COMPANY RESEARCH AND ANALYSIS REPORT

Medical System Network Co., Ltd.

4350

Tokyo Stock Exchange First Section

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Index

Summary

Hopes to realize double-digit earnings growth in FY3/18 on recovery in the dispensing pharmacy business

Medical System Network Co., Ltd. <4350> (hereafter, also "the Company") operates two main businesses: a pharmaceutical network business that caters to small and mid-sized pharmacies and a dispensing pharmacy business. The increase pace in network members has started accelerating with a tailwind from changes in the environment facing dispensing pharmacy and brings within sight the Company's goal of 5,000 members, which amounts to a market share of about 10%. In dispensing pharmacy business, the Company aims to reach ¥300bn in consolidated sales in 10 years from now through a strategy of expanding the number of stores utilizing M&A.

1. Double-digit profit decline in FY3/17 mainly due to the impact of revisions to dispensing fees and drug prices

In FY3/17 consolidated results announced on May 9, the Company sustained sales growth with a 1.3% YoY rise in net sales to ¥88,865mn, but operating profit dropped sharply by 44.1% to ¥2,113mn. While the main setback was a hefty decline in profits from the dispensing pharmacy business because of impacts from dispensing fee revisions and drug price reductions, earnings were also lower in all other segments, including rental & medical facilities-related business and catering business. Pharmaceuticals network business, meanwhile, expanded at a faster pace than planned with an increase of 370 members to 1,770 members at the end of March. Interest in the Company's network service, which gives a boost to management efficiency, is rising amid an increasingly difficult business environment in the dispensing pharmacy industry, particularly with the growth in membership of larger dispensing pharmacies running 10-20 stores.

2. Aims to rebound to double-digit earnings growth in FY3/18 with the dispensing pharmacy business as a driver

The Company guides for FY3/18 consolidated results with ¥95,000mn in net sales (+6.9% YoY) and ¥3,100mn in operating profit (+46.7%), rebounding to a double-digit increase. The plan expects about 60% of the profit increase from the dispensing pharmacy business on likely manifestation of benefits from responses to dispensing fee revisions. It also factors in a contribution to higher earnings from the pharmaceutical network business with an addition of 430 members YoY to 2,200 members. While it projects continuation of losses in other businesses, the Company hopes to contract losses by implementing various measures. The targets are lower than the business goals of ¥105,000mn in net sales and ¥4,000mn in operating profit in FY3/18, the final year of the 4th Medium-term Management Plan. However, the shortfall primarily reflects lower number of stores in the dispensing pharmacy business than envisioned in the plan (407 stores expected in FY3/18 guidance vs. 500 stores in the medium-term plan) due to not having enough M&A opportunities that meet the Company's desired terms. Downward revision of FY3/17 forecasts appears to have influenced the conservative plan for FY3/18.

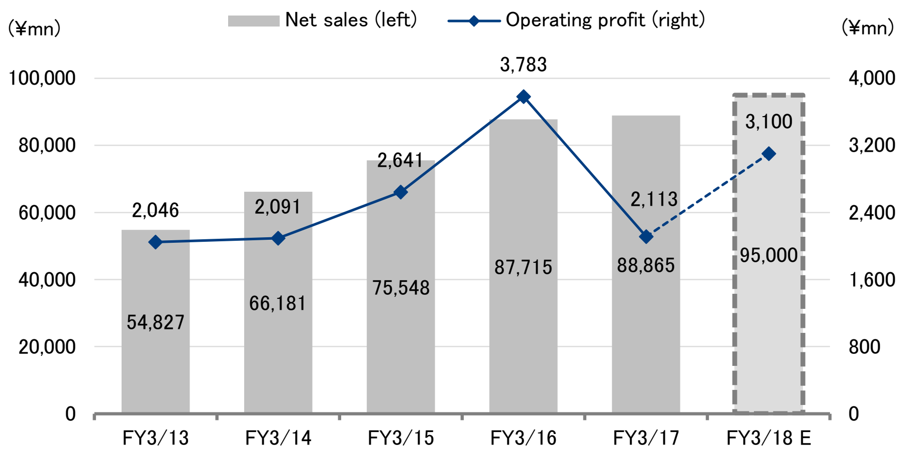
3. Focus on group reorganization and initiatives in home medical services

The Company intends to merge three Hokkaido companies in the dispensing pharmacy business in July 2017 and absorb three consolidated subsidiaries itself in October 2017 with the aim of building an optimized group organization that targets growth. Primary reorganization goals are cost savings from elimination of overlapping functions among organizations, enhanced group governance and faster decision-making, and concentration of business resources in pharmaceutical network and dispensing pharmacy businesses. We think this reorganization should strengthen profitability and boost growth potential. Additionally, the Company will begin steady rollout nationwide in FY3/18 of prescription drugs delivery service and shopping-support service, which it started as test offerings through collaboration with JAPAN POST Co., Ltd. in FY3/17, as home medical services. These services should be closely watched as initiatives likely to raise profitability in the dispensing pharmacy business because they lighten work load on pharmacists and diversify income sources for dispensing pharmacies.

Key Points

- Guides for a rebound to double-digit earnings growth in FY3/18 led by the two main businesses
- Increase pace in member stores for the pharmaceutical network business is picking up
- Expecting boosts to profitability and growth potential from reorganization; also headed toward nationwide rollout of home medical services

Consolidated results trends



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

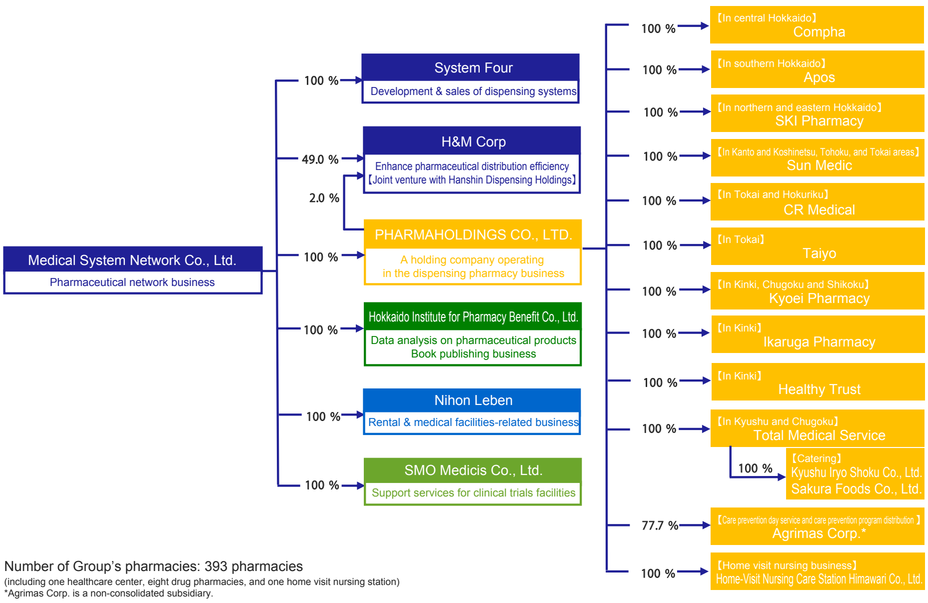
Business overview

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

The Company has two main businesses: the pharmaceutical network business and the dispensing pharmacy business. It is also undertaking peripheral businesses through its respective subsidiaries, including a rental & medical facilities-related business, catering business, a clinical trial facilities support business, and a home visit nursing business. The pharmaceutical network business is conducted by the Company and its subsidiaries, System Four and H&M Corp, while the dispensing pharmacy business is conducted by PHARMAHOLDINGS Co., LTD., its subsidiaries and the Hokkaido Institute for Pharmacy Benefit Co., Ltd.

