NIHON CHOUZAI Co.,Ltd.

3341 Tokyo Stock Exchange First Section

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Completely absorbed the impact of the revisions to the dispensing fees and achieved a V-shaped recovery after results bottomed-out in Q1

Nihon Chouzai Co., Ltd. <3341> (hereinafter, also "the Company") is a leading domestic dispensing pharmacy company that ranks second in sales in the dispensing pharmacy industry. The Nihon Chouzai Group manufactures generic pharmaceuticals, so one of its key characteristics is that it has a manufacturing function. It additionally has a staffing business for medical practitioners and an information-provision and consulting business, and it is developing its operations with a structure that covers four business departments.

The content of the April 2016 revisions to the dispensing fees and drug prices were disadvantageous for the major pharmacy chains, including the Company, so there were concerns about their impact on revenue. But the Company, in line with the direction taken by the revisions, strove to provide guidance to patients on taking medications as a family pharmacist and to promote the use of generic pharmaceuticals, and as a result, by the end of September it had succeeded in completely recovering from the negative impact of the revisions.

Looking at the Dispensing Pharmacy business segment results on a quarterly basis, we see that they reflect the impact of the above-mentioned revisions and the subsequent recovery, with the Q1 FY3/17 operating income declining 26.8% y-o-y and then increasing 15.7% in Q2 and tracing a V-shaped recovery. These results can be said to confirm the strength of the Company's ability to respond to systemic changes and the steadiness of its profitability.

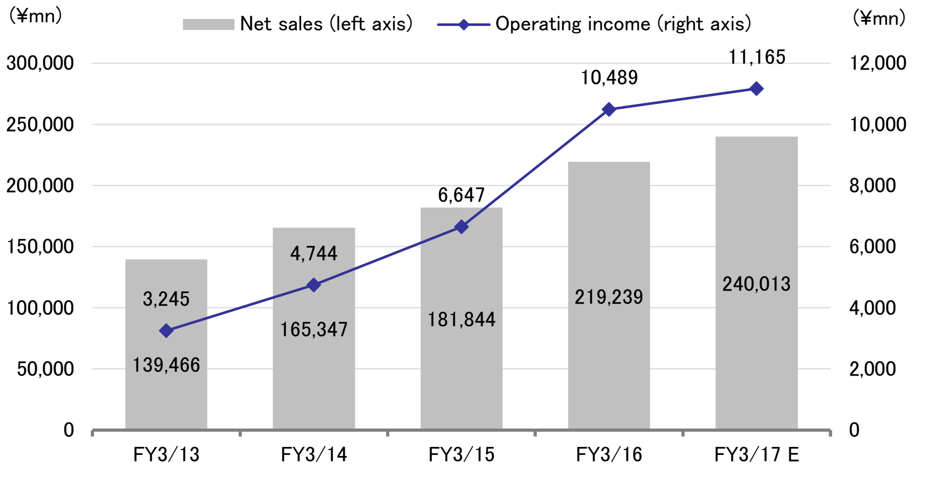
In the Dispensing Pharmacy business, a shift can be seen in terms of the Company's pharmacy strategy. It has focused on realizing highly functional and highly efficient pharmacies, and as a result, its pharmacy network had previously expanded mainly through opening its own pharmacies rather than through M&A. But in Q2 FY3/17, of the 23 newly opened pharmacies, 11 were from M&A, which is a noticeably higher number than in recent years. The background to this is that the number of M&A candidates that meet the Company's strict standards has increased. A good example of this is that it has made Mizuno LLC that manages the Mizuno Pharmacies chain, a subsidiary. It seems that this development will continue in the future and the pace at which the Company opens pharmacies is expected to accelerate from its greater utilization of M&A.

The Pharmaceutical Manufacturing and Sales business is also continuing to make steady progress. The trend to promote the use of generic pharmaceuticals is further strengthening, and in response to this, the Company is steadily increasing its number of sales items. In addition, in terms of capital investment to increase production capacity to respond to the further expansion of the market in the future, the construction of Tsukuba Plant No.2 is fully underway and steady progress is being made. One point to keep in mind for Q2 FY3/17 is that this segment's operating income declined slightly due to the impact of the intensified price competition, but at FISCO we think that the Company, which possesses a powerful sales network of 544 dispensing pharmacies, is fully capable of responding to this situation.

Check Point

- Sales increased in Q2 FY3/17 also, but did not fully compensate for the negative impact immediately after the drug price revisions, and profits declined
- Attention to be paid to the extent to which it can recover from the negative impact of the dispensing fees and drug price revisions
- Outlook is for higher sales and profits for the FY3/17 full year

Trends in the Consolidated Results



Overview of the Q2 FY3/17 results

Sales increased in Q2 FY3/17 also, but did not fully compensate for the negative impact immediately after the drug price revisions, and profits declined

In the Q2 FY3/17 results, net sales were ¥109,478mn (up 9.2% y-o-y), operating income was ¥3,940mn (down 6.5%), recurring income was ¥3,751mn (down 4.7%), and net income attributable to the owners of the parent company was ¥2,339mn (down 5.3%), for an increase in sales but a decrease in profits. Compared to the initial forecasts, net sales and each income item were below their respective targets.

Overview of the Q2 FY3/17 results

(¥mn)

	FY3/16			1H FY3/17				
	1H result	2H result	Full year result	Forecast	Result	y-o-y	vs. target	Rate of progress compared to full year forecast
Net sales	100,269	118,970	219,239	118,321	109,478	9.2%	-7.5%	45.6%
Operating income	4,214	6,275	10,489	4,991	3,940	-6.5%	-21.1%	35.3%
Recurring income	3,936	5,942	9,878	4,829	3,751	-4.7%	-22.3%	34.8%
Net income attributable to the owners of the parent company	2,471	3,858	6,329	3,086	2,339	-5.3%	-24.2%	35.2%

Source: prepared by FISCO from the Company's financial results summary

In the pharmaceuticals and dispensing pharmacy industry in April 2016, the dispensing fees and drug price revisions, which take place once every two years, were implemented, which meant that FY3/17 started from a revenue base at a level lower than in the previous fiscal year. The details according to business segment are as follows.

In the Dispensing Pharmacy business segment, sales increased but profits decreased, with net sales of ¥92,329mn (up 5.9% y-o-y) and operating income of ¥4,064mn (down 4.4%). With regard to the dispensing fees, the Company was able to cover the impact of the revisions, including by providing guidance to patients on taking medications as a family pharmacist and accumulating generic pharmaceuticals dispensing system incentives from promoting the use of generic pharmaceuticals, and as of Q2, the results had recovered to the same level as prior to the revisions. Also, factors such as new pharmacy openings, including from M&A (a net increase of 18 pharmacies from 23 pharmacy openings and 5 pharmacy closures), and the increase in demand for prescriptions for a new drug with a high drug price to treat hepatitis C, also had an effect, and net sales increased 5.9% y-o-y, meaning steady progress was made and 46.7% of the full fiscal year forecast was achieved. In terms of profits, the effects of the higher sales did not completely compensate for the negative impact immediately after the drug price revisions, and profits fell 4.4%.

In the Pharmaceutical Manufacturing and Sales business segment, net sales were ¥18,722mn (up 21.8% y-o-y) and operating income was ¥1,191mn (down 1.6%), for higher sales and slightly lower profits. The revisions to drug prices had an impact, but the higher net sales were secured because the use of generics increased in medical institutions as a result of the revisions to medical fees in April, and also as cooperation between companies in the Group was further strengthened. Profits were down slightly y-o-y from the impact of the intensification of price competition between generic manufacturers, particularly for new products.

