on a straight-line basis over 20 years.

Sales by pharmacies in operation for more than a year increased by 6.1% y-o-y in FY3/14 because the number of prescriptions filled rose by 0.6% and the average prescription price increased by 5.5%, reflecting a rise in the average prescription period. The number of customers increased because the company shortened the average waiting time for a prescription to be filled and otherwise improved hospitality.

The technical fee (pharmacist fee) per prescription paid by pharmacies in operation for more than a year grew by 2.0% y-o-y in FY3/14, reflecting a rise in the number of pharmacies qualifying for additional technical fees by increasing their weightings in generic drug prescriptions and a rise in the proportion of pharmacies receiving large additional technical fees because of their high weightings in generic drug prescriptions.

Breakdown of Sales Generated in FY3/13 and FY3/14 by Pharmacies in Operation for More than a Year

	FY3/13	FY3/14	% change
No. of prescriptions filled (thous)	5,216	5,245	0.6%
Average prescription price (¥)	9,357	9,873	5.5%
Technical fee per prescription (¥)	2,206	2,251	2.0%
Pharmaceutical revenue per prescription (¥)	7,151	7,622	6.6%
Pharmaceutical sales (¥mn)	48,815	51,788	6.1%



Cost of first residence building for the elderly offering medical services led to a loss, but building occupancy is growing

○Leasing and Medical Facility Business

Sales increased by 17.4% y-o-y to ¥1,317mn, but the business suffered an operating loss of ¥39mn, reversing an operating profit of ¥111mn in FY3/13. Revenue from leasing buildings increased, but the depreciation cost of the business grew by ¥98mn y-o-y following the opening, in May 2013, of the Wisteria Kiyota residence building for the elderly offering medical services in Sapporo City. The business hired more personnel to develop other such residences, which also increased its operating costs.

At the end of FY3/14, 47 of the 75 apartments in the Wisteria Kiyota residence building had been occupied.

○Meal Supply Business and Other Businesses

The meal supply business is a new business stemming from the acquisition of Total Medical Service Co. In FY3/14, this business generated sales of ¥607mn but suffered an operating loss of ¥12mn due to an increase in its cost of foods. At subsidiary SMO Medicis, sales grew by 61.5% y-o-y in FY3/14 to ¥407mn and operating profit surged by 116.3% to ¥10mn as the company contracted with many new medical institutions undertaking clinical tests.

Projecting record-high sales, operating profit and recurring profit as of FY3/15

(2) Company Forecasts for FY3/15

For FY3/15, Medical System Network forecasts a 14.9% y-o-y rise in sales to ¥76,013mn, a 15.0% upturn in operating profit to ¥2,404mn, a 9.9% increase in recurring profit to ¥2,219mn, and a 5.6% rise in net profit to ¥706mn. If achieved, the sales forecast would be a record high for the third straight financial years, although the year to 3/12 contained only six months. The operating and recurring profit forecasts would be also be record highs, eclipsing the levels in FY9/11. The company projects a lower rate of growth for net profit than for recurring profit because it foresees some extraordinary losses stemming from the closure of unprofitable operations.

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Performance (¥mn) by Business, FY9/11 – FY3/15E

	FY9/11	FY3/12	FY3/13	FY3/14	FY3/15E	y-o-y
Sales						
Pharmaceutical Network	2,126	1,348	2,650	2,843	2,850	0.2%
Operating Pharmacies	44,641	24,273	52,581	63,006	72,248	14.7%
Leasing and Medical Facility	987	509	1,122	1,317	1,435	8.9%
Meal Supply	–	–	–	607	1,881	210.0%
Other Businesses	225	131	252	407	329	-19.1%
Internal sales	-1,473	-852	-1,779	-1,999	-2,731	–
Total sales	46,508	25,410	54,827	66,181	76,013	14.9%
Operating profit						
Pharmaceutical Network	997	596	1,221	1,475	1,500	1.7%
Operating Pharmacies	2,032	1,233	1,766	1,840	2,138	16.2%
Leasing and Medical Facility	136	65	111	-39	9	–
Meal Supply	–	–	–	-12	-33	–
Other Businesses	-18	5	4	10	4	–
Company-wide operating costs	-884	-542	-1,057	-1,183	-1,215	–
Total operating profit	2,262	1,357	2,046	2,091	2,404	15.0%
Operating profit margin (%)						
Pharmaceutical Network	46.9	44.2	46.1	51.9	52.6	
Operating Pharmacies	4.6	5.1	3.4	2.9	3.0	
Leasing and Medical Facility	13.8	12.8	9.9	–	0.7	
Meal Supply	–	–	–	–	–	
Other Businesses	–	4.1	1.9	2.5	1.5	
Total operating profit margin	4.9	5.3	3.7	3.2	3.2	

