COMPANY RESEARCH AND ANALYSIS REPORT

NIHON CHOUZAI Co., Ltd.

3341

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Summary

Turning the severity of the revisions to its advantage, is aiming for dramatic growth in the medium- to long-term

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 and placement business for medical professionals and an information-provision and consulting business, and it is developing its operations with a structure that covers four business departments.

**1. Announced its Long-term Vision toward 2030.
Aiming to achieve a 10% share of the dispensing pharmacy market and net sales of ¥1 trillion**

The Company has announced its Long-term Vision toward 2030. Starting with the Dispensing Pharmacy business, the Vision sets-out its aims of increasing sales and profits in its existing three businesses and achieving net sales of ¥1 trillion by 2030. In the Dispensing Pharmacy business, the growth strategy is to "expand market share through surviving and winning the competition," and it is aiming to acquire a 10% share of the dispensing pharmacy market, which is expected to expand to a scale of ¥9 trillion, and thereby to dramatically increase net sales to around ¥900bn. In the Pharmaceutical Manufacturing and Sales business, its goals are to secure its position as one of the five major companies and to acquire a market share of 15% through a growth strategy centered on utilizing its state-of-the-art Tsukuba Plant No.2.

**2. Aiming to survive and win the competition and to expand market share
by utilizing its strength of creating highly efficient, highly profitable pharmacies**

Surviving and winning the competition and expanding market share are considered to be themes common to all companies operating dispensing pharmacy business, but among them, at FISCO we think that the Company is the one that is most likely to achieve these aims. What we are focusing on the most is that the Company's net sales per pharmacy is overwhelming higher than those of its industry peers. This creates a virtuous circle, in which it uses the cash flow created from its highly profitable pharmacies to invest in ICT and human resources, which further improves the efficiency of pharmacy management, which in turn leads to higher sales and profits. The April 2018 revisions to the dispensing fees are expected to result in the fully-fledged acceleration of the industry reorganization. The Company plans to realize its targeted growth strategy that reflects the industry reorganization (namely, M&A) by fully utilizing its strengths that are supported by its highly efficient pharmacy management, which include its capital strength, its track record in rehabilitation, and its abundant human resources and ICT.

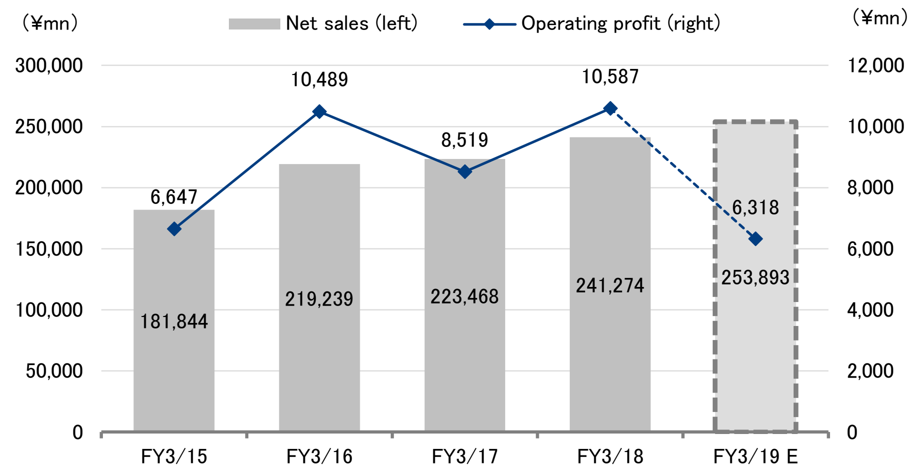
3. Profits are forecast to decline greatly in FY3/19 due to the revisions to fees, but it is not a cause for excessive concern

FY3/18 was not a year affected by revisions, so sales and profits grew steadily in the Dispensing Pharmacy business and new record highs were achieved for net sales, operating profit, and ordinary profit. However in FY3/19, in addition to the decline in profits in the Dispensing Pharmacy business from the effects of the April 2018 revisions, profits are forecast to significantly decline in the Pharmaceutical Manufacturing and Sales business from the increase in costs on the start of operations at the new plant. So on a Company-wide basis, operating profit is forecast to decrease 40% YoY. But as described above, as a result of the pharmacy-building efforts up to the present time, at FISCO we think that not only does the Company have the strength to resist the negative effects of the system revisions, it has actually reached a point where it is able to turn them to its advantage. In the Pharmaceutical Manufacturing and Sales business, a V-shaped recovery in profits is expected due to factors including the expansion of products manufactured in-house and in commissioned manufacturing. So the decline in profits in FY3/19 is not considered to be a cause for excessive concern.

Key Points

- Announced the Long-term Vision toward 2030, with the aim of net sales of ¥1 trillion
- The growth-strategy framework is surviving and winning the competition and expanding market share, which it is aiming to realize through the three elements of highly profitable pharmacies and investment in human resources and in ICT
- The focus will also be on the acceleration of M&A in response to environmental changes

Results trends



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

Results trends

Results steadily grew in the Dispensing Pharmacy and the Medical Professional Staffing and Placement businesses, for higher sales and profits
Achieved new record highs for net sales, operating profit, and ordinary profit

● Summary of the FY3/18 results

Both sales and profits increased in the Company's FY3/18 results, with net sales of ¥241,274mn (up 8.0% YoY), operating profit of ¥10,587mn (up 24.3%), ordinary profit of ¥10,138mn (up 27.1%), and profit attributable to owners of parent of ¥6,104mn (up 31.6%).

Compared to the previous Company forecasts, net sales were 2.8% above forecast, while each of the profit items from operating profit down were around 5% above their respective forecasts. Further, each of net sales, operating profit, and ordinary profit were record highs.

Overview of FY3/18 results

(¥mn)

	FY3/17	FY3/18			
	Full year	Full year			
	Results	Forecast	Results	YoY	Vs. forecast
Net sales	223,468	234,697	241,274	8.0%	2.8%
Operating profit	8,519	10,105	10,587	24.3%	4.8%
Ordinary profit	7,976	9,804	10,138	27.1%	3.4%
Profit attributable to owners of parent	4,638	5,639	6,104	31.6%	8.3%

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

(1) Dispensing Pharmacy business

In FY3/18, the Company newly opened 36 pharmacies (20 hospital-adjacent type and 16 hybrid type) and closed 8 pharmacies. So the number of pharmacies at the end of March 2017 had increased by 28 compared to the end of March 2018 to 585 pharmacies (including 2 product-sales pharmacies).

For the main KPI (key performance indicators), on a Company-wide basis, the number of prescriptions increased 6.1% YoY to 13,739,000, while the prescription unit price rose 2.5% to ¥14,739. Breaking this down, on an existing-pharmacies basis, the number of prescriptions increased 0.9%, the prescription unit price rose 2.8%, and existing pharmacy net sales grew 3.7%, confirming that the Company is making steady progress in improving profitability.

KPI growth rates by pharmacy opening and by fiscal year in the Dispensing Pharmacy business

	FY3/18		
	Dispensing net sales	No. of prescriptions	Prescription unit price
Existing pharmacies	3.7%	0.9%	2.8%
Pharmacies opened in FY3/17	87.2%	82.0%	2.9%
All pharmacies	8.3%	6.1%	2.5%

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

In profits, the Company worked continuously to improve the technical fees, and therefore the gross profit margin improved by 0.8 of a percentage point YoY to 16.0%. As a result, gross profit increased 14.6% (¥4,189mn), absorbing the rise in SG&A expenses (up 7.0% to ¥1,338mn), and operating profit rose to ¥2,851mn.

