Medical System Network
4350 Tokyo Stock Exchange First Section

14-Jul.-16

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Achieved record highs in FY3/16, with double-digit increases in sales and profits

Medical System Network <4350> (hereafter, also "the company") is engaged in two main businesses: the dispensing pharmacy business, and the pharmaceutical network business that caters to small- and medium-sized pharmacies. In the dispensing pharmacy business, the company is promoting its Group expansion strategy through proactively conducting M&As. It is aiming for consolidated net sales of approximately ¥300bn in 10 years.

In the FY3/16 consolidated results, net sales increased 16.1% year-on-year (y-o-y) to ¥87,715mn, and operating profit rose 43.2% to ¥3,783mn, which were new record highs. The driving force behind these results was that in the dispensing pharmacy business, revenue from existing pharmacies greatly improved from promoting the use of generic pharmaceuticals and improving the efficiency of pharmacy management, while the pharmacy M&As implemented in the previous fiscal year also contributed. In the pharmaceutical network business also, the number of member pharmacies steadily increased by 200 compared to the end of the previous fiscal year to 1,400 pharmacies, and both sales and profits increased.

The outlook for the FY3/17 results is for an increase in sales but a decline in profits, with net sales expected to rise 4.9% y-o-y to ¥92,000mn, but operating profit to fall 13.6% to ¥3,270mn. The factors behind this are that profits will decline in the dispensing pharmacy business due to the effects of the revisions to the medical fees, and also that the temporary factors that caused profits to rise in the previous fiscal year will not be recorded. However, the pharmaceutical network business will benefit from the deterioration of the market environment, as this is expected to accelerate the increase in the number of member pharmacies, which will grow by 350 from the end of the previous fiscal year to 1,750 pharmacies. The company is also implementing measures in the dispensing pharmacy business to respond to the revisions to medical fees, and its policy will be to actively pursue M&As, which it held back from doing in the previous fiscal year. Therefore, looking on a quarterly basis, results are expected to recover after bottoming-out in Q1.

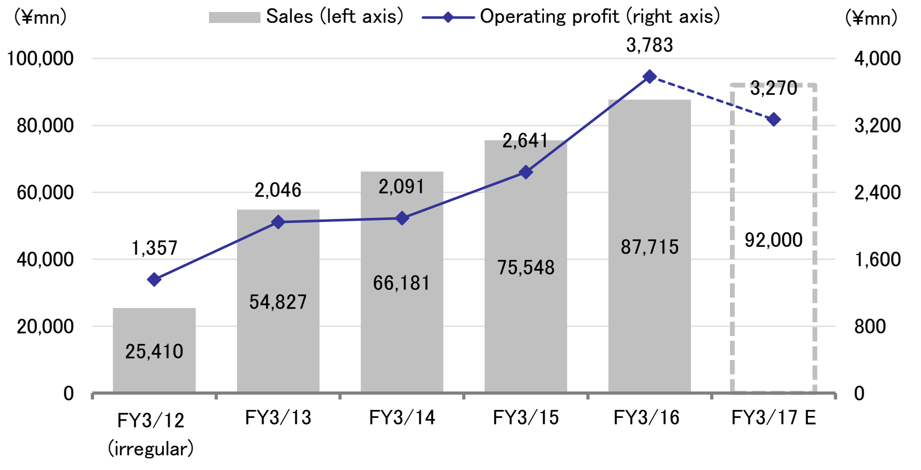
The company is targeting net sales of ¥105,000mn and operating profit of ¥4,000mn in FY3/18, the final year of the 4th Medium-term Management Plan, which would seem to be targets that are sufficiency achievable. Due to the current revisions to medical fees, selection and restructuring will take place in the dispensing pharmacies industry in the context of the increasingly severe management environment, and in addition, demand for the company's pharmaceutical network services is forecast to increase to the next level.

From June 2016, the company plans to start the industry's first prescription drug home delivery service with Japan Post Co., Ltd., and after that, it will launch a shopping support service, including for sanitary products and other daily necessities. Also, while for the time being it will providing these services through its own pharmacies, on considering that at some point it wants to expand them to its member pharmacies, going forward these services can be expected to contribute to an increase in the number of member pharmacies and higher earnings in the pharmaceutical network business.

Check Point

- The two main businesses are the pharmaceutical network business and the dispensing pharmacy business
- The double-digit increases in sales and profits in the dispensing pharmacy business are driving performance
- It will launch the industry's first ever prescription drug home delivery service utilizing Yu-Pack

Consolidated Results Trends

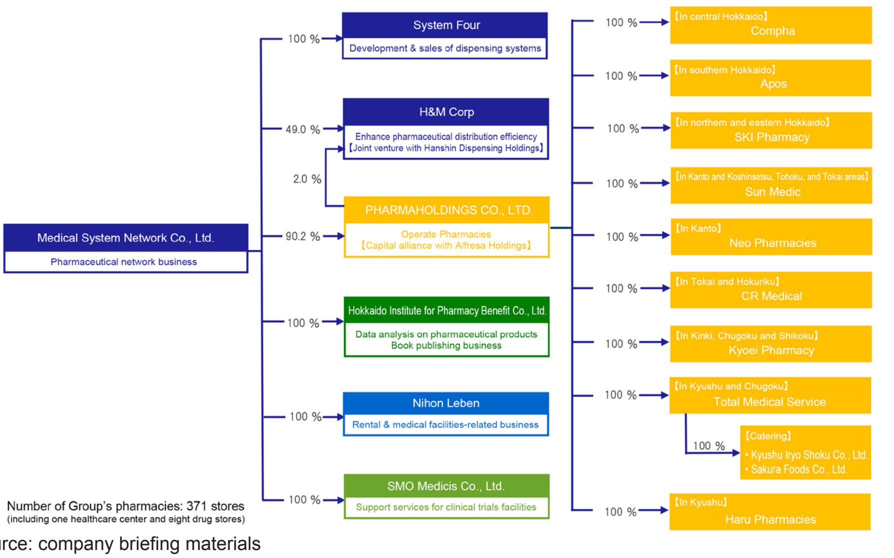


Company Outline

The two main businesses are the pharmaceutical network business and the dispensing pharmacy business

The company has two main businesses; the dispensing pharmacy business and the pharmaceutical network business. It is also undertaking peripheral businesses through its respective subsidiaries, including rental & medical facilities-related business, catering services, and clinical trial facilities support business. The pharmaceutical network business is conducted by the company and its subsidiaries, System Four and H&M, while the dispensing pharmacy business is conducted by Pharmaholdings, its subsidiaries and the Hokkaido Institute for Pharmacy Benefit.

