Medical System Network
4350 Tokyo Stock Exchange
First Section

19-Jan.-15

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FISCO Ltd. Analyst
Yuzuru Sato

Steadily improving profitability, aiming for double-digit revenue & earnings growth in FY3/15

Medical System Network <4350> (hereafter, "the Company") has developed two main businesses: a dispensing pharmacy business, and a pharmaceutical network business that caters to small- and medium-sized pharmacies. In the dispensing pharmacy business it is promoting its Group expansion strategy through proactively employing M&A. The Company aims for consolidated sales in the order of ¥300bn in 10 years.

Consolidated 1H FY3/15 results were basically in line with management's plan, with consolidated sales up 18.0% y-o-y to ¥35,911mn, while operating profit was down 26.4% to ¥888mn. Despite sales from Total Medical Services (TMS), that was consolidated as a subsidiary in November last year contributing to sales growth, operating profit declined due to factors such as the impact from the NHI (National Health Insurance) drug price and dispensing fee revision in April.

FY3/15 consolidated sales and operating profit are expected to show double-digit growth in both revenues and earnings, with consolidated sales of ¥76,013mn (+14.9% y-o-y) and operating profit of ¥2,404mn (+15.0% y-o-y). Apart from anticipating expansion in the number of member pharmacies in the pharmaceutical network business, within the dispensing pharmacy business the Company will seek to improve store profitability through measures to strengthen the handling of generic drugs and home care operations. Further, profits are expected to grow due to reductions in indirect costs from the impact of the consolidation of regional subsidiaries and full-scale operation of the Company's Dispensing Headquarter systems. There is the possibility that sales will fall marginally below plan with a curbing of the number of new stores opened, however, profitability is improving steadily, and we feel that, on the basis of profits, it is possible the Company will meet its plan.

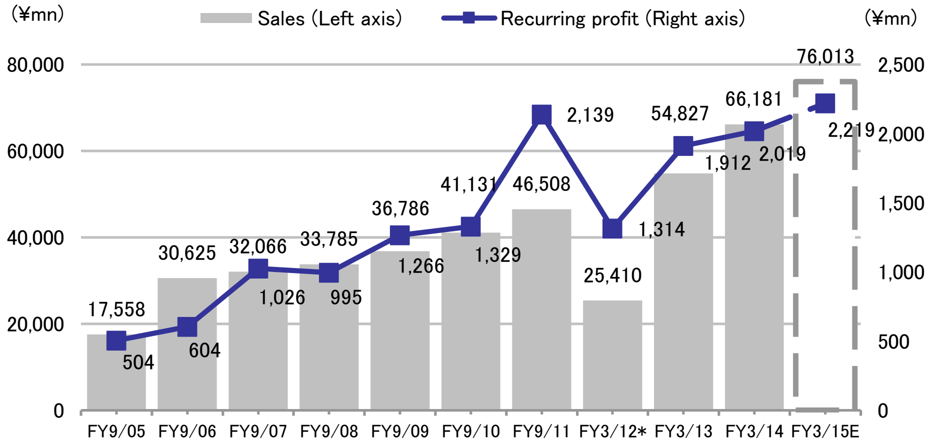
The market environment for dispensing pharmacies is becoming harsher year by year for small- and medium-sized pharmacies, with joining one of the major player groups or participating in the Company's network arguably becoming powerful survival choices. Actually, in the Company's network business in H1, including posting a record high for new member numbers on a semi-annual basis, the pace of growth is accelerating, and further growth may be expected in this segment.

Domestically there are 57,000 pharmacies, with the majority being medium- and small-scale pharmacies. At the same time as experiencing growth in member numbers in the Company's network business, in its dispensing pharmacy business it is also seeking store expansion while proactively engaging also in M&A. The strategy being is to aim for further earnings growth with these respective businesses operating in concert.

Check Point

- Aiming for consolidated sales of ¥100bn under the new 3-Year Management Plan & ¥300bn in 10 years.
- Both operating & recurring profit expected to set their record highs since FY9/11
- Continuing a business expansion strategy utilizing financial leverage under the low interest rate regime

Sales & Consolidated Sales and Recurring profit (¥mn) Trends



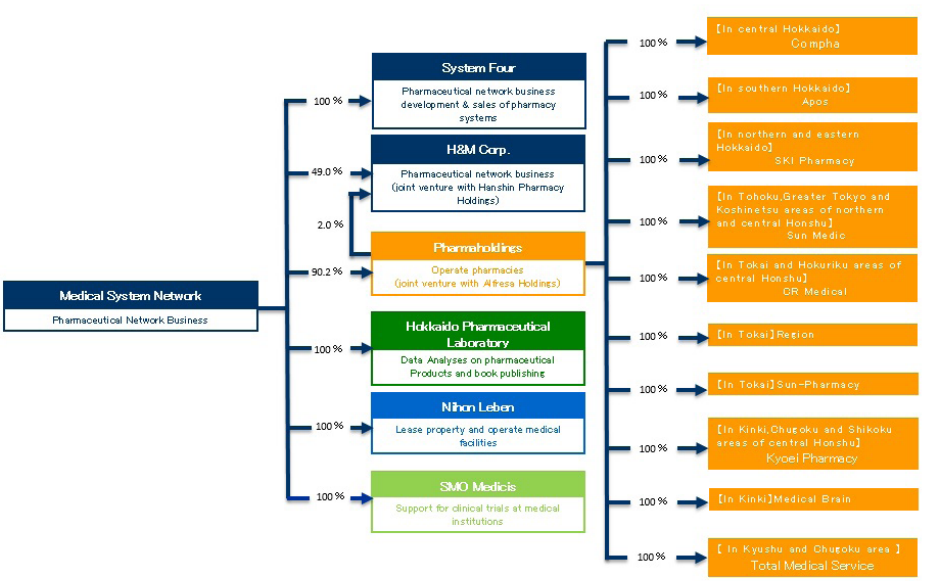
* Due to a change in the accounting period FY3/12 is an irregular 6-month set of accounts.

Company Outline

Operations divided into the Pharmaceutical Network & Dispensing Pharmacy Businesses

The Company has two main businesses: the dispensing pharmacy business and the pharmaceutical network business. It is also undertaking peripheral businesses including rental and other medical facility-related operations, catering services and clinical facility support services. The pharmaceutical network business is conducted by Medical System Network and subsidiaries System Four and H&M, while the dispensing pharmacy business is conducted by PHARMAHOLDINGS CO.,LTD., its subsidiaries and the Hokkaido Institute for Pharmacy Benefit Co., Ltd.