As a result of the above, in the Dispensing Pharmacy business, net sales were ¥205,192mn (up 8.4% YoY) and operating profit was ¥12,411mn (up 29.8%). Both net sales and operating profit were above their initial forecasts.

(2) Pharmaceutical Manufacturing and Sales business

In the Pharmaceutical Manufacturing and Sales business, net sales increased 3.4% YoY to ¥38,066mn, while operating profit decreased 30.5% to ¥1,194mn, for higher sales but lower profits. Both net sales and operating profit were below their initial forecasts.

Net sales are broadly dividend into internal sales, which are to the Company's own chain of pharmacies, and external sales. Within them, internal sales have grown steadily alongside the expansion of the Dispensing Pharmacy business. Conversely, external sales have increased only slightly as a result of the review of the sales strategy to focus more on profitability.

While profits rose from the effects of the higher sales, overall profits declined YoY due to the increases in R&D costs and depreciation costs, including due to upgrading existing equipment. The Company expected a decline in profits from the beginning, but the extent of this decline was greater than anticipated because net sales were less than forecast.

(3) Medical Professional Staffing and Placement business

Sales and profits increased in the Medical Professional Staffing and Placement business, with net sales rising 14.0% YoY to ¥11,970mn and operating profit climbing 7.7% to ¥1,842mn. Compared to the forecasts, net sales were basically as forecast and operating profit was very slightly below forecast, so steady progress was made.

Sales increased due to the rise in the number of staffing appointments in the context of the growth in demand for staffing against the backdrop of the shortage of pharmacists. The number of placements also grew, including due to the strengthening of measures in the industry as a whole for family pharmacists and pharmacies, and this also contributed to the higher sales.

For profits, on the one hand, profits increased due to the effect of the higher sales and also the expansion of the placement business, which has a high gross profit margin. But on the other hand, profits declined because of the increases in recruitment costs and in costs for strengthening measures in the doctor placement business. Therefore, the growth in profits was slightly less than forecast

Breakdown by business segment for FY3/18

(¥mn)

		FY3/17	FY3/18			
		Full year	Full year			
		Results	Forecast	Results	YoY	Vs. forecast
Net sales	Dispensing Pharmacy business	189,327	196,681	205,192	8.4%	4.3%
	Pharmaceutical Manufacturing and Sales business	36,821	41,500	38,066	3.4%	-8.3%
	Medical Professional Staffing and Placement business	10,500	12,000	11,970	14.0%	-0.2%
	Before adjustment	236,649	250,181	255,230	7.9%	2.0%
	Adjustment	-13,180	-15,484	-13,955	-	-
	Net sales total	223,468	234,697	241,274	8.0%	2.8%
Operating profit	Dispensing Pharmacy business	9,560	11,019	12,411	29.8%	12.6%
	Pharmaceutical Manufacturing and Sales business	1,719	1,673	1,194	-30.5%	-28.6%
	Medical Professional Staffing and Placement business	1,710	2,000	1,842	7.7%	-7.9%
	Before adjustment	12,989	14,692	15,448	18.9%	5.1%
	Adjustment	-4,470	-4,587	-4,861	-	-
	Operating profit total	8,519	10,105	10,587	24.3%	4.8%

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

The content and the effects of the April 2018 revisions to dispensing fees

The content of the April 2018 revisions is severe, but it is fully possibly that the Company will be able to utilize its pharmacy strategy up to the present time and turn this to its advantage

1. Summary of and thinking behind the April 2018 revisions

The drug prices and dispensing fees were revised in April 2018 for the first time in 2 years. The revisions' impact on results is expected to be extremely severe, and the Company is forecasting that in FY3/19, operating profit in the Dispensing Pharmacy business will decline 24.0% YoY.

However, while it cannot be denied that the April 2018 revisions will have a negative impact on results in the short term, at FISCO we think that if we look on a medium-term time axis, they may actually serve to reinforce the Company's relative superiority. There are many aspects that will rely on the Company's efforts going forward so we will not go as far to say that the revisions will be "advantageous for the Company." But we consider that it is entirely possible that when we reflect back in the future, we will see the April 2018 revisions as one turning point for it.

At FISCO, we understand the two major points in the April 2018 revisions to be as follows; first is the fact that the direction the government (the Ministry of Health, Labour and Welfare) is aiming for has been cleared by one more level, and second is that it is expected that the reorganization of the dispensing pharmacy industry will be accelerated by the severity of the revisions. On these points, the Company is operating pharmacies in an industry-leading manner in line with the approach for pharmacies that the Japanese government considers to be ideal (which it sets out in its Vision of Pharmacies for Patients). The details will be given in the Medium- to Long-Term Growth Strategy section, but it is expected that the Company will finally be able to demonstrate the true value of its strategy of maximizing net sales per pharmacy, which it has consistently pursued. If the industry reorganization accelerates as expected, it would seem that it will be able to use its highly functional, highly efficient pharmacies as a weapon and be on the winning side in the reorganization. It is said that threat and opportunity are two sides of the same coin, and we think that the Company is one of the few companies that has the ability to turn the severity of the April 2018 revisions to its advantage.

Below, within the April 2018 revisions, the three points whose effects are expected to be particularly great–of the basic dispensing fee, the generic pharmaceuticals dispensing system incentive, and the abolition of the standard dispensing incentive and the establishment of the community support system incentive–will be described. The other revision items will have effects on a prescription-by-prescription basis, but the effects of these three items will affect all of the prescriptions handled by every pharmacy. Also, it can be said that the eight requirement items for the calculation of the community support system incentive bring together all of the government's requirements of pharmacies, and it is considered that the progress made in responding to these requirements will play an important role in determining whether or not companies survive or do not survive the industry reorganization, and also the suitability of companies as investment targets.

The review of the evaluations of hospital-adjacent pharmacies is continuing, and the basic dispensing fee is being greatly reduced

2. Revision to the basic dispensing fee

The government has set different basic dispensing fees according to the type of pharmacy. The government's awareness with regards to the types of pharmacy are as follows: 1) there are many hospital-adjacent pharmacies, including large-scale ones, but there are few pharmacies that are accepting prescriptions from various medical facilities; and 2) major dispensing pharmacy chains (major insurance pharmacies with a chain of more than 20 pharmacies) are increasing and profitability is tending to rise from the deployment of multiple pharmacies. Based on this awareness, the government has reached the conclusion that it cannot be said that the current situation realizes the "family pharmacists and pharmacies" that it is aiming for. Therefore, it is introducing measures to specifically reduce the basic dispensing fee with the aim of optimizing hospital-adjacent pharmacies' dispensing fees.

Specifically, the basic dispensing fee is divided into four levels, of 1 (41 points) to 3 (20 points or 15 points) depending on the concentration rate and the number of prescriptions. The difference between the basic dispensing fees 1 to 3 is a maximum of 26 points. But this basic dispensing fee applies to all of the prescriptions handled by the relevant pharmacies, so taking as an example a pharmacy that handles 200 prescriptions per day, it would create a difference in revenue (which is more or less equivalent to profit) of "200 prescriptions x 26 points x 22 days (assuming 2 days of holidays per week) x 12 months x ¥10 / points = ¥13,728,000."

In the April 2018 revisions, the standard for the concentration rate was lowered, so it has become easier for pharmacies that had calculated as the basic dispensing fee 1 up to that time to calculate as 2. In addition, the basic dispensing fee 3 was divided into a further 2 levels, and the group with more than 400,000 prescriptions per month was reduced to 15 points, as “3-b.” Also, a special basic dispensing fee (10 points) was newly created, targeting pharmacies located within hospital premises.