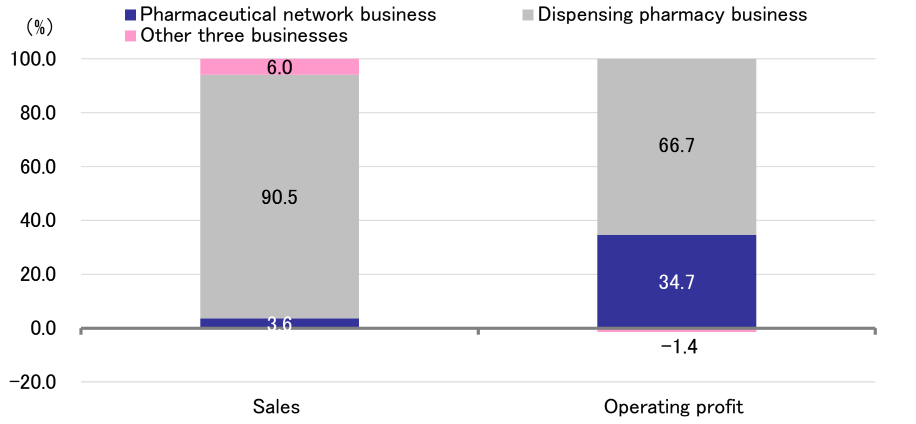
Organization Chart



Source: company briefing materials

Looking at the breakdown by business segment (FY3/16), we see that while the dispensing pharmacy business contributes more than 90% of total net sales, operating profit was 34.7% from the pharmaceutical network business and 66.7% from the dispensing pharmacy businesses, making them the company's two core businesses. An overview of each segment is as described below.

Contribution by Operating Segment (FY3/16)



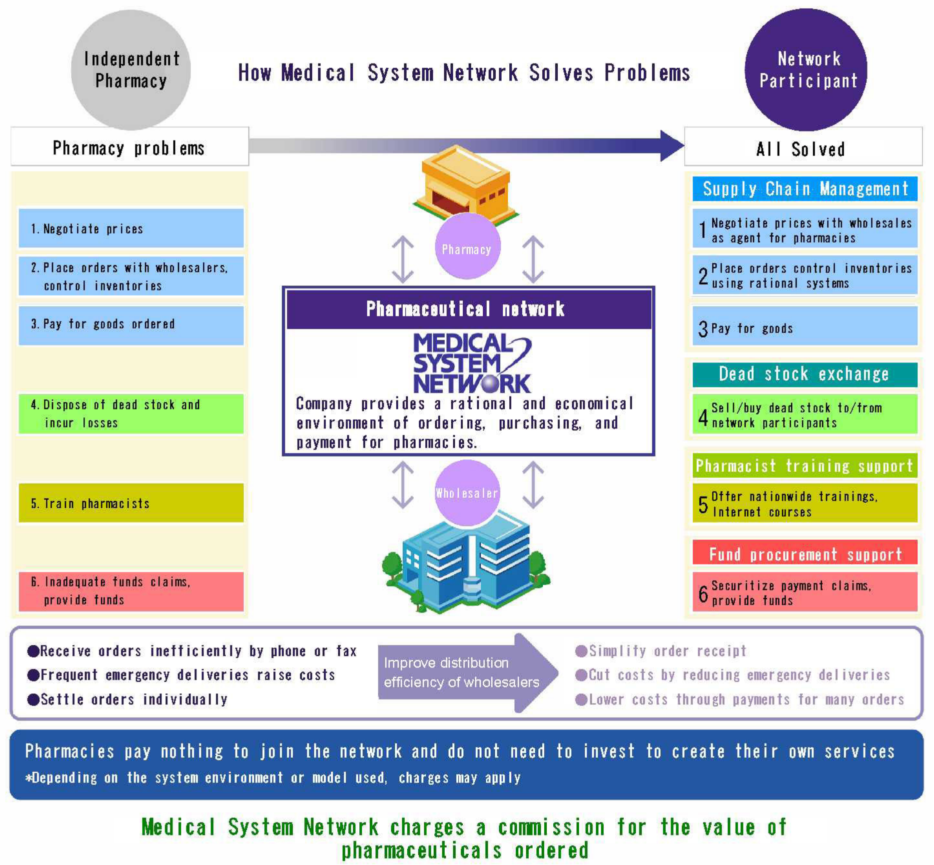
Note: before the offsetting of internal transactions, the other three businesses (rental & medical facilities-related business, catering business, clinical trial facilities support business)
Source: prepared by FISCO from the company' s briefing materials

○Pharmaceutical Network Business

The business model for the pharmaceutical network business is that it supports the improvement of pharmaceutical distribution efficiency by acting as an intermediary in pharmaceutical sales between dispensing pharmacies, medical facilities and pharmaceutical wholesalers. Customers are mainly small- or medium-sized dispensing pharmacies, or those operated by sole traders.

The services the company provides in the pharmaceutical network business are a supply chain management service, in which the company negotiates prices with wholesalers as an agent, orders as an agent, and acts as an agent for account functions, and furthermore it provides a dead stock exchange service (immobile stock liquidation), which allows member pharmacies to exchange dead stock at each of their pharmacies. It also provides support for pharmacist training and for fund raising.

Outline of Pharmaceutical Supply (Network) Business



Source: company materials

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Medical System Network
4350 Tokyo Stock Exchange First Section

14-Jul.-16

By becoming a member of the network, dispensing pharmacies are able to conduct price negotiations with pharmaceutical wholesalers on more favorable terms than if they did so alone. In addition, they can enjoy a number of other operational benefits, such as reducing pharmaceutical disposal losses and simplifying ordering-related work. The benefits of becoming a network member are particularly large for small- to medium-sized dispensing pharmacies.

Also, in its other businesses, the company conducts development, sales and maintenance operations for the receipt computer systems, O/E systems (pharmaceutical ordering system) and peripheral equipment that it installs in dispensing pharmacies, as well as sales of prescription dispensing equipment, fixtures and fittings.

As of the end of March 2016, the total number of member pharmacies in the network, including those in the Group and external members, was 1,400 (including 39 hospitals and clinics) and the number is continuing to increase. The only three prefectures in which the company does not have a presence are Tottori, Tokushima, and Kochi, and it is aiming to have a presence in them as soon as possible. Ordering fees, which arise corresponding to the order volumes, and system sales represent the majority of the sales of this segment, and revenue from ordering fees has become a major source of earnings. Therefore, it can be described as a stock business model in which sales rise stably in line with the increase in the number of member pharmacies.

Breakdown of Contracted Network Store Numbers

(unit: stores)

By member type	FY3/12	FY3/13	FY3/14	FY3/15	FY3/16
General member	631	764	842	855	1,047
MSN Group	223	269	321	345	353
Total	854	1,033	1,163	1,200	1,400

By area	FY3/12	FY3/13	FY3/14	FY3/15	FY3/16
Hokkaido	197	212	216	207	221
Tohoku	63	80	91	93	99
Kanto / Koshinetsu	214	270	298	362	425
Tokai / Hokuriku	96	138	160	182	227
Kinki	150	178	187	131	147
Chugoku / Shikoku	70	77	87	84	86
Kyushu / Okinawa	64	78	124	141	195
Total	854	1,033	1,163	1,200	1,400

Source: prepared by FISCO from company materials

○Dispensing Pharmacy Business

This business develops dispensing pharmacies in each area mainly under the Nanohana Pharmacy brand, and it is expanding its number of Group pharmacies while actively utilizing M&As. As of the end of March 2016, the company had 353 dispensing pharmacies, making it one of the market leaders. By area, it has the most pharmacies in Hokkaido at 115, followed by Kanto and Koshinetsu at 79, and then Kinki at 48. In addition to pharmacies, the company operates eight drug stores and one healthcare center.

