

# TerraSky Co., Ltd.

**3915**

TSE Mothers

12-Jun.-2018

FISCO Ltd. Analyst

**Yuzuru Sato**



FISCO Ltd.

<http://www.fisco.co.jp>

## ■ Index

|   |           |
|---|-----------|
| ■ <b>Summary</b> .....  | <b>01</b> |
| 1. Results of FY12/18 .....   | 01        |
| 2. Outlook for Results of FY2/19 .....                                    | 01        |
| 3. Preparing to enter earnings growth phase from FY2/20 .....             | 01        |
| 4. Issuing of subscription rights to share, returns to shareholders ..... | 02        |
| ■ <b>Company profile</b> .....  | <b>03</b> |
| 1. Company profile .....  | 03        |
| 2. History .....  | 03        |
| ■ <b>Cloud computing market and TerraSky's businesses</b> .....           | <b>04</b> |
| 1. Cloud market .....   | 04        |
| 2. The Company's business .....   | 06        |
| 3. Strengths .....  | 09        |
| 4. Business risks .....   | 10        |
| ■ <b>Results trends</b> .....   | <b>10</b> |
| 1. FY2/18 results .....   | 10        |
| 2. Financial position and management indicators .....                     | 13        |
| ■ <b>Outlook</b> .....  | <b>15</b> |
| 1. Forecast for FY2/19 .....  | 15        |
| 2. Medium-term forecast and growth strategy .....                         | 16        |
| ■ <b>Shareholder return policy</b> .....                                  | <b>19</b> |
| ■ <b>Information security policy</b> .....                                | <b>19</b> |

## Summary

### Leading domestic cloud integration company poised for continued rapid growth

TerraSky Co., Ltd. <3915> is Japan's leading cloud integration services company, providing support services for the installation of cloud-based systems and the development of related applications. It has an extensive track record of more than 3,000 installations of cloud-based systems, most of which use the Salesforce platform. In addition to its large staff of Salesforce-certified technicians, TerraSky's technical expertise extends to other cloud platforms such as Amazon Web Services (AWS). In FY2/18, 74% of sales came from Salesforce platform-related projects and the remaining 26% from AWS-related work. By segment, its Solution segment accounts for 82% of sales, covering cloud system installation, development, maintenance, and operations services. The remaining 18% of sales are generated by the Product segment, which sells products that have been developed internally.

#### 1. Results of FY12/18

For FY2/18, TerraSky reported consolidated sales of ¥4,684mn (+37.6% YoY) and operating income of ¥268mn (+32.8%), setting a new high for the first time in two years. Sales at the Solution segment showed continued rapid growth, rising 41.5% YoY on strong demand cloud-based system. Sales at the Product segment were up 22.5% YoY, underpinned by the growing number of companies signing up for SkyVisualEditor, a Salesforce screen development tool. The operating income margin was down 0.2ppts from the previous year; this was due in large part to the cost of additional development work for mitoco, a socialware service launched in 2016.

#### 2. Outlook for Results of FY2/19

For FY2/19, the Company is forecasting higher sales but lower earnings, projecting consolidated sales of ¥6,777mn (+39.3% YoY) and operating income of ¥199mn (-25.8%). Aided by a strong tailwind from the expanding cloud computing market, both the Solution and Product segments are expected to see sales grow by nearly 40%. The top-line gains notwithstanding, earnings are expected fall to under the weight rising fixed costs as the Company relocates to a larger headquarters building (adding about ¥200mn to costs) and expands the parent company workforce by another 135 employees (an increase of roughly 80%). The large influx of new employees is aimed facilitating continued growth in the business in the medium to long term, but will weigh especially heavily on earnings this year as it will require a lot of upfront spending on salaries and training before the new employees can begin to contribute to sales and earnings.

#### 3. Preparing to enter earnings growth phase from FY2/20

Under its medium-term business plan, TerraSky is currently in the midst of a three-year "expansion phase" that runs through the end of FY2/19. During the expansion phase the Company is looking to put in place the business infrastructure that will allow it to remain Japan's leading cloud integration service provider and, toward this end, is investing heavily in personnel and new product development, and is also looking to make additional acquisitions. The expansion phase will lay the groundwork for the next phase -the earnings growth phase- which is slated to begin in FY2/20. The Company has set a target for FY2/20 sales of ¥10.0bn and ordinary income of ¥1.0bn. Earnings are expected to decline in FY2/19 owing to a temporary jump in spending, but the Company expects investment spending on personnel to peak out in FY2/20 and sees this together with rising sales of high-margin products pushing up its overall profit margin and allowing it to reach its target for ordinary income, provided sales grow as expected.

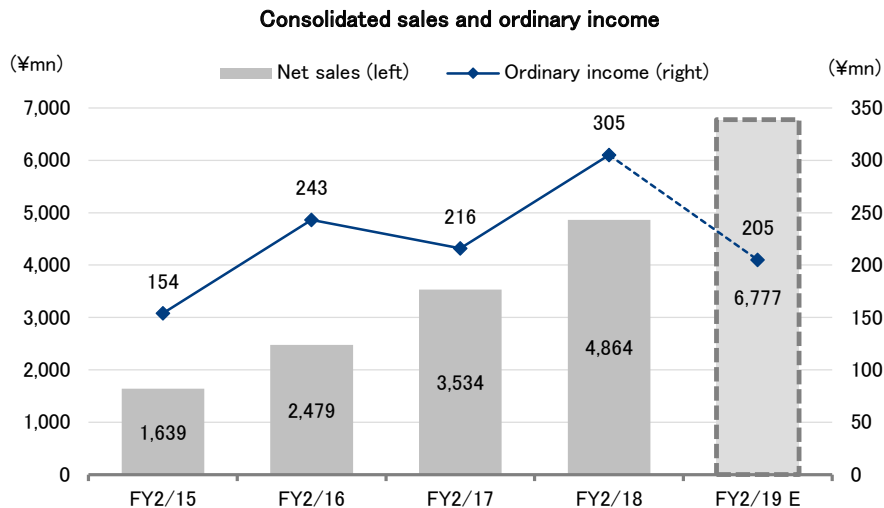
Summary

4. Issuing of subscription rights to share, returns to shareholders

The company issued subscription rights to share through a third party allocation on May 9, 2018. The offering is expected to raise roughly ¥2.4bn in new capital and, assuming all the subscription rights to share are exercised, will increase the number of shares outstanding by 10.5%. Plans call for using the funds raised to make additional acquisitions and capital/business alliances, make additional investments in personnel, and to repay debt. The Company is currently making preparations to move its listing to either the First Section or Second Section of the Tokyo Stock Exchange during FY2/19. TerraSky has paid no dividends in the past but has indicated that it would like to start paying dividends in FY2/20, provided sales and earnings growth is on track.

Key Points

- Cloud computing market expected to continue growing at rapid pace of 20% per annum as more corporate information systems move to the cloud
- As upfront investment spending swells, Company sees earnings declining in FY2/19, but expects earnings to move into rapid growth phase starting in FY2/20
- Company targeting ¥10.0bn in sales and ¥1.0bn in ordinary income in FY2/20



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

## ■ Company profile

### Japan's top-class cloud integrator

#### 1. Company profile

Since its founding in 2006, TerraSky has specialized in cloud computing services and, as the leading domestic cloud integration company, has been the driving force behind the growth of the cloud computing market in Japan. With more than 3,000 installations under its belt (as of October 2017), TerraSky has experience with wide range of development projects for companies big and small and in all kinds of industries. The Company has five consolidated subsidiaries: Sky365 Co. Ltd., BeeX Co., Ltd., Cloudia Japan inc., Kitalive Inc., and TerraSky Inc. It also as one equity-method affiliate, Serverworks Co., Ltd.