In the Medical Professional Staffing and Placement business segment, net sales were ¥5,068mn (up 21.0% y-o-y) and operating income was ¥808mn (down 1.4%). Demand for the staffing and placement of pharmacists is trending at a high level, and in this situation, the Company steadily implemented measures both to develop new clients for staffing and placements and to retain registered pharmacists, which resulted in the higher sales. Profits were down slightly because of higher costs, including due to the soaring costs of Web advertising in order to secure pharmacists.

Results by Business Segment

(¥mn)

		FY3/16			FY3/17		
		1H result	2H result	Full year result	1H result	y-o-y	Rate of progress compared to forecast
Net sales	Dispensing Pharmacy business	87,208	103,666	190,874	92,329	5.9%	46.7%
	Pharmaceutical Manufacturing and Sales business	15,367	17,231	32,598	18,722	21.8%	40.5%
	Medical Professional Staffing and Placement business	4,188	4,746	8,934	5,068	21.0%	48.3%
	Before adjustment	106,764	125,642	232,406	116,119	8.8%	45.7%
	Adjustment amount	-6,494	-6,672	-13,166	-6,641	-	-
	Net sales total	100,269	118,970	219,239	109,478	9.2%	45.6%
Operating income	Dispensing Pharmacy business	4,252	6,455	10,707	4,064	-4.4%	-
	Pharmaceutical Manufacturing and Sales business	1,210	1,458	2,668	1,191	-1.6%	-
	Medical Professional Staffing and Placement business	820	779	1,599	808	-1.5%	-
	Before adjustment	6,283	8,691	14,974	6,063	-3.5%	-
	Adjustment amount	-2,068	-2,416	-4,484	-2,123	-	-
	Operating income total	4,214	6,275	10,489	3,940	-6.5%	35.3%
Operating income margin	Dispensing Pharmacy business	4.9%	6.2%	5.6%	4.4%	-	-
	Pharmaceutical Manufacturing and Sales business	7.9%	8.5%	8.2%	6.4%	-	-
	Medical Professional Staffing and Placement business	19.6%	16.4%	17.9%	15.9%	-	-
	Company-wide total	4.2%	5.3%	4.8%	3.6%	-	-

Source: prepared by FISCO from the Company's financial results summary

■ Trends by business segment

Attention to be paid to the extent to which it can recover from the negative impact of the dispensing fees and drug price revisions

(1) Dispensing Pharmacy business

a) Overall picture

The revisions to the dispensing fees and drug prices, which take place once every two years, were implemented in April 2016. The most important point when looking at FY3/17 is the extent to which the negative impact of these revisions can be recovered from. This can be said to be a shared theme for the entire dispensing pharmacy industry, not just for the Company. As is explained in detail below, recovering from the negative impact of the revisions to the dispensing fees signifies that progress is being made in the various types of systemic responses required to manage dispensing pharmacies, and moreover, it also signifies that progress is being made in creating pharmacies that match the "Vision of Pharmacies for Patients" that the government (the Ministry of Health, Labour and Welfare) is aiming for.

Another important point for the Company is the change to the number of pharmacy openings by M&A in its pharmacy-opening strategy. Although the Company's stance toward M&A has not changed even slightly, as a result of changes to its external environment, in Q2 FY3/17 we saw developments that are expected to increase the importance of M&A in the Company's pharmacy-opening strategy. These two points are described in detail below.

b) Impact of the revisions to the dispensing fees and the state of the Company's response

1) Dispensing pharmacies' revenue structure and the impact of the revisions

Fundamentally, together with hospitals (doctors), dispensing pharmacies are incorporated into the Japanese government's health insurance system. These insurance pharmacies' fees (revenue) are determined by a (medical fees) points system that forms the basis for the revenue calculations stipulated in the health insurance system. The Japanese government (the Ministry of Health, Labour and Welfare) changes and adjusts these medical fees to keep down medical costs and to incentivize the relevant parties toward achieving its health care policies, and toward this end the fees are revised once every two years. FY16 was a medical fees revision year, and as part of these revisions, the dispensing fees points table was also revised.

The main content of these revisions is described in detail below, but in order to understand them, it is first necessary to understand dispensing pharmacies' basic revenue structure. The dispensing fees per prescription are comprised of three main fees; the dispensing technical fee, the pharmacy admin fee, and the drug fee. Within these fees, pharmacists and pharmacies are not involved with the drug fee.

Of the remaining two fees, the dispensing technical fee is comprised of "the basic dispensing fee and its incentive items" + "the dispensing fee and its incentive items." Within this fee, the basic part, of the "dispensing fee," changes according to the type of medication and the number of prescription days, which are also aspects that the pharmacists and pharmacies are not involved in. Therefore in the final analysis, revisions to dispensing fees are centered on the revisions to "the basic dispensing fee," to the various incentive items such as "the standard dispensing incentives" and the "generic pharmaceuticals dispensing system incentives," and to "the pharmacy admin fee."

A model of the breakdown of the dispensing fees

Dispensing fees	Dispensing technical fee	Basic dispensing fee	Various incentives	Standard dispensing incentives
				Generic pharmaceuticals dispensing system incentives
		Dispensing fee	Various incentives	
	The pharmacy admin fee		Various incentives	
	Drug fee			

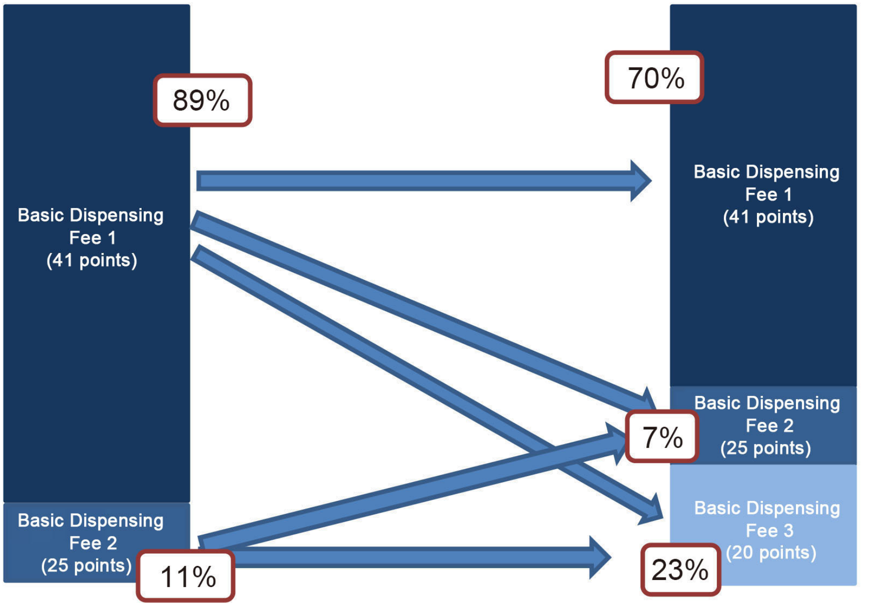
Source: prepared by FISCO from Company materials

The April 2016 revisions to the basic dispensing fee included that the revenue from the basic dispensing fee obtained by large-scale, hospital adjacent-type pharmacy chains was greatly reduced. Small-scale pharmacies, such as those managed by individuals, can obtain 41 points (1 point = approximately ¥10) as the basic dispensing fee, while special cases have been stipulated so that a low basic dispensing fee is applied according to scale, and it is the application of this special-cases stipulation that made these revisions particularly severe for pharmacies within large-scale, hospital adjacent-type pharmacy chains, such as the Company.

