

Daikoku Denki Co., Ltd.

6430

Tokyo Stock Exchange Prime Market and Nagoya Stock Exchange Premier Market

18-Aug.-2022

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FISCO Ltd.

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

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Summary

Posted higher sales and significantly stronger profits in FY3/22. Disclosed a medium-term management plan and addresses the smart gaming machine era; path is clear for full-fledged market revitalization and expanded share

1. Business overview

Daikoku Denki Co., Ltd. <6430> (hereafter, “the Company”) has two main businesses: one that develops, manufactures and sells computer systems for pachinko (Japanese slot machines) parlors and halls, and the other that develops, produces and sells display and control units for pachinko machines. The Company holds the leading market share, approximately 37.1%, of the Japanese market for hall computers, reflecting an information management method that is the de facto standard for the industry. Furthermore, the industry’s leading membership-based information provision service Daikoku Denki Strategic Information System (DK-SIS) facilitating the operations of pachinko hall associations forms a network of 3,303 pachinko halls and supports the Company’s business foundation.

With the pachinko market on a trend of steady annual shrinkage, the Company is striving to increase market share at large halls and promoting business reforms, including a shift to a business model with recurring revenue that continues over time, from a medium to long term perspective. However, with the series of revisions to regulations (including controlled ball payouts, measures against gambling addiction, and replacement with machines complying with the new regulations) having brought the industry to a major turning point, earnings right now remain difficult due to the impact of future uncertainty, along with the impact of the COVID-19 pandemic. Meanwhile, replacement of machines complying with the former regulations at the end of January 2022 will be carried out in stages, the gaming machine market is showing signs of an upswing driven by pachinko machines that meet the new regulations, and this trend is contributing to recovery in the Company’s recent results. In addition, the Company plans to introduce smart gaming machines in 2H FY3/23, and is finally entering a new phase.

2. Overview of FY3/22 results

The Company posted FY3/22 results with higher sales and significantly stronger profits*, including net sales of ¥24,390mn (+4.5% YoY) and operating income of ¥1,191mn (+96.2% YoY). Pachinko halls remained downbeat on capital investment, and refrained from new openings and large-scale remodeling. However, utilization was brisk for pachinko machines compliant with the new regulations, sales of the mainstay Information Service Segment product AI hall computer “X (Kai),” CR unit VEGASIA, and information disclosure terminals REVOLA and BiGMO PREMIUM rose YoY, and service sales steadily grew to contribute to the rise in net sales. In the Control System Segment, sales of products for pachinko machines were strong, and mainstay display and control units did well due to the start of consignment manufacturing of pachislot machines. On the earnings front, growth for core products with high margins, recovery in recurring-revenue business from MIRAIGATE SERVICE (hereinafter, “MG Services”), and steps to reduce companywide costs drove sharp growth in operating income.

* The Company has applied Accounting Standard for Revenue Recognition (ASBJ Statement No. 29; March 31, 2020) since FY3/22, and reported figures following application of the relevant accounting standard in FY3/22 values. Furthermore, updated figures for FY3/21 reflect the change in presentation method and YoY comparisons are shown.

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Summary

3. Disclosure of a new medium-term management plan

In November 2021, the Company disclosed a new medium-term management plan (three years) starting from FY3/23. While disclosure had been delayed for some time due to persisting uncertain conditions, factors supporting the decision to move ahead with the timing of disclosure were full transition to machines that meet the new regulations from February 2022 and seeing a path to livelier conditions in the gaming machine market and pachinko hall capital investments as the new era of smart gaming machines* emerges. In other words, the Company outlined a strategy of capturing demand using smart gaming machines, continued promotion of AI hall computer X (Kai) uptake, and carrying on building the industry's only platform through rollout of business utilizing a cloud server (reinforcement of new MG Services). Numerical goals for FY3/25, the final fiscal year, are ¥34,000mn in net sales (11.7% average growth rate over three years) and ¥2,200mn in operating income (6.5% operating income margin). Projected incremental improvement in the operating income margin relies on recurring business led by MG Services becoming the growth driver and substantial contributions from the resulting change in the earnings structure (lifting the bottom line).

* This refers to "managed gaming machines" (smart pachinko) and "medal-less gaming machines" (smart pachislot) and enables users to play without directly touching the balls and medals in contrast to the past format. Key points are elimination of facilities related to balls and medals at pachinko halls and enhancement of gaming performance compared to existing gaming machines. Future developments should be closely monitored considering support from gaming machine manufacturer organizations (Nikkoso and Nichidenkyo).