#### 2. History

Established under the name Head Inc. in 2006, the Company has specialized in cloud computing services since its inception. Company president Hideya Sato left IBM Japan to join the Japanese subsidiary of Salesforce.com, Inc. <CRM>, helping it get off the ground in Japan. In 2007, the fledgling operation adopted its current name, TerraSky Co., Ltd.

In 2008, TerraSky started marketing its SkyEditor\*<sup>1</sup> screen development service (now SkyVisualEditor) and its SkyOnDemand\*<sup>2</sup> data integration service. In 2012, the Company started its AppComponent service that allowed system vendors and developers to offer applications that could be used to develop the scalability of SkyVisualEditor. In 2013, the Company started selling its Cloud ERP Concierge Service, its Automigration for Notes package (jointly developed with FUJISOFT Inc. <9749>), which enables the automatic migration from Notes to Salesforce, and its Hybrid Cloud Solution service. In 2016, the Company entered a new field of business by launching sales of its mitoco\*<sup>3</sup> socialware service.

\*1 SkyEditor, now called SkyVisualEditor, is a Salesforce screen development tool that allows companies to customize screens on Salesforce for easier use. By making it quick and easy for companies to develop desired screens, SkyVisualEditor outshines competing products to such an extent that is viewed as the de facto industry standard.

\*2 SkyOnDemand in an on-demand integration service that allows internal corporate systems to link to the data on Salesforce, AWS, Microsoft Azure, or other public cloud services as well as link the data on other cloud-based data with each other.

\*3 mitoco is communications platform (SaaS) developed for use on the Salesforce cloud platform. It can serve not only as an internal corporate communication tool but also makes it possible to connect with outside parties at partner companies. Connections with the IoT also allow it to be used to make reservations for intelligent conference rooms.

TerraSky is also known for its active use of capital and business alliances over the years. In 2010, TerraSky entered into a capital and business alliances with NTT TechnoCross Corporation (formerly NTT Software Corporation) and in 2013 formed a similar alliance with Serverworks Co., Ltd. (whose primary business is AWS installation support services). In 2014, TerraSky entered into a capital alliance with US-based Salesforce.com, Inc. In 2012, it established sales subsidiary TerraSky Inc. in California to market its cloud computing services in North America. In 2015, TerraSky listed on Tokyo Stock Exchange Mothers market and, following its stock exchange listing, stepped up pursuit of capital and business alliances, concluding partnership agreements in 2016 with Ecomott Inc. (IoT and mobile cloud solutions) and Cloudia Japan inc. (cloud integration service provider in the Kyushu region). During 2016 TerraSky also established subsidiary BeeX Co., Ltd. as a provider of support services for companies migrating to cloud computing systems on SAP platform and, partnering with Win Consul, Inc., established subsidiary Kitalive Inc. in Hokkaido to provide cloud system installation services in northern Japan.

Company profile

Company timeline

| Date           | Major events  |
|----------------|---|
| March 2006     | Founded as Head Inc.  |
| July 2008      | Began offering screen development tool SkyEditor (now known as SkyVisualEditor)   |
| October 2008   | Began offering cloud integration tool SkyOnDemand   |
| September 2010 | Entered into capital and business alliance with NTT TechnoCross Corporation (formerly NTT Software Corporation)   |
| August 2012    | Established US-based subsidiary TerraSky Inc. (now a consolidated subsidiary)   |
| September 2013 | Entered into capital and business alliance with Serverworks Co., Ltd., making it an equity-method affiliate   |
| May 2014       | Established subsidiary Sky 365 Co., Ltd. (now a consolidated subsidiary) in Sapporo, Hokkaido, as joint venture with Serverworks Co., Ltd   |
| October 2014   | Entered into capital alliance with US-based Salesforce Inc.   |
| April 2015     | Listed shares on the Mothers market of the Tokyo Stock Exchange   |
| January 2016   | Entered into capital and business alliance with Ecomott Inc.  |
| March 2016     | Established subsidiary BeeX Co., Ltd. (now a consolidated subsidiary) to provide cloud integration services for SAP software-based systems<br>Entered into capital and business alliance with Cloudia Japan inc., making it a consolidated subsidiary |
| July 2016      | Started selling the mitoco socialware service   |
| August 2016    | Opened TerraSky Lab<br>Established subsidiary Kitaiive Inc. (now a consolidated subsidiary) as joint venture with Win Consult, Inc. to provide cloud integration services   |
| March 2017     | Entered into capital and business alliance with Phone Appli Inc.  |
| May 2017       | Entered into capital and business alliance with IGUAZU Corporation  |

Source: Prepared by FISCO from the Company's securities report

## Cloud computing market and TerraSky's businesses

### Company sees cloud computing market continuing to grow at rapid pace of 20% per annum as more corporate IT systems move to the cloud

#### 1. Cloud market

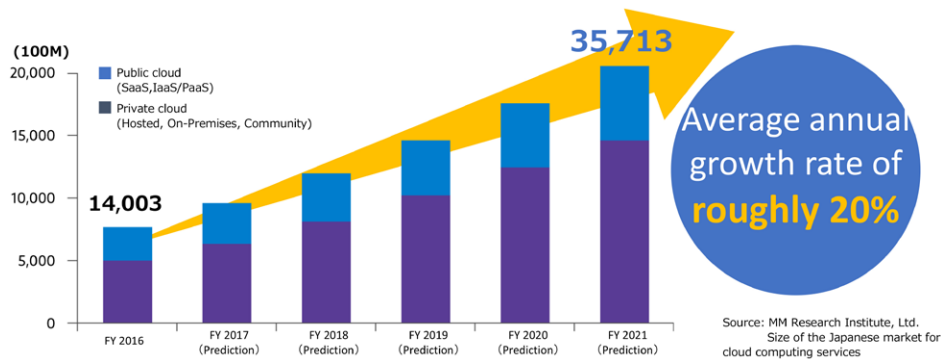
The history of the development of computers shows that in the first half of the 1960s, companies started adopting mainframe computers. Since the 1980s, mainframe computers have been replaced by desktop office computers and minicomputers. From the late 1990s, the form of computer systems started changing to client-server systems together with performance improvements, and from the late 2000s there have been increasingly high-speed communication networks along with progress being made in Internet technology. Against this background, cloud computing services appeared. With the spread of cloud computing, IT applications have entered an era in which usage is considered more important than ownership.

Cloud computing market and TerraSky's businesses

The cloud is a platform that allows the offering of software and data through a network as a service. A user of the cloud for computing no longer needs to buy hardware, software, and data. The construction and maintenance of a cloud computing system also requires less time and effort than the construction and maintenance of an on-premises computer system, so cloud computing also works to lower costs and improve work efficiency. Moreover, cloud systems can be used by companies of all sizes and in any industry, require no initial investment, and the development time required for system construction can be shortened. These large advantages over client server systems have motivated companies to switch to cloud-based systems. And with the improvements in the quality of communication networks and the enhanced cybersecurity measures being implemented by cloud service providers in recent years providing still more motivation to make the switch, we find more and more companies of all sizes making the switch from existing systems to cloud computing.