Content of the revisions to the basic dispensing fee

		FY2016 revision	Points		FY2018 revision	Points
Basic dispensing fee	1	Other than 2 or 3	41	1	Other than 2 or 3	41
	2	4,000+ prescriptions/month and 70%+ from a single medical institution 2,000+ prescriptions/month and 90%+ from a single medical institution 4,000+ prescriptions/month from particular medical institutions	25	2	4,000+ prescriptions/month and 70%+ from a single medical institution 2,000+ prescriptions/month and 85%+ from a single medical institution 4,000+ prescriptions/month from particular medical institutions If the same medical institution also has the highest pct. of prescriptions for an entire pharmacy group, 4,000+ prescriptions/month at group pharmacies	25
	3	Group with 40,000+ prescriptions/month and 95%+ for a single medical institution	20	3-a	Group with 40,000+ prescriptions/month and 85%+ for a single medical institution	20
				3-b	Group with 400,000+ prescriptions/month and 85%+ for a single medical institution	15
Special basic dispensing fee		-	-		Real estate and other transactions with a hospital and 95%+ for a single medical institution	10

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

Immediately before the revisions in March 2018, 85% of the Company’s pharmacies calculated as basic dispensing fee 1. On applying the April 2018 revisions, this percentage drops greatly, to 48%. In contrast, the percentage taking the basic dispensing fee 3–b increases to 50%, and in addition, the percentage calculating the newly established special basic dispensing fee for pharmacies located within hospital premises becomes 1%. The weighted-average points, which is based on the number of dispensing pharmacies at the end of March 2018 of 583 pharmacies, falls by 10.6 points, from 38.1 points before the revision to 27.5 points after the revision.

There are not many measures available to respond to this. For the pharmacies that calculated as basic dispensing fee 2 or 3 up until last year, there had been a provision that they could be excluded from the application of the special case for the lowering of the basic dispensing fee (or in other words, they could be calculated as basic dispensing fee 1) by enhancing their responses as family pharmacists and pharmacies, but this was abolished in the April 2018 revisions. Therefore, for pharmacies other than those calculating with basic dispensing fee 1, the only recovery measure available to them is to acquire the community support system incentive that is described below. But this requires them to clear an extremely high hurdle compared to that required for the previous exclusion from the application of the special case.

Effects of revisions to the basic dispensing fee

Before revision		
Classification	Points	% of pharmacies
Basic dispensing fee 1	41	85%
Basic dispensing fee 2	25	4%
Basic dispensing fee 3	20	11%
Average	38.1	100%
No. of pharmacies (excluding product-sales pharmacies)	583	

After revision		
Classification	Points	% of pharmacies
Basic dispensing fee 1	41	48%
Basic dispensing fee 2	25	1%
Basic dispensing fee 3-b	15	50%
Special basic dispensing fee	10	1%
Average	27.5	100%
No. of pharmacies (excluding product-sales pharmacies)	583	

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

For the Company, which has already achieved the percentage target for the use of generics, the impact of the revisions will be limited

3. The generic pharmaceuticals dispensing system incentive

Depending on the generic pharmaceuticals dispensing conditions, each pharmacy can receive the incentive. The incentive points differ depending on the percentage of generic pharmaceuticals dispensed (on a volume basis), and previously pharmacies with a percentage of 75% or more were calculated as incentive 2 and were able to receive 22 points. However, following the April 2018 revisions, this standard was raised to 80% or more. The figure of 80% is the level that the government (the Ministry of Health, Labour and Welfare) has set as the overall target up to 2020. Also, pharmacies with 85% or above are to be newly calculated as incentive 3 (26 points), but conversely, the level to acquire incentive 1 (18 points) has been raised to 75%. This is a so-called carrot and stick strategy, and it shows the strengths of the government's intention to achieve the target.

The revisions to the generic pharmaceuticals dispensing system incentive

	FY2016 revision		Points	FY2018 revision		Points
The generic pharmaceuticals dispensing system incentive	1	65-75%	18	1	75-80%	18
	2	More than 75%	22	2	80-85%	22
				3	More than 85%	26

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

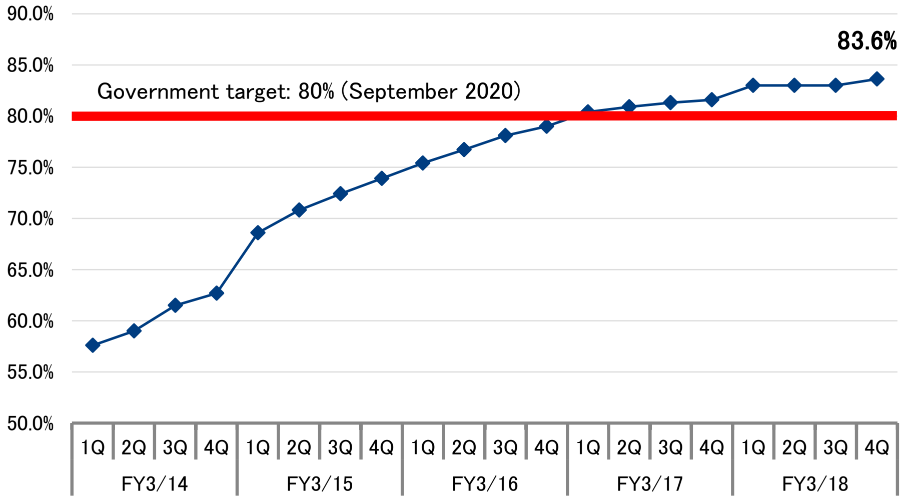
The Company has already achieved the government's percentage target for the use of generic pharmaceuticals, and it would seem to be running at the head of the field among the companies in the dispensing pharmacies industry. As a result of the incentive 1 calculation standard being raised from the previous 65% to 75%, the percentage of the Company's pharmacies receiving no incentives rose from 4% immediately before the revision to 12% after it. But as the percentage of pharmacies receiving the newly established incentive 3 had reached 38% at the end of March 2018, the decline in the weighted average points for the 583 pharmacies that were the subjects of the revisions was only 0.7 of a point, from 20.7 points before the revision to 20.0 points after it. For the Company, which has focused on expanding the use of generic pharmaceuticals since the past, the impact of the recent revisions will be limited, and at FISCO we think that their impact will have disappeared in the not-too-distant future.

Impact of the revision to the generic pharmaceuticals dispensing system incentive

Before revision			After revision		
Classification	Points	% of pharmacies	Classification	Points	% of pharmacies
Incentive 1	18	10%	Incentive 1	18	23%
Incentive 2	22	86%	Incentive 2	22	27%
No incentives	0	4%	Incentive 3	26	38%
			No incentives	0	12%
Average	20.7	100%	Average	20.0	100%
No. of pharmacies (excluding product-sales pharmacies)	583		No. of pharmacies (excluding product-sales pharmacies)	583	

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

Trend in the percentage of the Company's use of generic pharmaceuticals



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

With the establishment of the community support system incentive, the role that the government requires of pharmacies has been further clarified

4. Abolition of the standard dispensing incentive and the establishment of the community support system incentive

Up until recently, the standard dispensing incentive (32 points) was calculated for pharmacies that received the classification of 1 for basic dispensing fee by them meeting certain requirements. But this system was abolished in the April 2018 revisions and the community support system incentive (35 points) was established.

For the standard for facilities, the government set 11 items as the calculation requirements, and within them, the biggest point is the requirement of having "A considerable track record showing that there is a system in place that contributes to community medical care (hereafter, abbreviated to "track record requirement"). The specific content of the track record requirement is that it is necessary to satisfy all eight items per full-time pharmacist in one year.