Further, its subsidiary, the Hokkaido Institute for Pharmacy Benefit, provides training services to pharmacists and operational staff at both Group and non-Group dispensing pharmacies.

○Rental & Medical Facilities-related Business

The company's subsidiary, Nihon Leben, mainly develops sites for building pharmacies, as well as renting buildings and providing other leasing and insurance services. Further, at the same time as offering consulting services for medical practices, it also provides consulting for medical malls that gather multiple medical disciplines on the same floor, and for medical buildings that gather various medical clinics in the same building, and also management of housing for the elderly with support services.

○Catering Business

Total Medical Service (TMS), which was consolidated as a subsidiary in November 2013, and its subsidiary Sakura Foods and Kyushu Iryo Shoku, engage in catering outsourcing operations within hospitals and welfare facilities. Kyushu Iryo Shoku was newly made a subsidiary in October 2015.

○Other Business

The company's subsidiary SMO Medisys (hereafter, SMO) contracts with clinical trial facilities (medical facilities) as a clinical site management organization to provide support for clinical trials.

Business Trends

The double-digit increases in sales and profits in the dispensing pharmacy business are driving performance

(1) Overview of the FY3/16 Consolidated Results

In the FY3/16 consolidated results announced on May 2, net sales were ¥87,715mn, up 16.1% y-o-y, operating profit was ¥3,783mn, up 43.2%, recurring profit was ¥3,860mn, up 52.0%, and net profit attributable to owners of parent was ¥1,720mn, up 94.3%, and all of these results were record highs. Furthermore, they all exceeded the upwardly revised targets the company announced in January.

Consolidated FY3/16 Results

(¥mn)

	FY3/15		FY3/16				
	Actual	% Sales	Company plan	Actual	% Sales	YoY	vs Plan
Sales	75,548	-	87,300	87,715	-	16.1%	0.5%
COGs	47,072	62.3%	-	54,913	62.6%	16.7%	-
SG&A	25,835	34.2%	-	29,018	33.1%	12.3%	-
Operating profit	2,641	3.5%	3,600	3,783	4.3%	43.2%	5.1%
Recurring profit	2,540	3.4%	3,600	3,860	4.4%	52.0%	7.2%
Extraordinary profit/loss	-246	-	-	-382	-	-	-
Profit attributable to owners of parent	885	1.2%	1,500	1,720	2.0%	94.3%	14.7%

Note: company plans are the revised forecasts announced on January 29, 2016
Source: prepared by FISCO from the company's financial reports summary

The driving force behind the record results in this fiscal period was the dispensing pharmacy business, which contributed approximately 84% of the increase in net sales and around 91% of the increase in operating profit. Existing pharmacies obtained higher dispensing technical fees from promoting the use of generic pharmaceuticals and strengthening measures for home care services, while pharmacy management was made more efficient, including through the optimal placement of personnel. These efforts particularly improved profitability in the Honshu area and contributed to the higher profits.

Looking at the breakdown of the main factors causing operating profit to rise and fall, in the dispensing pharmacy business, the higher profits from existing pharmacies contributed ¥764mn and the pharmacy M&As implemented in FY3/15 added ¥279mn, and from these and other factors, profits from this business as a whole rose ¥1,035mn. In the pharmaceutical network business also, profits increased ¥226mn from the growth in the number of new members, while the rental & medical facilities-related business contributed ¥103mn to profits from the recording of a gain on the divestment of real estate for sale (¥242mn). Conversely, the catering business decreased ¥76mn, and there was a decline from the clinical trial facilities support business of ¥33mn.

Reasons for OP Fluctuations (FY3/16, YoY)

(¥mn)

Category	Amount Change	Category	Amount Change
Dispensing pharmacy business	1,035	Pharmaceutical network business	226
(breakdown of change in OP)		Rental & medical facilities-related business	103
Existing stores	764	Catering business	-76
Stores opened FY3/15	102	Other business	-33
M&A FY3/15	279	Group expenses (adjusted)	-113
Stores opened FY3/16	-132		
M&A FY3/16	12		
Stores closed	76		
Headquarters' expenses	-66	Total	1,142

Source: prepared by FISCO from the company's briefing materials

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Medical System Network
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14-Jul.-16

The pharmaceutical order volume greatly increased, by 26.6% y-o-y, due to growth in the number of member pharmacies and the launch of a hepatitis C treatment drug with a high drug price

(2) Trends by Operating Segment

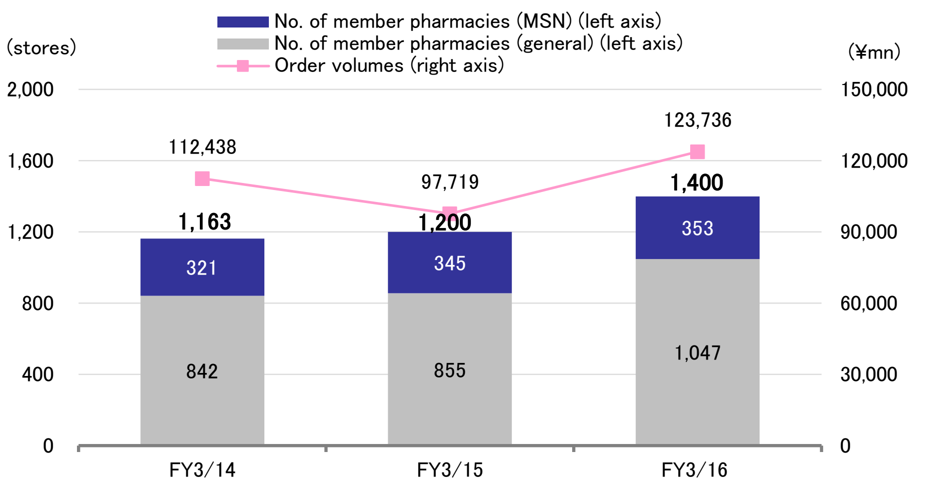
○Pharmaceutical Network Business

Results trended positively in this business, with net sales increasing 15.0% y-o-y to ¥3,235mn, and operating profit rising 14.6% to ¥1,776mn. Network member numbers increased by 200 compared to the end of the previous fiscal year to 1,400 members. Although this was below the target number of 1,485, it is still a record high increase of 92 new member companies, so new member numbers continue to trend strongly. Breaking down the increase in members, the number of pharmacies in the company's Group rose by 8 compared to the end of the previous fiscal year to 353 pharmacies, while general member pharmacies increased by 192 to 1,047 pharmacies. In terms of this rise in the number of general member pharmacies by area, in descending order, the number increased by 59 in Kanto and Koshinetsu, by 53 in Kyushu and Okinawa, and by 43 in Tokai and Hokuriku, and these 3 areas accounted for approximately 80% of the increase. The pharmaceutical order volume also greatly increased, rising 26.6% y-o-y to ¥123,736mn, from the growth in the number of member pharmacies and the launch of a hepatitis C treatment drug with a high drug price.