According to MM Research Institute, Ltd., in FY2016 the Japanese market for cloud computing services was worth ¥1.4003trn, a 38.5% increase over the previous year. MM Research forecasts that Japan's cloud computing market will grow to ¥3.5713trn by FY2021; this represents a 2.5-fold increase over FY2016 or an average growth rate of roughly 20% per annum. The main battleground for the Company is the public cloud market, which in FY2016 was worth ¥388.3bn, a 40.9% increase over the previous year. MM Research forecasts that the public cloud market will grow to ¥1.0556trn by FY2021; this represents a 2.7-fold increase over FY2016 or an average growth rate of approximately 22% per annum. As there are still many companies using client server systems, the number of companies moving to cloud computing appears likely to continue its high growth in the years ahead.

Japanese market for cloud computing service  
**Japanese market for cloud computing service**  
**¥1.4003trn in FY2016 Over ¥3.0trn in FY2021**



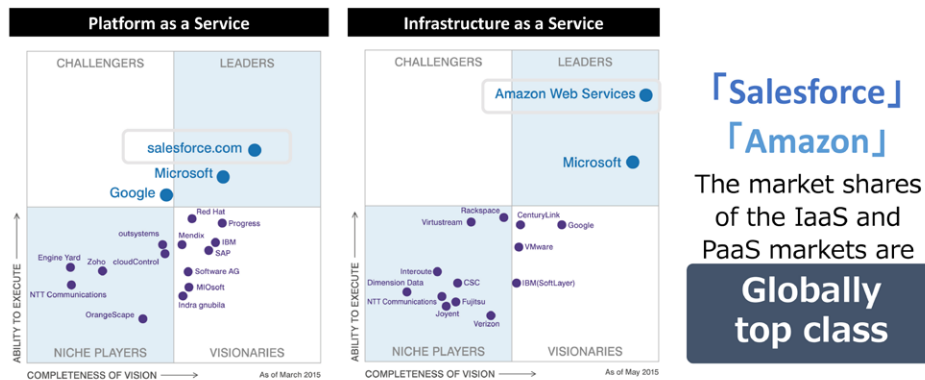
Source: From the Company's results briefing materials

Cloud computing market and TerraSky's businesses

Public cloud service is broadly split into three different types: SaaS\*1, PaaS\*2, and IaaS\*3 (see note below for definitions). Of these, PaaS and IaaS are used when companies create information systems. In terms of world market share, Salesforce.com is the leading player in the PaaS market with sales rising at the rate of roughly 25% per annum. AWS has the top share of IaaS market with sales rising at the rate of roughly 50% per annum.

- \*1 SaaS (Software as a Service) refers to online services that provide users access to software that had been available as a packaged product.
- \*2 PaaS (Platform as a Service) refers to online services that provide a platform (hardware and operating system) that allows user to run applications.
- \*3 IaaS (Infrastructure as a Service) refers to online services that provide the virtual servers, equipment, and all other network infrastructure needed to operate information systems.

Market share in cloud service



Source: From the Company's results briefing materials

TerraSky logged ¥150mn in sales in its first year (FY2/07) and been growing sales ever since, logging especially strong growth in recent years thanks to the rapid expansion of the domestic cloud computing market.

2. The Company's business

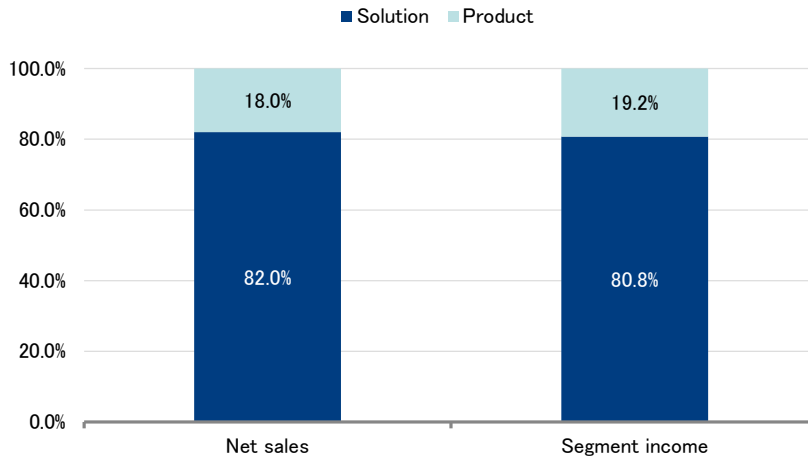
TerraSky has two segments, Solution and Product. In FY2/18 the Solution segment accounted for 82.0% of total sales and 80.8% of segment profit; the Product segment accounted 18.0% of sales and 19.2% of segment profit. The segment profit margin at the Solution segment is 14.4%. This is roughly in line with the 15.6% margin at the Product segment, but only because the Product segment bears a large burden of depreciation of the product development costs. Before depreciation and goodwill amortization, the segment profitability at the Product segment in FY2/18 was 34.7% versus 15.2% at the Solutions segment. Because the Product segment is a stock-type business, if sales continue to grow profit margins should rise in future years as development costs are fully depreciated. In contrast, the labor-intensive nature of the businesses under the Solution segment means that profitability improvement here will depend mainly on productivity gains.

At the Solution segment, in FY2/18 Salesforce-related projects accounted for 74% of sales and AWS-related work 26%. The proportion of sales coming AWS-related work increased over previous year due in large part to the rapid growth in AWS installation support work at subsidiary BeeX.



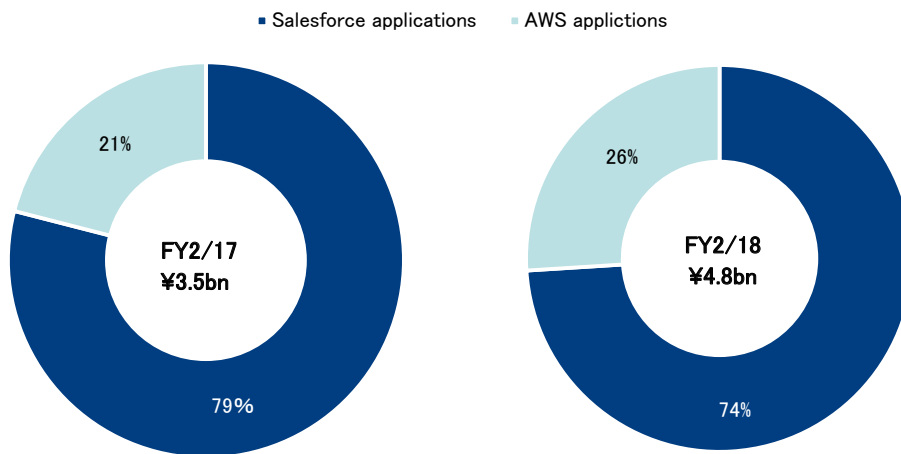
Cloud computing market and TerraSky's businesses

Sales and earnings by segment (FY2/18)



\* Segment income is before the deduction of corporate expenses  
Source: Prepared by FISCO from the Company's results briefing materials

Sales composition ratio by cloud services



Source: From the Company's results briefing materials

(1) Solution Business

The Solution Business provides support services for the installation of cloud-based systems designed to meet the needs of client companies. Solution services cover everything from defining business requirements for front-end or backbone systems, to design, development, testing, operations, validation of effectiveness, and planning improvement policies and systemization planning. As most of its front-end system development work is done on Salesforce, TerraSky has a licensing and sales agreement with Salesforce.com.