This requirement is not applied to pharmacies classified as basic dispensing fee 1, and it is only necessary for them to clear the same requirement as that of the previous standard dispensing incentive. As previously explained, the government's policy clarifies that the calculation of the basic dispensing fee 1 has been made stricter for hospital-adjacent pharmacies, and it seems that the basic dispensing fee 1 will be mainly applied to pharmacies managed by individuals and to foot traffic-type pharmacies in urban areas. The major dispensing chains that have a high percentage of hospital-adjacent pharmacies must supplement the part of the basic dispensing fee that has been reduced with the community support system incentive. So it seems that the government's intention is to bring pharmacies closer to the image it has for them through the efforts to obtain this incentive.

Details of the abolition of the standard dispensing incentive and the establishment of the community support system incentive

	FY2016 revision	Points	FY2018 revision	Points
Standard dispensing incentive	Only basic fee 1 ・At-home medical care services: more than one service a year ・Notice of family pharmacist on the staff ・Managing pharmacist (5 years of pharmacy experience, 1 year at the current pharmacy, 32 working hours every week)	32	Terminated	
Community support system incentive	-	-	Basic fee 1 Same as requirements for the previous premium for standard dispensing system ・At-home Medical Care Services: more than one service a year ・Notice of family pharmacist on the staff ・Managing pharmacist (5 years of pharmacy experience, 1 year at the current pharmacy, 32 working hours every week) Other than basic fee 1 All of the following items have been added for each full-time pharmacist in every year 1. Nighttime and weekend/holiday services: 400 times 2. Receipt of narcotic guidance premium: 10 times 3. Receipt of premium for prevention of overlapping dosages and harmful drug interactions, etc.: 40 times 4. Receipt of family pharmacist guidance fee, etc.: 40 times 5. Receipt of outpatient drug use assistance fee: 12 times 6. Receipt of drug use adjustment assistance fee: 1 time 7. At-home pharmacist supervision of a one patient in a single building: 12 times 8. Receipt of drug use information provision fee: 60 times	35

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

As of March 2018, which was before the April 2018 revisions, 58% of the Company's pharmacies received the standard dispensing incentive. However, on the application of the requirements of the community support system incentive, the percentage of pharmacies receiving the incentive fell to 32%. This was due to the impact of the previously described major decline in the percentage of pharmacies calculating as basic dispensing fee 1, based on the standard after the April 2018 revision. Pharmacies other than those calculating as the basic dispensing fee 1 have to clear the eight track record requirements in 1 year in order to obtain the community support system incentive, but a certain amount of time will be required for this (the evaluation for the standard that will be conducted in April of each year will be based on the results for the past most recent 1 year. The calculations will be in July for 2018, as it is the first year of its introduction). As the Company has been progressing pharmacy management in accordance with the government's Vision of Pharmacies for Patients, it seems to be in a relatively superior position to clear the track record requirements compared to its industry peers. But it is considered that it will not be easy even for the Company to recover the percentage of pharmacies receiving incentives back to the previous level.

Medium to Long-Term Growth Strategy: Long-term Vision toward 2030

In the Dispensing Pharmacy business, aiming to achieve a market share of 10% and net sales of ¥1 trillion by 2030

1. Summary of the Long-term Vision toward 2030

The Company announced its Long-term Vision toward 2030 in April 2018. In terms of its content, it describes how the Company will overcome the changes in the social structure within Japan (including the progress toward an ultra-aging society) and the increasing demands to reduce medical costs, and also the environmental changes, such as the advanced functions being required of pharmacies and the weeding-out of dispensing pharmacies. It states that, starting with the Dispensing Pharmacy business, it will dramatically expand each business toward achieving a corporate scale of ¥1tn in net sales by 2030.

In addition, the Company has set the targets of acquiring market shares of 10% in its mainstay Dispensing Pharmacy business and 15% in its Pharmaceutical Manufacturing and Sales business. For the Dispensing Pharmacy business, the market scale is expected to expand from the current scale of approximately ¥8 trillion to around ¥9 trillion by 2030. So by acquiring a 10% share of this market, it plans to grow this into a business in the scale of ¥900bn. For the Pharmaceutical Manufacturing and Sales business, the Company's opinion is that generic pharmaceuticals manufacturers will be consolidated into five or six major companies in the future, and in this situation, this value of 15% indicates its intention to be in the group that survives and wins the competition.

In terms of its business portfolio, currently around 80% of the Company's operating profit is provided by the Dispensing Pharmacy business. But at the 2030 stage, the prospect is that the percentage of operating profit from businesses other than Dispensing Pharmacies business will have risen to as high as around 50%. Its policy is to accelerate the growth of the Pharmaceutical Manufacturing and Sales business, as well as speed-up training and development in the Medical Professional Staffing and Placement business, so it comes to have a presence that supports profitability.

Through investing in human resources and IT, the Company is aiming to provide high quality medical services and to achieve dramatic growth through a strategy of surviving and winning the competition and expanding market share

2. The Dispensing Pharmacy business growth strategy

The government's various policies for dispensing pharmacies are being advanced in accordance with its Vision of Pharmacies for Patients, which was announced in October 2015. The measures are being progressed in stages toward realizing the vision of pharmacies being aimed for, but the April 2018 revisions further clarified the direction the government wants to achieve.

The realization of a community-based integrated care system is the highest-ranking concept in the government's measures for medical care and nursing care. Dispensing pharmacies are expected to play a role in this community-based integrated care system, and the Vision of Pharmacies for Patients indicates the ideal images of pharmacists and pharmacies in order for them to do this. One of the specific approaches for this is family pharmacists and pharmacies, and in the last few years, the Company has been actively working for this.

In the April 2018 revisions, the community support system incentive was established, which once again emphasized the government's attitude of aiming to realize a community-based integrated care system (community collaborations). It announced the 8 severe requirement items that reflect this intention, which were described above. On analyzing the eight track record requirements, we understand that the essence of this severity is to be found in "collaboration," as they include requirements that cannot be achieved by the efforts of the pharmacies alone. They also include content that requires a change of awareness (and of actual behavior) among the individual pharmacists, from being passive to being proactive. This is also a major item in the April 2018 revisions, expressed as "Enhancing the evaluation of person-to-person operations at pharmacies"

Based on this government policy, the Company's growth strategy is clear and consistent. Specifically, it is aiming to expand market share by surviving and winning the competition. Surviving and winning the competition and expanding market share can be said to be universal themes shared by all major dispensing pharmacy chains. But what is important is whether or not they have specific methodologies and are implementing reliable and persuasive measures toward realizing these aims.

In conclusion, at FISCO we think that the Company is in the powerful position of being able to realize a strategy of surviving and winning the competition and expanding market share.