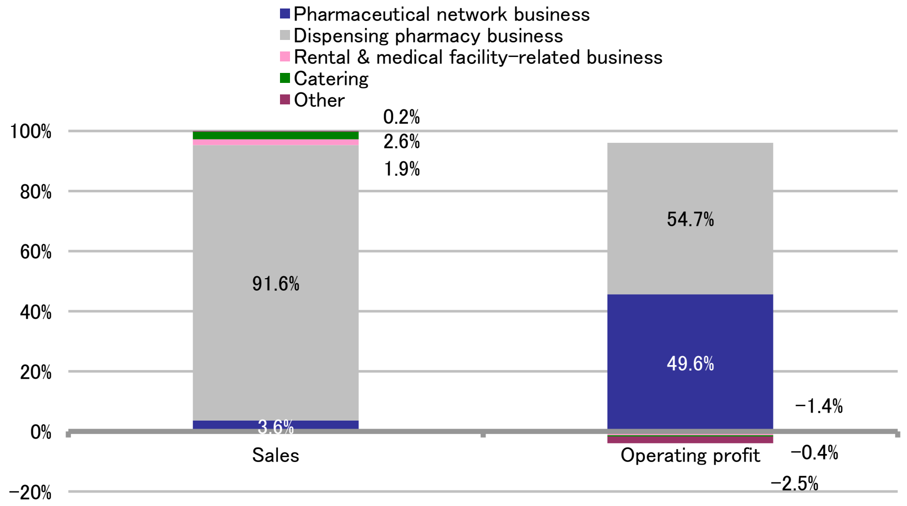
Organization Chart of Medical System Network Group as of October 31, 2014



The subsidiaries of Pharmaholdings operated 345 stores, including drug stores, healthcare centers and welfare equipment rental center.
Source: Company materials

Looking at the breakdown by segment (1H FY3/15) we see that while the operation of pharmacies represents more than 90% of total consolidated sales, operating profit may be virtually split into the pharmaceutical network and dispensing pharmacy businesses, allowing us to understand that these are the Company's two core businesses. An overview of each segment is as set out below.

Contribution by Operating Segment (H1 FY3/15)



○Pharmaceutical Network Business

A business engaged in since the Company's establishment, the pharmaceutical network business is conducted by Medical System Network and two subsidiaries, System Four and H&M. The business model is one that supports enhancement in the level of pharmaceutical distribution efficiency by acting as an intermediary in pharmaceutical sales between dispensing pharmacies, medical institutions and pharmaceutical wholesalers. By becoming a member of the Company's network, apart from supply chain management services, a participant can access services such as dead stock exchange services (immobile stock liquidation), pharmacist training support and fund procurement support.

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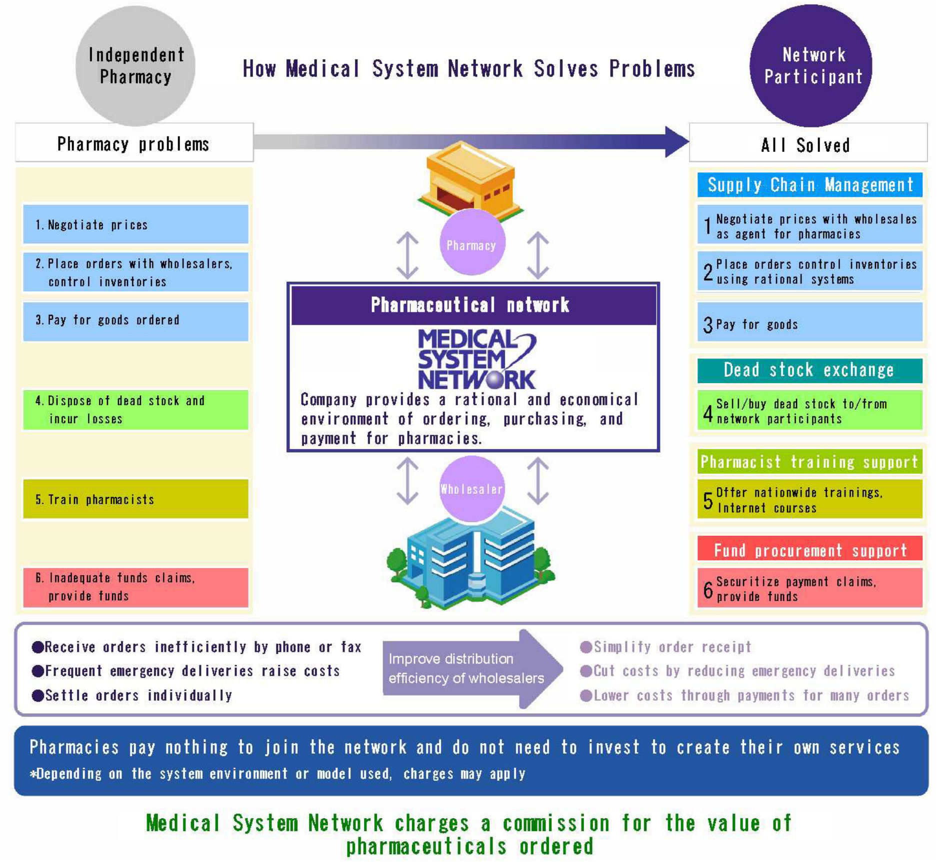
Outline of Pharmaceutical Supply (Network) Business



Source: Company materials

In its supply chain management service, not only is efficiency in day-to-day ordering, settlement and inventory control operations improved, the Company also acts as an agent in price negotiations. By installing the Company's Order Entry (O/E) System, apart from improving productivity in the sections in charge at member stores, from a price negotiation perspective also, because the Company undertakes negotiations previously conducted by individual pharmacies collectively, it gives rise to the merit of being able to purchase stock on better terms than achieved previously.

The dead stock exchange service (immobile stock liquidation) is a system that allows member pharmacies to exchange dead stock at each of their stores, efficiently reducing pharmaceutical disposal losses.

In its pharmacist training support service, apart from holding 30-40 group training (seminars) nationwide per month to improve pharmacist skills, the Company also undertakes eLearning courses. Also, the Company operates a pharmacy payment claim securitization service as a fund procurement support service. Given that, at an average of approximately two months, the sales proceeds collection period for dispensing pharmacies is quite lengthy, the Company employs a securitization scheme for these receivables aimed at providing support from a funding perspective. The benefit when using the system is that sales proceeds collections may be reduced by more than one month.

Also, the Company conducts development, sales and maintenance operations for the receipt computer systems, O/E systems and peripheral equipment that it installs in dispending pharmacies, as well as sales of prescription dispensing machines, fixtures and fittings.

Moreover, target customers in its pharmaceutical network services are small-scale companies operating 20 or fewer pharmacies and dispensing pharmacies operated by sole traders. As of end-September 2014, the combined number of member pharmacies in the network, including those in the Group and external members, was 1,053 (including 30 hospitals and clinics). This is a year-on-year decline of 110, however, this was due to the withdrawal of a large trading counterparty in April 2014 (230 pharmacies) which had ceased trading, and taking that aside there was an increase of 120 pharmacies, which set a record for increases in the number of new members on a half-yearly basis. Further, by region, Hokkaido, where the Company was founded, Kanto and Koshinetsu represent almost half of overall pharmacy numbers, followed by the Kinki, Tokai and Hokuriku regions in that order. By adding Total Medical Service to the Group in November 2013 by way of TOB, which is based in Kyushu, pharmacy numbers in the Kyushu and Okinawa regions increased significantly, with a roll-out currently covering 42 prefectures.