Cloud computing market and TerraSky's businesses

The Solution business of TerraSky Co. mainly serves large corporate customers. Consolidated subsidiary Cloudia Japan support services for the development and installation of the Salesforce cloud platform in Kyushu, while consolidated subsidiary Kitalive provides similar services to companies in Hokkaido. Subsidiary BeeX mainly providing services to support the transition of companies to cloud systems to SAP systems running on AWS, and has a track record in SAP cloud migration work that places it among the leading companies in Japan in this field. Consolidated subsidiary Sky365 provides MSP\* services for the cloud. Equity-method affiliate Serverworks also provide cloud system installation support services, primarily for system running on AWS. Because there are few Japanese companies located in rural areas that have moved their internal systems to the cloud and also very few who have made the move among small to medium sized companies, TerraSky strategically established subsidiaries like Cloudia Japan in Kyushu and Kitalive in Hokkaido to target this demand.

\* MSP ("Management Services Provider"): It provides service and network operation, monitoring, and maintenance services. It covers development and installation support work done by group companies, and also repairs any flaws found in the system.

In other areas, TerraSky provides construction and installation support services for FUJITSU <6702> GLOVIA OM, a cloud-based ERP solution. In contrast to the SAP-based cloud systems handled by BeeX that are designed for large companies, GLOVIA OM is designed for use by mid-tier all the way down to small to medium sized companies, thus effectively segregating the cloud ERP services market based on the size of the client company.

TerraSky has done more than 3,000 Salesforce installations for companies of all sizes and in many industries and business, with noteworthy clients including the Mizuho Financial Group, Inc. <8411>, Odakyu Electric Railway Co., Ltd. <9007>, and KDDI Corporation, <9433>. By industry, roughly 40% of sales come from the financial sector. Reflecting the strength of Salesforce in customer relationship management (CRM) software, TerraSky also derives a large proportion of its sales from companies in the service industry and Bto2C businesses.

**(2) Product Business**

TerraSky is developing and marketing cloud services as SaaS vendor, including its screen development tools SkyVisualEditor and SuPICE, the data integration services SkyOnDemand and DataSpiderCloud, the socialware service mitoco, and the IAS service for insurance agencies. Among these, its biggest earner is SkyVisualEditor, which accounts for roughly 40% of segment sales. SkyVisualEditor has the No. 1 spot in the UI design-implementation tool market with approximately a 40% market share (according to MIC Research Institute's 2016 survey of trends in the market for advanced, ultrafast development tools). SkyOnDemand and DataSpiderCloud are the next biggest earners, together accounting for about 40% of segment sales. With SkyVisualEditor allowing users customize screens and processing logic to fit the needs of their own system operations and, importantly, also being extremely user friendly, SkyVisualEditor has become the de facto industry standard in Japan.

TerraSky had previously developed products for engineers in charge of developing and maintaining systems, but in July 2016 it released mitoco, its first socialware (next-generation groupware) product. mitoco serves as a communication platform and allows even greater use Salesforce. While there are already a lot of groupware products on the market from various companies, the different between them and mitoco is mitoco was specifically developed for use on the cloud. Competing products from other companies use database engines that were designed long ago when today's cloud environment was not foreseen, making them difficult to use on smartphones and putting great stress on computer systems when functioning has originally intended. Because mitoco was specifically developed for use on the cloud, it performs well in a mobile environment and, as a platform is highly scalable, comes with standard application programming interfaces (API) that allow it to connect to other applications. And, because mitoco provides a simple user interface, it can be readily used not only by managers but by general employees as well, and can also establish external links to the systems of partner companies.

Cloud computing market and TerraSky's businesses

In cooperation with Ecomott Inc., an IoT solution company, TerraSky has developed an IoT optional service that can include such things as sensors to detect whether conference rooms are in use. By installing conference room usage sensors, the system will know whether a conference room that has been reserved it is actually use and, if it is not in use, it will automatically send a message to the person that reserved the room and cancel the reservation if the person that made the reservation does not respond. A similar option is available to facilitate motor vehicle management, allowing users to improve efficiency by comparing the status of vehicle reservations with actual usage, determining whether the drive recorder is in use, and whether or not there are any problems with the vehicle. The name mitoco was derived from the English-language expression, "More in today's company".

The Product Business is being developed by TerraSky Co. and US-based TerraSky Inc., though the US subsidiary is largely serving in a marketing capacity and is not generating enough sales to have a material impact on overall results. With regard to SkyOnDemand, the Company noted that it has contracted with NTT TechnoCross (with which it has a capital and business alliance) and general sales agents in Japan to handle sales, but most of the sales go through NTT TechnoCross.

## **With largest number of Salesforce-certified engineers in Japan, strong in both cloud integration technology development and number of personnel**

### **3. Strengths**

TerraSky has three main strengths. The first is its extensive experience. With more than 3,000 installations under its belt as of October 2017, TerraSky has acquired substantial expertise in not only cloud integration, but also in project management, quality control, and delivering systems that meet the needs of a wide range of client companies. Since there are only a limited number of companies that are capable of taking on large projects, this puts TerraSky in a strong position vis-à-vis competitors.

The second strength of TerraSky is the number and quality of its engineers, which are unmatched in Japan's cloud integration industry. The number of certifications or awards won by the Company's engineers attests to their high quality. Salesforce has presented MVP awards to only eight engineers in Japan (as of March 1, 2018), and two of those work for TerraSky. There are only eleven certified technical architects in Japan and four of them work for TerraSky. TerraSky is also Japan's large employer of Certified Advanced Platform Developers, Platform Application Builders, Advanced Administrators, Platform Developers, SalesCloud Consultants, and ServiceCloud Consultants. TerraSky also employs many AWS-certified engineers. Because the number of certified engineers corresponds closely to a company's ability to undertake project orders, it is not an exaggeration to say that TerraSky has more experience and more capacity to do development and installation work for Salesforce cloud systems than any other company in Japan. Lagging behind TerraSky in terms of the number of Salesforce-certified technicians are various consulting companies including PwC Consulting (LLC), Accenture Japan Ltd <ACN>, and ABeam Consulting Ltd., as well as major IT companies such as NTT Data Corporation <9613> and IBM Japan.

Cloud computing market and TerraSky's businesses

After engineers join the Company, they spend roughly six months in classes and undergoing training to acquire technical certifications and only after they are certified are they sent to job sites as part of a project team. Employee training and certification are necessary for TerraSky to establish its core competence, and are viewed as the driving force behind the growth of its business. For this reason, TerraSky makes sure it maintains the type of work environment that attracts and retains good employees, including competitive salaries and reasonable working hours and, as a result, has a better retention rate for engineering personnel than the industry average. As of the end of FY2/18, the Company had a total of 262 employees. Of these, 70%–80% were in engineering, roughly 20% in sales, and roughly 10% in administration.