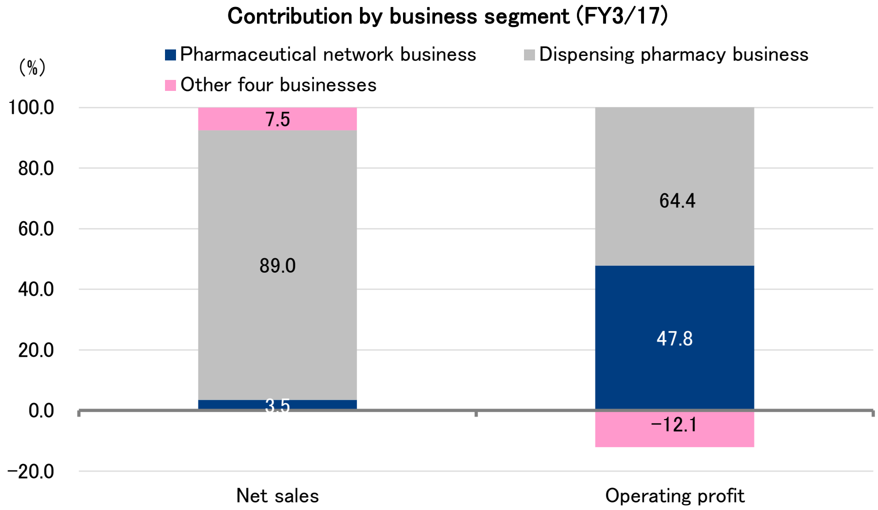
* The Company concluded a basic agreement with EP-SOGO Co., Ltd. regarding the transfer of SMO-MDS Co., Ltd. shares on May 19, 2017.

The Group (as of May 1, 2017)



Source: Prepared by FISCO from the Company's results briefing materials

Looking at the breakdown by business segment, we see that in FY3/17, the dispensing pharmacy business provided 89% of total net sales, while for operating profit, the dispensing pharmacy business provided 64.4%, and pharmaceutical network business 47.8%, making them the Company's two main businesses. An overview of each segment is as described below.



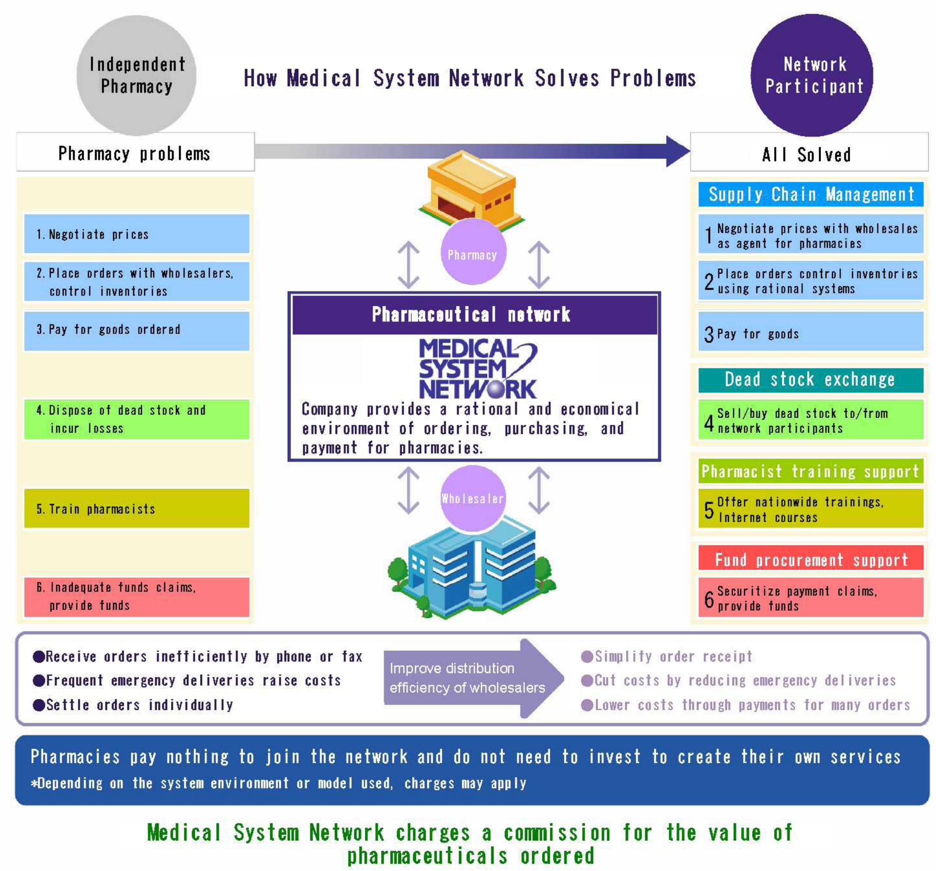
Note: Before the offsetting of internal transactions. The other four businesses are the rental & medical facilities-related business, the catering business, the clinical trial facilities support business and the home visit nursing business.
Source: Prepared by FISCO from the Company's results briefing materials

1. 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, medium-sized or self-run dispensing pharmacies.

The services the Company provides in the pharmaceutical network business are a supply chain management service, in which it 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. The Company also provides support for pharmacist training and for fund raising.

Outline of pharmaceutical supply (network) business



Source: Company materials

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 2017, the total number of member pharmacies in the network, including those in the Group and external members, was 1,770 (including 34 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 member stores in the pharmaceutical network business

(pharmacies)

By member type	FY3/13	FY3/14	FY3/15	FY3/16	FY3/17
General member	764	842	855	1,047	1,393
MSN Group	269	321	345	353	377
Total	1,033	1,163	1,200	1,400	1,770

By area	FY3/13	FY3/14	FY3/15	FY3/16	FY3/17
Hokkaido	212	216	207	221	228
Tohoku	80	91	93	99	112
Kanto/Koshinetsu	270	298	362	425	535
Tokai/Hokuriku	138	160	182	227	348
Kinki	178	187	131	147	201
Chugoku/Shikoku	77	87	84	86	75
Kyushu/Okinawa	78	124	141	195	271
Total	1,033	1,163	1,200	1,400	1,770

Source: Prepared by FISCO from the Company's results briefing materials

2. Dispensing pharmacy business

This business develops dispensing pharmacies in each area mainly under the Nanohana Pharmacy brand, and it is expanding its number of pharmacies while actively utilizing M&As. As of the end of March 2017, the Company had 377 dispensing pharmacies, making it one of the market leaders. By area, it has the most pharmacies in Hokkaido at 118, making it the industry leader for the most pharmacies in the area, followed by Kanto/Koshinetsu at 85, and then Kinki and Tokai/Hokuriku each at 54. In addition to pharmacies, the Company operates eight drugstores and one healthcare center.