Additionally, sales from this segment arise corresponding with order volumes from member pharmacies, with ordering fees and system sales representing the majority of overall sales. It is a stock business model in which sales rise stably in line with increases in member pharmacy numbers, and with operating profit margins in the range of 45-55% it forms a stable, highly profitable business.

Breakdown of contracted network store numbers

(Unit: Stores)

By member type	FY9/10	FY9/11	FY3/12	FY3/13	FY3/14	FY9/14	FY3/15E
General member	393	526	631	764	842	722	
MSN Group	204	214	223	269	321	331	
Total	597	740	854	1,033	1,163	1,053	1,400

By region	FY9/10	FY9/11	FY3/12	FY3/13	FY3/14	FY9/14	FY3/15E
Hokkaido	188	180	197	212	216	205	
Tohoku	28	31	63	80	91	90	
Kanto/Koshinetsu	194	202	214	270	298	282	
Tokai/Hokuriku	28	79	96	138	160	130	
Kinki	85	150	150	178	187	141	
Chugoku/Shikoku	48	55	70	77	87	82	
Kyushu/Okinawa	26	43	64	78	124	123	
Total	597	740	854	1,033	1,163	1,053	1,400

Note: From April 2014 figures reflect the withdrawal of one large trading counterparty (230 stores) that had ceased trading.

○Dispensing Pharmacy Business

The dispensing pharmacy business, with subsidiary PHARMAHOLDINGS acting as a holding company, through its 10 subsidiaries (as of end-September 2014), is developing dispensing pharmacies, mainly under the Nanohana Pharmacy brand. A distinctive feature of Nanohana pharmacies is that they aim To be community pharmacies that offer to regional communities a range of health-related services, breaking free from the simple dispensing pharmacy chain model.

At the end of September 2014 the number of dispensing pharmacies was 331 (excluding 1 store that has currently suspended operations), with the Company operating an additional two Healthcare centers, 12 drug stores, and one welfare equipment rental center. By region, Hokkaido has the greatest number with 111, followed by Kanto/Koshinetsu with 70, and Kinki with 52 stores. The Company is expanding its number of stores nationally, while also employing M&A. Further, at its subsidiary, the Hokkaido Institute for Pharmacy Benefit, it provides training services to pharmacists and operations staff at both internal Group and external dispensing pharmacies.

In the last few years the operating profit margin has trended at 3-5%, being slightly below average levels in comparison to major pharmacy players, and making improving profitability at each store an issue going forward.

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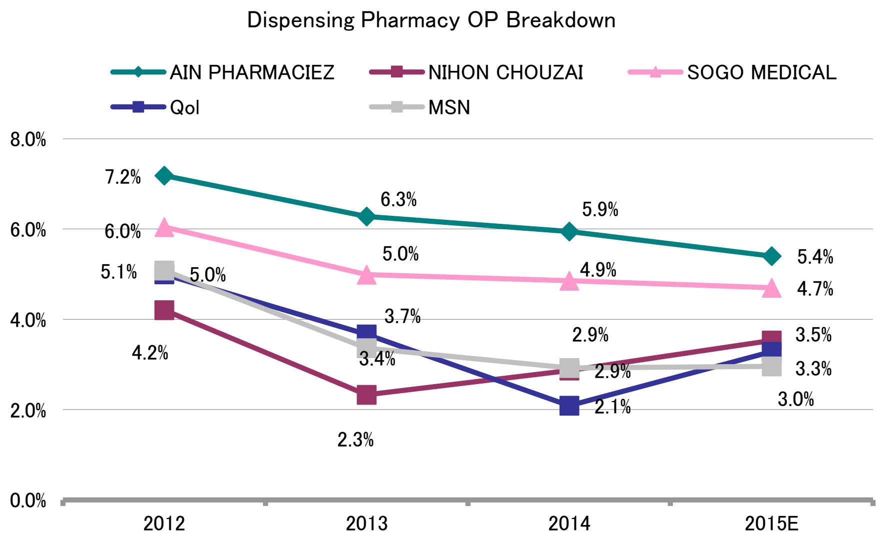


〇Rental & Medical Facilities-related Business

Medical System Network subsidiary Nihon Leben mainly develops sites for building group pharmacies, as well as renting buildings for medical services, car leasing and insurance services. Further, at the same time as offering consulting services for medical practices, it also operates medical malls that gather multiple treatment disciplines on the same floor, medical buildings that gather clinics in one building, and elderly housing with supportive services (herein "EHSS").

〇Catering Business

The food service division of Total Medical Service (TMS), that was consolidated as a subsidiary in November 2013, and its subsidiary, Sakura Foods, engage in catering outsourcing operations within hospitals and welfare facilities.

〇 Other Business

Medical System Network subsidiary SMO Medisys contracts with clinical trial facilities (medical institutions) as a clinical site management organization to provide support services for clinical trials.

Business Trends

1H FY3/15 consolidated results above initial Company plan on a profit basis

(1) H1 FY3/15 Results

The H1 FY3/15 consolidated results announced on October 31 show consolidated sales up 18.0% y-o-y to ¥35,911mn, operating profit down 26.4% y-o-y to ¥888mn, recurring profit down 27.5% y-o-y to ¥850mn, and net profit down 46.7% to ¥230mn. Compared with the initial Company plan, while sales fall marginally short, on a profit basis all other figures exceeded plan.

Consolidated H1 FY3/15 Results

(¥mn)

	H1 FY3/14		H1 FY3/15				
	Actual	% Sales	Initial Plan	Actual	% Sales	Y-o-Y	Vs Plan
Consolidated sales	30,438	100.0%	36,593	35,911	100.0%	18.0%	-1.9%
COGs	19,735	64.8%	-	22,368	62.3%	13.3%	-
SG&A	9,496	31.2%	-	12,653	35.2%	33.2%	-
Operating profit	1,207	4.0%	875	888	2.5%	-26.4%	1.6%
Recurring profit	1,172	3.9%	785	850	2.4%	-27.5%	8.3%
Extraordinary profit	-67	-	-	-167	-	-	-
Net profit	433	1.4%	201	230	0.6%	-46.7%	14.8%

The impact of adding sales from TMS, which was consolidated as a subsidiary in November 2013 was a significant factor in the growth in consolidated sales. On the other hand, examining by segment the reasons for the decline in operating profit, profit declines of ¥262mn in the dispensing pharmacy business represented the majority of overall declines, with all segments, with the exception of the pharmaceutical network business, contributing to lower income.

In the dispensing pharmacy business, despite a revenue contribution from M&A effected in the previous term, this year marks the biennial NHI drug price and dispensing fee revision, the result of which, in addition to causing sales to decline at existing stores, is a factor leading to lower profits, including higher headquarter costs. Also, the headquarter costs for TMS, which was consolidated as a subsidiary, are included in consolidated headquarter costs. The fiscal term for drug price revisions occurs in the April-September period, usually bringing with it a tendency to lower profitability, with movements this time arguably being virtually in line with expectations.