The factors behind the increase in the number of member pharmacies include that the business environment for small- and medium-sized dispensing pharmacies is becoming more and more severe each year, and therefore the benefits from becoming a member of the company's network are growing greater. In addition, in January 2015 the company formed a business alliance with Fuyo General Lease Co., Ltd. <8424> and newly launched a pharmaceutical purchase price repayment service, which is having a considerable effect on member numbers. The payment period for the pharmaceutical purchase price was determined to be two months as a condition to become a member of the company's pharmaceutical network services. But as it is normally three months for many small- and medium-sized pharmacies, when these pharmacies become members they incur temporary costs due to this shortening of the payment period. The pharmaceutical purchase price repayment service entails Fuyo General Lease paying in bulk the pharmaceutical purchase prices of members during their first month of membership, and they subsequently repay the amounts advanced to them in installments (over 3 to 5 years). This greatly reduces the financial burden placed on new members. From February 2015, when the service was launched, through to April 28, 2016, membership applications were received from 36 companies operating 125 pharmacies.

Breaking down the net sales, ordering fee income increased approximately 19% y-o-y to ¥1,913mn alongside the growth in the pharmaceutical order volume, while system sales and other sales also both increased from the rise in the number of member pharmacies.

Member Pharmacy Numbers & Order Volumes



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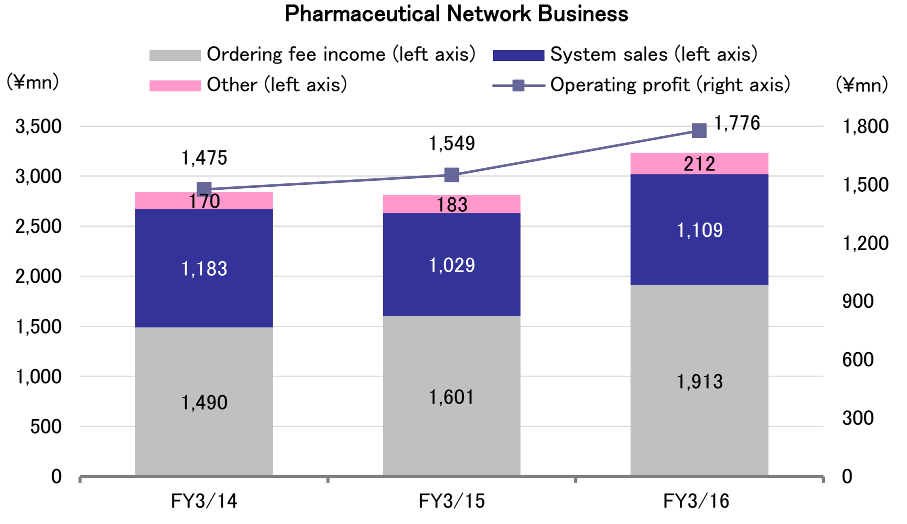


Source: prepared by FISCO from company materials

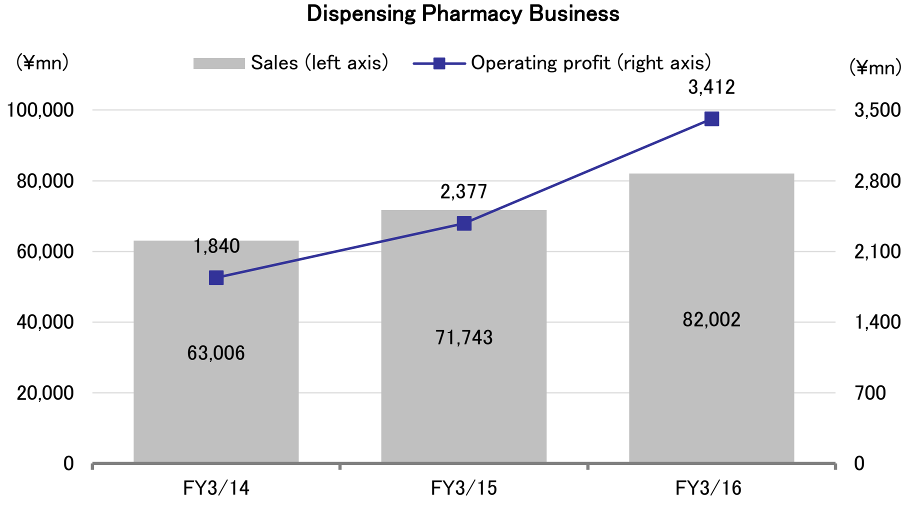
○Dispensing Pharmacy Business

In this business, net sales grew 14.3% y-o-y to ¥82,002mn and operating profit increased 43.5% to ¥3,412mn, for double-digit increases in both sales and profits, while the operating profit margin rose 0.9 of a percentage point. The number of pharmacies increased by 8 compared to the end of the previous fiscal year for a total of 353 pharmacies, which was from 9 new pharmacy openings and 7 M&A pharmacies, while 8 existing pharmacies were closed. The pace of the increase in the number of pharmacies has slowed greatly compared to the increases of 52 pharmacies 2 fiscal years ago and 24 pharmacies in the previous fiscal year. This is because the prices of M&A projects have remained high, and also that during this fiscal year, the company deliberately refrained from acquiring pharmacies by M&As in anticipation of the effects of investment and the softening of demand in the M&A market following the revisions to medical fees in the spring of 2016. In fact, the number of pharmacies acquired through M&As in this fiscal period was 7, compared to 45 2 fiscal periods ago and 27 in the previous fiscal period.

In this situation, the factors behind the major growth in net sales, of up 14.3% y-o-y, were that existing pharmacies' dispensing fees (net sales) rose 8.5%, and also from the full fiscal year contributions of the newly opened pharmacies and pharmacies acquired through M&As in FY3/15. Looking at the breakdown in the growth rate of existing pharmacies' dispensing fees, the number of prescriptions increased 1.6% and prescription unit prices rose 6.8%, and this growth in prescription unit prices contributed greatly. Breaking this down, drug fees rose 8.0% and technical fees increased 3.0%, both of which were the highest growth rates in the last 4 years. The factors behind the higher drug fees include the tendency to purchase an increasing amount per single prescription, and in addition, the launch in this fiscal year of a hepatitis C treatment drug with a high drug price.