In the Company's case, prior to the revisions, the full amount of the basic dispensing fee level 1 applied to 89% of all its pharmacies and they obtained 41 points. But after the revisions, this percentage fell to 70%. In contrast, the percentage of pharmacies to which the newly established basic dispensing fee level 3 (20 points) applied became 23%, so there were concerns that its revenue base would fall significantly.

In terms of the various incentives, for example the "generic pharmaceuticals dispensing system incentives" is a mechanism that adds (incentivizes) 18 points or 22 points according to the situation of the prescription of generic pharmaceuticals. While it is possible that the reduction in the basic dispensing fee points can be compensated by the acquisition of these incentives, the standards for obtaining the incentives are also getting stricter with each revision.

The impact of the revisions to the basic dispensing fees



Source: prepared by FISCO from Company materials

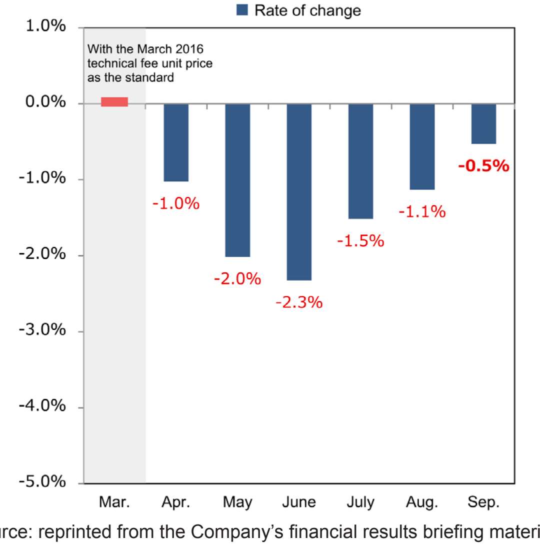
2) Status of the response by Nihon Chouzai

We can conclude that Company's response to the dispensing fee revisions have been more successful than actually planned. With regard to the dispensing technical fee unit price, using March 2016 immediately before the revisions as the standard, and looking at the monthly trend after that, we see that in April to June, the dispensing technical fee unit price fell significantly, in a range of -1% to -2.3%, but then in June this fall bottomed-out in and the extent of the negative growth was reduced, and by September the negative growth had shrunk to -0.5%.

As previously explained, the dispensing technical fee includes the dispensing fee that is determined by the type of medication and the number of prescription days (that is to say, it does not involve the dispensing pharmacy). According to the Company, the dispensing technical fee unit price after excluding this dispensing fee returned to positive growth in September compared to March. Therefore, it would seem that the Company can be evaluated as having completely absorbed the negative impact from the most recent revisions.

The Company, in its results targets for the current fiscal year, assumed that a dispensing technical fee unit price of -2% compared to March would continue throughout the year. But as of September this had shrunk to -0.5% and on an actual basis it had changed to positive growth, so this has become a factor for results to exceed the targets.

Trends in the dispensing technical fee unit price (change compared to March 2016)



Source: reprinted from the Company's financial results briefing materials

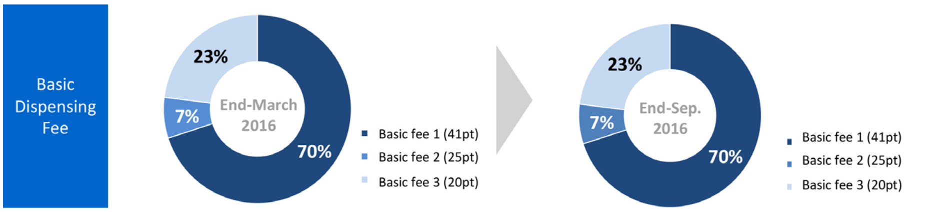
■ Trends by business segment

There were three major factors behind the Company successfully improving its dispensing technical fee unit price; improvements to the basic dispensing fee, the acquisition of standard dispensing incentives, and the acquisition of generic pharmaceuticals dispensing system incentives.

As described above, as a result of the revisions to the basic dispensing fee that were particularly severe for large-scale, hospital adjacent-type pharmacies, the percentage of the Company's pharmacies that obtain 41 points fell to 70%, and 23% of its pharmacies became 20-point pharmacies, so its pharmacy structure according to points obtained had greatly worsened by the end of September. On the surface, there have been no changes compared to the end of March. However, the Company succeeding in having 3 pharmacies excluded from the "special cases" for which the dispensing fee points are lowered (in other words, 41 points were still applied to them). At first glance, it would seem that having only 3 pharmacies excluded from the "special cases" from within its 544 pharmacies (number as of the end of September, dispensing pharmacies only) would not have that much of an effect, but this is absolutely not the case.

Each of the pharmacies that were excluded from the special cases in Q2 FY3/17 were large-scale pharmacies. Supposing that they handle 5,000 prescriptions a month, improving the basic dispensing fee by 21 points, from 20 points to 41 points, equals 5,000 prescriptions x ¥210《21 points ×10¥》x 12 months = ¥12.6mn of increased revenue. Also, as described below, a condition for the exclusion from special cases includes having a track record of being a family pharmacist that provides guidance to patients on taking medications. It is estimated that in the pharmacies that succeeded in being exempted from special cases, the number of cases where family pharmacist guidance fees applied is increasing, which has also become a factor pushing-up revenue. The standard for successfully being excluded from the special cases is extremely strict, but the Company is aiming to have more than 10 pharmacies excluded during the current fiscal year.

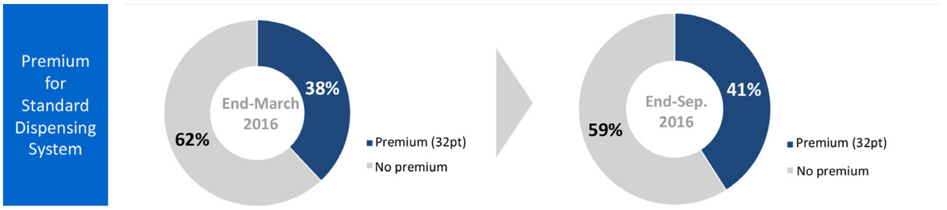
Comparison of the percentages of pharmacies by basic dispensing fee points (end of March 2016: end of September 2016)



Source: reprinted from the Company's financial results briefing materials

Standard dispensing incentives have the quality of adding points (incentivizing) to the basic dispensing fee in the pharmacy "system." In the most recent revisions, 32 points were added to pharmacies with a basic dispensing fee of 41 points that had in place a system with certain check items. The necessity of working to achieve exclusions from the special cases described above can also be found here. The check items for the "system" include the pharmacy's opening hours, the number of items in stock, if it has a 24-hour system, and its home care services. While the level to be cleared in order to obtain the incentives has been raised overall, the Company succeeded in raising the percentage of pharmacies with these incentives by 3 percentage points, from 38% at the end of March to 41% at the end of September.