Reasons for OP Fluctuations (H1 FY3/15)

(¥mn)

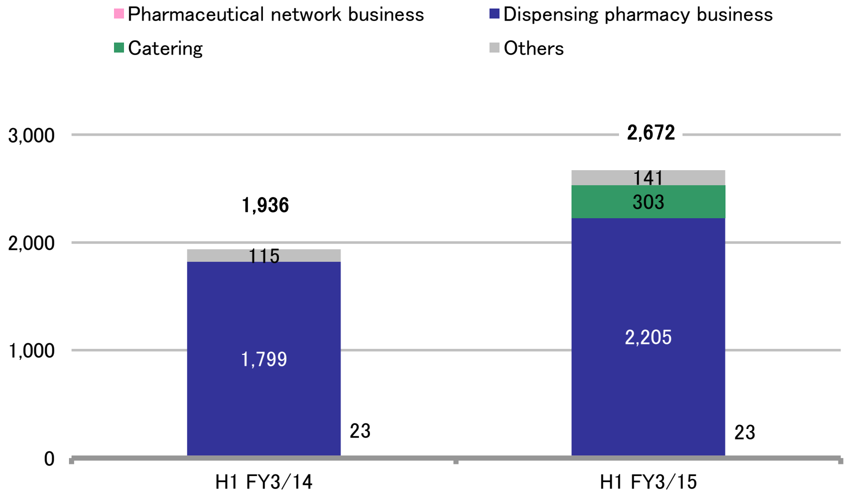
Category	Amount Change	Category	Amount Change
Dispensing pharmacy business	▲ 262	Pharmaceutical network business	△ 20
(Breakdown of change in OP)		Rental & medical facility-related business	▲ 14
Existing stores	▲ 379	Catering business	▲ 6
Stores opened last year (incl. M&A, excl. TMS)	△ 104	Other business	▲ 43
M&A FY3/14 (TMS)	△ 396	Group expenses (adjusted)	▲ 12
Stores opened this year	▲ 79		
Stores closed	▲ 25		
M&A FY3/15	△ 21		
Headquarter costs	▲ 301	Total	▲ 318

Note: [△] increased profit, [▲] decreased profit

The COGs ratio declined from 64.8% in the same period last year to 62.3%, while conversely the SG&A ratio rose from 31.2% to 35.2%, however, this was mainly in the dispensing pharmacy business, where, in order to ease increased burden from rises in the consumption tax (a cause for increases in the SG&A ratio), the impact from adjustments in the drug price revision percentages, aimed at expanding drug price margins (a cause for the lower COGs ratio) was significant. (Note) Additionally, extraordinary losses widened by approximately ¥100mn, which was due to a blowout (¥163mn) in impairment losses on store assets. Also, one other factor as regards the SG&A ratio was a rise in the staff cost ratio from 18.3% to 19.9% resulting from M&A activities.

Note: In purchasing pharmaceuticals pharmacies bear the consumption tax (cost), however, given that no consumption tax is incurred at the point of sale, the consumption tax increase becomes a factor behind increased cost prices (increased tax and public dues). As a result, in order to ease the pharmacy's burden from increased taxes, drug prices are revised, aiming to expand drug price margins (selling price — purchase price).

Staff Numbers by Operating Segment

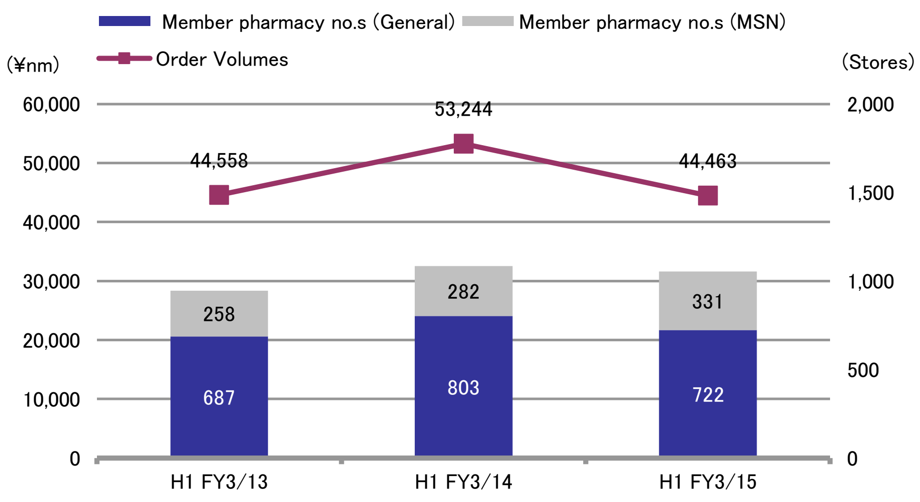


Trends by segment are as set out below.

○ Pharmaceutical Network Business

Consolidated sales from the pharmaceutical network business declined 6.9% y-o-y to ¥1,353mn, while operating profit rose 2.9% y-o-y to ¥737mn. While systems sales declined, gains in revenue from the highly profitable ordering fee income was a factor in increased profits.

Member Pharmacy Numbers & Order Volumes



As of end-September 2014 the number of member pharmacies declined by 32 stores year-on-year to 1,053, however, as noted above, the impact from the withdrawal of one large trading counterparty (230 stores) group was significant. The impact was also felt in a significant decline in order volumes which fell 16.5% y-o-y to ¥44,463mn. The fact that fee income from new member pharmacies were able to cover this was a reason ordering fees rose despite this incident.

Examining the number of general member pharmacies, excluding large counterparties, stores numbers were 573 at end-September 2103, 612 at end-march 2014 and 722 at end-September 2014, the rise in numbers for the most recent half-year of 110 stores being a record high pace for new participants.

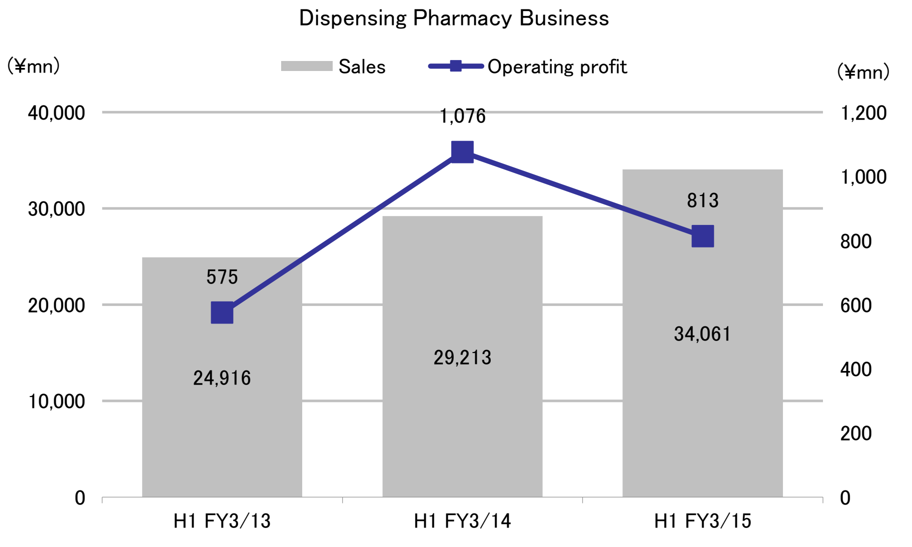
Two factors may be cited behind the increase in member numbers. Firstly, a fixed period from the NHI drug price revision to September 30 was newly established as deadline to finalize terms in the price negotiations with pharmaceutical wholesalers. By way of penalty, dispensing fees will be lowered for pharmacies that have not agreed terms for over 50% of items within this period. Arguably, by applying penalties on the buyer side mid-tier pharmacies operating 20-30 stores in particular will feel the pinch in purchase price negotiations. This is because previously, even at this type of mid-tier pharmacy, by dragging out price negotiations, were able to agree on purchasing price terms similar to large pharmacy chains.