TerraSky's third strength is its ability to provide service for multiple cloud service platform, including Salesforce and AWS. Its ability to do development work for multiple platforms allows it to cover a wider range of customer needs, which in turn leads to more orders. As discussed previously, Salesforce and AWS not only have leading shares in the PaaS and IaaS markets, they also have continued to grow rapidly in recent years. This is a good indication that demand for cloud computing services remains strong and will lead to continue growth in sales at TerraSky in the future.

**4. Business risks**

In terms of business risks, the Company obviously has to hire and retain enough engineers to expand its business. If TerraSky were unable to meet its hiring and retention goals it would have a hard time growing its order book. Its stock exchange listing has helped greatly in this regard by raising its profile and making it easier to attract good people. There is also the risk that, as the Company takes on larger and larger projects, that some of those projects will be unprofitable. Although the shorter development time needed for cloud systems versus development work of on-premise systems means there is less risk of a project being unprofitable, projects still need to be managed carefully and proceed on schedule and failure to do so can lead to losses. For this reason, TerraSky has established a separate department for process management that sees all information on all projects underway and monitors their progress, and also created a support structure to aid projects that struggling to stay on schedule and, as a result, has been able to reduce the number of unprofitable projects over the past few years.

## ■ Results trends

### Aided by the growing cloud computing services market, results hit a record-high for the first time in two fiscal years in FY2/18

**1. FY2/18 results**

For FY2/18, TerraSky reported consolidated sales of ¥4,864mn (+37.6% YoY), operating income of ¥268mn (+32.8%), ordinary income of ¥305mn (+40.7%), and net income attributable to parent company shareholders of ¥171mn (+33.9%). Sales have consistently risen since the Company's inception and this was the highest sales figure yet; on the earnings, however, this was the first new high in two fiscal years. Compared with the Company's forecast, operating income came in 25.1% ahead of plan despite the fact that sales finished slightly below plan. However, the above-plan earnings were due to the Company's failure to meet its hiring goal (hiring just over 70 new employees versus its goal of just under 100) and its success in reducing the number of unprofitable projects.

Results trends

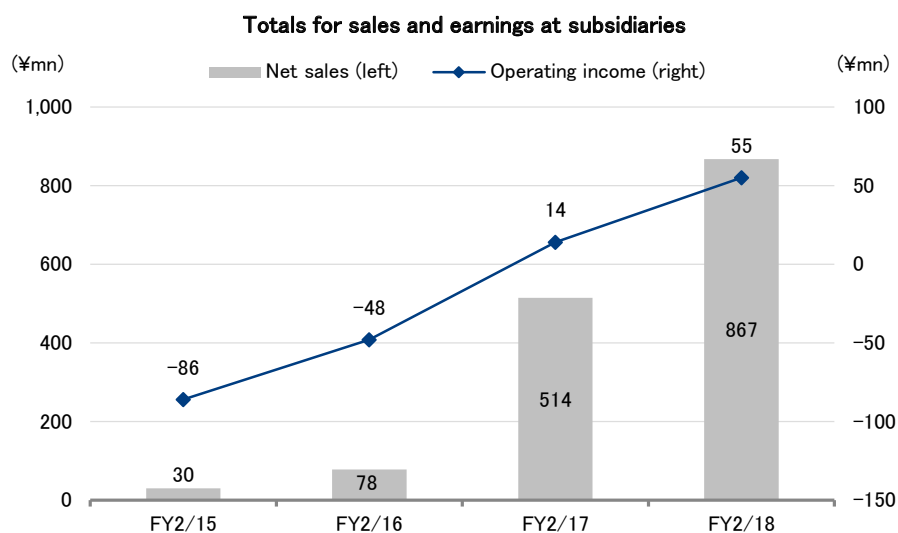
Sales continued their high growth due to the expansion of cloud system development and installation projects, and expanded sales of cloud products. Earnings growth was dampened by the increase in the CoGS ratio, which rose 4.6ppts YoY to 67.2% as development expenses for mitoco increased and the proportion of sales accounted for by the Solution segment rose from 79.8% to 82.0%. SG&A expenses also increased, due mainly to rising personnel-related spending, but the increase was outpaced by top-line growth, leading to 27.3%, a 4.4ppts decline in the SG&A expense ratio. This limited the decline in the operating income ratio, leaving it to finish the year at 5.5%, down 0.2ppts versus the previous year and above the Company's initial forecast.

In FY2/18 the Company's subsidiaries also saw strong growth in sales and earnings, and contributed to growth at the consolidated group level. Of its five consolidated subsidiaries, only two finished the year in the red, US-based TerraSky Inc. and Cloudia Japan. The other three all logged higher sales and higher earnings, led by BeeX (which provides support services for companies transitioning to SAP-based systems cloud systems). In contrast to the parent company, which saw 32.4% rise in sales to ¥3,977mn and a 13.4% rise in operating income to ¥213mn, the five consolidated subsidiaries on a combined basis saw sales rise 68.7% to ¥867mn and operating income rise 292.9% to ¥55mn.

FY2/18 consolidated results

|   | FY2/17  |            |          | FY2/18  |            |        |              |
|---|---------|------------|----------|---------|------------|--------|--------------|
|   | Results | % of sales | Forecast | Results | % of sales | YoY    | vs. forecast |
| Net sales                                   | 3,534   | -          | 5,044    | 4,864   | -          | +37.6% | -3.6%        |
| Cost of sales                               | 2,211   | 62.6%      | -        | 3,267   | 67.2%      | +47.7% | -            |
| SG&A expenses                               | 1,120   | 31.7%      | -        | 1,328   | 27.3%      | +18.6% | -            |
| Operating income                            | 202     | 5.7%       | 215      | 268     | 5.5%       | +32.8% | +25.1%       |
| Ordinary income                             | 216     | 6.1%       | 253      | 305     | 6.3%       | +40.7% | +20.6%       |
| Net income attributable to owners of parent | 128     | 3.6%       | 150      | 171     | 3.5%       | +33.9% | +14.4%       |

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



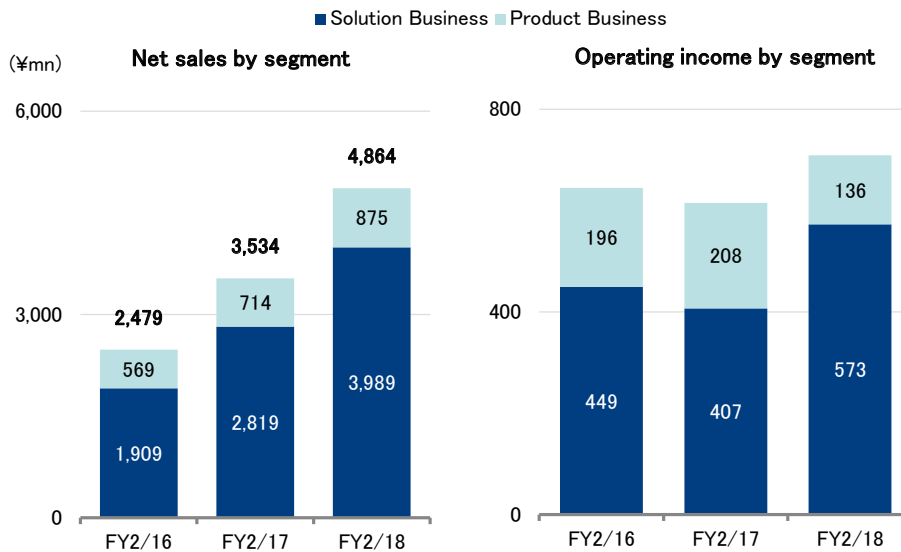
Source: Prepared by FISCO from Company materials

Results trends

**(1) Results by segment**

Looking at results by segment, we find the Solution segment logging strong gains in both revenues and earnings, with FY2/18 net sales rising 41.5% YoY to ¥3,989mn and segment profit (operating income) rising 40.9% to ¥573mn. The growth was driven by demand from companies transitioning to cloud-based systems; with majority of these being large companies, TerraSky saw more orders that exceeded ¥10mn in value. TerraSky also saw an increase in demand from companies that already had cloud systems but were look to make upgrades. Because TerraSky was not able to hire as many new employees as it had expected, its use of outside contractors remained largely unchanged from the previous year (in percentage terms) and the segment profitability remained flat at 14.4%.