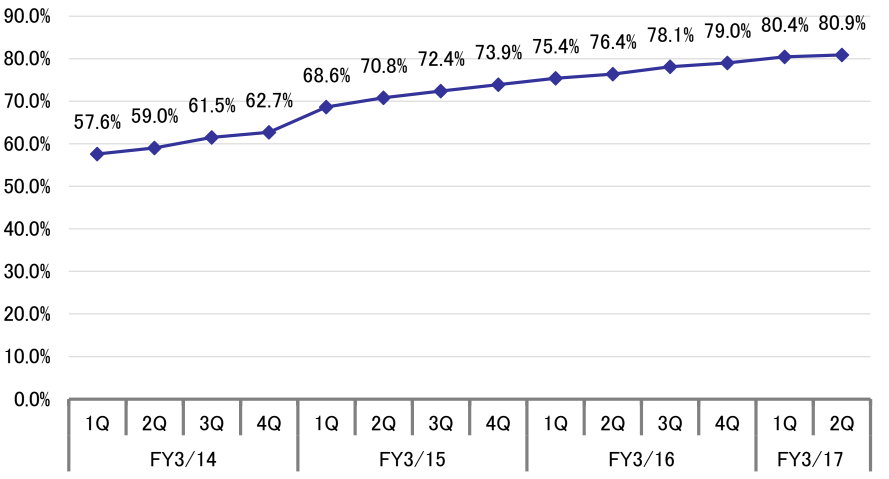
Comparison of the percentage of pharmacies by standard dispensing incentives (end of March 2016: end of September 2016)



Source: reprinted from the Company's financial results briefing materials

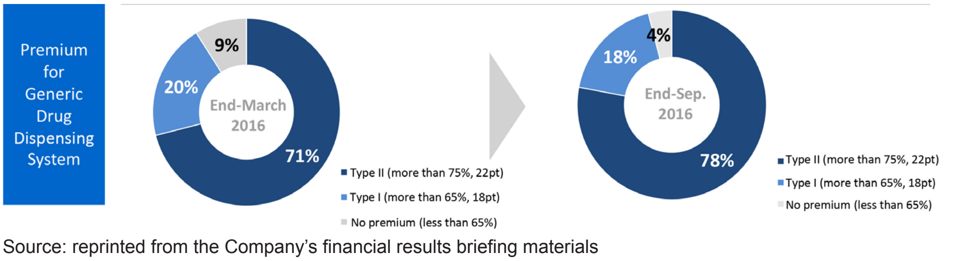
The acquisition of generic pharmaceuticals dispensing system incentives – or in other words improving the generic pharmaceuticals usage rate – is the most advantageous approach for the Company, and it is pursuing measures toward this as its basic philosophy. In the recent revisions, the standard to obtain the incentives was raised, yet the Company succeeded in increasing from 71% to 78% the percentage of its pharmacies that achieved this standard and that obtained incentive level 2 (22 points), and also in lowering from 9% to 4% the percentage of its pharmacies not receiving incentives. On a company-wide basis, the Company had already achieved its final target of 80% by April 2016.

Trends in the generic pharmaceuticals usage rate ＜quarterly basis＞



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

Comparison of the percentage of pharmacies by number of pharmacies obtaining generic pharmaceuticals dispensing system incentives (end of March 2016: end of September 2016)



Source: reprinted from the Company's financial results briefing materials

3) Responding to the shift to "family pharmacists"

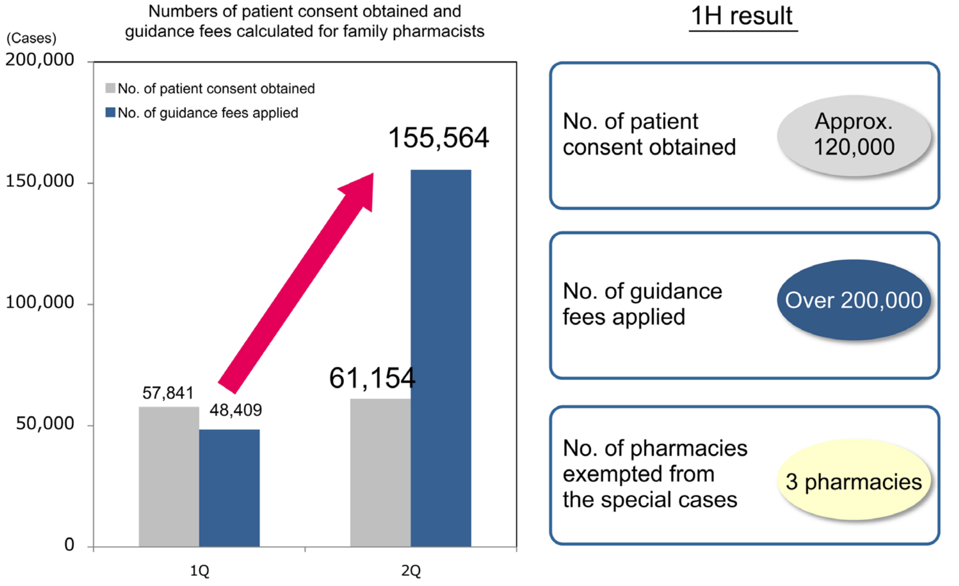
The direction of the shift being advocated by the Ministry of Health, Labour and Welfare is "from hospital adjacent-type pharmacies to family pharmacies." In other words, what is required of pharmacies is to shift from prioritizing "location" to "functions." The FY16 revisions to the dispensing fees were in line with this basic policy.

"Family pharmacist guidance fees" have been newly established as one part of this policy. It is a mechanism to create relations of trust between pharmacists and patients from their position of being "family pharmacists," and based on this, a higher pharmacy admin fee is calculated for the pharmacy from its provision of pharmacy administrative guidance. If the pharmacy satisfies the calculation requirements, the pharmacy admin fee is calculated as 70 points. As described above, the number of points for the basic dispensing fees can be calculated for it simply being "a pharmacy," but in this case, the pace of the reduction of points is fast. In contrast, the family pharmacist guidance fees are calculated according to "the role and function played by the pharmacy," and the high number of points (70) reflects the strong intention of the Ministry of Health, Labour and Welfare to promote this system. Therefore going forward, it is an area that can be expected to become a source of revenue.

Strict requirements have been set for the family pharmacist guidance fee calculation, such as obtaining consent forms from individual patients. With regard to these requirements, in Q2 FY3/17 the Company greatly improved its results, obtaining the consent of approximately 120,000 patients and calculations of more than 200,000 family pharmacist guidance fees. The number of cases where family pharmacist guidance fees applied, is one requirement for exclusion from the special cases provided for in the previously described revisions to the basic dispensing fees targeting large-scale, hospital adjacent-type pharmacies, so it is extremely meaningful in terms of increasing the number of pharmacies exempted from the special cases.

■ Trends by business segment

Status of measures to respond to the shift to "family pharmacists"



Source: reprinted from the Company's financial results briefing materials

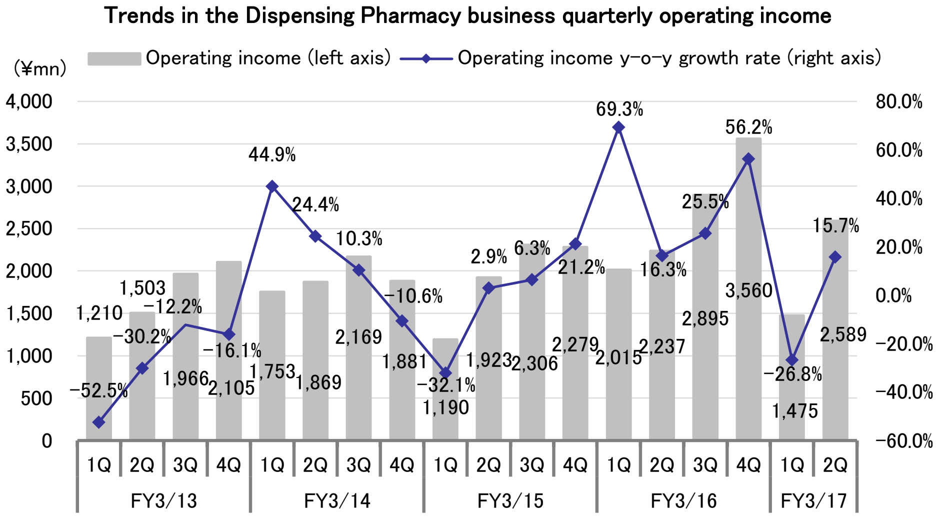
4) Trends in the Dispensing Pharmacy business results

As previously mentioned, in Q2 FY3/17 in the Dispensing Pharmacy business, sales increased but profits decreased. There may be a sense of disappointment about this decrease in profits, but at FISCO we think that the Dispensing Pharmacy business' Q2 FY3/17 results can be evaluated positively.