There is a prospect of the number of customers in PNB to strengthen its increasing trend

○Pharmaceutical Network Business

For FY3/15, the company foresees a 0.2% rise in sales in the pharmaceutical network business to ¥2,850mn and a 1.7% increase in operating profit to ¥1,500mn. The business plans to raise the number of customers in its network by 237 to 1,400 by the end of FY3/15. At the same time, it aims to raise its pharmaceutical orders by 6.7% y-o-y to ¥120bn.

The projection of 1,400 customers by the end of FY3/15 includes pharmacies and OTC drug stores operated by cocokara fine Inc. (3098), which are currently customers, but cocokara fine is now re-negotiating its contract with the pharmaceutical network business. Orders expected from pharmacies operated by cocokara fine are not included in the business's forecast of total orders transacted. The business plans to add 237 new customers in FY3/15, much more than the 130 added in FY3/14, because the merits of its service are increasingly evident as competition in the pharmacy industry intensifies. Many small pharmacies appreciate the business for absorbing the large additional cost of drugs bought over the past two years in FY3/14.

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By increasing sales of generic drugs and drugs for treatment at home, the business targets profit growth Dispensing

○Pharmacy Operation Business

For FY3/15, the company foresees a 14.7% rise in sales in the pharmacy operation business to ¥72,248mn and a 16.2% increase in operating profit to ¥2,138mn. Changes to Japan's official prices for drugs and medical treatment that took effect from April 1, 2014 could theoretically lower the business's operating profit by ¥458mn in FY3/14, but by promoting sales of generic drugs and drugs for treatment at home, the business plans to limit this operating profit decline to ¥166mn.

Impact (¥mn) of 2014 Revision of Official Medical Care Prices on Company's Operating Profit

Revision	Estimated Impact (¥mn)		Countermeasure
	without countermeasure	with countermeasure	
Higher requirement for extra fees for generic drugs	-167	-94	sell more generic drugs
Higher standards for pharmacies	-203	12	sell more drugs for home treatment
Lower pharmaceutical prices	-47	-43	
Medication history management and guidance fee (handbook of prescription record)	-41	-41	
Total	-458	-166	

Source: Fisco Inc., based on company materials

Based on the higher genetic drug sales weight requirements for additional technical fees for the sale of generic drugs, the proportion of the business's pharmacies that qualified for these fees at the end of FY3/14 falls to 53.6%, from 86.9% based on the previous requirements. By selling more generic drugs, the business aims to raise the proportion of its pharmacies qualifying for additional fees under the new requirements to 65.7% by the end of FY3/15. Based on the new requirements, about 48% of all pharmacies in Japan qualify for additional fees.

Number and Proportion of Pharmacies Qualifying for Additional Technical Fees per Prescription in FY3/14 Under Old and New Genetic Drug Sales Weight Requirements and in FY3/15E

	FY3/14 Old requirements
35% or more (19 pts)	135
30-34.9% (15 pts)	85
22-29.9% (5pts)	59
Total	279
Ratio of all pharmacies qualifying	86.9%

	FY3/14 New requirements	FY3/15E New requirements
65% or more (22 pts)	77	101
55-64.9% (18 pts)	95	110
Total	172	211
Ratio of all pharmacies qualifying	53.6%	65.7%