In contrast, the Product segment saw higher sales but lower earnings, with sales rising 22.5% YoY to ¥875mn while operating income fell 34.7% to ¥136mn. The top-line gain were driven by the growing market for Salesforce products, rising sales of mainstay products like SkyVisualEditor and SkyonDemand, and steady growth in the number of companies signing up for mitoco services, especially among major financial institutions and publishing companies. The drop in earnings was attributed in large part to personnel costs and the development costs incurred to add new functions to mitoco. Depreciation costs in FY2/18 booked under the Product segment came to ¥198mn for the year, an increase of ¥103mn over the previous year, with most of the increase coming from the depreciation of the development costs for mitoco.



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

**(2) Initiatives undertaken during FY2/18**

Major initiatives undertaken by the Company during FY2/18 are as follows:

- a) Entered into capital and business alliance with Phone Appli Inc., a major developer of Web telephone book applications, in March 2017. The partnership was primarily established to link mitoco with Phone Appli's Web telephone book application (Phone Appli Collaboration Directory) and coordinate joint-promotions to promote sales going forward.

## Results trends

b) Established office in Fukuoka in April 2017; established large-scale operations center in Sapporo to be utilized by subsidiaries Sky365 and Kitalive to operate cloud systems and applications; also opened Joetsu satellite office (Niigata Prefecture).

c) Entered into capital and business alliance with IGUAZU Corp. in May 2017. IGUAZU provides hardware and software solutions; it has a total of nine offices nationwide but is able to provide service at the local level by working through some 650 partner companies. The partnership with IGUAZU will allow TerraSky to use the sales channels established by IGUAZU to expand sales of its cloud products and cloud integration services, and will also allow the two companies to pursue joint expansion nationwide.

d) Subsidiary Kitalive, established in June 2017, received a capital infusion from via a private placement of shares with Salesforce Ventures (the investment division of US-based Salesforce.com). This reduced TerraSky's stake in Kitalive from 70% to 60%.

e) TerraSky concluded an agreement with AGREX Inc. (part of the TIS INTEC Group, owned by TIS Inc.<3626>) under which AGREX would serve as a sales agent for the sales support tool (IAS, for Insurance Agency Solution) developed by TerraSky specifically for insurance agencies. Entered its business partnership agreement with Bengo4.com <6027>, under which TerraSky will adapt Bengo4.com's cloud contract service (CloudSign) for use with Salesforce, leading to the creation of a new service that will allow users to connect to and utilize customer data stored under Salesforce; the new app was made available on Salesforce's online marketplace (AppExchange) starting in October 2017. TerraSky also announced the start of a new service (Solutions for Customer Support Operations) that would support live chat with operators on LINE Customer Connect (the corporate customer support service operated by LINE <3938>) via connections over Salesforce Service Cloud (from Salesforce.com).

f) Subsidiary BeeX, established in February 2018, entered into a capital and business alliance with TIS, a major independent systems integration company. BeeX made a private placement of new shares with TIS, reducing TerraSky's stake in BeeX from 67% to 61%. The alliance was formed to assure that the SAP cloud transition support services that TIS had been receiving from the TerraSky group would continue and the two would continue working together in the future.

g) In March 2018, TerraSky took a small stake (less than 5%) in Toyo Business Engineering Corporation <4828>, whose primary business is SAP installation support services, to seal a business partnership agreement under which the two companies will work together to provide cloud transition support services to Toyo Business Engineering's customers that had SAP or other EPR packaged software.

## Business expansion increasing interesting-bearing debt, but financial position remains solid

### 2. Financial position and management indicators

As of the end of FY2/18, the Company's balance sheet showed total assets of ¥3,817mn, up ¥1,264mn from the end of the previous fiscal year. Behind the jump in assets we find a substantial rise in current assets, including a ¥274mn increase in cash/ deposits and a ¥264mn increase in notes and accounts receivable - trade. Under non-current assets, we find a ¥131mn increase in software assets reflecting the development work done on mitoco, ¥192mn for acquisition of investment securities, and an increase of ¥360mn security deposits made in connection with the Company's move to a new headquarters building.

**TerraSky Co., Ltd.** | **12-Jun.-2018**  
 3915 TSE Mothers | <https://www.terrasky.co.jp/ir/>

Results trends

Total liabilities of ¥2,155mn were up ¥841mn from the end of the previous fiscal year, driven by a ¥325mn increase in interest-bearing debt and ¥254mn increase in long-term account payable. Net assets of ¥1,661mn were up ¥423mn, with retained earnings up ¥171mn, capital surplus up ¥94mn, and a ¥102mn increase in non-controlling shareholders' equity as a result of additional capital contributions to subsidiaries.

Looking at key management indicators, we note that the shareholders equity ratio declined from 45.0% at the end of FY2/18 to 38.5% at the end of FY2/18, but that the current ratio remains in safe territory around 200% and the Company's net cash position (cash/deposits minus interest-bearing debt) was slightly positive—an indication that the TerraSky's overall financial position remains solid. As for profitability ratios, we note that the operating income margin has slipped in recent years has been stuck at a little over 5% since FY2/17. This is much as the Company had expected, though, since it has been stepping up hiring and putting more money into new product development with the aim of facilitating further growth in the future. As this aggressive investment spending is expected to last only through the end of this fiscal year, the Company sees profit margins turning up from FY2/20.