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

3. Rental & medical facilities-related business

Nihon Leben, which was made into a subsidiary in 2002, 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.

As serviced senior living facilities, the Company operates Wisteria Kiyota and Wisteria N17 in Sapporo (Hokkaido), Wisteria Otaru Inaho in Otaru (Hokkaido), and Wisteria Senri Chuo in Toyonaka (Osaka). It also plans to open Wisteria Minami Ichijo (provisional name) in Sapporo in November 2018. These facilities are generally profitable at an occupancy rate of 90% or more and reach 90% in about three years.

Rental & medical facilities-related business
– Building areas with integrated medical and care services

Source: Prepared by FISCO from the Company's results briefing materials

4. Catering business

Total Medical Service, which was made into a subsidiary in November 2013, its subsidiary Sakura Foods, and Kyushu Iryo Shoku, which was made into a subsidiary in October 2015, carry out catering outsourcing operations within hospitals and welfare facilities.

5. Other businesses

Other businesses include clinical test assistance services in Hokkaido run by SMO-MDS*, which was made into a subsidiary in 2007, and home visit nursing business operated by Home-Visit Nursing Care Station Himawari Co., Ltd., which was made into a subsidiary in May 2016. Home-visit nursing is a service in which home-visit nursing stations dispatch nurses and other staff to the living environments of recuperating patients for provision of nursing care, assistance in achieving independence, and support in recuperative living. For the local comprehensive care system advocated by the national government, nursing stations occupy a central role in provision of high-quality medical and care services by collaborating with pharmacists, nutritionists, doctors, care managers, and other professions.

The Company added home visit nursing business to its group as a way of bolstering home medical services in the dispensing pharmacy business. It aims to expand this business nationwide by working with group pharmacies. The service is currently available in parts of Tokyo and Saitama (Nerima Ward, Nishi-Tokyo, Wako, and Niiza cities) with sales at tens of million yen.

* The Company concluded a basic agreement with EP-SOGO Co., Ltd. regarding the transfer of SMO-MDS Co., Ltd. shares on May 19, 2017.

Results trends

Double-digit profit decline in FY3/17 mainly due to the impact of revisions to dispensing fees and drug prices

1. Summary of the FY3/17 results

In FY3/17 consolidated results, the Company reported weaker earnings on increased sales with ¥88,865mn in net sales (+1.3%), ¥2,113mn in operating profit (-44.1%), ¥2,109mn in recurring profit (-45.4%), and ¥571mn in net profit attributable to owners of parent (-66.8%). Sales and earnings slightly missed revised forecasts announced in November 2016.

While net sales continued to post an all-time high thanks to healthy growth in the pharmaceutical network business and M&A benefits in dispensing pharmacy and catering businesses, earnings fell sharply because of the decline in dispensing pharmacy profit in the wake of revisions to dispensing fees and drug prices. Dispensing pharmacy business accounted for 66% of the overall setback in FY3/17 operating profit, but earnings were also lower in all other segments. However, operating profit has been rising with each quarter owing to progress in responses to dispensing fee revisions, and the rate of decline (YoY) is narrowing.

FY3/17 consolidated results

(¥mn)

	FY3/16		FY3/17				
	Results	% of net sales	Company forecast	Results	% of net sales	YoY	Vs. forecast
Net sales	87,715	-	90,000	88,865	-	1.3%	-1.3%
Cost of sales	54,913	62.6%	-	54,700	61.6%	-0.4%	-
SG&A expenses	29,018	33.1%	-	32,050	36.1%	10.4%	-
Operating profit	3,783	4.3%	2,300	2,113	2.4%	-44.1%	-8.1%
Recurring profit	3,860	4.4%	2,300	2,109	2.4%	-45.4%	-8.3%
Net profit attributable to owners of parent	1,720	2.0%	650	571	0.6%	-66.8%	-12.0%

Note: Company plan uses figures from the revised forecast announced in November 2016.
Source: Prepared by FISCO from the Company's results briefing materials

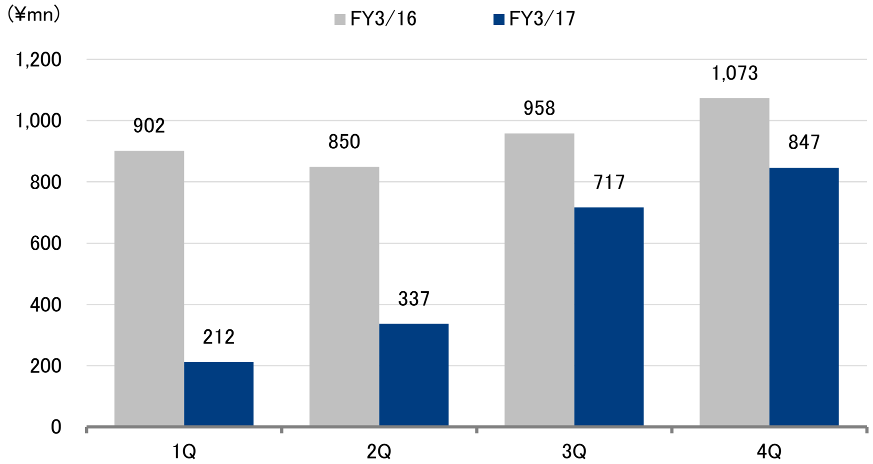
Factors behind the changes to operating profit (FY3/17, YoY)

(¥mn)

Category	Change	Category	Change
Dispensing pharmacy business	- 1,098	Pharmaceutical network business	- 57
(Breakdown of change in operating profit)		Rental & medical facilities-related business	- 273
Existing pharmacies	- 818	Catering business	- 40
Pharmacies opened FY3/16-17	- 70	Other businesses	- 53
M&A FY3/16-17	197	Group expenses (adjustments)	- 147
Pharmacies closed, etc.	- 35		
Headquarters' expenses	- 370	Total	- 1,669

Source: Prepared by FISCO from the Company's results briefing materials

Quarterly operating profit trend



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

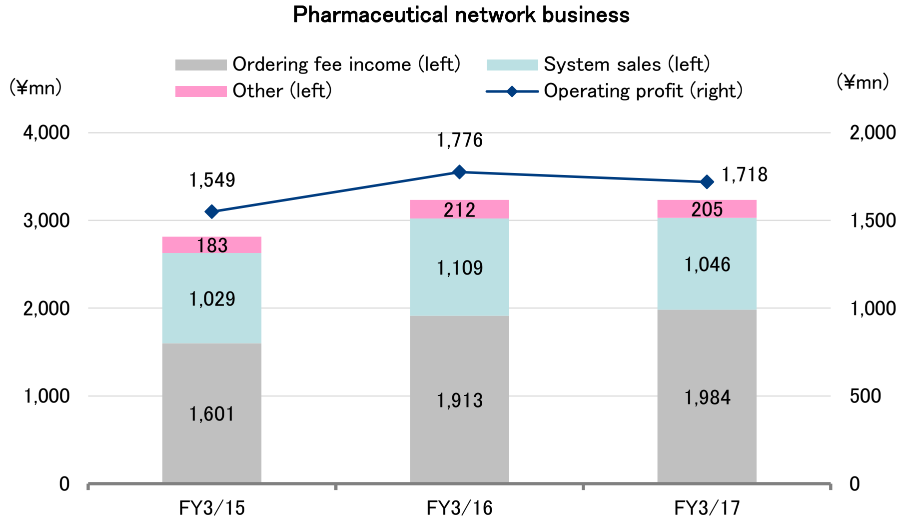
Healthy increase in member stores for the pharmaceutical network