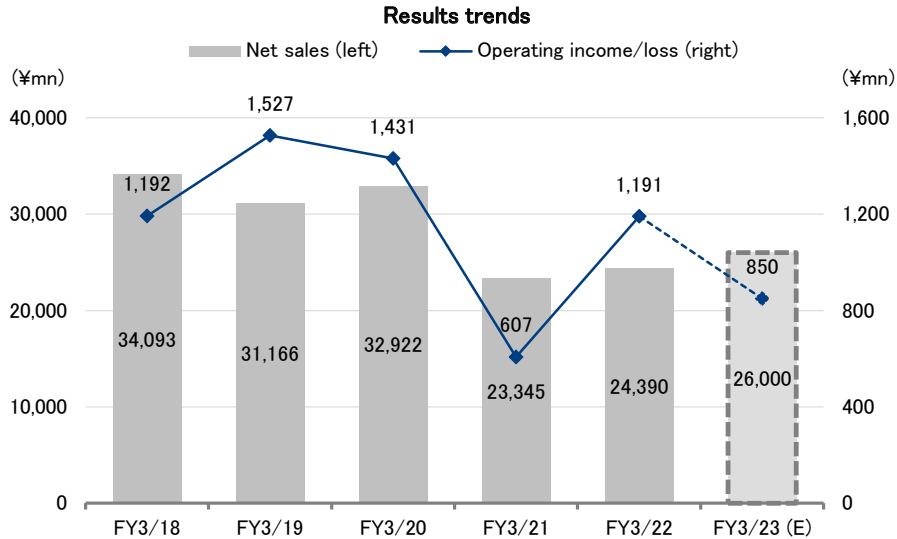
4. FY3/23 forecasts

In FY3/23, the first year of the new medium-term management plan, the Company forecasts net sales of ¥26,000mn (+6.6% YoY) and operating income of ¥850mn (-28.6%). It expects net sales to grow in both the Information System Segment and the Control System Segment as pachinko halls' appetite for capital investment is recovering. However, it should be noted that the Company forecasts Information System Segment earnings will be weighted towards 2H, assuming 1) it will remain difficult to procure electronic components and other parts due to semiconductor shortages in 1H and 2) the emergence of smart gaming machines will invigorate the market in 2H. As for earnings, the Company forecasts operating income will decline based on conservative estimates regarding impact from semiconductor shortages and surging raw material prices, in addition to proactive investments in areas such as the cloud and pachislot.

Key Points

- Posted higher sales and significantly stronger profits in FY3/22. Growth in mainstay products, recovery in MG Services, and an improved income structure contributed to profit increases exceeding the plan despite ongoing difficult conditions
- Disclosed the new medium-term management plan that begins in FY3/23. Aims to build the industry's only platform through rollout of business utilizing a cloud server (reinforcement of new MG Services) for the arrival of a new era with smart gaming machines
- Forecasts higher sales in FY3/23 accompanying market revitalization but lower profit based on conservative estimates for impact from semiconductor shortages, soaring raw material prices, and so on

Summary



Notes: The Company has applied Accounting Standard for Revenue Recognition since FY3/22. Updated figures for FY3/21 reflect the change in presentation method
 Source: Prepared by FISCO from the Company's financial results

Description of businesses

Focuses on hall computers and peripheral equipment for pachinko halls. Aims to further expand its top market share in the industry by promoting the industry's first AI hall computer

While emphasizing development, production and sales of computer systems for pachinko halls, the Company also develops, manufactures and sells display and control units for pachinko machines.

As a pioneer in the development of hall computers, which assist in the management of pachinko halls, and holder of the top market share in the Japanese market, the Company won halls' trust and satisfied pachinko players by proposing a management method which puts emphasis on data management, introducing innovative peripheral equipment for its hall computers, and providing the industry's leading membership-based information provision service.

The Company's share of the hall computer market is 37.1%, and in particular, its market share of large-scale halls with at least 501 machines is 61.4%.

The Company's two main businesses are the Information System Segment and Control System Segment, but the Information System Segment provided around 75% of its net sales and has been the main source of stable profit in the past few years.

Description of businesses

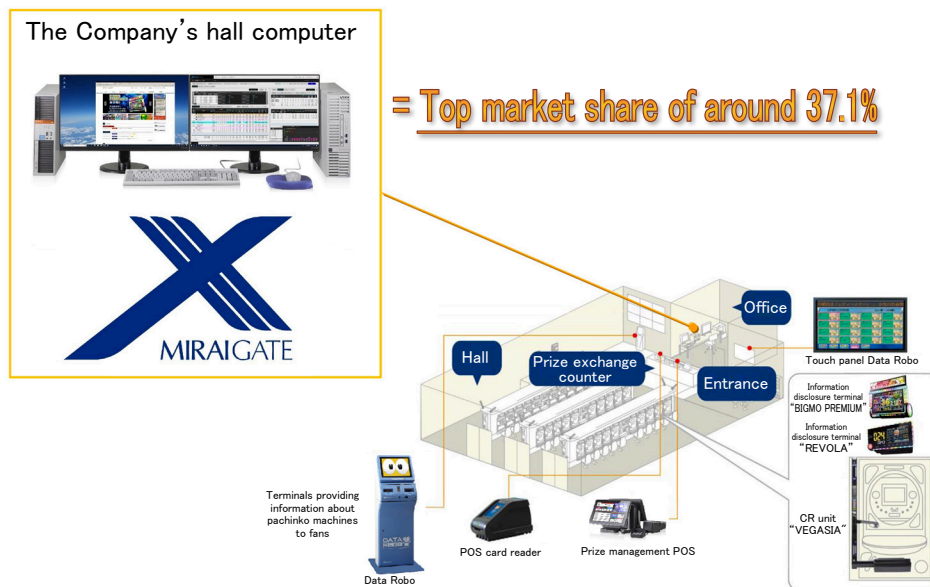
1. Information System Segment

The Company sells hall computers, which serve as core systems at pachinko halls, and peripheral equipment, such as prize and customer management systems and information disclosure systems, and offers MG Services that provide various services on hall computers and over the internet via a server. DK-SIS, a membership information provision service and the industry's foremost strategic information tool, is the pillar of MG Services.