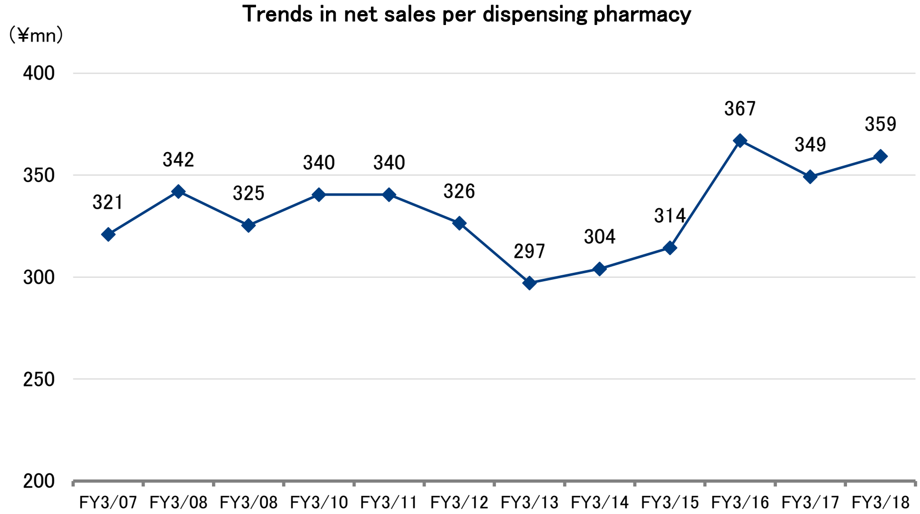
Within the various reasons, what we shall be focusing on the most is the scale of net sales per pharmacy, which the Company has consistently pursued. Its net sales per pharmacy are ¥359mn (FY3/18 result), which is significantly higher than those of its industry peers. Pharmacy net sales are calculated as the prescription unit price multiplied by the number of prescriptions, and the Company surpasses its industry peers for both these elements, which is reflected in its pharmacies' net sales.

The Company's prescription unit price in FY3/18 was ¥14,739. On comparing this to the range of the other dispensing majors' prescription unit prices, of ¥9,000 to ¥11,000 and mainly around ¥10,000, we see that is approximately 40% higher. These differences in the prescription unit prices seem largely to be due to the differences in the dispensing technical fees and also the differences in drug fees. The difference in drug fees is considered to be because in its development of pharmacies, the Company has strengthened its opening of pharmacies in locations where advanced medical care is provided, such as at university hospitals and specialist cancer hospitals.

For the number of prescriptions, based on the Company's FY3/18 results, the average number of prescriptions per pharmacy was 24,100 (calculated by dividing the total number of prescriptions by the average number of dispensing pharmacies at the beginning and the end of the fiscal period). The average number of prescriptions by pharmacy of the other dispensing majors is around 20,000, so the Company's pharmacies have many more prescriptions, of around 20% more. Part of the reason why it fills more prescriptions than other companies overlaps with the reasons for its high prescription unit price. In addition to that, at FISCO we estimate that in the process of steadily implementing the functions of pharmacies that are expected in the Vision of Pharmacies for Patients (including family pharmacists and pharmacies and advanced pharmaceutical management functions), which are being progressed by the Company, there has inevitably been an increase in the number of prescriptions.

Looking in this way, the meaning of the Company's comparatively high pharmacy net sales (in other words, the scale of its pharmacies) is not merely one element that constitutes its results, it can also be said to suggest that it is in a relatively favorable position toward acquiring the various incentives (meaning that it is adapting to the government's measures), and also the roles and functions that its pharmacies are playing in their respective local communities.

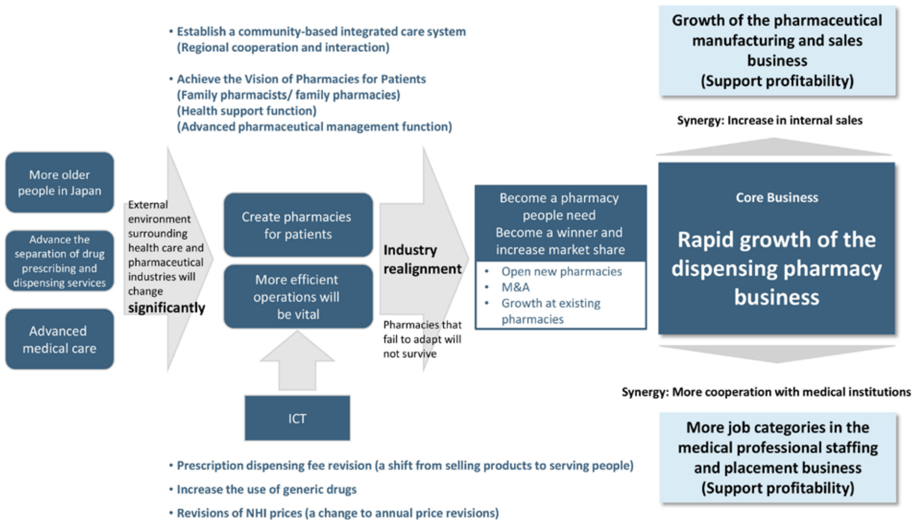
Trends in net sales per dispensing pharmacy



Note: Net sales per pharmacy is calculated as the dispensing segment net sales ÷ the average number of dispensing pharmacies during the period. Based on results that include product-sales pharmacies.
Source: Prepared by FISCO from the Company's financial results and other materials

One more important point is that the Company has had a consistent vision for the role and mission that dispensing pharmacies must fulfill, and it has continuously invested in order to realize this vision. Specifically, based on the awareness that the Company (its dispensing pharmacies) is expected to provide high-quality medical services and strive to keep down the increase in medical costs, it has continuously invested in human resources and ICT toward realizing this. The fruits of these efforts are its abundant cash flow that is produced from its symbolic and highly efficiency management from the previously described net sales per pharmacy. It signifies that it is able to create a positive spiral, in creating customer- (patient-) oriented pharmacies backed by its investment in ICT and human resources, thereby realizing high pharmacy revenue and highly efficient management, and it then improves the quality of services through re-investing these funds into ICT and human resources. At FISCO, we think that this is the core of the Company's growth strategy and its strength.

Growth strategy for the Dispensing Pharmacy Business



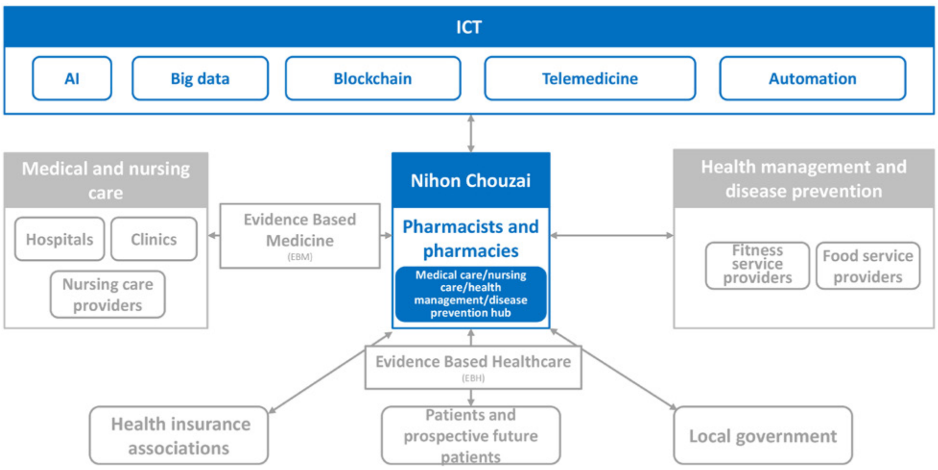
Source: Prepared by FISCO from the Company's results briefing materials

The main points will be described in detail below.

(1) ICT measures

The Company considers that its next-generation dispensing pharmacies will play a role for the optimization and improved efficiency of medical care toward keeping down medical costs, and moreover that they can form a hub for the collaboration of various fields of medical care, nursing care, health management, and disease prevention. Based on this, it is investing in ICT (Information and Communication Technology), because the utilization of ICT will be essential for these aims.