2. Earnings by business segment

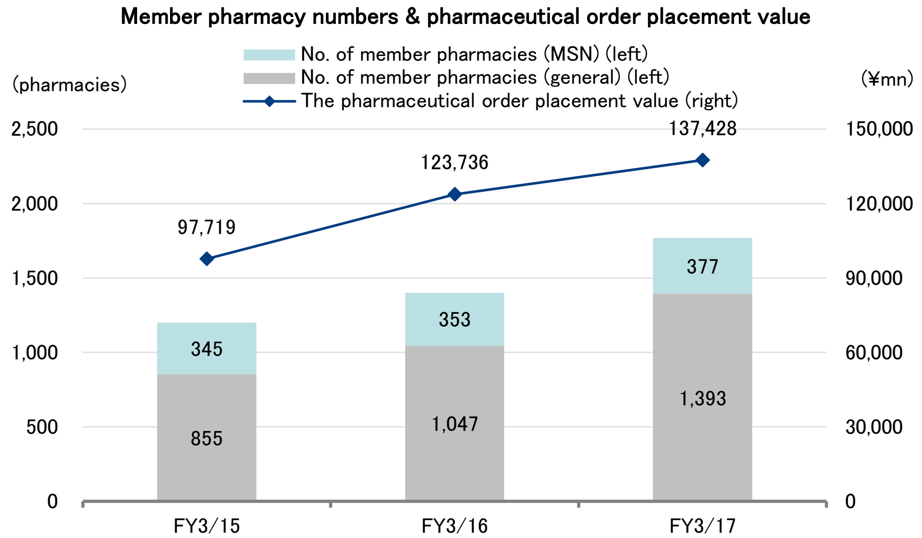
(1) Pharmaceutical network business

Pharmaceutical network business recorded ¥3,237mn in net sales (flat YoY) and ¥1,718mn in operating profit (-3.3%) in FY3/17. The number of network members was up by healthy 370 YoY at end-FY3/17 to 1,770, and pharmaceutical order placement value climbed 11.1% YoY to ¥137,428mn, the third straight year of double-digit gains. Order handling fees, however, only rose 3.7% due to a 0.11pp decline in the average fee rate (order handling fees ÷ pharmaceutical order placement value) to 1.44% linked to change in customer mix. Fee rates vary by customer size. Self-run pharmacies and operators with 4-5 pharmacies were primary members in the past, and recent increase in larger customers running 10-20 pharmacies appears to be having an impact. Additionally, system sales and other sales modestly declined YoY.

In earnings, main setbacks were higher personnel expenses associated with reinforcement of sales operations and increase in depreciation costs following an upgrade of the core system (+¥37mn). The system investment significantly improved processing capacity.



Source: Prepared by FISCO from the Company's results briefing materials



Source: Prepared by FISCO from the Company's results briefing materials

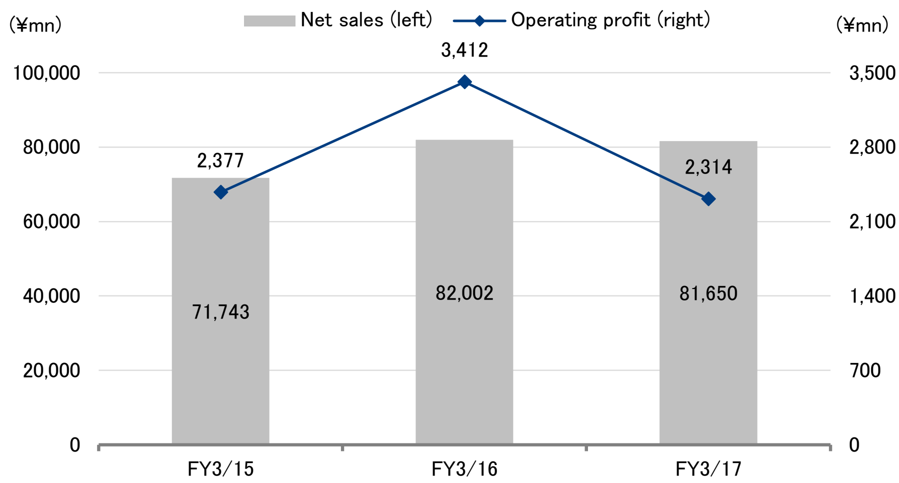
(2) Dispensing pharmacy business

Dispensing pharmacy business posted ¥81,650mn in net sales (-0.4%) and ¥2,314mn in operating profit (-32.2%). The number of pharmacies increased by 24 YoY to 377 at period-end with eight new pharmacies opening, acquiring 20 through business transfers and M&As, and elimination of four through closures and transfers. The Company targeted opening 10 new pharmacies and obtaining 30 through M&A in the period-start plan. However, it switched to a policy of limiting acquisitions to deals with attractive terms due to the continued high price of M&As.

Sales weakened on a decline in the average prescription price following the dispensing fee and drug price revisions implemented in April 2016. The average prescription price at existing stores fell 6.0% YoY (including drug costs by 7.3% and technical fees by 1.5%). Decline in drug costs stands out. In particular, the hepatitis C drug released in fall 2015 had a steep 32% decline because it was originally priced high, and this drug alone contributed about ¥900mn of the YoY drop in sales. Also, the number of prescriptions was sluggish with an increase of 0.1% YoY on a same-store basis, missing the +1.0% target from guidance.

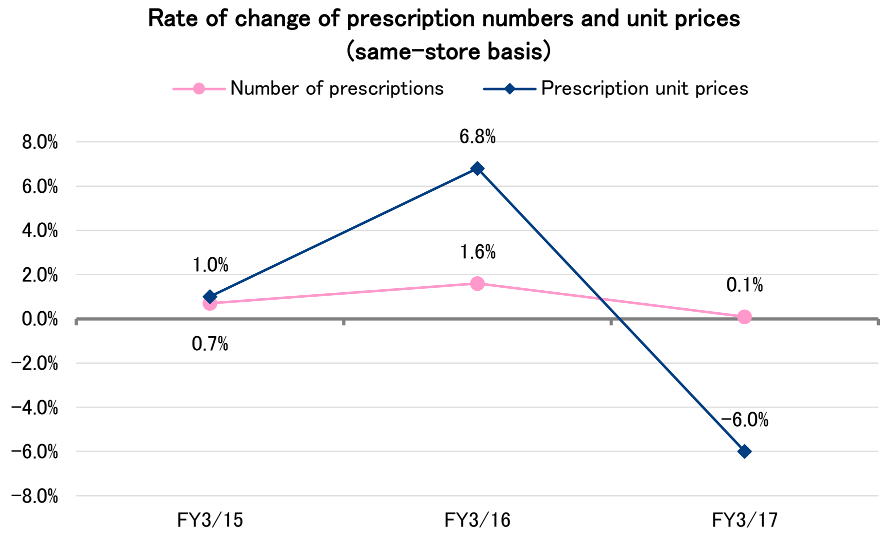
In earnings, lower same-store sales because of the decline in the average prescription price and higher pharmacist personnel costs delivered setbacks. The Company has been adding pharmacists as part of bolstering the role of stores as “family pharmacies,” lifting pharmacist headcount by 9.8% to 1,276 pharmacists at the end of March 2017 (including temporary pharmacists). The number of pharmacists per store has been trending upward too. Home visits are required as a “family pharmacy” function in order to receive the basic dispensing fee incentives. The Company’s promotion of home visit activities (which increases personnel) is a factor raising the number of pharmacists per store. The percentage of Company pharmacies providing home visits rose to just over 80% of group stores at the end of March 2017 at 308 stores (289 counted stores).