Hall computers are the core systems for supporting pachinko hall operations. These computers display the operating conditions and sales of each machine in a hall, are supported by peripheral equipment such as prize management and information disclosure systems, and serve as the foundation of MG Services. Introducing a hall computer provides the advantage that peripheral equipment and support services can be sold as a package deal.

In June 2019, the Company released industry-first AI hall computer X (Kai), its first launch in 12 years since the release of the hall computer CII. Based on the concept of a "hall computer that teaches," the main feature of this AI hall computer is that it will guide pachinko hall operators to optimal solutions by utilizing the Company's big data and having AI automatically analyze the data. By using AI's ability to prepare forecasts utilizing big data that cannot be processed by people to instantaneously generate analyses that previously required significant time and assist personnel with limited experience in making assessments expected of highly experienced personnel, the Company wants to enhance efficiency and reduce labor resources in hall management, contribute to further customer attraction and expand its market share and improve profitability.

Hall computers and main peripheral equipment



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

Description of businesses

2. Control System Segment

The Control System Segment produces and sells displays and control units, as well as components used for pachinko and pachislot machines for game machine manufacturers. Applying the knowledge obtained from analyzing data from pachinko machines as a hall computer manufacturer for many years, the segment serves as a development partner for the content as well, moving beyond the scope of a machine manufacturer by proposing plans based on the trends of popular models and sales of copyrights for popular characters. In particular, the Company is ramping up pachislot business from FY3/22 by leveraging hardware and software technologies cultivated up to now and broadening its business scope, including through sales of proprietary pachislot systems.

■ Company strengths

Track record of creating new product opportunities for the industry and provides added value for hall management in various aspects

1. Growth model based on market expansion through innovation

Since its establishment, the Company has consistently planned and developed new categories of goods and services, thereby cultivating the pachinko market and achieving growth. It has not just developed machines with superior functions but emphasized the importance of data management and the necessity for information disclosure. Thus, it has been able to provide added value to various aspects of pachinko hall management.

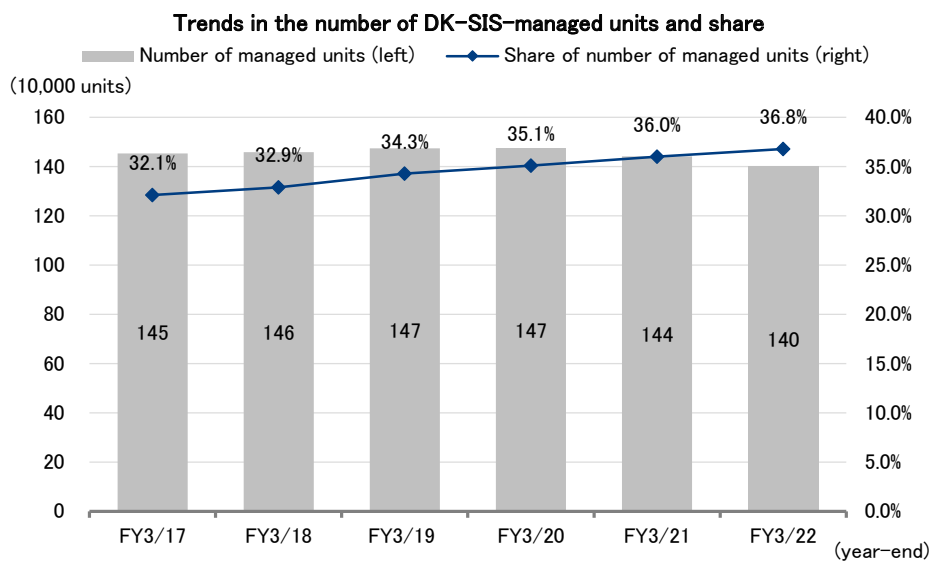
Launched in 1974, the Company's first hall computer enabled managers of pachinko halls to introduce a hall management method based on data management. Previously, pachinko halls accumulated only basic data, but with the introduction of hall computers, data-based hall management became the de facto standard. Ever since then, it has been steadily rolling out industry-first information equipment that contains innovative functions, such as the Data Robot information disclosure terminal that provides operational information about gaming machines at pachinko halls to fans. It has contributed to healthier hall results by boosting the efficiency of hall management and supplying added value that raises fan satisfaction.