On the other hand, the higher technical fees were due to an increase in the number of pharmacies eligible for incentive points from promoting the use of generic pharmaceuticals and strengthening measures for home prescriptions. Looking at this situation in more detail, the percentage of pharmacies that were eligible for generic pharmaceuticals dispensing incentive points from among all pharmacies rose from 77.1% at the end of the previous fiscal year to 84.4% at the end of this fiscal year. In the Basic Dispensing Incentives also, which indicate the eligibility conditions for factors such as home care services and a 24 hour dispensing system, the ratio of pharmacies eligible for the Basic Dispensing Incentive 2 category, which provides a higher number of points, rose from 24.1% at the end of the previous fiscal year to 29.7% at the end of this fiscal year. The number of pharmacies providing home care services increased from 227 at the end of the previous fiscal year to 279 at the end of this fiscal year, reaching 79% of all pharmacies.

The factors resulting in the higher operating profit was this increase in dispensing fees from existing pharmacies, and also the contribution of measures to improve management efficiency at pharmacies, including the appropriate deployment of personnel. Profitability particular improved at the three subsidiaries of Sun Medic, Kyoei Pharmacy, and CR Medical, which are responsible for operations in Honshu.



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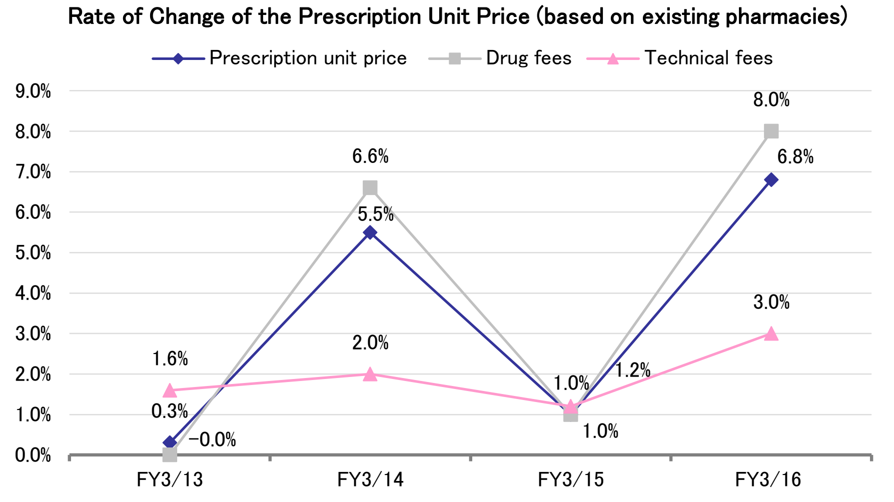

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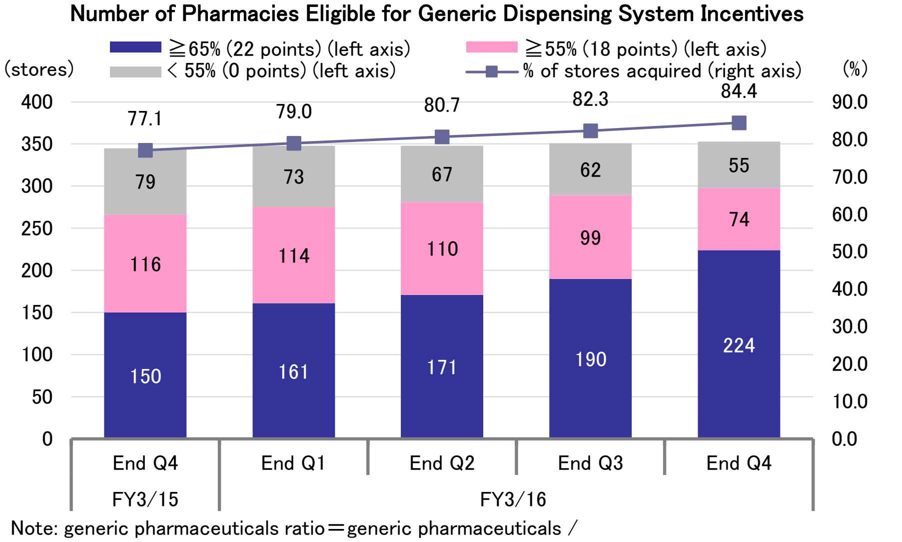
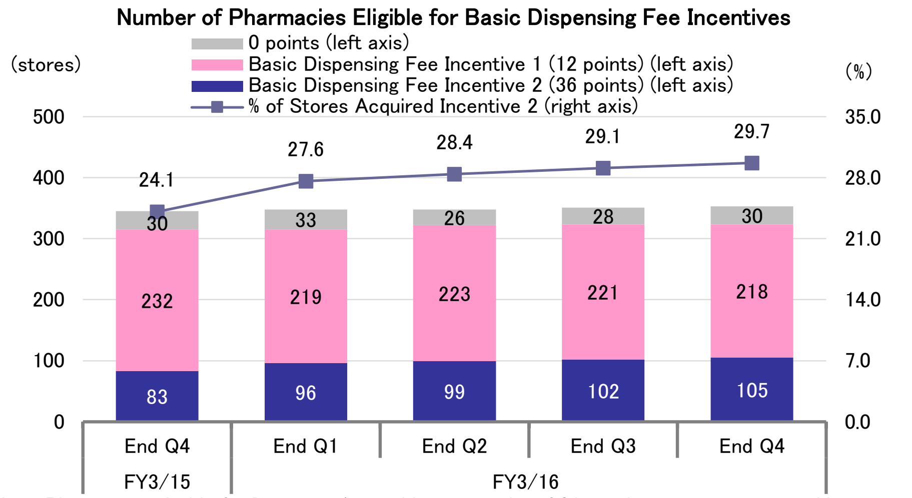


Note: generic pharmaceuticals ratio = generic pharmaceuticals / (the forerunner pharmaceuticals of the generic pharmaceuticals + generic pharmaceuticals)
Source: prepared by FISCO from the company's briefing materials



Note: Pharmacies eligible for Incentive 1 are able to provide a 24 hour dispensing system and home care services independently or in collaboration with neighboring pharmacies, while pharmacies eligible for Incentive 2 are able to provide a 24 hour dispensing system and home care services independently.

Source: prepared by FISCO from the company's briefing materials

○Rental & Medical Facilities-related Business

In this business, net sales increased 60.2% y-o-y to ¥2,430mn and operating profit rose 409.3% to ¥129mn. The main reason for the increase in profits was the recording of a gain on the divestment of real estate for sale. Also, the number of tenancy agreements in housing for the elderly with support services at Wisteria Kiyota (in Kiyota Ward, Sapporo), which began operations in May 2013, reached 70 out of a total of 75 units at the end of March and became profitable, which contributed to the higher profits. The business would have been unprofitable if excluding the gain on the divestment of real estate, but this was due to an increase in start-up costs and labor costs for two facilities; Wisteria Otaru Inaho, which opened in December 2015, and Wisteria Senri Chuo, which opened in May 2016. The number of tenants at Wisteria Otaru Inaho was 72 out of a total of 81 units at the end of March, while as of April 28, there had been 11 applications for the 82 units at Wisteria Senri Chuo.