As explained above, the Company responded to the revisions to the dispensing fees by acquiring incentives for the dispensing technical fee and increasing the number of calculations of "family pharmacist guidance fees" in the pharmacy admin fee. As it will require some time to recover from the negative impact of these revisions, at FISCO we had thought that the effects of these responses would appear from 2H. But in fact, the extent of the negative growth started to fall from Q2 on a single quarterly period basis (July to September), and as of end of September, in substantive terms the impact of the revisions had been completely eliminated.

This can be clearly seen in the trend in operating income on a quarterly basis. The segment operating income in Q1 FY3/17 was ¥1,475mn, down significantly, by 26.8%, y-o-y. However, in Q2 on a single quarterly period basis, operating income reached ¥2,589mn, which is a y-o-y growth rate of 15.7%. As the dispensing fees and drug prices were revised in this fiscal year, there were considered to be many investors who were concerned about the results of the various companies in the dispensing pharmacy industry. But the Company has already completely absorbed the impact of the revisions and can be thought to have returned to the growth track that it has followed so far.

The point we will be paying attention to from the 2H FY3/17 onwards is the increase in the number of cases where family pharmacist guidance fees applied. As described above, on the one hand obtaining the patient's consent is one of the requirements, while on the other hand these fees have the characteristic of being stock-type revenue. The consent from patients obtained in this quarter will be reflected in the number of cases where family pharmacist guidance fees applied in the next quarter, with this cycle being repeated thereafter. During 1H FY3/17, the number applied was in excess of 200,000, but it is possible that they will increase dramatically, to around 400,000 to 500,000, in the 2H. At FISCO, we estimate that the impact of such a result on net sales and profits would be in the region of ¥280mn to ¥350mn.



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

c) Nihon Chouzai's pharmacy-opening strategy

1)The pharmacy-opening strategy basic approach

Up until the present time, the Company has expanded its pharmacy network mainly through organic pharmacy openings, or in other words, opening new pharmacies itself. As a result, the image held of the Company is that it does not actively seek to expand its pharmacy network through M&A, but this is absolutely not the case.

The Company's pharmacy-opening strategy and its approach to utilizing M&A for pharmacy openings have been consistent. It sets in-house standards for the ideal form of dispensing pharmacies and judges whether or not these standards have been met. The fact that it is extremely strict about adhering to these standards can be said to be one way the Company differs to its industry peers.

There are a number of factors in the background to and reasons why the Company has insisted these standards be met up to the present time. One is that, as previously explained, the Ministry of Health, Labour and Welfare is placing greater emphasis on pharmacies' "functions." The Company is aiming to open pharmacies in line with this emphasis, which inevitably determines aspects such as the pharmacy's floor area and the number of pharmacists required. When such pharmacies of a certain scale get on track, naturally they record sales of a commensurate scale.

On comparing net sales per pharmacy of the major listed dispensing pharmacy chains, we clearly see that the Company surpasses its industry peers. Its net sales per pharmacy in Q2 FY3/17 (annual basis) were ¥345mn, significantly surpassing the ¥251mn of Ain Holdings <9627> (based on its FY4/17 forecast).

Comparison of net sales per dispensing pharmacy

Company name	Code	Dispensing Pharmacy business						Net sales per dispensing pharmacy	Remarks
		No. of pharmacies		No. of pharmacies		Net sales			
		(pharmacies)	Point in time	(pharmacies)	Point in time	(¥mn)	Results period	(¥mn)	
Nihon Chouzai	3341	526	End of March 2016	544	End of September 2016	92,329	Q2 FY3/17	345	The number of pharmacies is dispensing pharmacies only and does not include product-sales drug stores
Ain Holdings	9627	881	End of April 2016	1,001	End of April 2017 E	236,100	FY4/17 E	251	Number of pharmacies is the number of dispensing pharmacies based on the company forecast
Qol	3034	563	End of March 2016	587	End of September 2016	55,079	Q2 FY3/17	192	The number of pharmacies includes pharmacies in Lawson, Bic Camera, and West Japan Railway, and JV pharmacies
Sogo Medical	4775	576	End of March 2016	580	End of September 2016	45,298	Q2 FY3/17	157	
Welcia Holdings	3141	894	End of February 2016	919	End of August 2016	47,572	Q2 FY2/17	105	The number of pharmacies is the number of "pharmacies also handling dispensing"

Note: net sales per dispensing pharmacy are calculated by dividing the Dispensing Pharmacy business net sales by the number of pharmacies handling dispensing at the beginning and at the end of the fiscal period. The values for Q2 FY16 have been doubled to calculate the annual rate. However, the value for Ain Holdings was calculated based on its FY4/17 full year forecast.

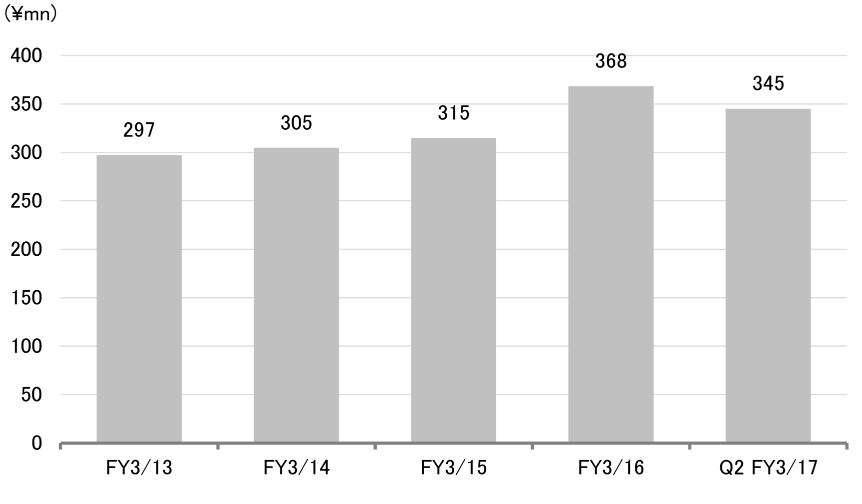
Source: prepared by FISCO from materials published by each company

But what is important here is that the net sales value is a result of the approach taken for opening pharmacies. As previously explained, if the pharmacy the Company considers to be "ideal" gets on track, net sales per pharmacy will be of a commensurate value. Net sales per pharmacy is merely a result of this approach for the Company.

The trend in net sales per pharmacy is an important indicator in order to correctly evaluate the Company's pharmacy-opening strategy. The Company's net sales per pharmacy have been rising year by year. As they were significantly pushed-up in FY3/16 by the effects of strong sales of a drug for hepatitis C, they appeared to decline in Q2 FY3/17 (the value has been doubled to convert the Q2 result into the annual result), but in substantive terms, they have been continuing to trend upward.