Positioning of the next generation dispensing pharmacies utilizing ICT



Source: The Company's results briefing materials

A feature of the Company's investment in ICT is its "in-house development." It seems that in the background to its focus on in-house development is that it is prioritizing scalability and a sense of speed. Currently, the Company has completed converting the in-house systems such as the Nihon Chouzai's Okusuri Techo Plus electronic medication notebook, the dispensing system, and the home communication system utilizing ICT. This has demonstrated positive effects in promoting family pharmacists and pharmacies so far. Going forward the Company hopes to play a part in the community-based integrated care system, including through strengthening person-to-person operations and medical collaborations.

ICT investment requires a huge amount of spending, but the Company has completed the majority of this investment up to the present time, and it seems that it has already shifted to a cost structure that is mainly based on running costs. Therefore, at FISCO we think that there is little risk that large-scale investment in ICT will put downward pressure on profits.

(2) Training and developing human resources

We cannot speak of the dispensing pharmacies business without speaking of pharmacists. However, what is required of pharmacists has changed greatly compared to in the past. It is considered that the keywords that will be focused on going forward will be "person-to-person operations" and "expertise." On this point, in April 2018 the Company launched the Pharmacists Stage System JP-STAR, which evaluates and promotes expertise in terms of the pharmacists' knowledge and skills.

In addition, as a measure for advanced pharmaceutical management functions in hospital-adjacent pharmacies, the Company is progressing the acquisition of certification by external evaluations. Specifically, in three years, more than 30 of its pharmacists have become "outpatient cancer treatment certified pharmacists," and more than 20 have become "palliative medication therapy certified pharmacists." It is currently conducting human resources training with the aim of more of its pharmacists acquiring these certifications.

On the point of securing pharmacists, at FISCO we think that that the Company is in a relatively superior position though the height of its name recognition as a major dispensing chain, and also from the synergies generated with the Medical Professional Staffing and Placement business.

(3) Pharmacy-opening strategy and M&A

For its pharmacy-opening strategy, based on its pharmacy openings, it is considered that the Company's standard is to open 50 new pharmacies a year (the total for pharmacies opened independently and through M&A).

In terms of the types of pharmacy, the issue is how to respond to a situation in which the government is looking increasingly severely on hospital-adjacent pharmacies and particularly on pharmacies made more efficient through management by the major dispensing chains. On this point, it seems that the Company is accelerating the opening of hybrid-type pharmacies*, especially in urban areas, while also taking the direction of expanding its chain of hospital-adjacent pharmacies if it sees opportunities to do so.

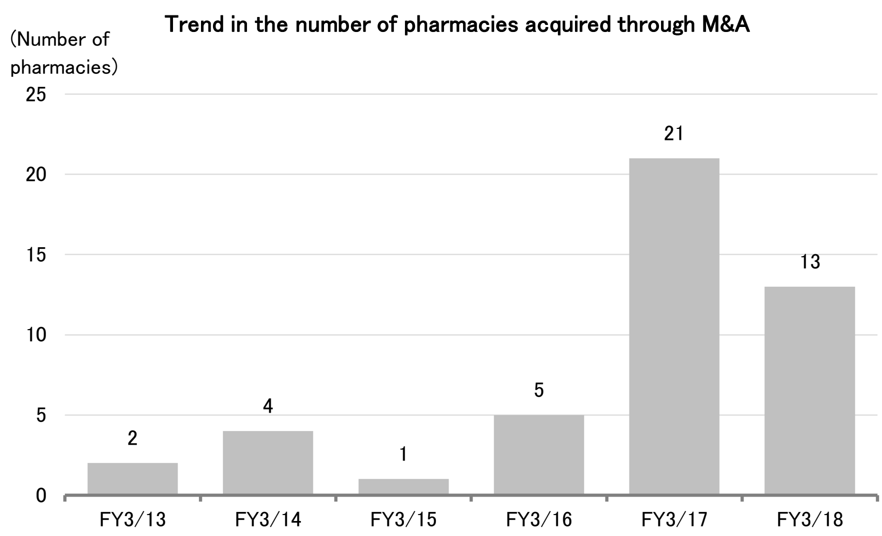
* Hybrid-type pharmacies combine the functions of both medical mall-type pharmacies (hereafter, MC type) and foot traffic-type pharmacies (pharmacies that handle prescriptions from multiple medical facilities).

The Company has opened hospital-adjacent pharmacies at approximately 40% of the large university hospitals nationwide, and even within its industry, its percentage of large-scale hospital-adjacent pharmacies is extremely high. It seems that going forward also, we can expect it to maintain the effectiveness of its hospital-adjacent pharmacies through highly efficient management from the utilization of ICT, and also from the provision of functions and services that only hospital-adjacent pharmacies can provide.

On the other hand, its policy for hybrid-type pharmacies is to enhance their health-support functions and family pharmacist and pharmacy functions, and for them to play a central role in community collaborations and disease prevention.

The Company has been seen to be negative about pharmacy openings through M&A. The reason for this is thought to be that it considers M&A while carefully investigating proposals that meet its demanding "Nihon Chouzai standards," as typified by the previously discussed net sales per pharmacy. As a result, a situation has continued in which it has significantly fewer prospective M&A proposals than its industry peers, which has led to the view that it is negative about M&A

However, the expansion of pharmacy networks through M&A will proceed ahead of "the fully fledged industry reorganization" and "expanding market share through surviving and winning the competition," so it seems that going forward, this will make the Company more proactive about M&A.



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

In this situation, the business environment relating to M&A seems to be improving compared to in the past. With the April 2018 revisions as the turning point, the Company predicts that there will be an oversupply in the demand-supply balance and that the evaluations of enterprise value of the proposals (the acquisition prices) will decline. In terms of the content of the proposals also, those corresponding to rehabilitation proposals are expected to increase. It is considered that these environmental changes will be advantageous to the Company, which has accumulated experience and expertise in rehabilitation-type M&A. In its past track record for the pharmacies it acquired, it did not acquire them haphazardly but spent time and effort to make the pharmacies "of a Nihon Chouzai standard." So we shall be paying attention to the Company's future developments that are backed by such a track record.

Core of the growth strategy is to make the state-of-the-art Tsukuba Plant No.2 profitable
Aiming to increase the operations rate through expanding pharmaceuticals manufactured in-house and commissioned production

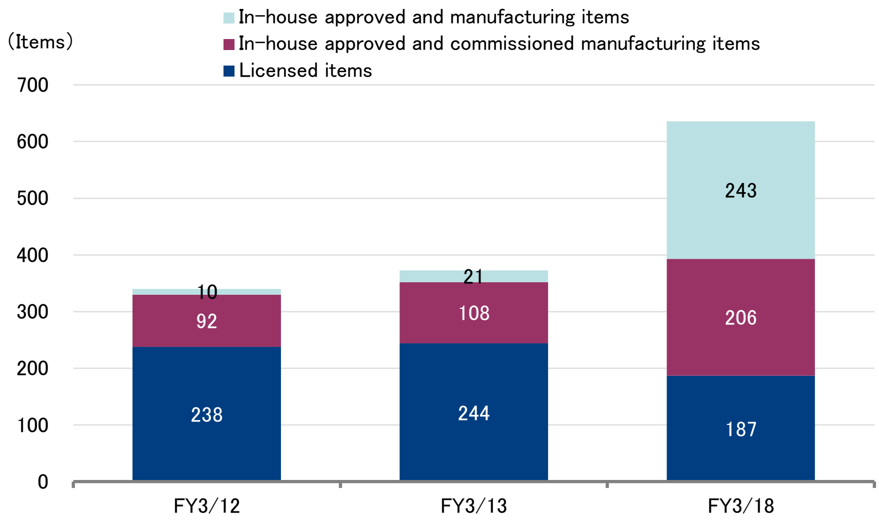
3. The Pharmaceutical Manufacturing and Sales business growth strategy

The government has set the target of increasing the usage percentage of generic pharmaceuticals to 80% by the end of September 2020. The Company has constructed the Tsukuba Plant No.2 to respond to the expected increase in demand for generic pharmaceuticals as a result of this target.