【Genetic drug sales weight】

$$\text{Old calculation} = \frac{\text{generic drug sales}}{\text{original drug sales (generics exist)} + \text{original drug sales (generics do not exist)} + \text{generic drug sales}}$$

$$\text{New calculation} = \frac{\text{generic drug sales}}{\text{original drug sales (generics exist)} + \text{generic drug sales}}$$

Source: Fisco Inc., based on company materials

The revised medical fees of 2014 increase the incentive for home medical care because the need for such care is growing while the infrastructure for it is not. Pharmacies that operate 24 hours a day and second dispensing pharmacist to homes receive additional fees (points). The fee for dispensing pharmacy services to patients at home was reviewed. Under the old point system, a pharmacy may not have received enough additional income to justify the employment of additional pharmacists to earn the fees. Now, there is a greater chance to profit from doing so.

The pharmacy operation business plans to equip all of its pharmacies to offer dispensing pharmacy services at home in FY3/15. It also plans to offer the services in 130 newly identified care-giving facilities , bringing the total number of such facilities to 350. It aims to fill 20,000 prescriptions per month for home patients, which would be about 50% more than the 13,000 prescriptions per month filled in FY3/13.

Revised Points for Dispensing Pharmaceutical Services at Home

Basic Additional Points

Category	Main requirements	Points	
		Old	New
Standard #1	・24 hour operation and visit by pharmacists (in association with local pharmacies)	10	12
Standard #2	・24 hour operation and visit by pharmacists (own pharmacies) ・More than 10 times visit during the past one year.	30	36

Fee for dispensing pharmacy services to patients at home

Category	Main requirements	Points	
		Old	New
1. Patients not living in the same building	・Four visits per month per patient (two visits per week or eight per month to patients with final stage cancer or being fed intravenously)	500	650
2. Patients living in the same building	・No more than five visits per day per pharmacist to patients of either type	350	300

Source: Fisco Inc., based on company materials

The business aims to add 14 pharmacies in FY3/15, the same number added in FY3/14. Of these, four pharmacies will be located in medical malls. It also plans to open 11 new facilities to assist medical doctors to open clinics or offices. In FY3/14, it opened five such facilities. It will continue to acquire other pharmacy companies, mainly 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 improve profitability, the business plans to close 10 unprofitable pharmacies and continue to consolidate its subsidiaries to reduce indirect costs. In July 2014, it intends to merge two subsidiaries in the Tokai region and two in Kyushu. To reduce costs at pharmacies and improve management efficiency, the business will open a new pharmaceutical headquarter system in autumn 2014.

To attract more customers, the business will continue to reduce the waiting time at its pharmacies, instill the importance of offering hospitality in its staff, and continue to maintain strict safety standards to prevent the dispensing of a wrong drug. At the end of FY3/14, the business employed 1,009 pharmacists, including some temporary employees. This was 200 more than the number employed at the end of FY3/13. The business plans to increase the number of pharmacists in FY3/15. For example, it aims to hire 100 recent graduates from pharmacy school, up from 47 in FY3/14.

To start constructing three more residence buildings expecting an increasing demand because of the aging population in Japan.

○Leasing and Medical Facility Business

For FY3/15, the company foresees an 8.9% rise in sales in the leasing and medical facility business to ¥1,435mn and an operating profit of ¥9mn, reversing the ¥39mn operating loss suffered in FY3/14. The Wisteria Kiyota residence building with medical services for the elderly, opened in Sapporo City in May 2013, should contribute to sales and profits.

In FY3/15, the business plans to start the construction of three more residence buildings with care-giving services for the elderly, a second such building in Sapporo City, one in Otaru City, and one in Osaka. Each will contain about 80 living units and will be completed in FY3/16. Through a securitization program, these properties will be taken off from the balance sheet. In fact, it plans to apply the same scheme to its first such building, the Wisteria Kiyota residence building. As Japanese society continues to age rapidly, the business foresees strong demand for such buildings. Therefore, it plans to open two such buildings every year in the future.