○Catering Business, Other Business

In the Catering business operated by the subsidiary TMS, net sales rose 46.5% y-o-y to ¥2,830mn, while the operating loss was ¥89mn (compared to a loss of ¥13mn in the previous fiscal year). While sales increased after Kyushu Iryo Shoku was made into a subsidiary in October 2015, profits were adversely affected by the losses made in the two new projects in Metropolitan Tokyo commissioned in the previous fiscal year, as they are still covering launch costs.

In the other business (clinical trial facilities support business), due to the decline in new projects, net sales fell 21.5% y-o-y to ¥143mn, and the operating loss was ¥109mn (compared to a loss of ¥76mn in the previous fiscal year).

Results Outlook

The outlook is for profits to decline in the dispensing pharmacy business due to factors including the revision to medical fees

(1) FY3/17 Results Outlook

The outlook for the FY3/17 consolidated results is for an increase in sales but decreases in profits, with net sales to rise 4.9% y-o-y to ¥92,000mn, but operating profit to fall 13.6% to ¥3,270mn, recurring profit to decline 19.7% to ¥3,100mn, and net profit to decrease 29.7% to ¥1,210mn. Profits will fall in the dispensing pharmacy business from the effects of the revisions to medical fees, and in addition, the lower profits will be a reaction to the recording of temporary profits in the previous fiscal period. These temporary profits included a ¥242mn gain from the divestment of real estate for sale, ¥100mn subsidy income (non-operating income) on the launch of housing for the elderly with support services, and ¥90mn of tax effects following the acquisition of shares of a subsidiary, and these factors contributed to net profit attributable to owners of parent rising to ¥436mn in FY3/16. If we look at the situation once these temporary factors have been excluded, the outlook is for net profit attributable to owners of parent to decline in the region of 6% in this fiscal period.

Also, looking on a fiscal half-year basis, a major decline in profits in 1H is expected to change to increases in sales and profits in 2H, and the target is for the operating profit margin to exceed the level of the previous fiscal year of 4.9%. This will be from implementing measures in the dispensing pharmacy business to respond to the revisions to medical fees and to improve profitability, and also through actively opening new pharmacies and conducting M&As. In addition, in the pharmaceutical network business, the pace of the increase in member numbers is expected to accelerate from 2H onwards. In a typical year, the negotiations for purchase prices with pharmaceutical wholesalers are concluded in September, but negotiations in this fiscal year are expected to be fiercer than usual due to the implementation of an overall reduction in drug prices of around 6%, and in this context, an increasing number of small- and medium-sized pharmacies are expected to join the company's network. Looking at the situation at the present time, as of May 2, there had already been an increase of 87 pharmacies compared to the end of the previous fiscal year.

FY3/17 Consolidated Results Outlook

(¥mn)

	FY3/16	FY3/17 (E)					
	Full fiscal year	1H	YoY	2H	YoY	Full fiscal year	YoY
Sales	87,715	44,500	5.7%	47,500	4.1%	92,000	4.9%
Operating profit	3,783	950	-45.8%	2,320	14.2%	3,270	-13.6%
(operating profit margin)	4.3%	2.1%		4.9%		3.6%	
Recurring profit	3,860	850	-51.4%	2,250	6.5%	3,100	-19.7%
Net profit attributable to owners of parent	1,720	160	-79.2%	1,050	10.4%	1,210	-29.7%

Source: prepared by FISCO from financial reports summary

Outlook for Recurring Profit Fluctuations (FY3/17, YoY)

(¥mn)

Category	Amount Change	Category	Amount Change
Dispensing pharmacy business	-445	Pharmaceutical network business	105
(breakdown of change in RP)		Reaction to temporary factors	-432
Effects of revisions to drug prices	-425	Others	12
Effects of revisions to dispensing fees	-379		
Increase in personnel cost at existing pharmacies	-351		
Increase in the number of prescriptions at existing pharmacies	363		
FY3/16 pharmacy openings and M&A	220		
FY3/17 pharmacy openings and M&A	127	Total	-760

Source: prepared by FISCO from the company's briefing materials

(2) Outlook by Segment

Results Outlook by Segment

(¥mn)

Sales	FY3/16	FY3/17 (E)	Chg %
Pharmaceutical network business	3,235	3,421	5.7%
Dispensing pharmacy business	82,002	84,325	2.8%
Other 3 businesses	5,404	7,000	29.5%
Adjustments	-2,926	-2,748	-
Total	87,715	92,000	4.9%

Operating profit	FY3/16	FY3/17 (E)	Chg %
Pharmaceutical network business	1,776	1,886	6.2%
Dispensing pharmacy business	3,412	3,033	-11.1%
Other 3 businesses	-70	-214	-
Adjustments	-1,335	-1,434	-
Total	3,783	3,270	-13.6%

Source: prepared by FISCO from the company's briefing materials

○Pharmaceutical Network Business

In this business, the outlook is for net sales to increase 5.7% y-o-y to ¥3,421mn and operating profit to rise 6.2% to ¥1,886mn. Network member numbers are expected to grow by a record 350 compared to the end of the previous fiscal year, to 1,750 members. In the context of the dispensing pharmacies industry's increasingly severe market environment, the benefits to becoming a member of the company network member are growing, and so the number of member pharmacies is forecast to further increase in the future. In order to steadily capture these needs, the company is developing a region-specific sales structure through the introduction of an area system. Its policies are also to aim to strengthen the promotion of generic pharmaceuticals, enhance support for member pharmacies, and to improve network services.

The fact that net sales will only increase by a single digit, despite the fact that it is assumed that member numbers will increase greatly, would seem to be due to factors such as the impact of the reduction in drug prices and that the acceleration of the pace of increase of members will occur in 2H. Also, if member numbers increase as targeted, there would seem to be plenty of room for net sales to rise above the forecast.

○Dispensing Pharmacy Business

In this business, the forecast is for net sales to increase 2.8% y-o-y to ¥84,325mn and operating profit to decline 11.1% to ¥3,033mn. The priority measures for this fiscal year will be "Actively opening new pharmacies and conducting M&As" and "Strengthening the responses to the revisions to medical fees and the functions of existing pharmacies."

The company is targeting a total increase of 40 pharmacies in this fiscal period, 10 from new pharmacy openings and 30 from M&As. As previously described, acquisitions where kept down in the previous fiscal year because M&A prices had increased, but after the revisions to medical fees, the number of M&A sale projects is increasing and therefore the sales prices are trending downward. In fact, compared to the previous fiscal year, the number of proposals being brought to the company seems to be increasing significantly, so it can be said that an environment is in place for it to actively carry out M&As. The company pursues acquisitions through M&As by targeting proposals from which it can acquire dominance via pharmacies with specific characteristics (such as having home care services and nursing care coordination). In addition, its policy is to build a development format (including multi-functional pharmacies with an emphasis on the community function) based on the revisions to medical fees. As of June 1, the number of dispensing pharmacies had risen by 21 compared to the end of the previous fiscal year, to 374 pharmacies.