By establishing a deadline for price negotiations mid-tier purchase price negotiations become tighter, and thus joining a major pharmacy group or the Company's network have come to be powerful survival options, which may be viewed as a factor behind the increase in member numbers. Actually, previously, many of the companies becoming members of the Company's network were those operating in the order of 3-5 pharmacy stores, however, recently mid-tier companies operating 10-20 stores have started to increase.

What may be considered as a second factor is that there were a certain number of pharmacies that waited for the results of the NHI drug price revision to determine whether or not to join. Actually, in FY3/14 the annual number of increases in general member stores was 78, a slowdown compared with the 133 in the previous year. Accordingly, the pace of increase from October onwards will be a focus of attention, however, the Company feels that member numbers will continue to increase at the same rate.

○ Dispensing Pharmacy Business

Consolidated sales in the dispensing pharmacy business rose 16.6% y-o-y to ¥34,061mn, with operating profit declining 24.4% y-o-y to ¥813mn. As noted above, the impact on sales from expansion in stores numbers due to TMS and other M&A was significant, while from a profit perspective, the impact of the NHI drug price and dispensing fees revision was a cause of lower profits.



The status of stores openings in H1 showed 6 new store openings, three companies (9 stores) acquired by purchase of common stock, one store acquired via a transfer of operations, while on the other hand six non-profitable stores were closed. As of the end of September, store numbers showed 331 dispensing pharmacy stores (excluding one store at which operations have been suspended), which is an increase of 49 stores compared with the end of September the previous year. Among the companies acquired by M&A this time, there is Medical Brain Y.K., based in Shiga Prefecture, which has a total of 7 stores, and apart from proactively tackling home care, has also developed operations such as a care facility and a nursing care equipment rental business. It is a company that undertakes operations with deep roots in regional community medicine, and forms the direction the Company would like to aim at going forward.

Within sales, looking at the status of existing stores, dispensing fees rose 0.9% y-o-y, which was higher than the Company plan of 0.6% decline. The breakdown shows a 0.3% rise in the number of prescriptions, and a 0.7% rise in the prescription unit price. In the prescription unit price, both the technical fee unit cost and the medication unit cost rose by 0.6% and 0.7% respectively. In respect of the technical fee unit cost, fee incentive factors such as the number of pharmacies eligible for generic dispensing systems incentive and basic dispensing incentive have increased steadily.

Breakdown of Dispensing Fees (Existing stores)

	H1 FY3/14	H1 FY3/15	Growth %
Number of Prescriptions (Thousands)	2,772	2,779	0.3%
Prescription Unit Price (JPY)	9,781	9,845	0.7%
Technical fee/prescription	2,242	2,256	0.6%
Cost of medication/prescription	7,539	7,590	0.7%
Dispensing Fee (JPY mn, Unit cost x No. of prescriptions)	27,118	27,367	0.9%

Number of Pharmacies Eligible for Generic Dispensing Systems Incentive

	At the Start of FY	End Q1	End Q2	FY End Target
≥ 55% (18 points)	94	95	101	116
≥65% (22 points)	68	89	116	116
Total	162	184	217	232
% of Stores Acquired	50.2%	56.6%	65.6%	71.4%

Note: For FY3/15 end targets are based on the Company's initial plan

Number of Pharmacies Eligible for Basic Dispensing Fee Incentives

	At the Start of FY	End Q1	End Q2	FY End Target
Basic Dispensing Fee Incentive 1 (12 points)	248	253	239	228
Basic Dispensing Fee Incentive 2 (36 points)	38	40	62	72
Total	286	293	301	300
% of Stores Acquired	88.5%	90.2%	90.9%	92.3%

Note: For FY3/15 end targets are based on the Company's initial plan

Basic Dispensing Fee Incentive Conditions

Category	Major Conditions	Points	
		Pre-April Revision	Post-April Revision
Basic Dispensing Fee Incentive 1	· 24 hour prescription & home care structures (In cooperation with a pharmacy in the vicinity)	10 points	12 points
Basic Dispensing Fee Incentive 2	· 24 hour prescription & home care structures (own pharmacy only) · Track record of a total of 10 home care visits in the last year	30 points	36 points

Aside from that, seeking to reduce indirect costs, the Company progressed the consolidation of regional subsidiaries. Apart from the merger of Sunmedic K.K. (the surviving entity) and Tomioka Pharmacy K.K. (the defunct entity) in April, in July CR Medical K.K. (the surviving entity) and MCS K.K. (the defunct entity), as well as TMS (Tokyo Medical Supply) (the surviving entity) and Kyushu Pharmacy K.K. (the defunct entity) merged respectively.

○Rental & Medical Facility-related Business

Sales from the rental and medical facility-related business rose 15.0% y-o-y to ¥715mn, with an operating loss of ¥21mn (versus a ¥6mn loss in the previous term). While real estate rental income rose, front loading of depreciation and amortization expenses incurred by Wisteria Kiyota (Kiyota Ward, Sapporo City) EHSS (elderly housing with supportive services) operations that commenced in May 2013 and increased hr costs due to the Company seeking to strengthen its staffing structures for new EHSS developments were the factors behind lower profits (at end-September staff numbers were up 19 y-o-y to 67).

The occupancy status in the second EHSS Site Wisteria Kiyota as of end-September was that 55 of the total 75 units were occupied, being broadly speaking a satisfactory performance, with the breakeven point of 60 units within reach.

○ Catering Business, Other Business

The catering business, that was newly added by way of the consolidation of TMS as a subsidiary, had sales of ¥967mn and an operating loss of ¥6mn. A condition that was attached at the time of consolidating TMS as a subsidiary was that in the event that the catering business made a loss in either FY3/15 or FY3/16 on an operating profit basis, it could be sold to TMS' CEO, Mr. Shigeki Ono, for ¥400mn plus net cash (cash and deposits less interest bearing liabilities). Looking at it on a quarterly basis, since becoming a subsidiary, it had continued to make operating losses of around ¥10mn, however, in Q2, for the first time, it shifted to a profit of ¥3mn.