At FISCO, we interpret this upward trend as a reflection of the fact that the Company has been steadily strengthening the functions of its dispensing pharmacies and that the percentage of its pharmacies that are highly functional and highly efficient has been rising. It is the result of the Company's pharmacy-opening strategy in which it focuses not on the number, but on the quality of its pharmacies.

Trends in net sales per dispensing pharmacy

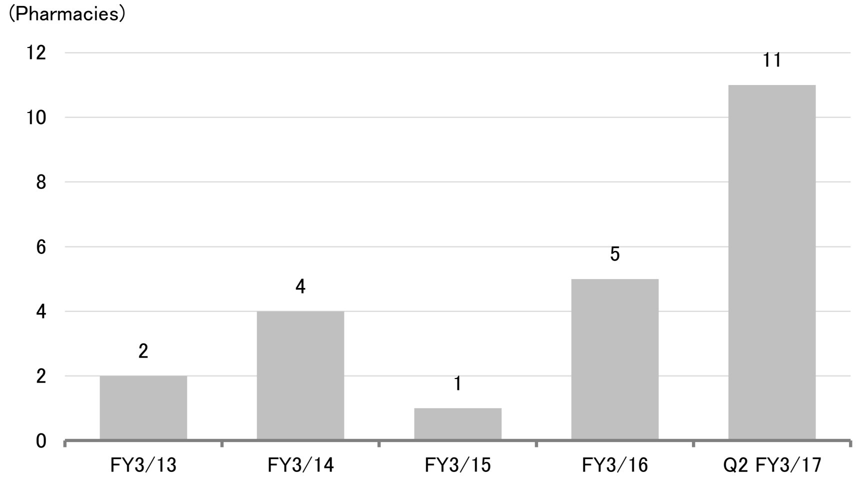


Source: prepared by FISCO from the Company's financial results briefing materials

2) Progress made in FY3/17 and outlook for the future.

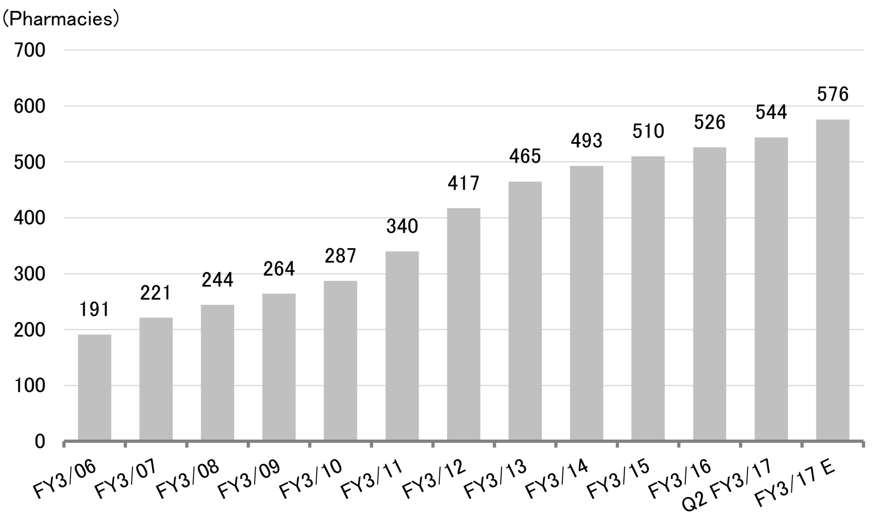
In Q2 FY3/17, changes have been seen to the Company's pharmacy-opening strategy described above. In the 1H FY3/17, the Company newly opened 23 pharmacies, and on breaking this down, 12 were pharmacies opened organically and 11 were pharmacies opened through M&A. As a result of the closure of 5 pharmacies during this period, compared to the previous fiscal year the total number of pharmacies increased by 18 to 545 pharmacies (of which, 1 specializes in product sales).

Trends in the number of M&A pharmacies



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

Trends in the number of dispensing pharmacies at the end of the fiscal year



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

The background to the rapid increase in the number of pharmacies opened by M&A to 11 pharmacies in Q2 FY3/17 includes the rise in the number of M&A candidates that meet the Company's standards. A model example of this is Mizuno Pharmacies, which the Company made into a subsidiary in October 2016. The company, known as Japan's first dispensing pharmacy, manages the Mizuno Pharmacies chain. It has two hospital adjacent-type pharmacies next to the University of Tokyo Hospital and the Nippon Medical School Hospital, and its results in FY11/15 were net sales of ¥2,788mn and recurring income of ¥79mn. It is exceptional on the point that its net sales per pharmacy are close to ¥1.4 billion, but in addition to this, it is characterized by features such as its safety-management system ("Chorec") that utilizes video cameras, thorough quality control symbolized by its acquisition of ISO certification, and ICT (operations systems) that are state-of-the-art in the industry. The Company expects to realize various synergies, including strengthening its advanced pharmaceutical administrative functions, developing next-generations operations systems, and utilizing the value of the Mizuno Pharmacies brand.

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3341 Tokyo Stock Exchange First Section

5-Jan.-17

At FISCO, we feel what is even more interesting about the Company making a subsidiary of Mizuno Pharmacies than its impact on results or the increase in the number of pharmacies, is the fact that Mizuno Pharmacies chose the Company. The background to Mizuno Pharmacies choosing Nihon Chouzai to become its parent is estimated to be from its comprehensive judgment of aspects such as the Company's management philosophy, governance, management expertise, and operations systems. Mizuno Pharmacies' brand power within the industry is extremely high, and at FISCO we expect other M&A projects will appear following on from Mizuno Pharmacies. Supposing that this will be the case, it would seem that the Company will be able to leverage brand-value synergies.

The number of Nihon Chouzai dispensing pharmacies was 544 pharmacies (as of the end of September 2016), meaning that to a certain extent there is a gap between the Company and the industry leaders for pharmacy numbers, of Ain Holdings (forecast for the end of April 2017: 1,001 pharmacies) and Welcia Holdings <3141> (result at the end of August 2016: 919 pharmacies). But the Company is not dwelling on this point, as there has been absolutely no change on the point that it prioritizes quality not quantity for its pharmacies. On the other hand, M&A candidates that meet the Company's standards are increasing and it has indicated that it recognizes that an environment is being established toward accelerating the pace of expansion of pharmacy numbers. The Company is planning to open 50 pharmacies in the FY3/17 full year, and in Q2 opened 23 new pharmacies. In 2H also, it intends to make steady progress in opening new pharmacies both organically and from M&A, and it seems confident that it will achieve its full year target. It is also expected to continue to actively open new pharmacies from the next fiscal year onwards, further securing its foothold as one of the largest chains in the industry and widening the gap between the Company and the medium- and small-scale chains.

Construction of Tsukuba Plant No.2 is fully underway and the current production capacity will be trebled

(2) Pharmaceutical Manufacturing and Sales business

The point that we at FISCO are currently focusing on for the Pharmaceutical Manufacturing and Sales business is the progress made in strengthening facilities. The Company is conducting capital investment to strengthen facilities aiming to approximately treble its current production capacity. The construction of Tsukuba Plant No.2 is central to this aim. Following on from the ground-breaking ceremony in June 2016, the ceremony to erect the main pillar was conducted in late October, and the construction of the building is now finally underway.