In June 2019, the Company released the industry's first AI hall computer, X (Kai). This AI hall computer is unique in that it will not only greatly help the performance of pachinko halls, but also improve operating efficiency by having AI automatically analyze big data that the Company possesses, thus reducing labor necessary for hall management already undergoing labor shortages.

Company strengths

2. Strong network of pachinko halls

Another one of the Company's strengths is that it has built a robust network with member pachinko halls through an array of services based on hall computers (MG Services), and evolved it into the industry's only platform. Launched in 1990, DK-SIS is a service offering feedback in the form of information that is useful in hall operations after processing and analyzing the daily operational information of pachinko and pachislot machines received from pachinko halls. Simulations based on nationwide gaming machine sales data support forecast management, and a strong network of members underpins the Company's business foundation. Additionally, the service takes on a role as a sort of think tank in the industry, helping to enhance the Company's brand power as a leading company, and it is apparently being utilized in strategic proposals and sales activities to game machine manufacturers. Membership totaled 3,303 halls at the end of March 2022 with 1.4mn managed machines (36.8% share in managed machines). Recently, the Company has been focusing on promoting widespread use of its Market-SIS market area analysis service, which analyzes customer numbers, utilization rates, market share, and support rates of pachinko hall rivals operating in the commercial sphere. Market-SIS is being well received as a tool that grasps mobility (player) trends and helps halls improve their ability to attract customers. Moreover, the Company launched the cloud-based chain store management system ClarisLink in 2021. The new system is its first using the cloud.



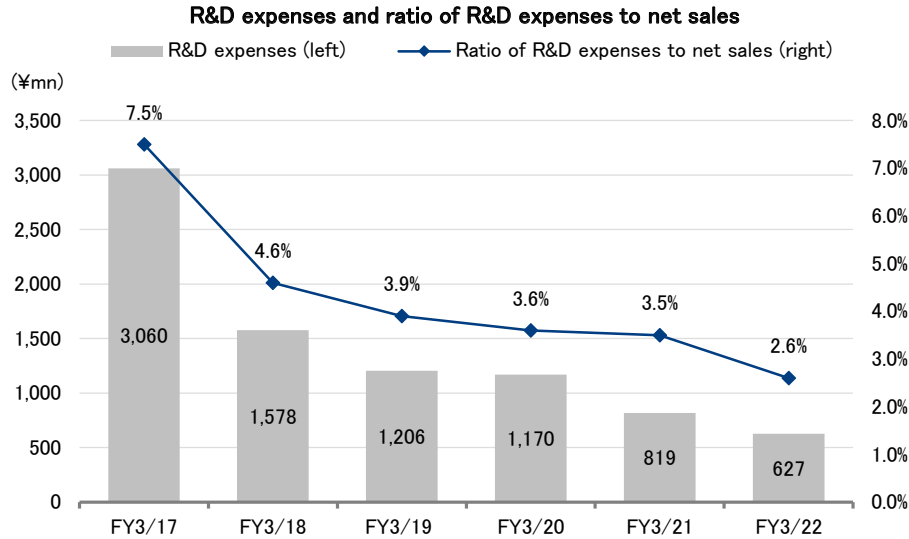
Source: Prepared by FISCO from the Company's materials

3. Stable profit base that supports investment for the future

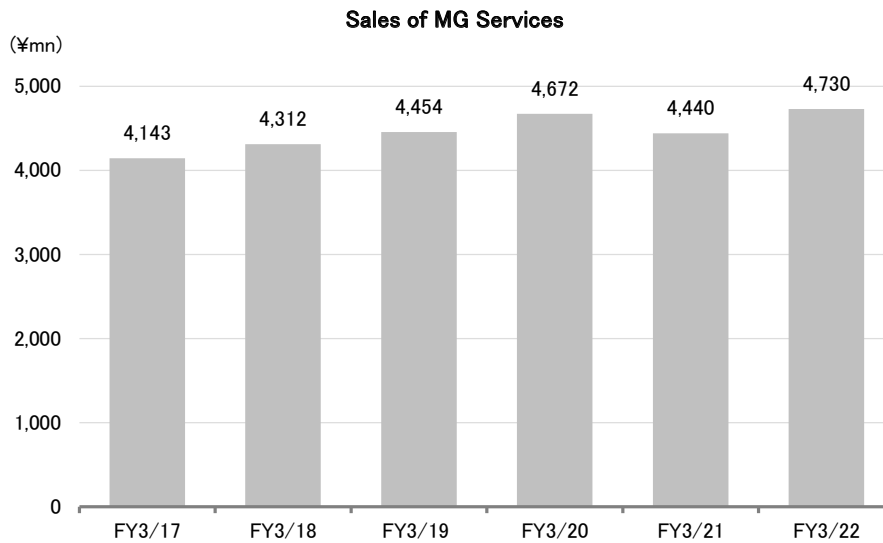
The Company's main source of competitiveness is its proactive upfront investment eyeing future growth, including its R&D expenses. Development of a next-generation hall computer (and peripheral equipment) and start of a new MG Services in recent years are evidence of continued aggressive investment in areas expected to become its growth driver. The stable revenue stream provided by the high-margin Information System Segment makes this investment possible. In particular, MG Services promoted by the Company as a recurring-revenue business model have grown and enabled funding of R&D at a high level while maintaining stable segment income, and investment risk has been limited. The Company's ability to balance large profits from its existing businesses with heavy investment in businesses for future growth allows it to produce value on a continuing basis. While exhaustion of large-scale investments in the next-generation hall computer and other outlays have kept R&D expenses at roughly 3% of net sales since FY3/18, the Company intends to aggressively allocate R&D expenses, mainly for central components of its strategy such as the cloud and smart pachislot, in the new medium-term management plan (Details below).