Further, clinical trial support operations developed by subsidiary, SMO Medisys, form its other business, which showed sales down 24.9% y-o-y to ¥92mn and an operating loss of ¥37mn (versus a profit of ¥6mn in the same period a year earlier). These operations are being developed in Hokkaido, however, due to changes in the particulars of the clinical trials, there were amongst other things delays in securing new projects, and thus it performed poorly.

Operating & recurring profit expected to post their record highs since FY9/11

(2) FY3/15 Results Outlook

The FY3/15 consolidated results outlook is unchanged from the Company's initial plan with consolidated sales up 14.9% y-o-y to ¥76,013mn, operating profit up 15.0% y-o-y to ¥2,404mn, recurring profit up 9.9% y-o-y to ¥2,219mn and net profit up 5.6% y-o-y to ¥706mn. It is expected that sales will set a new record high for a 3rd consecutive period (FY3/12 3 years earlier being an irregular 6-month set of accounts), with operating and recurring profit both setting their record highs since FY9/11. The reason that the increase in net profit is slightly low is that extraordinary losses are expected in line with the closing of loss-making stores.

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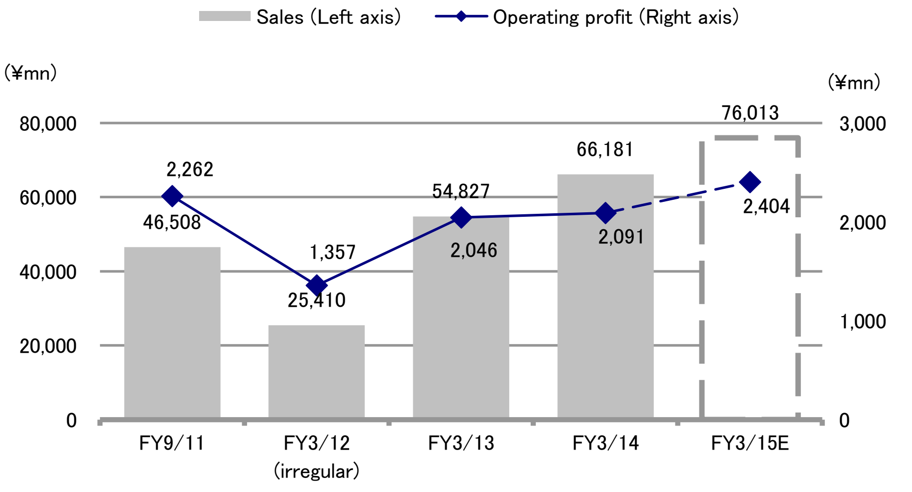
Consolidated Results Trends



The outlook by operating segment is as set out below.

Outlook by Operating Segment

(¥mn, %)

	FY9/11	FY3/12 (irregular)	FY3/13	FY3/14	FY3/15E	Chg %
Sales by segment						
Pharmaceutical network business	2,126	1,348	2,650	2,843	2,850	0.2%
Dispensing pharmacy business	44,641	24,273	52,581	63,006	72,248	14.7%
Rental & medical facility-related business	987	509	1,122	1,317	1,435	8.9%
Catering business	-	-	-	607	1,881	210.0%
Other business	225	131	252	407	329	-19.1%
Adjustments	-1,473	-852	-1,779	-1,999	-2,731	-
Total	46,508	25,410	54,827	66,181	76,013	14.9%
Segment profit						
Pharmaceutical network business	997	596	1,221	1,475	1,500	1.7%
Dispensing pharmacy business	2,032	1,233	1,766	1,840	2,138	16.2%
Rental & medical facility-related business	136	65	111	-39	9	-
Catering business	-	-	-	-12	-33	-
Other business	-18	5	4	10	4	-
Adjustments	-884	-542	-1,057	-1,183	-1,215	-
Total	2,262	1,357	2,046	2,091	2,404	15.0%
Segment profit margins						
Pharmaceutical network business	46.9	44.2	46.1	51.9	52.6	
Dispensing pharmacy business	4.6	5.1	3.4	2.9	3.0	
Rental & medical facility-related business	13.8	12.8	9.9	-	0.7	
Catering business	-	-	-	-	-	
Other business	-	4.1	1.9	2.5	1.5	
Total	4.9	5.3	3.7	3.2	3.2	

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○ Pharmaceutical Network Business

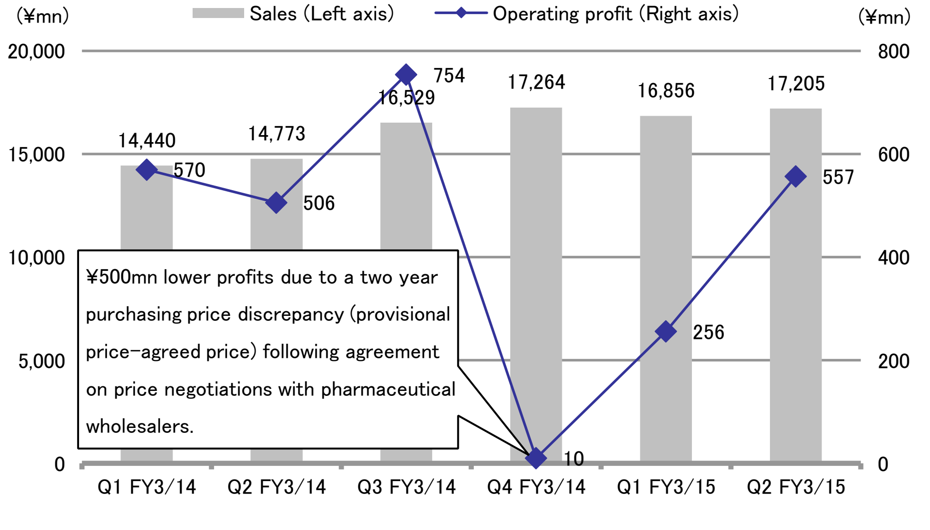
The pharmaceutical network business is expected to be flat year-on-year, with sales up 0.2% y-o-y to ¥2,850mn, and operating profit up 1.7% y-o-y to ¥1,500mn. The budget completion rate to Q2 is 47% for sales and 49% for operating profit. This supposes a rise of 6.7% in pharmaceutical turnover volumes to ¥120bn, and a year-on-year rise in member numbers by period end of 237 to 1,400. Also, given that the withdrawal of one large counterparty (230 stores) is included in this 1,400, it is actually a year-on-year rise of 7 to 1,170. With a year-on-year increase totaling 117 at the end of September, we feel the plan is readily achievable with a rate of increase in line with that in H1.