○Meal Supply Business

In FY3/15, this business will make a full-year contribution to sales and profits. Thus, it projects a 210.0% jump in sales to ¥1,881mn, but it foresees an operating loss of ¥33mn. When Medical System Network bought Total Medical Service Co. in November 2013, one condition attached to the transaction was that, if the meal supply business operated by subsidiaries of Total Medical Service suffered an aggregate operating loss in FY3/15 or FY3/16, President Ono of Total Medical Service can buy the business for ¥400mn plus the net cash generated by the business.

■ Growth Strategy

Aiming for annual sales of ¥300bn in 10 years by expanding two main businesses: Pharmaceutical Network Business and Dispensing Pharmacy Operation.

For FY3/24, Medical System Network targets consolidated sales of ¥300bn. It aims to achieve this target by expanding its pharmaceutical network business and its pharmacy operation business.

There are about 50,000 pharmacies in Japan, but the industry is consolidating as larger companies expand their market shares. Most of the pharmacies are operated by small companies that cannot afford to build their own supply chain management systems and would therefore benefit from using Medical System Network's network system. Thus, the pharmaceutical network business still has substantial growth potential.

The pharmacy operation business will continue to increase the number of its pharmacies, in part, through M&A in large cities. One key to the growth of this business is the efficient provision of drugs to patients at their homes. The demand for this service is projected to grow strongly. A subsidiary in this business educates and trains pharmacists, and this capability should contribute to the growth of the business.

The leasing and medical facility business will aggressively develop residence buildings offering care-giving services for the elderly. In doing so, it will benefit from growing municipal plans to construct complexes of hospitals, medical malls, pharmacies and homes for the elderly to cater to the rapid increase in the elderly population. By undertaking numerous developments, the business will try to achieve greater synergy with the other businesses in the company.

Financial Condition

Effectively applying financial leverage while maintaining an ROE of more than 10%

The company's financial condition at the end of FY3/14 is shown in the summary balance sheet below. In FY3/14, its tangible fixed assets grew by ¥4,504mn accompanying the opening of new pharmacies and the first residence building offering medical services for the elderly. Goodwill increased by ¥4,076mn accompanying business expansion. These were the two main factors contributing to a ¥12,325mn rise in total assets to ¥43,114mn.

A ¥9,818mn rise in interest-bearing debt was the main factor contributing to a ¥13,208mn increase in total liabilities to ¥37,761mn. Total equity decreased by ¥883mn in FY3/14 due to a ¥1,135mn purchase of treasury stock.

The purchase of Total Medical Service Co. in November 2013 added ¥6,452mn to the company's assets, or about a half of the total increase in assets during FY3/14, while increasing liabilities by ¥5,166mn.

In FY3/14, the company continued its strategy of taking advantage of Japan's low interest rates to increase its interest-bearing debt to finance business expansion. The two major expansions of the fiscal year were the purchase of Total Medical Service Co. and the opening of the Wisteria Kiyota residence building with medical services for the elderly. The increase in interest-bearing debt caused the company's current ratio, equity ratio and debt-to-equity ratio to deteriorate. However, its ROE remained high, at 12.2%. Thus, the company continued to effectively apply financial leverage for growth while generating respectable returns on investment.

Summary Consolidated Balance Sheet (¥mn), FY9/11 – FY3/14

	FY9/11	FY3/12	FY3/13	FY3/14
Current assets	7,786	8,901	8,271	10,941
Cash and deposits	1,329	2,072	2,091	3,106
Tangible fixed assets	9,162	9,975	11,471	15,975
Intangible fixed assets	4,982	5,040	8,263	12,399
Goodwill	4,900	4,968	8,176	12,253
Total assets	24,533	26,602	30,789	43,114
Current liabilities	10,800	12,693	14,375	24,879
Fixed liabilities	8,470	8,229	10,177	12,881
Interest-bearing debt	8,663	9,480	12,193	22,011
Total liabilities	19,270	20,923	24,553	37,761
Total equity	5,263	5,679	6,236	5,352
Total liabilities & equity	24,533	26,602	30,789	43,114
Ratios of financial security				
Current ratio (current assets ÷ current liabilities)	72.1%	70.1%	57.5%	44.0%
Equity ratio (total equity ÷ total assets)	19.9%	19.7%	18.8%	11.9%
Debt-to-equity ratio (interest-bearing debt ÷ total equity)	177.5%	180.8%	210.7%	429.2%
Ratios of profitability				
ROA (recurring profit ÷ term-end total assets)	9.1%	5.1%	6.7%	5.5%
ROE (net profit ÷ term-end total equity)	22.6%	10.2%	13.7%	12.2%
Operating profit margin	4.9%	5.3%	3.7%	3.2%