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

Company strengths



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



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

Financial results trends

Posted higher sales and significantly stronger profits in FY3/22. Growth in mainstay products, recovery in MG Services, and an improved income structure contributed amid ongoing difficult conditions

1. Overview of FY3/22 results

The Company posted FY3/22 results with higher sales and significantly stronger profits, including ¥24,390mn in net sales (+4.5% YoY), ¥1,191mn in operating income (+96.2% YoY), ¥1,367mn in ordinary income (+38.6% YoY), and achieved ¥1,228mn in net income attributable to owners of parent (+100.6% YoY). Even compared to the initial outlook, while net sales were slightly below plan, earnings ended substantially outpacing targets.

Pachinko halls remained downbeat on capital investment, and refrained from new openings and large-scale remodeling. However, utilization was brisk for pachinko machines compliant with the new regulations, sales of the mainstay Information Service Segment product AI hall computer “X (Kai),” CR unit VEGASIA, and information disclosure terminals REVOLA and BiGMO PREMIUM rose YoY, and service sales steadily grew to contribute to the rise in net sales. That said, net sales fell short of the Company’s initial forecast as semiconductor shortages forced it to adjust its sales plans in 3Q onward.

Turning to the Control System Segment, sales of products for pachinko machines were strong, and mainstay display and control units did well due to the start of consignment manufacturing of pachislot machines. In contrast, parts and others were sluggish.

As for earnings, operating income grew sharply, owing mainly to improvement in the earnings structure and a boost to profit from higher sales, and the operating income margin rose to 4.9% (2.6% in FY3/21). Main sources of large upside versus the initial profit outlook were growth in mainstay products with high profitability, recovery in MG Services that generate recurring revenue, and success in initiatives to lower companywide costs (workstyle reforms and other operational improvements, efficiency gains, promotion of insourcing, etc.).

Looking at financial conditions, non-current assets declined due mainly to the recording of impairment losses on idle assets, but cash and deposits and accounts receivable - trade increased. As a result, total assets increased 1.0% from the end of FY3/21 to ¥41,489mn. In addition, total net assets rose 1.5% to ¥31,141mn, reflecting an accumulation of retained earnings, such that the equity ratio improved to 75.1% (74.6% at the end of FY3/21).

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Financial results trends

Overview of FY3/22

	FY3/21		FY3/22		Change		FY3/22			
	Results	Share	Results	Share	%	change	Initial forecast	Share	Updated outlook	Share
Net sales	23,345		24,390		1,044	4.5%	26,000		24,500	
Information System Segment	17,462	74.8%	18,647	76.4%	1,185	6.8%	19,500	-	-	-
Control System Segment	5,892	25.2%	5,759	23.6%	-132	-2.2%	6,500	-	-	-
Adjustment	-9	-	-17	-	-7	-	-	-	-	-
Gross profit	9,504	40.7%	10,143	41.6%	638	6.7%	-	-	-	-
SG&A expenses	8,897	38.1%	8,952	36.7%	54	0.6%	-	-	-	-
Operating income (loss)	607	2.6%	1,191	4.9%	583	96.2%	850	3.3%	950	3.9%
Information System Segment	1,939	11.1%	2,171	11.6%	231	11.9%	1,850	-	-	-
Control System Segment	100	1.7%	537	9.3%	436	433.0%	600	-	-	-
Adjustment	-1,433	-	-1,518	-	-84	-	-1,600	-	-	-
Ordinary income (loss)	986	4.2%	1,367	5.6%	380	38.6%	1,000	3.8%	1,100	4.5%
Net income (loss) attributable to owners of the parent	612	2.6%	1,228	5.0%	616	100.6%	650	2.5%	750	3.1%
Depreciation	1,967		1,762		-205	-10.4%				

	End of FY3/21	End of FY3/22	YoY	
				% change
Total assets	41,084	41,489	405	1.0%
Total equity	30,662	31,141	479	1.5%
Equity ratio	74.6%	75.1%	0.5pt	-

Notes: The Company has applied Accounting Standard for Revenue Recognition since FY3/22, and reported figures following application of the relevant accounting standard in FY3/22 values. Furthermore, updated figures for FY3/21 reflect the change in presentation method and YoY comparisons are shown.

Revised FY3/22 estimates are those disclosed on February 24, 2022

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

The results by segment were as follows.