**Simplified consolidated balance sheet**

|   | (¥mn)  |        |        |        |        |
|---|--------|--------|--------|--------|--------|
|   | FY2/15 | FY2/16 | FY2/17 | FY2/18 | Change |
| <b>Current assets</b>                   | 827    | 1,334  | 1,772  | 2,320  | 548    |
| (Cash and deposits)                     | 450    | 692    | 814    | 1,089  | 274    |
| (Notes and accounts receivable - trade) | 309    | 514    | 707    | 972    | 264    |
| <b>Non-current assets</b>               | 267    | 425    | 777    | 1,495  | 717    |
| <b>Total assets</b>                     | 1,096  | 1,761  | 2,552  | 3,817  | 1,264  |
| <b>Current liabilities</b>              | 625    | 799    | 1,314  | 2,155  | 841    |
| (Interest-bearing debt)                 | 214    | 200    | 723    | 1,049  | 325    |
| <b>Net assets</b>                       | 470    | 962    | 1,238  | 1,661  | 423    |
| <b>Management indicators</b>            |        |        |        |        |        |
| <b>(Stability)</b>                      |        |        |        |        |        |
| Current ratio                           | 133.7% | 173.8% | 232.1% | 197.8% |        |
| Equity ratio                            | 40.0%  | 53.8%  | 45.0%  | 38.5%  |        |
| Interest-bearing debt ratio             | 50.4%  | 21.4%  | 63.0%  | 71.4%  |        |
| <b>(Profitability)</b>                  |        |        |        |        |        |
| ROA                                     | 18.0%  | 17.0%  | 10.1%  | 9.6%   |        |
| ROE                                     | 19.4%  | 22.1%  | 12.3%  | 13.1%  |        |
| Operating income margin                 | 9.8%   | 10.5%  | 5.7%   | 5.5%   |        |

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



## ■ Outlook

### As investment spending swells, Company sees earnings declining in FY2/19, but expects earnings to move into rapid growth phase starting in FY2/20

#### 1. Forecast for FY2/19

For FY2/19, the Company is forecasting higher sales but lower earnings, projecting consolidated sales of ¥6,777mn (+39.3%), operating income of ¥199mn (-25.8%), ordinary income of ¥205 (-32.5%), and net income attributable to parent company shareholders of ¥82mn (-51.7%). During the year ahead, TerraSky is looking to lay the ground for rapid and sustained growth in sales and earnings from FY2/20 and, towards this end, will be implementing a number of initiatives aimed at securing high-and-stable growth, moving into new growth markets, and improving product and service quality.

Forecast for FY2/19 consolidated results

|   | FY2/18  |            | FY2/19   |            | YoY    |
|---|---------|------------|----------|------------|--------|
|   | Results | % of sales | Forecast | % of sales |        |
|   | (¥mn)   |            |          |            |        |
| Net sales                                   | 4,864   | 100.0%     | 6,777    | 100.0%     | +39.3% |
| Operating income                            | 268     | 5.5%       | 199      | 2.9%       | -25.8% |
| Ordinary income                             | 305     | 6.3%       | 205      | 3.0%       | -32.5% |
| Net income attributable to owners of parent | 171     | 3.5%       | 82       | 1.2%       | -51.7% |
| Net income per share (¥)                    | 30.64   |            | 14.70    |            |        |

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

#### (1) Factors behind outlook for lower earnings

Despite the high growth in net sales, the Company sees operating income coming down in FY2/19 due to its plans to continue investing heavily in human resources to facilitate future growth and increases in fixed costs (such as rent) following its move to a new headquarters in May 2018.

On the hiring front, plans call for hiring another 135 employees in FY2/19, enough to increase staff by roughly 80% YoY. For the most part, the Company is looking for experienced staff, and plans to hire only 18 new grads (versus 13 in FY2/18). At the consolidated level, the Company is looking to add a total of 168 new employees, which would bring its total workforce to 550 at the group level. Among subsidiaries, most of the new hiring will be done by BeeX and Kitalive, both of which are running increasingly short on staff as their order books continue to grow. The Company reports that its hiring during March and April in 2018 was basically in line with plan.

Both new grads and mid-career hires undergo roughly six months of classes and training to get technical certifications (with new grads typically requiring more than a year of training). The total cost of paying and training this year's batch of new employees for FY2/19 is expected to come to several hundred million yen by the time they are ready to go out into field and earn their keep, and this comes on top of the ¥20mn–¥30mn the Company expects to spend in just in hiring costs. Since the number of new employees the Company expects to hire in FY2/19 is roughly twice the number hired last year, we estimate that all the related costs will be nearly ¥300mn more than last year. If the Company meets its hiring target in FY2/19 it expects to hire fewer new employees in FY2/20. Since fewer hires would mean less the spending on employee training, this too would provide an additional boost to earnings in FY2/20.

#### Outlook

The Company's move to a new headquarters building was aimed precisely at acquiring the space needed to accommodate the growth in its workforce and business. In the past, the Company had a habit of moving to a new headquarters building every three years, and even with this latest move it appears to have secured enough floor space to get it through at least another three years. When making the move in May 2018, the Company will use the opportunity to move its Product Business department (TerraSky Lab), which had been housed in a separate building located in the vicinity of the old headquarters building, into the new headquarters building. (The Tokyo offices of subsidiaries BeeX and Kitalive with remain in their current locations.) The new headquarters building is 2.5 times larger in terms of floor space and has room to seat up to 700 employees. In terms of moving expenses, because during the move the Company will be paying rent on two facilities, its rent payments alone will increase by more than ¥200mn in FY2/19.

If these two big factors pushing up costs in FY2/19 were excluded, TerraSky would otherwise see operating income rise in FY2/19. In any case, as the drag on earnings from these two factor drops off in FY2/20, we can expect to see a sharp improvement in profitability as more of the top-line gains flow through to the bottom line.

#### (2) Outlook by business segment

The Company is forecasting sales growth of nearly 40% YoY at both segments in FY2/19, projecting sales of ¥5,564mn (+39% YoY) for the Solution segment and sales of ¥1,212mn (+38%) for the Product segment.

The strong growth projected for the Solution segment reflects not just increased revenues from Salesforce-related projects, but continue growth development work for AWS, cloud ERP systems, and other cloud systems, plus additional revenues from maintenance and operations under MSP service agreements. The strong top-line growth notwithstanding, the Company sees segment profit coming down under the weight of upfront spending on new hires.

In contrast, at the Product segment, the Company sees the rapid growth being driven primarily by its SkyVisualEditor screen development tool for Salesforce. It is also looking for sales momentum to pick up for its new socialware service, mitoco, as the recently added functions that make use of IoT technology allow users to establish links with more operating systems. On the earnings front, depreciation of the costs related to the development of the additional features for mitoco will bring the segment profit margin down but segment profit is still expected to rise thanks to higher sales.

## Targeting ordinary income of ¥1.0bn in FY2/20

### 2. Medium-term forecast and growth strategy

Under its medium-term business plan, one of the performance targets TerraSky has set is ordinary income of ¥1.0bn in FY2/20. The Company mapped out the three-year period from FY2/17 through FY2/19 as an investment phase during which it focuses on building a solid base for future growth by investing heavily in personnel and new product development. Although the Company's forecast sees earnings declining in FY2/19, this was fully expected under its medium-term strategy and, at the current juncture, the Company appears to be where it should be under its medium-term plan. As mentioned previously, once the heavy investment spending drops off in FY2/20, the Company's target of ¥1.0bn in ordinary income should be within reach, provided the Company hits its FY2/20 sales target of ¥10.0bn (which represents a 47% increase over its forecast for FY2/19). The Company's target figures for FY2/20 works out to an ordinary income margin of 10.0%. While this would be almost a 4.0ppts improvement over the 6.3% margin recorded in FY2/18, it appears satisfactorily achievable if the profitability of the Product segment increases and investing spending on personnel comes down as expected. In this relation, we note that the high mark for the ordinary income margin was 9.8%, recorded in FY2/16.

We encourage readers to review our complete legal statement on "Disclaimer" page.

#### Outlook

To achieve the high growth, it is currently targeting, the Company plans to undertake the following initiatives.