The Nihon Chouzai Group's targets to expand its generic pharmaceuticals production capacity

Company name	Plant name	Production capacity (100mn tablets/year)			
		End of FY3/15	End of FY3/16	End of FY3/17 E	Target
Nihon Generic	Tsukuba plant N building	10	10	10	10
	Tsukuba plant S building	13	13	26	26
	Tsukuba Plant No.2	-	-	-	100
	Kasukabe plant	9	9	9	9
	Sub-total	32	32	45	145
Choseido Pharmaceutical	Head Office Plant	7	7	7	7
	Head Office Plant No.2	2	2	2	2
	Kawauchi Plant	2	3	3	3
	Sub-total	11	12	12	12
Total		43	44	57	157

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

The Company is strengthening its production capacity at the same time as its industry peers, so there are concerns that the industry is heading toward having excess facilities. With regard to this point, Mr. Hiroshi Mitsuhara, President and Representative Director of the Company, stated at the financial results briefing that he believes the production of generics will be consolidated into five major companies, including the Company, in the future. The use of generics is also expected to become mandatory in future revisions to systems, so the Company, which is aiming to increase the number of items it manufactures from the current 599 items (as of the end of September 2016) to 1,000 items in the future, has expressed its view that concerns about excess facilities are unfounded. It has also suggested that it is considering producing injection medications in the future.

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5-Jan.-17

At FISCO, on the one hand we consider the view of President Mitsuhara to be persuasive, but on the other hand we think it will be necessary to pay attention to the intensification of price competition for generic pharmaceuticals that is currently occurring. The problem of price competition was the direct cause of the fall in profits despite higher sales in Q2 FY3/17 in the Pharmaceutical Manufacturing and Sales business segment. After the completion of Tsukuba Plant No.2, the Company Group will be placed in a disadvantageous position in the price competition compared to its industry peers with older facilities. In order to absorb the impact of this disadvantage as much as possible, it will be necessary to smoothly construct the plant and for it to have a high operations rate after it has been constructed. In this sense also, the progress made in the construction of Tsukuba Plant No.2 can be said to be a major point to focus on in conjunction with the trends in the generics market.

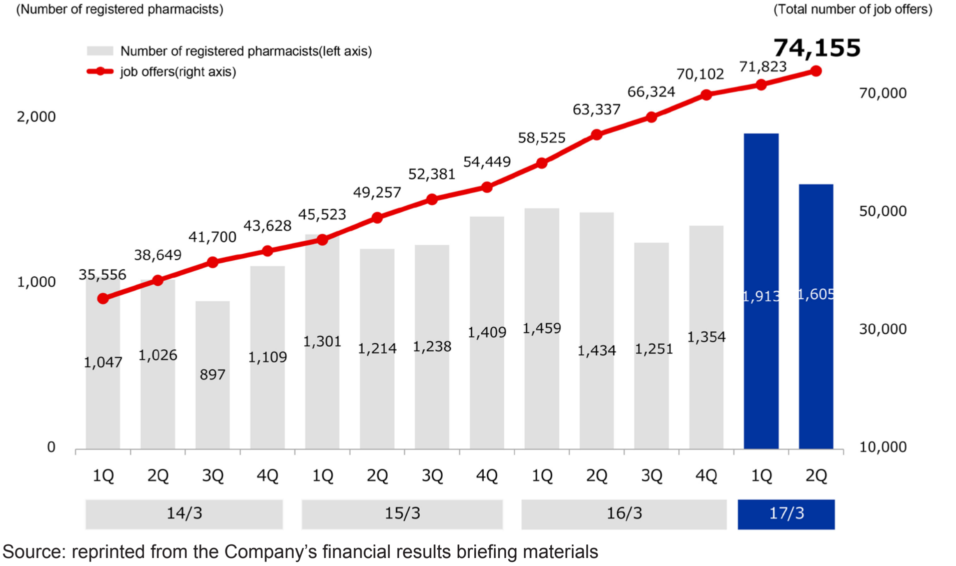
In its Dispensing Pharmacy business, the Company has a powerful sales network of 544 dispensing pharmacies (as of the end of September 2016). On this point, it is completely different to the other manufacturers of generic pharmaceuticals and it can be said to be the Company's strength. At FISCO, we think that by strengthening cooperation with its own sales network, the Company will be fully able to get past the time period in which the burden of depreciation will be heaviest after the completion of the capital investment.

Pharmacist entrant numbers are steadily increasing and growth in net sales is expected

(3) Medical Professional Staffing and Placement business

As previously described, sales increased but profits decreased in Q2 FY3/17 in the Medical Professional Staffing and Placement business. The total number of pharmacist job openings was for 74,155 people (end of September 2016), which ranked first among the main pharmacist recruitment websites. Pharmacist-entrant numbers also steadily increased and net sales are expected to smoothly grow in the future.

Trends in the number of registered pharmacists and job offers



Source: reprinted from the Company's financial results briefing materials

Conversely in terms of profits, in Q1 FY3/17 and Q2, the segment recorded the first y-o-y decline in profits since Q3 FY3/13. The reasons for this included the increase in recruitment costs and in advertising costs to improve the brand of the "Pharma Staff" website managed by the Company. The same as nurses, among medical professionals a high percentage of pharmacists are women. Therefore, there are viewpoints to consider such as work-life balance and it seems necessary to assume that pharmacist recruitment costs will remain high in the future.

Results outlook

Outlook is for higher sales and profits for the FY3/17 full year

(1) FY3/17 full year

For FY3/17 full year, the Company is forecasting net sales of ¥240,013mn (up 9.5% y-o-y), operating income of ¥11,165mn (up 6.4%), recurring income of ¥10,778mn (up 9.1%), and net income attributable to the owners of the parent company of ¥6,642mn (up 4.9%). These values are unchanged from the initial forecasts.

Summary of the outlook for the FY3/17 results

(¥mn)

	FY3/16			FY3/17					
	1H result	2H result	Full year result	1H		2H		Full year	
				Result	y-o-y	Forecast	y-o-y	Forecast	y-o-y
Net sales	100,269	118,970	219,239	109,478	9.2%	130,535	9.7%	240,013	9.5%
Operating income	4,214	6,275	10,489	3,940	-6.5%	7,225	15.1%	11,165	6.4%
Recurring income	3,936	5,942	9,878	3,751	-4.7%	7,027	18.3%	10,778	9.1%
Net income attributable to the owners of the parent company	2,471	3,858	6,329	2,339	-5.3%	4,303	11.5%	6,642	4.9%

Source: prepared by FISCO from the Company's financial results summary

As previously explained, in the Dispensing Pharmacy business, the impact of the revisions to the dispensing fees had been completely eliminated by Q2 FY3/17. On entering 2H also, from factors such as the increases in the number of pharmacies exempted from the special cases and in the number of cases where family pharmacist guidance fees applied, the prescriptions unit price was seen to continue to rise gradually after the drug fee and dispensing fee had been excluded. For pharmacy numbers also, the Company made steady progress toward its target of 50 new pharmacy openings for the year, including through M&A. It is forecasting full-year net sales in the Dispensing Pharmacy business segment of ¥197,536mn (up 3.5% y-o-y), and at FISCO we think it is highly likely that the result will exceed this forecast.

A key point in the Pharmaceutical Manufacturing and Sales business is whether the price competition we saw in Q2 FY3/17 will continue in 2H. Up to the present time, this competition has not eased so it seems we must assume that the fiercely competitive price environment will continue in 2H also. Conversely, net sales are expected to continue to trend upward from the increase in new products and the strengthened cooperation within the Group. Net sales for the full fiscal year in this segment were expected to be ¥46,271mn (up 41.9% y-o-y), but as the Q2 result was an increase of only 21.8%, it cannot be denied that the Company must clear a high hurdle in 2H to achieve its target.