(1) Information System Segment

The segment reported higher sales and profits, with net sales at ¥18,647mn (+6.8% YoY) and segment profit at ¥2,171mn (+11.9%). Net sales were below but profit was above the Company's initial forecast. Management at pachinko hall companies prioritized capital investments in replacing machines complying with the former regulations with machines that meet the new regulations by the deadline of January 31, 2022, and continue to refrain from new openings and large-scale remodeling, partly due to moves to get a feel for trends in smart gaming machines scheduled to be rolled out in the future. Segment sales grew even against this backdrop mainly due to AI hall computer "X (Kai)" introductions (system updates) accompanying a rise in small-scale projects* at pachinko halls entailing the replacement of some pachislot machines with pachinko machines with high utilization rates, along with YoY growth in sales of the CR unit VEGASIA and information disclosure terminals REVOLA and BiGMO PREMIUM. Also, service sales growth was solid, despite a decline in the number of halls in operation, owing to the release of the cloud-based chain store management system ClarisLink and strong sales of other core services. However, net sales trailed the Company's initial forecast. This is because it was affected by semiconductor shortages in 3Q onward, and forced to adjust sales volumes since supply could not keep up with strong demand for some products.

* Utilization is recovering at 102% in Jan-Mar 2022 compared with the year-ago level for all types of machines, and a strong 106.5% for pachinko machines reflecting the launch of hit models that are popular with players. However, utilization remains weak for pachislot machines at 95.1%, despite an increase in deliveries of the No. 6.2 model with new game features.

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Financial results trends

As for earnings, segment profit rose sharply on the back of growth for mainstay products with high profitability, a rise in service sales, recovery in MG Services—a recurring-revenue business, and cost reductions. The segment margin was also high at 11.6%.

(2) Control System Segment

The segment reported strong profit growth despite lower sales, with net sales at ¥5,759mn (-2.2% YoY) and segment profit at ¥537mn (+433.0%). As with the Information System Segment, sales were below but profit was above the Company's initial forecast. The market overall saw a rise in gaming machine sales volumes as halls gradually replaced machines complying with the old regulations with new machines complying with the new regulations ahead of the deadline for doing so at the end of January 2022, and gaming machine manufacturers released lots of machines that meet the new regulations. In this climate, sales of mainstay display and control units rose YoY, reflecting brisk sales of products for pachinko machines, in addition to the start of consignment manufacturing of pachislot machines with the aim of expanding the business domain. In contrast, performance was lackluster for parts and others. In earnings too, segment profit rose sharply, reflecting work to reduce costs by strengthening development management and bolstering work efficiency through reorganization conducted at the beginning of the period, growth for highly profitable mainstay products, and a rise in dividends received from copyrights. Also, the segment margin of 9.3% exceeded the level before the COVID-19 pandemic (7.2% in FY3/19).

2. Summary of FY3/22

To sum up FY3/22 based on the above, it is commendable that the Company achieved strong profit growth exceeding its plan despite being negatively affected by semiconductor shortages in 3Q onward. It is especially positive, including in terms of preparing for the market revitalization that is expected in the future, that the Company shored up its earnings by firmly tapping into new demand that gradually materialized while advancing fundamental earnings structure improvements, even though pachinko halls' appetite for capital investment remained weak. The Company's new services utilizing the cloud, start of consignment manufacturing of pachislot machines, and other activities also enabled it to solidify its footing for achieving the new medium-term management plan that begins in FY3/23.

Main activities

The Company launched its first service using the cloud, and announced its sustainability policy aiming to realize a sustainable society and growth

1. Key activities in each segment

(1) Information System Segment

The Company worked to expand sales of products and services that boost earnings by solving pachinko hall management companies' issues. That includes ClarisLink (a web-based service and the Company's first using the cloud), Smart Entry System (an online entry lottery service that realizes game machine reservations for the first time in the industry), One-Stop Self-Counter (a POS system for saving labor at pachinko halls), and Smart Membership Registration (web-based registration in advance eliminating the need for paper application forms). The Company also encouraged use of its Market-SIS market area analysis service, which provides information on customer traffic at pachinko halls in the surrounding area, and promoted replacement of existing hall computers (system updates) through proposals utilizing the AI hall computer "X (Kai)." It succeeded in bringing the number of pachinko halls that have introduced "X (Kai)" to over 1,000, about a third of its hall customers.

(2) Control System Segment

Regarding the Company's new undertaking in consignment manufacturing of pachislot machines with the aim of expanding its business scope, it worked on producing two models. It also began working on next-generation smart gaming machines, targeting releases from FY3/24.

2. Initiatives in sustainability

The Company formed a Sustainability Committee in November 2021 for the purpose of promoting sustainability activities in a continuous and organized manner and realizing sustained growth and a sustainable society through management that emphasizes ESG and SDGs. It aims to create medium- to long-term corporate value rooted in the corporate philosophy of "continuing to consistently deliver sustainable growth in the future by creating new value through innovations." Furthermore, the Board of Directors resolved the sustainability policy and identified materiality, disclosing information in March 2022.