##### **(1) Establish R&D department**

To grow its Product Business, the Company is working to develop products in six areas where demand is expected to grow for cloud applications: machine learning, virtual personal assistants, robotic process automation (RPA), quantum computing, IoT, and AR/VR (augmented reality/virtual reality). The Company expects to find applications for existing services like mitoco in all of these areas, and anticipates contributions to sales starting in FY2/19 from virtual personal assistants, RPA, and IoT.

##### **(2) Investing in mitoco**

Going forward, TerraSky is looking to put more money into developing mitoco, taking full advantage of its superior functionality as a next-generation groupware platform by building links with applications from other companies and eventually making mitoco one of its mainstay products. While there already companies that offer similar services over Salesforce, mitoco is seen as surpassing competing services both in terms of size and functionality.

##### **(3) Omnichannel**

In the area of omnichannel applications, in April 2018 the Company began offering its Omnichannel LINK for LINE Customer Connect service that links LINE Customer Connect with Salesforce Service Cloud (hereafter Service Cloud). On the Service Cloud console screen viewed by a contact center operator, the operator is able to display all interactions with a customer and, using a screen that displays all customer-related information and the customer's omnichannel interaction history, the operator is able to provide service that creates greater customer satisfaction.

Along with the spread of social networking services, the way in which companies contact their customer is constantly evolving, with contact methods moving from email and telephones to social networking services such as LINE, and even making use of chatbots. With Salesforce already widely used by retailers, service companies, and other BtoC companies, services offered by TerraSky that connect to LINE can be expected to draw a lot of attention and contribute to sales and earnings going forward. Here, too, there already companies that offer similar services over Salesforce, but we believe that TerraSky, which excels in developing applications for Salesforce, is offering a superior service in terms of functionality.

##### **(4) Support services for companies selling apps on AppExchange**

AppExchange is Salesforce's online marketplace for business applications and, with more than 3,000 such applications listed, is in fact the world's largest online marketplace for business apps. Among the services offered by Salesforce, it is also one of the fastest growing.

TerraSky provides support to companies looking to create apps that they hope to sell through AppExchange, including the web telephone book app created by Phone Appli, with whom TerraSky entered into a capital and business alliance in 2017. TerraSky also connected the ChoiceRESERVE cloud-based reservation management system from ReserveLINK Co., Ltd. with Salesforce in March 2018, and expects to work with a large number of other companies (especially BtoC) in a similar capacity going forward.

##### **(5) Postmodern ERP**

Postmodern ERP refers to new ERP systems (hybrid type ERP) that are in essence hybrid systems created by building on the long-lived ERP core system by finding and integrating best-of-breed applications in peripheral application areas where there have been a great deal of change as well as applications that are designed to meet the unique needs of particular businesses or services.

### Outlook

As a specialist in cloud ERP integrator, BeeX sees a great deal of room for growth in this field. Since its founding in March 2016, BeeX has completed more than 25 cloud ERP integration projects, mainly for large companies. And, because it specializes in the SAP cloud platform, BeeX already ranks among the most experienced cloud ERP integrators for SAP systems. The Company believes there is a great deal of latent demand in this field since relatively few of the large SAP ERP systems used by businesses have been moved to the cloud. BeeX plans to continue focusing on cloud integration for companies using SAP ERP systems and, towards this end, entered into a capital and business alliance with TIS Inc. in 2017 followed by a business partnership agreement with SAP business pioneer Toyo Business Engineering Corporation in March 2018.

#### (6) Procure capital by issuing subscription rights to share

During the past several years TerraSky has entered into capital and business alliances with a number of companies where business partnerships appear likely to generate synergies, and it plans to continue looking to make more business alliance in the future. In an effort to speed up growth over the next several years, TerraSky is looking at stepping up activities on this front, making even more acquisitions and establishing more capital and business alliances. To secure the funds needed for such investments, the company issued subscription rights to share through a third party allocation in May 2018. If all of the subscription rights to share are exercised, they are expected to bring in about ¥2.4bn in additional capital and increase the number of shares outstanding by 10.5%. Of the ¥2.4bn in funds raised, the Company plans to put about ¥1.2bn towards acquisitions and other capital and business alliances, use ¥600mn for investments in personnel, and use the remainder to repay debt. Likely acquisition targets include domestic companies engaged in Salesforce-related software engineering and companies that have apps that can run over mitco. The Company said it will consider investment candidates where it can expect to recoup its investment within no more than seven or eight years.

#### Overview of issuing of subscription rights to share through a third party allocation

| Issuing date                         | 2018/5/9  |                                   |
|--------------------------------------|---|-----------------------------------|
| Issuing amount                       | Price per subscription rights to share: ¥1,914 (total of ¥11mn) |                                   |
| Initial exercise amount              | ¥4,060 (minimum exercise price of ¥2,436)                       |                                   |
| Exercise period                      | 2018/5/10-2021/5/10   |                                   |
| Amount expected to procure           | ¥2,438mn  |                                   |
| Specified use of funds               | Amount (mn)   | Expected timeframe of expenditure |
| M&A, capital and business alliances  | 1,200   | 2018/5-2021/3                     |
| Personnel hiring (personnel expense) | 600   | 2018/5-2021/3                     |
| Loan repayment                       | 638   | 2018/5-2021/3                     |

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

## ■ Shareholder return policy

### Might start paying dividend as early as FY2/20

The Company recognizes that returning profits to shareholders is an important management concern but at this juncture is placing a higher priority on strengthening its financial position so as to support future business expansion and funding investments that will help it expand the business and, for this reason, is not paying dividends at this time. However, the Company has indicated that it would like to start paying dividends in FY2/20, provided in sales and earnings are on track and management is satisfied with the progress made towards building up internal reserves, the Company's financial position, and overall management performance. TerraSky is currently listed on the Tokyo Stock Exchange's Mothers market but is in the process of preparing to move its listing to either the exchange's First Section or the Second Section.

## ■ Information security policy

The TerraSky group has an established information security policy, provides management personnel regular training on information security, has been certified as meeting the ISO27001 information security management standards, and is constantly striving to strengthen its information management structure.



## Disclaimer

FISCO Ltd. (the terms “FISCO”, “we”, mean FISCO Ltd.) has legal agreements with the Tokyo Stock Exchange, the Osaka Exchange, and Nikkei Inc. as to the usage of stock price and index information. The trademark and value of the “JASDAQ INDEX” are the intellectual properties of the Tokyo Stock Exchange, and therefore all rights to them belong to the Tokyo Stock Exchange.

This report is based on information that we believe to be reliable, but we do not confirm or guarantee its accuracy, timeliness, or completeness, or the value of the securities issued by companies cited in this report. Regardless of purpose, investors should decide how to use this report and take full responsibility for such use. We shall not be liable for any result of its use. We provide this report solely for the purpose of information, not to induce investment or any other action.

This report was prepared at the request of its subject company using information provided by the company in interviews, but the entire content of the report, including suppositions and conclusions, is the result of our analysis. The content of this report is based on information that was current at the time the report was produced, but this information and the content of this report are subject to change without prior notice.

All intellectual property rights to this report, including copyrights to its text and data, are held exclusively by FISCO. Any alteration or processing of the report or duplications of the report, without the express written consent of FISCO, is strictly prohibited. Any transmission, reproduction, distribution or transfer of the report or its duplications is also strictly prohibited.

The final selection of investments and determination of appropriate prices for investment transactions are decisions for the recipients of this report.

FISCO Ltd.