On the other hand, in terms of its responses to the revisions to medical fees, the company is reviewing the management of pharmacies as family pharmacies and taking various other steps, including promoting the use of generic pharmaceuticals and reducing the prescription concentration ratio (reducing the concentration ratio on specific medical facilities by promoting family pharmacies). In the April revision to the medical fees, the family pharmacist guidance fees were newly established, and additionally, the revisions were harshest for those pharmacies with high prescription concentration ratios, and by taking these steps, the company will minimize the negative impact.

Also, toward strengthening the functions of existing pharmacies, as it has established the foundations of family pharmacies in local communities, the company is implementing measures for its pharmacies to support health maintenance and disease prevention among the members of local communities as "health support pharmacies." This includes holding nutrition consultations by dietitians and consultations on medications, and also the delivery of online yoga videos for health maintenance.

Looking at the increase and decrease factors for operating profit in this fiscal year, the revisions to the medical fees and the reduction in drug prices will cause profits to fall ¥379mn and ¥425mn respectively. Also, in order to train and recruit more family pharmacists and other personnel, personnel costs at existing pharmacies are expected to increase ¥351mn. Conversely, for the profit increase factors, the rise in the number of prescriptions is expected to contribute ¥363mn, new pharmacy openings and pharmacies acquired through M&As in FY3/16 to add ¥220mn, and similarly, new pharmacy openings and pharmacies acquired through M&As in FY3/17 to contribute ¥127mn. On an existing pharmacies basis, the forecasts are premised on that the number of prescriptions will be basically unchanged y-o-y, at up 1.6%, and that unit prices will decline 6.1% from the effects of the revisions to the drug prices.

○Other Three Businesses
In the other three businesses, of the rental & medical facilities-related business, the catering business, and the other business, net sales are forecast to increase 29.5% y-o-y to ¥7,000mn and the operating loss is expected to be ¥214mn (compared to a loss of ¥70mn in the previous fiscal year).

A double-digit increase in net sales is expected in the catering business from the full-fiscal year contribution to sales of Kyushu Iryo Shoku, which was made a subsidiary in the previous 2H. However, the operating loss is forecast to increase due to the elimination of the gain on the divestment of real estate (¥242mn) that was recorded in the rental & medical facilities-related business in the previous fiscal year. The catering business and clinical trial facilities support business are also expected to record losses in this fiscal year, with FY3/18 being targeted as the period for them to become profitable.

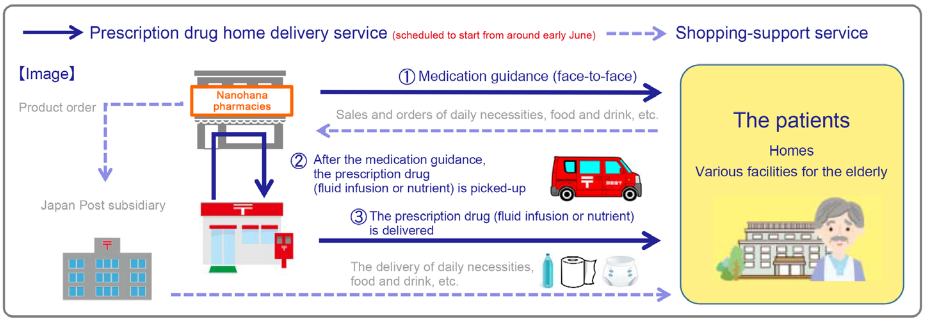
It will launch the industry's first ever prescription drug home delivery service utilizing Yu-Pack

(3) A joint business with Japan Post

In May 2016, the company announced that it was to cooperate with Japan Post to launch the industry's first home delivery service for prescription drugs using Yu-Pack. More specifically, when pharmacists at the company's directly managed Nanohana pharmacies fills a home prescription, after they complete the medication guidance, the post office will pick-up the relevant prescription drug from the dispensing pharmacy and deliver it by Yu-Pack to the home or residential facility of the home-care patient. The plan is to first start the service from June 2016 in some areas of Sapporo and Nagoya Cities. In terms of the merits of this service for the pharmacies, it will enable a system to be constructed in which the work load of pharmacists is reduced in terms of them making home visits, and also in which the pharmacists can concentrate on their main work duties, such as providing guidance on medications.

A Joint Initiative with Japan Post

■ Further improving the quality of the home care services on which the Nanohana pharmacies are focusing through Japan Post Group's "home delivery function" and "product sales function"



< Prescription drug home delivery service>

【Central area】
Sapporo, Nagoya

【Flow】
1. The pharmacist visits the patient's home and provides medication guidance
2. The prescription drug is delivered by Yu-Pack to the patient's home or residential facility

【Merits】
The construction of a system in which the work load of pharmacists is reduced in terms of them making home visits, and also in which the pharmacists can concentrate on their main work duties, such as providing guidance on medications.

【Items to be delivered】
The service will start limited to heavy items within prescription drugs, like fluid infusions and nutrients.
⇒ While establishing the management system, the plan is to gradually expand the scope of deliveries to other prescription drugs, such as internal medications.

<Shopping-support service >
In conjunction with the prescription drug home deliveries service, through the online sales function of a Japan Post subsidiary, the plan is to develop a shopping-support service for the sale and delivery to home patients of various products, including sanitary products and other daily necessities, drinks, and health foods.

Source: the company's financial results briefing materials

In terms of the items to be delivered, at the start deliveries will be limited to heavy items within prescription drugs, like fluid infusions and nutrients, and while establishing the management system, the plan is to gradually expand the scope of deliveries to other prescription drugs, such as internal medications. Also, in conjunction with the prescription drug home deliveries service, the plan is to develop a shopping-support service for the sale and delivery of various products, including sanitary products and other daily necessities, drinks, and health foods. For the time being, the service will be provided by the pharmacies within the company Group, but the goal is for both these services to be eventually provided in the same way by pharmaceutical network member pharmacies. If network member pharmacies are also able to provide this prescription drug home delivery service within their home care services, it can be expected to lead to a further increase in the number of member pharmacies and growth in profits in the pharmaceutical network business.

Focusing on "Expanding the pharmaceutical network" and "Enhancing the functions of community pharmacies"

(4) The Medium-term Management Plan

The company announced its 4th three-year Medium-term Management Plan in May 2015. In a situation where the issues of providing medical care and nursing are becoming increasingly serious because of the aging of society, the company is focusing on "Expanding the pharmaceutical network" and "Enhancing the functions of community pharmacies," and its policy is to aim to achieve further growth as a company that supports medical care in local communities.