Tsukuba Plant No.2 was scheduled to be completed in April 2018, and construction was progressed as planned and it was completed on schedule. The production facilities are set to be made operational in multiple stages, and currently, as stage 1, facilities with a production capacity of 3.3 billion tablets a year have been made operational. The growth strategy of the Pharmaceutical Manufacturing and Sales business can be said to be synonymous with how the operations of the new Tsukuba Plant No.2 will lead to an increase in profits.

The main point for production is how to raise the operations rate of the plant. On this point, the Company plans to raise the operations rate, and thereby absorb the increases in depreciation and other expenses and expand earnings, through two approaches; 1) expand products manufactured in-house as a percentage of generic pharmaceutical sales items, and 2) grow the commissioned production business through fully utilizing the Plant's state-of-the-art facilities.

Trend in the number of generic pharmaceutical sales item



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

For sales, the Company plans to utilize its strength of having an enormous dispensing pharmacy chain to expand the business scope both for internal sales and external sales. As previously stated for internal sales, the arrival of the fully-fledged industry reorganization is expected to increase pharmacy numbers while actively utilizing M&A, which will become the growth driver. On the other hand, for external sales, demand will be driven by the government's target of 80% for the usage percentage of generic pharmaceuticals.

In terms of results, in FY3/19, the first fiscal year of operations, costs are expected to increase due to depreciation and start-up costs, while product shipments are scheduled to start from December. Therefore, the forecast is for operating profit to decline sharply to ¥51mn (down 95.7% YoY). But after that, results are expected to achieve a V-shaped recovery from the steady increases in the production and sales volumes.

Expanding the occupations handled, including to doctors and nurses. The pharmacists field will continue to grow stably under the Nihon Chouzai brand

4. The Medical Professional Staffing and Placement business growth strategy

There are two main growth strategies for the Medical Professional Staffing and Placement business; the first is to grow the pharmacists staffing and placement business, and the second is to expand the occupations it handles.

In the pharmacists staffing and placement business, the Vision of Pharmacies for Patients being promoted by the government is expected to play the role of growth driver. The responses to the policies within it, of realizing family pharmacists and pharmacies and prioritizing person-to-person operations, are further exacerbating the already chronic shortage of pharmacists. In this situation, while there is the risk to the Company itself of an increase in recruitment costs, the scope of this business is expected to steadily expand, as in addition to the high name recognition of Nihon Chouzai, the name recognition of its Pharma Staff service brand is also spreading.

The expansion of occupations handled entails the expansion of services to doctors, nurses, and other medical practitioners. There are other business operators that have gone ahead of the Company in providing services for these occupations, but it plans to open-up new markets by utilizing its strength, of the expertise it has cultivated in the staffing and placing business for pharmacists, and by pursuing synergies. It is currently conducting upfront investment to grow the doctor placement business, and it is working to expand its sales bases and to increase the number of sales staff.

Business outlook

Forecasts are for higher sales but lower profits due to the effects of the April 2018 revisions and the increase in costs accompanied by the start of operations at the Tsukuba Plant No.2

● FY3/19 results outlook

For FY3/19, the Company is forecasting higher sales but substantially lower profits, with net sales of ¥253,893mn (up 5.2% YoY), operating profit of ¥6,318mn (down 40.3%), ordinary profit of ¥6,078mn (down 40.1%), and profit attributable to owners of parent of ¥3,756mn (down 38.5%).

Summary of FY3/19 outlook

(¥mn)

	FY3/18		FY3/19			
	1H	Full year	1H		Full year	
	Results	Results	Forecast	YoY	Forecast	YoY
Net sales	118,149	241,274	123,146	4.2%	253,893	5.2%
Operating profit	4,888	10,587	1,549	-68.3%	6,318	-40.3%
Ordinary profit	4,635	10,138	1,409	-69.6%	6,078	-40.1%
Profit attributable to owners of parent	2,805	6,104	932	-66.8%	3,756	-38.5%

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

Although the forecast of a major decline in profits is a reversal from the record high profits in FY3/18, at FISCO, we do not think it is a cause for excessive concern. The reasons for the decline in profits are the effects of the fee revisions in the Dispensing Pharmacy business, and the costs to start-up the new plant in the Pharmaceutical Manufacturing and Sales business. For the former, as previously explained the Company is in a relatively superior position and it may turn the revisions to its advantage in the medium- to long-term. For the latter, this fiscal year will be the peak year for the burden of costs, and from FY3/20 onwards, costs will decline and topline results (sales) will grow, so we can expect profits to recover.

The summaries by business segment are as follows.

In the Dispensing Pharmacy business, the forecasts are for higher sales but lower profits, with net sales of ¥213,133mn (up 3.9% YoY) and operating profit of ¥9,436mn (down 24.0%). Due to the effect of the April 2018 revisions, the outlook is for technical fees to decrease greatly. Net sales are expected to increase YoY due to the rise in the number of prescriptions in the existing pharmacies and the effects of the growth in sales from the newly opened pharmacies. But the rate of increase is set to be lower than a typical year (around 10%) due to the impact of the revisions. Conversely, it is considered that a decline in operating profit is unavoidable, as it will take some time before the dispensing fees recover to above the previous level.

In the Pharmaceutical Manufacturing and Sales business, the forecasts are for higher sales but substantially lower profits, with net sales of ¥42,123mn (up 10.7% YoY) and operating profit of ¥51mn (down 95.7%). Tsukuba Plant No.2 was completed during FY3/18, so in FY3/19 depreciation costs will be fully incurred and the outlook is for total depreciation costs to increase by ¥800mn, from ¥2.6bn in FY3/18 to ¥3.4bn. In addition, R&D costs are forecast to increase by ¥200mn to ¥2.9bn, Product shipments from the Tsukuba Plant No.2 are scheduled to start from December, so the start-up costs will be incurred in advance of this. This will put considerable downward pressure on profits, and therefore the outlook for FY3/19 is for profits to decline greatly.

In the Medical Professional Staffing and Placement business, the forecasts are for higher sales and profits, with net sales of ¥13,500mn (up 12.8% YoY) and operating profit of ¥1,950mn (up 5.9%). The business environment will be the same as up to FY3/18 and the staffing and placing businesses are expected to continue to operate at high levels. The outlook is that the increases in recruitment costs and in upfront costs alongside the expansion of the business scope, such as for placements of doctors, will be absorbed by the staffing and placing businesses and higher profits will be secured.