Main activities

Initiatives in sustainability

<p>Corporate philosophy</p> <p>Sustainability Policy</p>	<p>We will continue to achieves sustainable growth consistently from now on through the creation of new value based on innovation</p> <p>The Daikoku Denki Group solves social issues through business activities based on its management philosophy, and will aim for the realization of a sustainable society and the growth of the group together with stakeholders.</p>
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ESG	Materialities	SDGs
E	Contributions to the global environment	
S	Promotion of activities by human resources	
	Provision of solutions based on innovation	
	Handling of addiction	
G	Strengthening of governance and compliance	

Source: The Company's results briefing materials

Medium-term management plan

Disclosed the new medium-term management plan for an era of smart gaming machines. Aims to build the industry's only platform on a cloud server

The Company disclosed a new medium-term management plan (three years) starting from FY3/23 in November, 2021. While disclosure had been delayed for some time due to persisting uncertain conditions related to the pace of the transition from machines complying with the former regulations to machines that meet the new regulations and accompanying changes in the industry environment and capital investment trends, factors supporting the decision to move ahead with the timing of the disclosure, meanwhile, were full transition to machines that meet the new regulations with a deadline of the end of January 2022 and seeing a path to livelier conditions in the gaming machine market and pachinko hall capital investments as the switch to the new era of smart gaming machines emerges. Based on the corporate philosophy of “continuing to consistently deliver sustainable growth in the future by creating new value through innovations,” the Company intends to redefine business domains as a way of addressing future changes in the market environment. Specifically, it outlined a strategy of capturing demand related to inroads using smart gaming machines that are slated for new release, continuing promotion of AI hall computer X (Kai) uptake, and carrying on building the industry's only platform through rollout of business utilizing a cloud server (reinforcement of new MG Services).

Medium-term management plan

1. Market environment

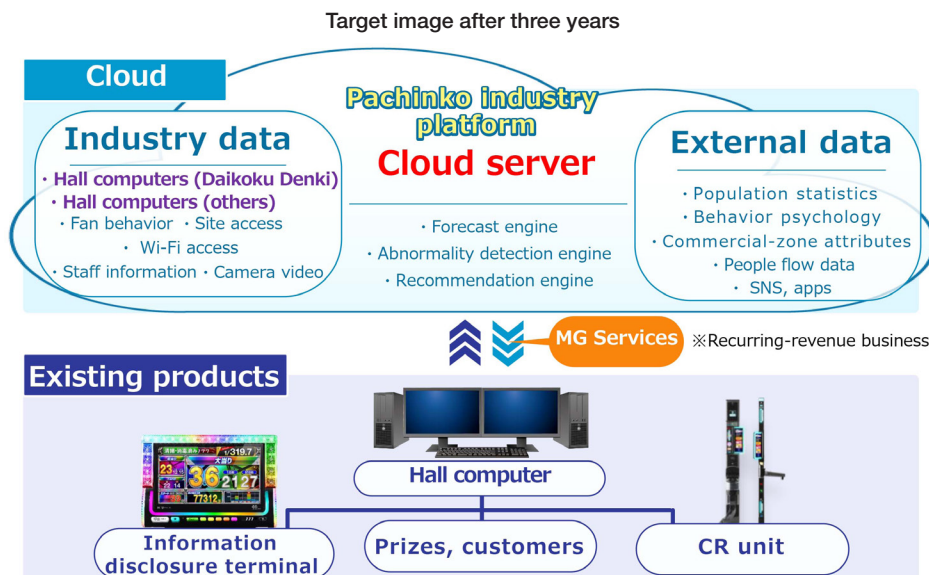
The gaming machine market and pachinko hall industry are anticipating the arrival of a new era led by smart gaming machines accompanying full transition to machines that meet the new regulations from February 2022 and new rollout of smart gaming machines planned in 2H FY3/23. The switch to smart gaming machines might dramatically advance data collection and utilization and significantly affect fan growth and the format of hall management by broadening “game” aspects. In particular, some observers think manifestation of differences in customer draw by individual pachinko halls might accelerate the trend of industry reorganization driven by leading companies. The Company envisions a scenario of significant income expansion from the second year of the medium-term management plan (FY3/24) amid advances in the shift to smart gaming machines as pachinko halls ramp up capital investments (including new site openings) for survival.

2. Priority measures (redefining business domains)

(1) Information System Segment

The centerpiece of the strategy is its aim to build the industry’s only platform through reinforcement of new MG Services that apply a cloud server in anticipation of future market changes, and thereby lock in customers (primarily major hall operators) and effectively assist hall management and contribute to industry reforms. This requires continued promotion of AI hall computer X (Kai), provision of products and services that flexibly address machines that meet the new regulations and smart gaming machines, further progression of labor and headcount savings, and improvement in the market shares of all products through timely launch of products that transform the way hall staff work and the strategy for attracting fans. It also involves launching a platform that consolidates and utilizes industry and external data on a cloud server* and raising stable income through reinforcement of new MG Services.

* The platform consolidates industry data (hall computers of Daikoku Denki and others, fan behavior, site access, Wi-Fi access, staff information, and surveillance video) and external data (population statistics, behavior psychology, trading area attributes, people flow data, and SNS and apps) on a cloud server, and effectively utilizes and analyzes it with engines focused on forecasting, abnormality detection, and recommendations, among other functions.