The Company aims to roll-out its network business to every prefecture, and is concentrating on developing operations in the blank spots which are Yamanashi Prefecture, Ibaraki Prefecture, Toyama Prefecture, Kochi Prefecture and Tokushima Prefecture. Also, as it is strengthening general member store acquisitions, its marketing approach also will not be based around its traditional referral method, but will shift from now on to an approach that promotes more proactive customer acquisition. Accordingly, the Company's policy is to promote an increase in sales staff, and in addition to already increasing by one staff member in September to an eight-man structure, it plans to add one member to its Kansai office this H2, and a further 1-2 staff in FY3/16. Also, it will continue to utilize customer referrals from collaborations with M&A intermediaries. This is because domestically the number of pharmacies runs to an enormous 57,000, and it is impossible resource-wise for the Company to cultivate all of them. By utilizing M&A intermediaries that have many points of contact with pharmacy managers, the Company wants to accelerate general member acquisitions.

○ Dispensing Pharmacy Business

Dispensing pharmacy business sales are expected to rise 14.7% y-o-y to ¥72,248mn, and operating profit to rise 16.2% y-o-y to ¥2,138mn. The budget completion rate to Q2 was 47% for sales and 38% for operating profit. The budget completion rate for profit appears to be low, however, as noted above, in the drug price revision system, given that there is a trend for the impact to be felt in the first half of the year (April-September), we feel there is the potential to recover in the second half of the year. Actually, on a profit basis in the last revision round (FY3/13) the budget completion rate was in the order of 33%. Further, even examining operating profit by quarter, there is an underlying recovery with a shift to a year-on-year gain in Q2, and considering that due to seasonal factors there is also an increase in sales in the second half of the year, we feel that there is ample potential to achieve the plan.

Dispensing Pharmacy Business (Quarterly Basis)



Note: Basic Dispensing Fee Incentive 2 — Establishes 24 hour prescription and home care operation systems, and further targets pharmacies with a track record of 10 or more visits per annum in home care operations.

As a measure for promoting improvement in existing store profitability, the Company increased the ratio of stores eligible for generic dispensing systems incentives at the end of September from 65.6% in the same period the previous year to 71.4%, and also increased the ratio of stores eligible for basic dispensing incentives from 90.9% to 92.3%. In particular, in respect of Basic Dispensing Fee Incentive 2 (refer note), due to medical payment system revisions this time, the points were raised significantly in order to promote home care. Home care operations are an important measure in the development of holistic regional care systems, and the Company's approach is to promote them even more proactively than they have done to date.

Further, this period the Company's policy is to prioritize achieving profits rather than sales, and will shift to curbing new store openings somewhat and proceed with the closing of up to 10 loss making stores. In respect of new store openings, while it is almost certain that there will be four new stores in the second half, there is the possibility that there will only be 10 for the full-year, down from the 14 in the initial Company plan. On the other hand, with the philosophy of proactively attracting clinics in order to revitalize existing stores, the Company plans for the full-year to attract 11 clinics in the vicinity of existing pharmacies (with 7 already completed by Q2).

The Company is continuing operational improvement. In particular, it plans for the dispensing headquarters' system, that has commenced trial operations since September, to be fully operational from December. This system not only automatically collates operational data including sales, inventories as well as receipts and disbursements, but also carries out automatic sorting for accounting systems, and is expected to have the effect of reducing clerical work. The data entry for which was previously undertaken at both the store and headquarters, but with this system the data entry will be done from the store side only. Also, it will enable faster operational analysis and business administration to be achieved, and is expected to contribute indirectly to improving store profitability.

Moreover, in respect of pharmacists, at the end of September 2014 there was a 1,100 strong structure (a year-on-year increase of 88 staff members), including temp staff, and in the future also the plan is to continue to increase staff. The number of new graduate hires is slated to expand from 47 in FY3/14 to 100 in FY3/15, with the goal of expanding store numbers further in FY3/16 though increasing pharmacist numbers.

○ Rental & Medical Facility-related Business

Sales in the rental and medical facilities-related business are expected to be up 8.9% y-o-y to ¥1,435mn, and operating profit to return to a profit of ¥9mn (from a loss of ¥39mn in the last period). We expect the EHSS property Wisteria Kiyota to make a full-year contribution, with the number of occupants 57 as of October, and achieving the breakeven point of 60 units likely by the end of the period. As a result, it is expected that a marginal loss will remain, even for the full-year.

Additionally, three new EHSS sites are being planned: Toyonaka City Osaka, Otaru City and Sapporo Hokkaido. Of these, apart from the Osaka site (85 units) which is expected to be completed in December 2015, and the Otaru site which is expected to be completed in November that year, taking into consideration that the scale of the Sapporo site is slightly large (115 units) and the impact of hikes in construction costs, it is the stage where designs are being worked out.

The total investment amount for the Osaka and Otaru properties is approximately ¥4,800mn which the Company plans to meet through borrowings, however, in respect of EHSS sites, the Company's policy is via securitization schemes to sell them REITs and other parties, and shift them off-balance sheet to the extent possible.

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Medical System Network
4350 Tokyo Stock Exchange
First Section

19-Jan.-15

○ Catering Business & Other Business

Given that from FY3/15 the catering business will make a full-year contribution, sales are expected to grow 210.0% y-o-y to ¥1,881mn. Conversely, it is expected that there will be a ¥33mn operating loss. Also, due to sluggish project enquiries, other business sales are expected to decline 19.1% y-o-y to ¥329mn and operating profit to decline 52.6% y-o-y to ¥4mn.

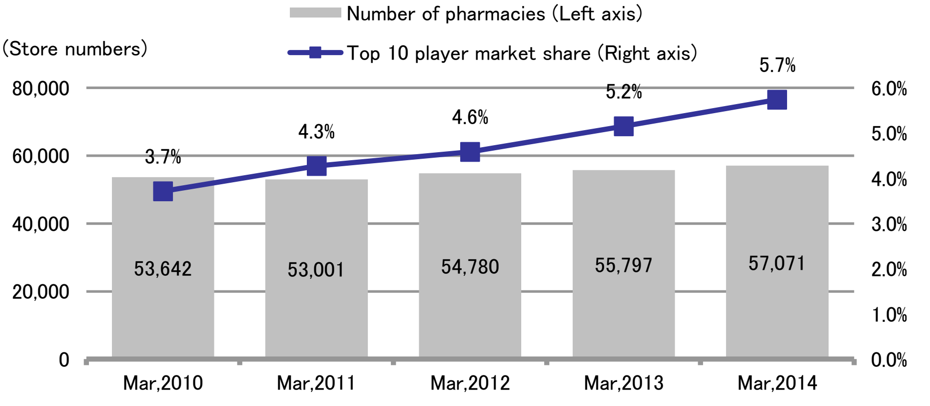
Growth Strategies

Sales of ¥100bn under the new 3-Year Management Plan, aiming for ¥300bn in 10 years

The Company has set a long-term target of achieving ¥300bn in sales in 10 years time. It is promoting expansion in growth in both its pharmaceutical network business and dispensing pharmacy business, which are currently its two core businesses. Further, it is eyeing sales in the final year of the new 3-Year Management Plan, that starts from FY3/16, above the ¥100bn mark.