Dispensing pharmacy business



Source: Prepared by FISCO from the Company's results briefing materials

Results trends



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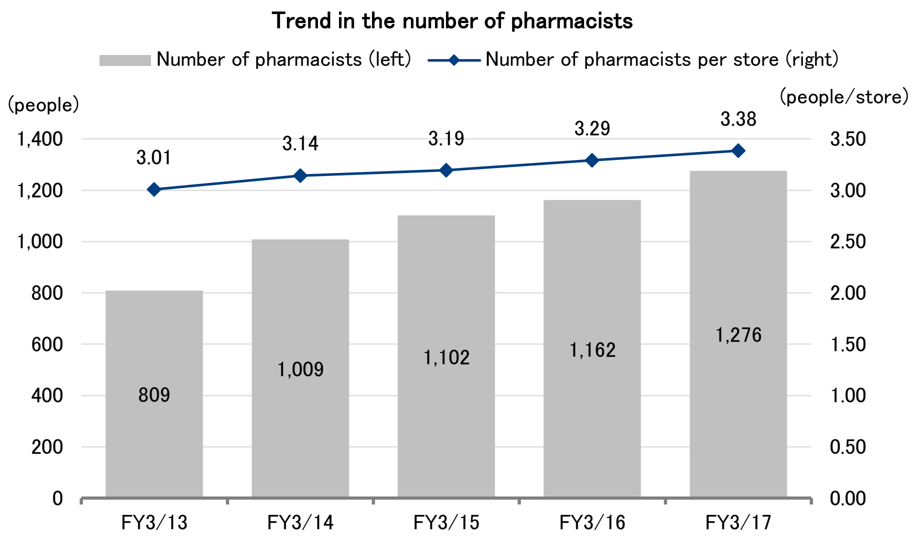


Note: Pharmacists includes temporary pharmacists.
Source: Company materials

(3) Rental & medical facilities-related business

In this business, net sales decreased 15.8% YoY to ¥2,046mn, and the operating loss was ¥143mn (compared to an operating profit of ¥129mn in the previous fiscal year). This was mainly as a reaction to the recording of a temporary item in the same period in the previous fiscal year, of a gain on sale of real estate of ¥242mn. But even when excluding this factor, profits still deteriorated slightly, mainly due to increases in depreciation costs of ¥183mn from the launches of Wisteria Otaru Inaho in December 2015 and Wisteria Senri Chuo in May 2016 in housing for the elderly with support services.

Occupancy rates at end-March 2017 were Wisteria Otaru Inaho at 99% and Wisteria Senri Chuo at 24%. These facilities typically become profitable in about three years after beginning operations when the occupancy rate moves above 90%. Wisteria Otaru Inaho surpassed 90% occupancy quickly because of its low rent in the range of ¥50,000 per month. However, the Company expects an operating profit from FY3/19 because of the heavy depreciation cost burden. Wisteria Senri Chuo, meanwhile, is slightly lagging the plan, but is currently finalizing contracts at a pace of two units per months and is likely to achieve profitability in FY3/20.

(4) Catering business

In this business, net sales increased 64.9% YoY to ¥4,667mn thanks to the effect of acquiring a Kyushu Iryo Shoku Co., Ltd. as a subsidiary in October 2015. But the operating loss widened to ¥129mn (from ¥89mn a year earlier) due to higher labor costs from using personnel dispatch services to cover manpower shortages and increase in food material costs. Nevertheless, profitability has been improving on revisions to money-losing deals, contract price hikes, and adjustment of food material costs, and the business reached a ¥10mn profit in 4Q (January-March 2017).

(5) Other businesses

Other business (clinical testing assistance service and home visit nursing) reported ¥163mn in net sales (+14.5% YoY) and a ¥163mn operating loss (vs. a ¥109mn loss a year earlier). Sales increased on the acquisition of Home-Visit Nursing Care Station Himawari as a subsidiary, but both businesses had losses.

Financial standing remains healthy even with higher interest-bearing debt

3. Financial position and management indicators

Next, we review financial standing at the end of FY3/17. Total assets were up ¥1,890mn YoY to ¥50,737mn. In current assets, while accounts receivable fell by ¥391mn, cash and deposits were up by ¥171mn and inventory assets increased by ¥622mn. In fixed assets, tangible fixed assets grew by ¥993mn, mainly from land, and goodwill expanded by ¥268mn.

Total liabilities were up ¥1,511mn to ¥40,092mn, as the increase in interest-bearing debt of ¥2,163mn exceeded the decreases in accounts payable and accrued income taxes of ¥381mn and ¥652mn respectively. Net assets were up ¥379mn to ¥10,644mn, as net profit attributable to owners of parent was recorded and retained earnings increased ¥268mn.

For management indicators, the equity ratio slipped from 20.3% a year earlier to 20.1% and the interest-bearing debt ratio increased from 197.3% to 212.5% due to higher interest-bearing debt. The Company might see a modest rise in interest-bearing debt again in FY3/18 because of construction costs for the Wisteria Minami Ichijo building and M&A outlays in the dispensing pharmacy business. However, the Company is not concerned about this level in light of the outlook for continuation of ultralow interest rates and the operating cash flow situation. We expect a switch to profit expansion and moderate-paced improvements in financial standing over the medium term. Profitability declined substantially in FY3/17 with the operating profit margin down from 4.3% in the previous year to 2.4% and ROE weakening from 21.9% to 5.7%. However, ROE should return to about 10% given likely recovery in profitability from FY3/18.