In the Medical Professional Staffing and Placement business, both the number of job openings and the number of entrants are steadily increasing, and the outlook for net sales for the full fiscal year is ¥10,500mn (up 17.5% y-o-y), which at FISCO we think is fully achievable.

In profits, 2H is expected to follow the same pattern as Q2. In other words, the slowdown in profits due to the intensification of price competition in the Pharmaceutical Manufacturing and Sales business will be absorbed by the growth in the Dispensing Pharmacy business. The question is to what extent will the results in each segment exceed or fall below their respective profit targets. We think that the amount that result exceeds the target in the Dispensing Pharmacy business, which accounts for 87% of total sales, will be able to make up for the amounts that the other two segments fall below their targets.

Income statement and the main indicators

(¥mn)

	FY3/13 full year	FY3/14 full year	FY3/15 full year	FY3/16 full year	FY3/17 1H	FY3/17 2H E	FY3/17 Full year E
Net sales	139,466	165,347	181,844	219,239	109,478	130,535	240,013
y-o-y	7.2%	18.6%	10.0%	20.6%	9.2%	9.7%	9.5%
Gross profit	21,494	25,623	31,929	39,068	18,906	-	-
Gross profit margin	15.4%	15.5%	17.6%	17.8%	17.3%	-	-
SG&A expenses	18,248	20,878	25,281	28,578	14,965	-	-
Ratio of SG&A expenses to net sales	13.1%	12.6%	13.9%	13.0%	13.7%	-	-
Operating income	3,245	4,744	6,647	10,489	3,940	7,225	11,165
y-o-y	-40.6%	46.2%	40.1%	57.8%	-6.5%	15.1%	6.4%
Operating income margin	2.3%	2.9%	3.7%	4.8%	3.6%	5.5%	4.7%
Recurring income	2,855	4,188	6,003	9,878	3,751	7,027	10,778
y-o-y	-42.2%	46.7%	43.3%	64.5%	-4.7%	18.3%	9.1%
Net income attributable to the owners of the parent company	184	1,901	2,778	6,329	2,339	4,303	6,642
y-o-y	-91.1%	928.4%	46.1%	127.8%	-5.3%	11.5%	4.9%
EPS (¥)	25.67	262.48	388.96	432.85	146.26	268.53	415.27
Dividend per share (¥)	70	70	70	65	25	25	50
BPS (¥)	2,034.09	2,181.26	2,515.19	2,030.22	-	-	-
EPS after adjustment for stock-split (¥)	12.83	131.24	194.48	-	-	-	-
Dividend per share after adjustment for stock-split (¥)	35	35	35	45	-	-	-
BPS after adjustment for stock-split (¥)	1,017.04	1,090.63	1,257.59	-	-	-	-

Balance sheet

(¥mn)

	End of FY3/13	End of FY3/14	End of FY3/15	End of FY3/16	End of Q2 FY3/17
Current assets	43,037	53,373	60,096	84,838	75,713
Cash and deposits	14,583	15,429	13,952	32,385	17,353
Accounts receivable, etc.	13,645	18,664	21,413	26,810	26,191
Inventories	12,405	16,396	21,066	22,016	28,357
Fixed assets	52,102	63,921	70,044	72,770	84,064
Tangible fixed assets	32,459	42,123	48,819	51,997	60,781
Intangible fixed assets	9,423	11,103	10,376	10,122	12,608
Investments, etc.	10,219	10,694	10,848	10,650	10,674
Total assets	95,140	117,295	130,141	157,609	159,777
Current liabilities	44,702	55,666	53,474	68,985	67,732
Accounts payable	24,542	28,963	33,392	44,653	41,753
Short-term debt, etc.	14,065	18,639	11,169	12,963	15,969
Fixed liabilities	35,735	45,779	59,031	56,151	57,672
Long-term debt	33,845	42,165	53,184	50,621	52,448
Shareholders' equity	14,353	15,845	17,515	32,507	34,446
Capital	3,953	3,953	3,953	3,953	3,953
Capital surplus	4,754	4,754	4,754	10,926	10,926
Retained earnings	7,915	9,310	11,868	17,672	19,611
Treasury stock	-2,269	-2,171	-3,059	-44	-45
Total accumulated other comprehensive income	349	3	119	-34	-73
Net assets, total	14,702	15,849	17,635	32,473	34,372
Total liabilities and net assets	95,140	117,295	130,141	157,609	159,777

Cash flow statement

(¥mn)

	FY3/13	FY3/14	FY3/15	FY3/16	Q2 FY3/17
Cash flow from operating activities	2,885	6,243	5,831	19,327	-4,588
Cash flow from investing activities	-6,422	-14,510	-8,437	-7,823	-14,366
Cash flow from financing activities	5,496	8,782	1,422	7,031	3,923
Change in cash and deposits balance	1,958	514	-1,183	18,536	-15,031
Cash and deposits balance at start of fiscal year	12,544	14,513	15,027	13,844	32,380
Cash and deposits balance at end of fiscal year	14,513	15,027	13,844	32,380	17,348

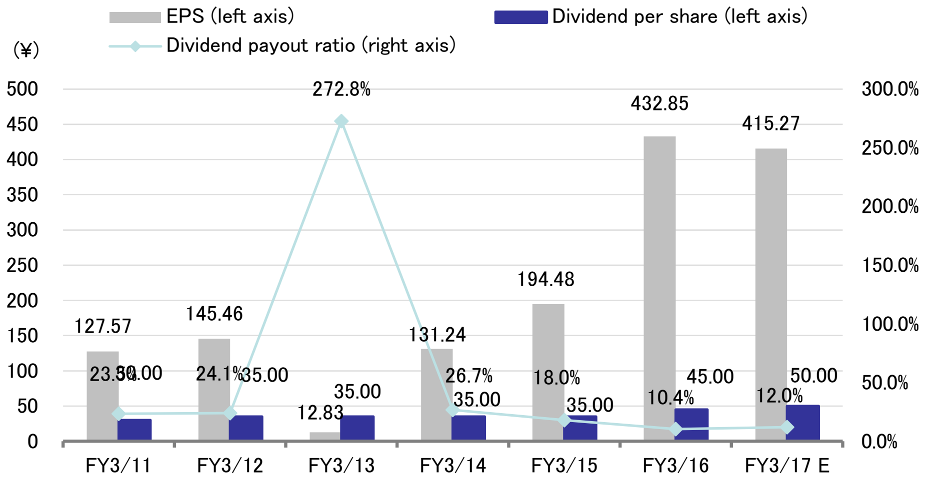
Returns to shareholders

Pays dividends while maintaining a balance with securing internal reserves for growth

The Company's basic approach to shareholder returns is to pay dividends linked to business performance while ensuring it maintains the internal reserves necessary for growth.

For FY3/17, the Company has announced its forecast of an annual dividend of ¥50, comprised of an interim dividend of ¥25, which it has paid, and a year-end dividend of ¥25. As of the time of the Q2 results announcement, the initial dividend forecast had not been changed. The Company conducted a stock-split on October 1, 2015, so upon adjusting for this, the annual dividend for FY3/16 becomes ¥45, meaning the FY3/17 dividend will increase by ¥5 y-o-y. The FY/17 forecast EPS is ¥415.27, and the dividend payout ratio calculated based on this is 12.0%.

Trends in EPS, dividend per share, and the dividend payout ratio



Source: prepared by FISCO from the Company's financial results summary

Note: the Company implemented a two-for-one stock split on October 1, 2015, and the EPS and the dividend per share in the graph take into account this stock split.

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