In its pharmaceutical network business, a steady trend is progressing for consolidation by large players within the domestic 57,000 pharmacies, with it expected that operating conditions for small- and medium-sized pharmacies to become increasingly harsher going forward. Against this background, it is expected that demand for the Company's network service, as one that leads to operational support for small- and medium-sized pharmacies, will expand going forward. As noted above, in Q2 the rate of increase in member numbers was accelerating, and given the fact alone that there is also the potential for these indications too start to appear, attention will focus on future trends.

Domestic Pharmacy Numbers & Top 10 Player Market Share



Source: Pharmacy numbers from Ministry of Health, Labour and Welfare. Top 10 players are AIN PHARMACIEZ INC., Nihon Chouzai Co., Ltd., SOGO MEDICAL CO., LTD., Qol Co., Ltd., Medicis,Inc. , HANSHIN Dispensing Pharmacy Co.,Ltd. , Aisei Pharmacy Co., Ltd. , Tokai Pharmacy Corporation, Pharmarise Holdings Corporation, and Medical Ikkou Co., LTD.

On the other hand, in dispensing pharmacy business the strategy is to steadily expand stores while promoting M&A centered around the major metropolitan areas. How to efficiently tackle home care operations that are expected to expand in the future is seen as holding the key to earnings. However, apart from employing M&A to bring into the Group Medical Brain that is proactively engaging in home care operations, the Company also possesses within the Group subsidiaries undertaking training, and by strengthening HR development we feel will promote strengthening of home care operations.

Also, in its rental and medical facility-related business, the Company is proactively tackling EHSS (elderly housing with supportive services). It is a new proposition that combines medical treatment and nursing care in a "seniors housing + medical mall + dispensing pharmacy" + "hospital" format with it expected that demand will expand further in the future as domestically we face a super aging society. It is expected that by engaging in this business, it wants, in respect of EHSS, to continue to gauge conditions, and undertake new sites at a pace of 1-2 buildings per annum, the result will be synergistic benefits with the dispensing pharmacy and other businesses.

Financial Position

Continuing a business expansion strategy that takes advantage of financial leverage under the low interest rate regime

The Company's end-September 2014 financial position is as set out in the chart below. Total assets declined ¥254mn y-o-y to ¥42,859mn, with an examination of the major factors for the fluctuation revealing a decline in cash and deposits of ¥1,057mn, while land increased ¥477mn.

At the same time, liabilities declined ¥416mn year-on-year to ¥37,344mn. Current liabilities declined while fixed liabilities grew, however, this was mainly due to a shift in borrowing at TMS (Total Medical Service) from short-term to long-term, with other changes including declines in accounts payable and accrued taxes payable in the order of ¥308mn and ¥221mn respectively offering no significant variation. Additionally, net assets rose ¥162mn y-o-y to ¥5,514mn mainly as a result of increases in retained earnings.

Within management indicators reflecting stability, while the shareholders' equity ratio improved slightly to 12.3%, the Company's ratio of interest bearing liabilities remains at a high level, with no change in management's policy of promoting a strategy of business expansion that takes advantage of financial leverage under current low interest rates.

Consolidated Balance Sheet

(¥mn)

	FY3/14	FY9/14	Chg JPY	Reason for change
Current assets	10,941	10,130	-811	Trade receivables (+66)、Merchandise inventory (+314)
(Cash & deposits)	3,106	2,048	-1,057	
Fixed assets	32,172	32,729	556	Land (+477)
(Goodwill)	12,253	12,454	201	
Total Assets	43,114	42,859	-254	
Current liabilities	24,879	20,388	-4,491	Trade payables (▲308)
Fixed liabilities	12,881	16,956	4,074	
(Interest bearing debt)	22,011	22,276	264	
Total liabilities	37,761	37,344	-416	
Total net assets	5,352	5,514	162	Retained earnings (+120)
Key operational indicators				
(Safety)				
Current ratio (Current assets/ Current liabilities)	44.0%	49.7%		
Equity ratio (Total equity/Total assets)	11.9%	12.3%		
D/E ratio (Interest bearing debt/Total equity)	433.3%	425.0%		

Shareholder Returns

Sharp share price declines post-results announcement, improvements in profitability to be re-evaluated

The Company's shareholder return policy is based on rewarding shareholders by way of dividends. Its basic policy is to pay stable dividends that reflect the Company's results, after securing sufficient internal reserves to strengthen its financial position, expand operations and effect human resource development. The Company plans a payout ratio in the order of 27% for FY3/15, with a dividend of ¥8 (the interim and final dividends being ¥4 each), unchanged from the previous year.

Following its FY3/14 results announcement, the Company's share price declined sharply, and is trending in ¥300s level. The reasons for the decline in the share price are thought to be the emergence of negative news, including the results of purchase pricing negotiations with pharmaceutical wholesalers, the fact that FY3/14 results were below the Company's plan. In addition, a temporary leveling off in revenue in respect of the FY3/15 results outlook also due to the withdrawal by one large counterparty in the pharmaceutical network business, and the prospect of lower profits in the dispensing pharmacy business in line with drug price revisions affected negatively.

However, as noted above, in its network business the impact from the withdrawal of one large trading counterparty was negligible, and given that the increase in the number of new member pharmacies is accelerating, and that entering into Q2 improvement in profitability in its dispensing pharmacy business has been confirmed, it is expected that a trend will emerge to re-appraise the Company's future growth strategies.

Share Price (¥) Chart for Medical System Network

Consolidated Income Statement

(¥mn, %)

	FY9/11	FY3/12	FY3/13	FY3/14	FY3/15E
Sales	46,508	25,410	54,827	66,181	76,013
(y-o-y)	13.1	-	-	20.7	14.9
COGs	30,291	16,450	35,415	43,444	47,915
% sales	65.1	64.7	64.6	65.6	63.0
SG&A	13,954	7,602	17,365	20,645	25,694
% sales	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)	48.0	-	-	2.2	15.0
(% sales)	4.9	5.3	3.7	3.2	3.2
Non-operating profit	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)	61.0	-	-	5.6	9.9
(% sales)	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)	50.5	-	-	-7.2	-
(% sales)	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 interests	146	77	133	29	-
Net profit	1,001	518	756	668	706
(y-o-y)	111.5	-	-	-11.6	5.6
(% sales)	2.2	2.0	1.4	1.0	0.9
[Major Indices]					
Shares outstanding (Thousands)	6,492	6,492	25,968	23,888	-
EPS (JPY)	38.56	19.97	29.12	27.74	29.55
Dividend per share (JPY)	6.25	3.75	8.00	8.00	8.00
BPS (JPY)	187.98	201.93	222.86	214.70	-
Cashflow per share (JPY)	75.96	40.42	80.25	100.21	-
Payout ratio (%)	16.2	18.8	27.5	28.8	27.1

Note 1: Due to a change in the accounting period FY3/12 is an irregular 6-month set of accounts.
Note 2: Shares outstanding excludes treasury shares.
Note 3: Per share data has been restated retrospectively to account for stock splits (April 2012 2-for-1, June 2-for-1).
Note 4: Cashflow per share is calculated as follows: (Net profit+depreciation expense+goodwill amortization)/Total number of shares outstanding less treasury shares (using the period average number of shares)

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