Consolidated balance sheet

(¥mn)

	FY3/14	FY3/15	FY3/16	FY3/17	Change
Current assets	10,941	11,023	10,783	11,098	315
(Cash & deposits)	3,106	2,499	2,081	2,252	171
Fixed assets	32,172	34,564	38,063	39,639	1,576
(Goodwill)	12,253	13,214	12,916	13,184	268
Investments, etc.	3,797	3,759	4,329	4,559	230
Total assets	43,114	45,587	48,847	50,737	1,890
Current liabilities	24,879	21,625	21,061	16,920	-4,141
Fixed liabilities	12,881	17,826	17,520	23,172	5,652
(Interest-bearing debt)	22,011	22,743	19,562	21,725	2,163
Total liabilities	37,761	39,451	38,581	40,092	1,511
Net assets	5,352	6,135	10,265	10,644	379
Key management indicators					
(Stability)					
Equity ratio	11.9%	12.7%	20.3%	20.1%	
Interest-bearing debt ratio	429.3%	391.3%	197.3%	212.5%	
(Profitability)					
ROA (return on assets)	5.5%	5.7%	8.2%	4.2%	
ROE (return on equity)	12.2%	16.2%	21.9%	5.7%	
Operating profit margin	3.2%	3.5%	4.3%	2.4%	

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

Business outlook

Expects a rebound to double-digit profit growth in FY3/18 led by the two main businesses

1. Forecast for FY3/18

The Company guides for higher consolidated sales and profits for the first time in two years in FY3/18 at ¥95,000mn in net sales (+6.9% YoY), ¥3,100mn in operating profit (+46.7%), ¥3,000mn in recurring profit (+42.2%), and ¥1,000mn in net profit attributable to owners of parent (+74.9%). It factors in profit gains in all segments in FY3/18 with dispensing pharmacy business as the main driver.

Nevertheless, this guidance constitutes a downward revision from goals of ¥105,000mn in net sales and ¥4,000mn in operating profit for the final fiscal year of the Medium-term Management Plan. The Company was unable to expand the number of pharmacies as much as initially in dispensing pharmacy business because M&A prices remained expensive. It had set a goal of 500 stores for FY3/18 in the Medium-term Management Plan, but the latest FY3/18 guidance assumes 407 stores. Growth in pharmaceutical network member stores, meanwhile, is accelerating on tailwind from market environment changes. The network might surpass the 2,200 stores assumed in FY3/18 guidance. We think the FY3/18 outlook is conservative after having to lower targets in FY3/17 and see room for upside depending on trends in the pharmaceutical network business. The Company factors in rapid recovery in 1H results, in part because of the low earnings level from the previous year, with increases of 4.8% in net sales and 100.3% in operating profit. It refrained from disclosing forecast of net profit attributable to owners of parent owing to many uncertainties, such as costs related to group reorganization that is under review.

FY3/18 consolidated earnings forecast

(¥mn)

	FY3/17	FY3/18			
	Full-year results	1H guidance	YoY	Full-year guidance	YoY
Net sales	88,865	45,500	4.8%	95,000	6.9%
Operating profit	2,113	1,100	100.3%	3,100	46.7%
(Operating profit margin)	2.4%	2.4%	-	3.3%	
Recurring profit	2,109	1,050	93.5%	3,000	42.2%
Net profit attributable to owners of parent	571	-	-	1,000	74.9%
Net income per share (¥)	19.31	-	-	33.77	

Note: Refrained from disclosing forecast of quarterly net profit attributable to owners of parent in 1H FY3/18 owing to many uncertainties, such as costs related to group reorganization that is under review.
Source: Prepared by FISCO from the Company's financial results

Factors behind the changes to operating profit (FY3/18 forecast, YoY)

(¥mn)

Category	Change
Dispensing pharmacy business	629
(Breakdown of change in operating profit)	
Existing pharmacies	493
Pharmacies opened FY3/17-18, M&A	80
Other	56

Category	Change
Pharmaceutical network business	120
Rental & medical facilities-related business	69
Catering business	83
Other businesses	30
Group expenses (adjustments)	55
Total	986

Source: Prepared by FISCO from the Company's results briefing materials

Accelerating increase pace in member stores for the pharmaceutical network business

2. Outlook by segment

Outlook by segment

(¥mn)

	FY3/17 results	FY3/18		FY3/18 target under the Medium-term Management Plan
		Company forecasts	% change	
Net sales				
Pharmaceutical network business	3,237	3,397	5.0%	3,600
Dispensing pharmacy business	81,650	87,539	7.2%	99,500
Other four businesses	6,878	6,923	0.7%	-
Adjustments	-2,900	-2,860	-	-
Total	88,865	95,000	6.9%	105,000
Operating profit				
Pharmaceutical network business	1,718	1,839	7.0%	2,200
Dispensing pharmacy business	2,314	2,943	27.2%	3,000
Other four businesses	-436	-254	-	-
Adjustments	-1,482	-1,428	-	-
Total	2,113	3,100	46.7%	4,000
The number of member pharmacies in the pharmaceutical network business	1,770	2,200	24.3%	2,200
Areas, the number of pharmacies	377	407	8.0%	500

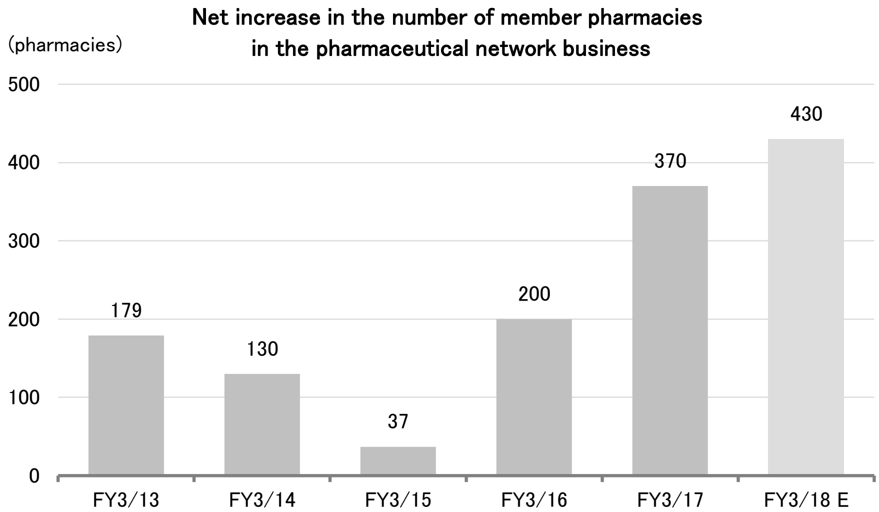
Note: The other four businesses are the rental & medical facilities-related business, the catering business, the clinical trial facilities support business and the home visit nursing business.
Source: Prepared by FISCO from the Company's results briefing materials

(1) Pharmaceutical network business

For pharmaceutical network business, the FY3/18 plan projects ¥3,397mn in net sales (+5.0% YoY) and ¥1,839mn in operating profit (+7.0%). It assumes an all-time high YoY increase in network members of 430 to 2,200. Business conditions are getting tougher for smaller and very small dispensing pharmacies mainly due to the impact of dispensing fee revisions. This environment enhances the benefits of joining the Company's service that lower procurement costs and raises inventory efficiency. The number of mid-sized pharmacy operators running 10-20 stores has been rising recently. The Company intends to further expand members with support from these favorable conditions and aims to reach 5,000 stores, a roughly 10% industry share, in five years.

Key initiatives in FY3/18 are reinforcing sales capabilities and deepening the area-based strategy. For sales capabilities, the Company plans to improve collaboration with external partner companies, hold seminars for dispensing pharmacies, and develop new services. For the area-based strategy, the Company intends to collaborate with drug wholesale firms and pharmacist associations in respective areas.