The 4th Medium-term Management Plan

Basic Policy
1. Invest resources in the pharmaceutical network, strengthen sales to small- and medium-sized pharmacies, and expand member pharmacies by providing new services.
2. Further strengthen existing measures, including for medical safety, customer reception, medication guidance, home care, and the reduction of waiting times, and establish the "Nanohana Standard" at an even higher level at every store.
3. Enhance to the greatest possible extent medical care, nursing, and preventative functions that are required within the holistic regional care system in accordance with conditions at existing stores, and develop new stores as next-generation pharmacies to provide customers with a full package.
4. Further strengthen support for doctors' medical practices to accelerate the construction of medical malls by attracting medical institutions to existing stores.
5. Aim to thoroughly implement cost controls with an eye to future revisions to medical fees

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

The company's management targets for the Plan's final year of FY3/18 are sales of ¥105,000mn and recurring profit of ¥3,800mn. It already achieved the recurring profit target in FY3/16, but it fell temporarily in FY3/17, so this target value has not been changed. If the FY3/17 results are as planned, at FISCO we think that these target values are fully achievable.

FISCO

Medical System Network
4350 Tokyo Stock Exchange First Section

14-Jul.-16

There are around 50,000 dispensing pharmacies nationwide in Japan, and within this number, the share of the major 6 dispensing pharmacy companies is less than 10%. Going forward, the market environment will become more and more severe due to factors like the increase in social security expenses, and it is possible that the selection and restructuring of small- and medium-sized dispensing pharmacies will accelerate. In this sort of environment, the company has significant growth potential, as with over 1,400 pharmacies, including network member pharmacies, it is an industry leader in terms of the number of pharmacies and pharmaceutical order volume, and it is expected to continue to achieve sustainable growth in the future.

Medium-term Management Plan Targets

(¥mn)

	FY3/15	FY3/16	FY3/17(E)	FY3/18 target
Sales	75,548	87,715	92,000	105,000
Pharmaceutical network business	2,814	3,235	3,421	3,600
Dispensing pharmacy business	71,743	82,002	84,325	99,500
Operating profit	2,641	3,783	3,270	4,000
Pharmaceutical network business	1,549	1,776	1,886	2,200
Dispensing pharmacy business	2,377	3,412	3,033	3,000
Recurring profit	2,540	3,860	3,100	3,800
Recurring profit margin	3.4%	4.4%	3.4%	3.6%
Net profit attributable to owners of parent	885	1,720	1,210	1,500
The number of member pharmacies in the pharmaceutical network business	1,200	1,400	1,750	2,200
The number of pharmacies	345	353	385	500

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

■ Financial Position

The equity ratio rose from 12.7% to 20.3% from increased capitalization and the disposal of treasury stock

Looking at the financial position at the end of March 2016, total assets were up ¥3,259mn compared to the end of the previous fiscal year to ¥48,847mn. The main reason for this was that the declines in cash and deposits and goodwill of ¥417mn and ¥297mn respectively were exceeded by an increase of ¥3,003mn in tangible fixed assets following the start of operations for housing for the elderly with support services.

Liabilities were down ¥870mn compared to the end of the previous fiscal year to ¥38,581mn. Interest bearing debt decreased ¥3,181mn, while accounts payable increased ¥926mn, accrued income taxes rose ¥466mn, and lease obligations grew ¥345mn. Net assets rose ¥4,129mn compared to the end of the previous fiscal year to ¥10,265mn. The main factors behind this were increases of ¥1,487mn in retained earnings and ¥2,815mn from the issuance of new shares for a public offering, a third-party allocation, and a disposal of treasury stock.

The company took advantage of the increased capitalization and disposal of treasury stock to reduce interest-bearing debt, and the equity ratio rose from 12.7% in the previous fiscal period to 20.3%, improving its financial position. Going forward, the company has no plans for any major capital investment in the immediate future, so the equity ratio is expected to continue to improve.

Consolidated Balance Sheet

(¥mn)

	FY3/14	FY3/15	FY3/16	Chg
Current assets	10,941	11,023	10,783	-239
(cash & deposits)	3,106	2,499	2,081	-417
Fixed assets	32,172	34,564	38,063	3,499
(goodwill)	12,253	13,214	12,916	-297
Total assets	43,114	45,587	48,847	3,259
(interest-bearing debt)	22,011	22,743	19,562	-3,181
Total liabilities	37,761	39,451	38,581	-870
Total net assets	5,352	6,135	10,265	4,129
Key operational indicators				
(safety)				
Equity ratio	11.9%	12.7%	20.3%	
D/E ratio (interest bearing debt / total equity)	4.29%	3.91%	1.97%	
(profitability)				
Recurring profit to total assets ratio (recurring profit / total assets)	5.5%	5.7%	8.2%	
Shareholders' equity to net profit ratio (net profit / shareholders' equity)	12.2%	16.2%	21.9%	
Operating profit margin	3.2%	3.5%	4.3%	

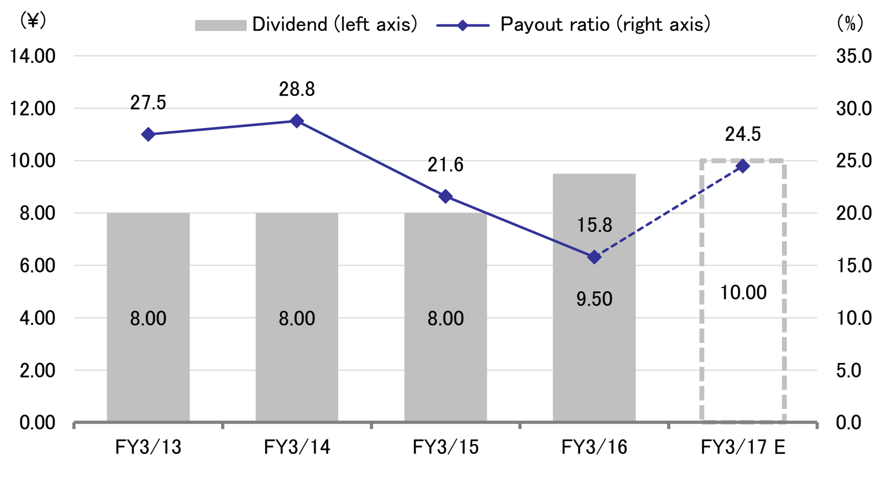
Source: prepared by FISCO from the company's financial reports summary

■ Shareholder Returns

Has set a standard dividend payout ratio of 20% or above

The company's policy is to return profits to shareholders by way of dividends. Its basic policy is to pay stable dividends that reflect results, after securing sufficient internal reserves to strengthen its financial position and to expand operations, with the standard being to maintain a dividend payout ratio of 20% or above. The company plans a dividend payout ratio in the order of 24.5% for FY3/17, with a dividend of ¥10, which will be an increase of ¥0.5 on the previous fiscal year. Dividend growth can be expected if profits continue to increase.

Dividend per Share and Payout Ratio



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