Outlook by business segment

(¥mn)

		FY3/18 Full year		FY3/19 Full year	
		Results	YoY	Forecast	YoY
Net sales	Dispensing Pharmacy business	205,192	8.4%	213,133	3.9%
	Pharmaceutical Manufacturing and Sales business	38,066	3.4%	42,123	10.7%
	Medical Professional Staffing and Placement business	11,970	14.0%	13,500	12.8%
	Before adjustment	255,230	7.9%	268,756	5.3%
	Adjustment	-13,955	-	-14,863	-
	Net sales total	241,274	8.0%	253,893	5.2%
Operating profit	Dispensing Pharmacy business	12,411	29.8%	9,436	-24.0%
	Pharmaceutical Manufacturing and Sales business	1,194	-30.5%	51	-95.7%
	Medical Professional Staffing and Placement business	1,842	7.7%	1,950	5.9%
	Before adjustment	15,448	18.9%	11,437	-26.0%
	Adjustment	-4,861	-	-5,119	-
	Operating profit total	10,587	24.3%	6,318	-40.3%

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

Income statement and the main indicators

(¥mn)

	FY3/15	FY3/16	FY3/17	FY3/18	FY3/19	
	Full year	Full year	Full year	Full year	1H E	Full year E
Net sales	181,844	219,239	223,468	241,274	123,146	253,893
YoY	10.0%	20.6%	1.9%	8.0%	4.2%	5.2%
Gross profit	31,929	39,068	39,258	43,837	-	41,500
Gross profit margin	17.6%	17.8%	17.6%	18.2%	-	16.3
SG&A expenses	25,281	28,578	30,738	33,250	-	35,182
Ratio of SG&A expenses to net sales	13.9%	13.0%	13.8%	13.8%	-	13.9
Operating profit	6,647	10,489	8,519	10,587	1,549	6,318
YoY	40.1%	57.8%	-18.8%	24.3%	-68.3%	-40.3%
Operating profit margin	3.7%	4.8%	3.8%	4.4%	1.3%	2.5%
Ordinary profit	6,003	9,878	7,976	10,138	1,409	6,078
YoY	43.3%	64.6%	-19.3%	27.1%	-69.6%	-40.1%
Profit attributable to owners of parent	2,778	6,329	4,638	6,104	932	3,756
YoY	46.1%	127.8%	-26.7%	31.6%	-66.8%	-38.5%
EPS after adjustment for stock split (¥)	194.48	432.85	290.03	381.69	58.32	234.84
Dividend per share after adjustment for stock split (¥)	35.00	45.00	50.00	50.00	25.00	50.00
BPS after adjustment for stock split (¥)	1,257.60	2,030.22	2,278.70	2,595.00	-	-

Note: The Company conducted a two-for-one stock split on October 1, 2015
Source: Prepared by FISCO from the Company's financial results

Balance sheet

(¥mn)

	End of FY3/14	End of FY3/15	End of FY3/16	End of FY3/17	End of FY3/18
Current assets	53,373	60,096	84,838	82,327	83,121
Cash and deposits	15,429	13,952	32,385	21,200	28,464
Accounts receivable, etc.	18,665	21,413	26,810	27,643	21,230
Inventories	16,396	21,066	22,016	29,514	28,224
Fixed assets	63,921	70,044	72,770	96,019	103,452
Tangible fixed assets	42,123	48,819	51,997	68,513	75,662
Intangible fixed assets	11,103	10,376	10,122	16,773	17,952
Investments, etc.	10,694	10,848	10,650	10,733	9,837
Total assets	117,295	130,141	157,609	178,347	186,573
Current liabilities	55,666	53,474	68,985	66,305	70,310
Accounts payable, etc.	28,963	33,392	44,653	41,033	39,973
Short-term debt, etc.	18,639	11,169	12,963	13,411	15,309
Fixed liabilities	45,779	59,031	56,151	75,595	74,756
Long-term debt, etc.	42,165	53,184	50,621	70,678	68,372
Shareholders' equity	15,845	17,515	32,507	36,345	41,648
Capital	3,953	3,953	3,953	3,953	3,953
Capital surplus	4,754	4,754	10,926	10,926	10,926
Retained earnings	9,310	11,868	17,672	21,511	26,816
Treasury stock	-2,171	-3,059	-44	-46	-47
Total accumulated other comprehensive income	3	119	-34	101	-144
Total net assets	15,849	17,635	32,473	36,447	41,506
Total liabilities and net assets	117,295	130,141	157,609	178,347	186,573

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

Cash flow statement

(¥mn)

	FY3/14	FY3/15	FY3/16	FY3/17	FY3/18
Cash flow from operating activities	6,243	5,831	19,327	-940	23,141
Cash flow from investing activities	-14,510	-8,437	-7,823	-28,444	-13,843
Cash flow from financing activities	8,782	1,422	7,031	18,205	-2,034
Change in cash and deposits	514	-1,183	18,535	-11,180	7,264
Cash and deposits at start of fiscal year	14,513	15,027	13,844	32,380	21,200
Cash and deposits at end of fiscal year	15,027	13,844	32,380	21,200	28,464

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

Shareholder returns

Paid a dividend of ¥50 in FY3/18, the same as in the previous fiscal year. Despite the decline in profits, the Company is forecast a dividend of ¥50 once again in FY3/19

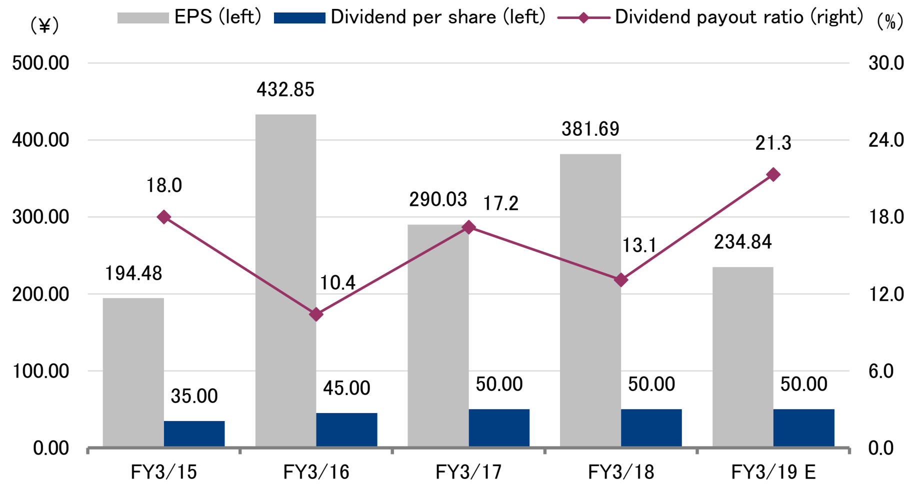
The Company's basic approach to shareholder returns is to pay dividends linked to business performance while ensuring it maintains the internal reserves necessary for growth.

In FY3/18, just as it previously forecast, the Company paid an annual dividend of ¥50 per share (interim dividend of ¥25 per share and year-end dividend of ¥25 per share), which was the same as in the previous fiscal year. As the earning per share (EPS) was ¥381.69, the dividend payout ratio was 13.1%.

For FY3/19 also, the Company has announced a forecast dividend of ¥50 per share (interim dividend of ¥25 per share and year-end dividend of ¥25 per share), again the same as in the previous fiscal year. As the EPS will be ¥234.84, the dividend payout ratio will be 21.3%. As previously explained, in FY3/19 profits are expected to decrease substantially YoY, by around 40%, so at FISCO, we think it has decided to maintain the current status for dividends, as the dividend payout ratio will be kept in the profit level of a low 20% range.

The Company has completed the construction of the new pharmaceuticals manufacturing plant, but the situation is that it still requires an abundance of funds to invest in growth, such as for M&A in the Dispensing Pharmacy business and to invest in ICT and human resources. In light of its management's previous track record, at FISCO there has been no change to our previous opinion that, rather than through paying dividends in the near future, returns to shareholders will be maximized through investing funds in growth.

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



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

Information security

In order to handle medical histories and other high-level personal information, it is focusing on the in-house development and management of information systems.

In its Dispensing Pharmacy business, the Company handles a large amount of extremely important personal information, such as medical histories, and therefore it is highly aware of the importance of information security. In order to mitigate the risk of information leakages, it employs a large number of information-systems managers within the Company and it develops systems in-house. In addition, it does not outsource the administration and management of the customer data it accumulates and conducts this administration and management in-house, and it also has prepared systems to counter information leakages and cyber-attacks.

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