The prospect of just a 5.0% increase in pharmaceutical network sales, despite a 24.3% targeted rise in member stores to 2,200 stores, factors in the likely continuation of a downward trend in the average fee rate because of the growing number of new mid-sized pharmacy operators with a lower rate. The Company also reduced goals in the Medium-term Management Plan for the same reason. However, recent demand remains vibrant and the Company added about 80 stores in April. We expect member stores to exceed the plan level.



Note: Net increase is small in FY3/15 because of the exit of a large customer with 230 pharmacies.
Source: Prepared by FISCO from the Company's results briefing materials

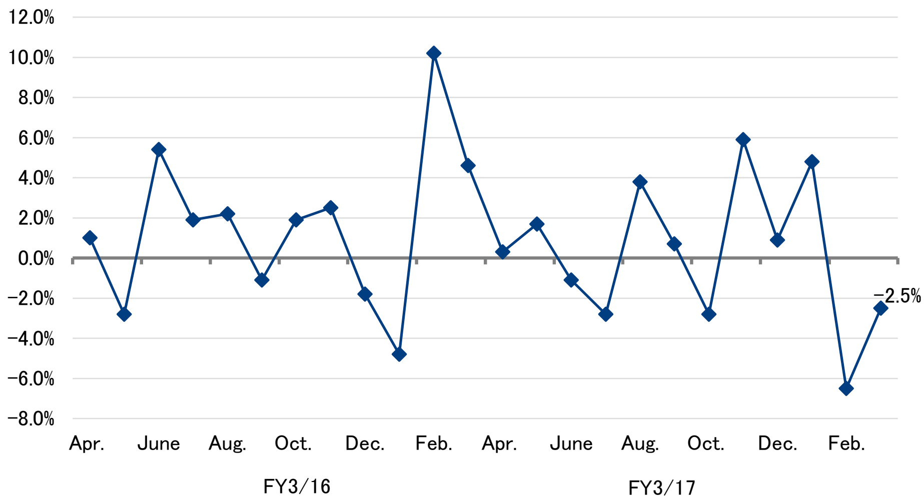
(2) Dispensing pharmacy business

For dispensing pharmacy business, the plan targets ¥87,539mn in sales (+7.2% YoY) and ¥2,943mn in operating profit (+27.2%). It assumes an addition of 30 stores (10 stores from new openings and 20 stores through M&A) from the end of the previous year to 407 stores. This business had 383 stores as of May 1.

Priority measures for FY3/18 are to increase the number of prescriptions by enhancing family pharmacy capabilities and to shift from switching to generic drugs to narrowing. The Company aims to increase the number of prescriptions by serving in the role of a family pharmacy for the local area. Specific initiatives include assigning one nutritionist per block to offer nutrition consulting (hypertension, diabetes, etc.), expanding the line-up of OTC drugs, health foods, and other products, holding regular yoga and other exercise programs, and expanding home services through collaboration with JAPAN POST. Efforts in this strategy seek to increase the number of customers and boost the number of prescriptions per customer.

The Company expects a 1.5% YoY rise in the number of prescriptions at existing stores in FY3/18 and a ¥51 gain in the average technical service fee on progress in responding to dispensing fee revisions. The breakdown of anticipated changes in operating profit consists of +¥415mn from increased number of prescriptions at existing stores, +¥36mn from a rise in the average drug price cost, +¥413mn from upturn in the average technical service fee, +¥80mn from new store openings and M&A additions in FY3/17-18, and +¥56mn from other items on the positive side and -¥371mn from higher labor costs for pharmacists and other staff and larger spending at existing stores.

Rate of change in the number of prescriptions at existing pharmacies



Source: Prepared by FISCO from Company materials

(3) Other four businesses

For the other four businesses (rental & medical facilities-related, catering, clinical trial facilities support*, and home visit nursing), the FY3/18 plan targets ¥6,923mn in net sales (+0.7% YoY) and a narrower ¥254mn operating loss (vs. a ¥436mn loss in FY3/17).

The Company expects ¥2,191mn in net sales (+7.1% YoY) and a ¥74mn operating loss (vs. a ¥143mn loss) in the rental & medical facilities-related business. It has a goal of having occupants for 50 units (out of a total of 82 units) at Wisteria Senri Chuo by the end of FY3/18, thereby reducing the loss (as a result of the increase in occupants). Additionally, the Company is slated to open Wisteria Minami Ichijo (provisional name) with 106 units, its third serviced senior living facility in Sapporo, as a new project in November 2018. This site is well placed near Sapporo Medical University and with robust transportation access and adopts comprehensive support for local residents from all generations by including clinics with 6-7 departments, a dispensing pharmacy, and a day-care center. It might become a model site for the local comprehensive care system. The Company is already receiving numerous inquiries about this facility. Occupant entry is likely to progress smoothly after the facility opens.

For catering busniess, the Company projects ¥4,479mn in net sales (-4.0% YoY) and a ¥46mn operating loss (vs. a ¥129mn loss in FY3/17). While sales are likely to be lower due to exiting money-losing deals, steady revisions to personnel operations should improve earnings. This business already posted a profit in 4Q FY3/17 and might be capable of attaining a full-year profit if it is not affected by setbacks, such as a large upswing in food material costs.

For clinical trial facilities support* and home visit nursing businesses, the Company forecasts ¥252mn in net sales (+53.9% YoY) and a ¥133mn operating loss (vs. a ¥163mn loss). While the home visit nursing business is likely to book a profit for existing outlets, it plans to open a new outlet (with three people) around summer 2017 and expand the service area to Setagaya Ward. The guidance factors in a slight loss because of ramp-up costs. The Company intends to broaden service area coverage within Tokyo.

* The Company concluded a basic agreement with EP-SOGO Co., Ltd. regarding the transfer of SMO-MDS Co., Ltd. shares on May 19, 2017.

Group reorganization and home medical service initiatives

Reorganization likely to raise profitability and growth potential, planning nationwide rollout of home medical service