Returns to Shareholders

Medium-to-long-term growth scenario remains unchanged; by improving its organization, the company should resume sales and profit growth

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. For FY3/15, the company plans to pay a full-year dividend of ¥8 per share (an interim dividend of ¥4 and a term-end dividend of ¥4), unchanged from its dividend in FY3/14. Based on the company's profit forecasts for FY3/15, this dividend would yield a dividend payout ratio of 27%.

After the company announced its results for FY3/14 and its forecasts for FY3/15, its share price fell notably. Most likely, this share price decline reflected the facts that FY3/14 profits were lower than the company had projected due to the company's unforeseen additional drug cost and the company's forecasts for FY3/15 were lower than market consensus forecasts because of the low growth projected for the pharmacy network business. However, both of these factors are temporary. The company's growth scenario over the medium-to-long term remains unchanged. The company foresees y-o-y profit declines in H1 FY3/15, reflecting further investment in growth, but it projects strong profit increases from H2 FY3/15, which should support a rise in its share price.

Share Price (¥) Chart for Medical System Network

FISCO

Medical System Network
4350 Tokyo Stock Exchange
First Section

8-Jul.-14

Consolidated Income Statement (¥mn), FY9/11 – FY3/15E

	FY9/11	FY3/12	FY3/13	FY3/14	FY3/15E
Sales	46,508	25,410	54,827	66,181	76,013
y-o-y growth	13.1	–	–	20.7	14.9
Cost of goods sold	30,291	16,450	35,415	43,444	47,915
Cost of goods sold ratio	65.1	64.7	64.6	65.6	63.0
SGA cost	13,954	7,602	17,365	20,645	25,694
SGA cost ratio	30.0	29.9	31.7	31.2	33.8
Operating profit	2,262	1,357	2,046	2,091	2,404
y-o-y growth	48.0	–	–	2.2	15.0
Operating profit margin	4.9	5.3	3.7	3.2	3.2
Non-operating income	100	81	149	249	–
Non-operating expenses	222	124	284	321	–
Recurring profit	2,139	1,314	1,912	2,019	2,219
y-o-y growth	61.0	–	–	5.6	9.9
Recurring profit margin	4.6	5.2	3.5	3.1	2.9
Extraordinary profits	110	24	59	154	–
Extraordinary losses	302	40	64	403	–
Pretax profit	1,948	1,298	1,907	1,770	–
y-o-y growth	50.5	–	–	-7.2	–
Pretax profit margin	4.2	5.1	3.5	2.7	–
Corporate taxes	800	702	1,017	1,072	–
Effective tax rate	41.1	54.1	53.4	60.6	–
Minority interest	146	77	133	29	–
Net profit	1,001	518	756	668	706
y-o-y growth	111.5	–	–	-11.6	5.6
Net profit margin	2.2	2.0	1.4	1.0	0.9
Number of shares outstanding (thousand)	6,492	6,492	25,968	23,888	–
EPS (¥)	38.56	19.97	29.12	27.74	29.55
DPS (¥)	6.25	3.75	8.00	8.00	8.00
BPS (¥)	187.98	201.93	222.86	214.70	–
CFS (¥)	75.96	40.42	80.25	100.21	–
Dividend payout ratio (%)	16.2	18.8	27.5	28.8	27.1

Notes:
1) Due to a change of fiscal year, the term to March 2012 contained six months of operations
2) the number of shares outstanding excludes treasury stock
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
4) Cash flow per share (CFS) is calculated as (net profit + depreciation cost + goodwill amortization) / average number of shares outstanding, excluding treasury stock

Disclaimer