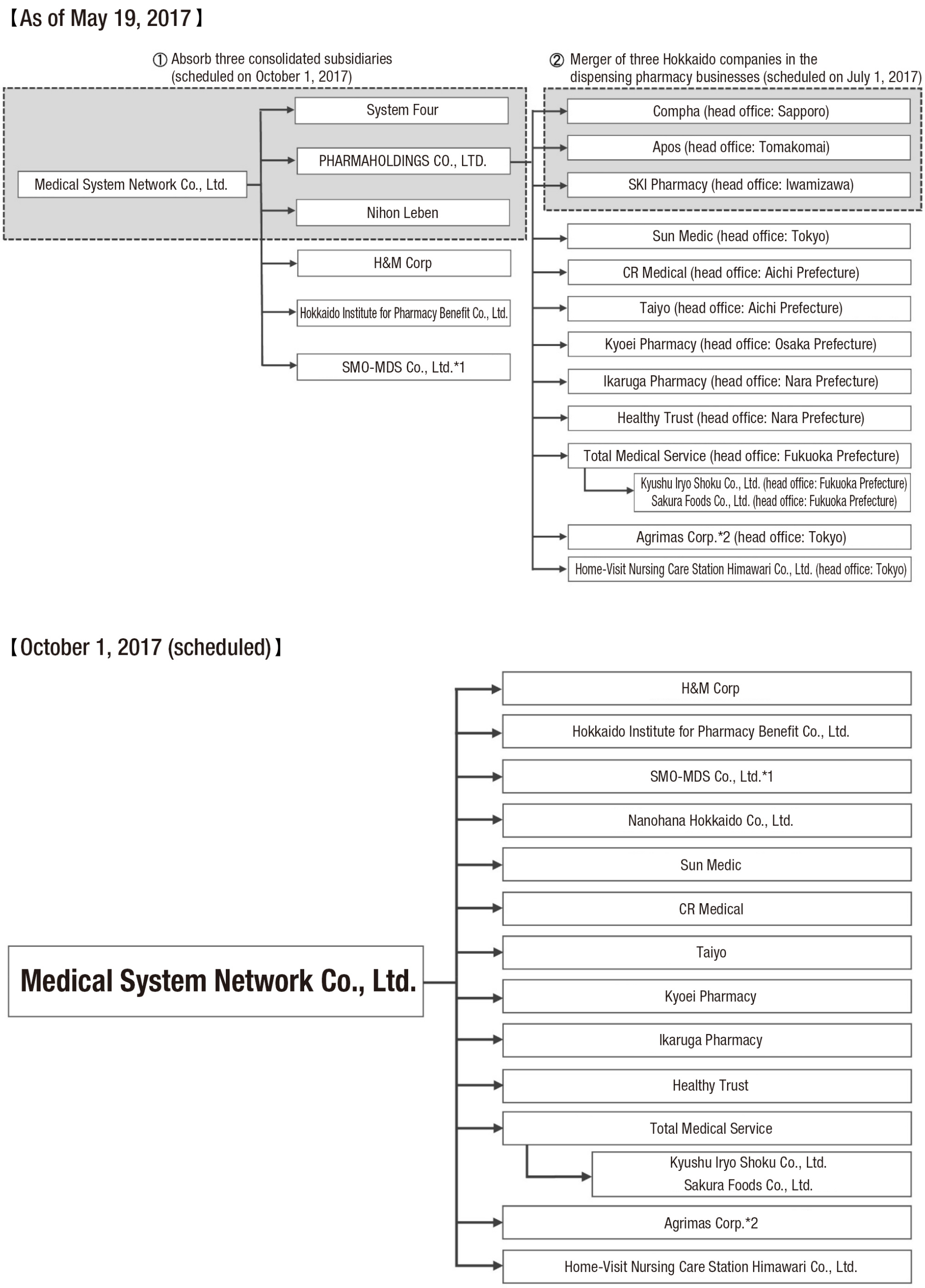
1. Group reorganization

On May 19, 2017, the Company announced the absorption of three consolidated subsidiaries and a merger of three Hokkaido companies in the dispensing pharmacy business with the aim of building an optimized group organization that targets growth. Primary goals are cost savings from elimination of overlapping functions among organizations, enhanced group governance and faster decision-making, and concentration of business resources in pharmaceutical network and dispensing pharmacy segments.

The merger of Hokkaido subsidiaries is slated to occur in July 2017, with the new entity as Nanohana Hokkaido Co., Ltd. Following the merger, the dispensing pharmacy business will have a subsidiary operating in each of five regional blocks. Absorption of the three consolidated subsidiaries, meanwhile, is scheduled in October. We expect the reorganization to not only boost the Company’s profitability, but also strengthen growth potential by raising concentration and selectivity of business resources and speeding up decisions.

Group reorganization and home medical service initiatives

Group reorganization



*1 The Company concluded a basic agreement regarding the transfer of SMO-MDS Co., Ltd. shares on May 19, 2017.
*2 Agrimas Corp. is a non-consolidated subsidiary.

Source: Company materials

2. Initiatives in the home medical service

The prescription drugs delivery service and shopping-support service offered through collaboration with JAPAN POST announced in May 2016 deserve attention as home medical services.

Five Nanohana Pharmacy stores in Sapporo and Nagoya have been testing home delivery of transfusion packs and nutrients for home patients who received usage guidance in the prescription drugs delivery service. These activities confirmed safeness in temperature control and other aspects during transport. The Company hence plans to begin nationwide rollout in FY3/18. It also intends to consider prescription drugs after introducing the service nationally. It might be possible for pharmacists to provide remote guidance on drug usage if the government approves remote medical services as part of deregulation measures from 2018. The ability to provide remote guidance might drive expansion of home delivery service for prescription drugs. We will be monitoring these developments. Dispensing pharmacies could reduce work load on pharmacists and increase the number of customers from early-mover benefits.

The shopping-support service, meanwhile, has been taking place on a test basis mainly for care facilities with the product limited to adult diapers in Otaru and Nagoya since October 2016 (this is product jointly developed with JAPAN POST and manufacturing consigned to Nippon Paper Crecia Co., Ltd.). This service has proceeded smoothly as well so the Company plans to begin steady sales rollout to care facilities nationwide during FY3/18. The Company intends to restrict service to just one product for the time being and promptly reach ¥1bn in annual sales. While it hopes to broaden scope to daily goods, health foods, and other products, this depends on the stance of partner JAPAN POST. Expansion of product scope has the potential to increase income opportunities at dispensing pharmacies.

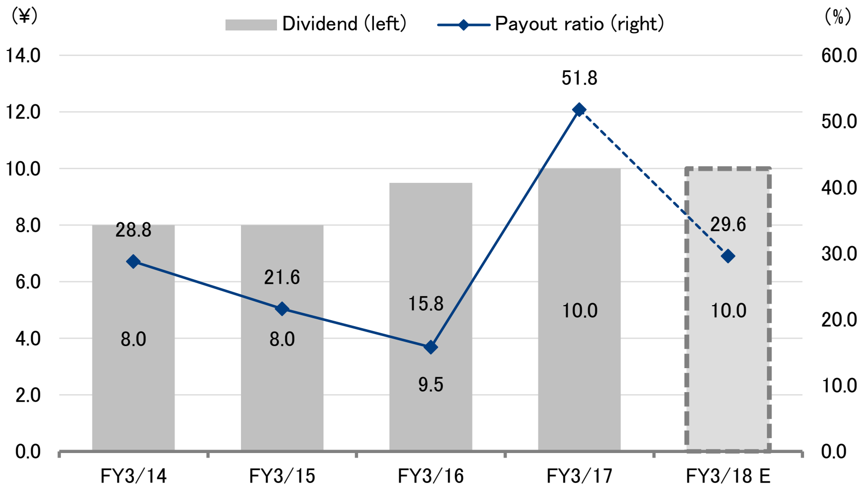
Demand for home delivery service is likely to grow amid increases in patients living at home and people requiring care with the arrival of an ultra-aged society. We expect this role to become increasingly important in regional areas with few pharmacies. The Company is a leader in the industry with these initiatives in home delivery service. The initiatives also offer ways of improving competitiveness and profitability in the dispensing pharmacy business.

Shareholder return policy

Pays dividends with a dividend payout ratio goal of at least 20%

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 considered to be maintaining a dividend payout ratio of 20% or above. For FY3/18, the Company plans to leave the dividend unchanged at ¥10.00 (for a dividend payout ratio of 29.6%). Dividend growth can be expected in the future if profits increase and as a result, the dividend payout ratio falls below this 20% level.

Dividend per share and dividend payout ratio



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

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