Source: The Company's results briefing materials

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Medium-term management plan

(2) Control System Segment

The Company advocates a policy of transitioning from “pachinko” to “smart pachislot” as the main business driver. It plans to further pursue consignments for comprehensive development of pachislot gaming machines that it started in 2H FY3/21 and aims to complete medal-less body and software development operations and cultivate this business into a core earnings source within three years.

3. Investment plan

In the three-year investment plan, the Company intends to cumulatively spend ¥4bn in R&D expenses (¥2.8bn in the previous three years) and ¥6.2bn in capital investments (¥4.1bn in the previous three years), exceeding combined outlays in the previous three years. It also plans to mainly allocate R&D expenses to smart pachislot machines (Control System Segment) and capital investments to server development (Information System Segment).

4. Numerical goals

Numerical goals for FY3/25, the final fiscal year, are ¥34,000mn in net sales (11.7% average growth rate over three years) and ¥2,200mn in operating income (6.5% operating income margin). While the Company conservatively anticipates results in FY3/23, reflecting the difficulty of assessing the timing of full-fledged profit gains (ramp-up of capital investments at pachinko halls) due to semiconductor shortages and the impact of the COVID-19 pandemic, it factors in realization of significant business expansion in the second year (FY3/24). Additionally, projected incremental improvement in the operating income margin, despite aggressive R&D spending and capital investments, relies on enhanced added value in various product areas, recurring business led by MG Services becoming the growth driver and substantial contributions from the resulting change in the earnings structure (lifting the bottom line).

New medium-term management plan

	(¥mn)									
	FY3/22		FY3/23 (First year of the medium-term management plan)		FY3/24 (Second year of the medium-term management plan)		FY3/25 (Third year of the medium-term management plan)		Average growth rate (Three years)	
	Results	Share	Target	Share	Target	Share	Target	Share		
Net sales	24,390		26,000		32,000		34,000		11.7%	
Information System Segment	18,647	76.4%	19,500	75.0%	25,000	78.1%	26,500	77.9%	12.4%	
Control System Segment	5,759	23.6%	6,500	25.0%	7,000	21.9%	7,500	22.1%	9.3%	
Gross profit	10,143	41.6%	10,400	40.0%	11,970	37.4%	13,100	38.5%	8.9%	
SG&A expenses	8,952	36.7%	9,550	36.7%	10,270	32.1%	10,900	32.1%	6.8%	
Operating income (loss)	1,191	4.9%	850	3.3%	1,700	5.3%	2,200	6.5%	22.7%	
Ordinary income (loss)	1,367	5.6%	950	3.7%	1,800	5.6%	2,300	6.8%	18.9%	
Net income (loss) attributable to owners of the parent	1,228	5.0%	650	2.5%	1,200	3.8%	1,500	4.4%	6.9%	

Source: Prepared by FISCO from the Company's financial results and medium-term management plan

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Medium-term management plan

5. FISCO analyst's strategy assessment

To reinforce MG Services premised on tapping into its strength in data for the arrival of a new era driven by smart gaming machines, FISCO agrees that the Company's strategy to advance from hall computers to business utilizing a cloud server makes sense when considering changes in the industry environment as opportunities to leverage its advantages. Furthermore, FISCO thinks the platform business it targets is likely to reinforce the Company's overwhelming position by fueling a beneficial cycle (networking effect) wherein members are drawn to places with extensive data and data accumulates in places with more members. We also intend to focus on the extent of new value realized through innovation and sustainability initiatives as its exercise of leadership in the industry contributes substantially to its own continuation and the sustainability of the industry and society. Additionally, since the know-how of using the Company's data can be expanded horizontally, it is important to closely monitor developments in M&A and business alliances aimed at entering other industries in order to secure new income sources and diversify risk.

■ Outlook

Expects lower profit despite higher net sales in FY3/23, but market to gain vigor heading into 2H

1. FY3/23 forecast

The Company forecasts results in FY3/23, the first year in the new medium-term management plan, that will deliver higher sales and profits with ¥26,000mn in net sales (+6.6% YoY), ¥850mn in operating income (-28.6%), ¥950mn in ordinary income (-30.5%), and ¥650mn in net income attributable to owners of the parent (-47.1%).

The Company expects net sales to grow in both the Information System Segment and the Control System Segment as pachinko halls' appetite for capital investment is recovering. However, it should be noted that the Company forecasts Information System Segment earnings will be weighted towards 2H, assuming 1) it will remain difficult to procure electronic components and other parts due to semiconductor shortages in 1H and 2) the emergence of smart gaming machines will invigorate the market in 2H.

In the Information Service Segment, the Company plans to accelerate investment in cloud development by strengthening its development framework, including by considering M&A, while working to expand existing products' market share by 1) increasing sales of CR units, information disclosure devices, and so forth alongside the deployment of smart gaming machines, 2) growing sales of Market-SIS looking to achieve No. 1 market share, and 3) expanding sales of ClarisLink, its first cloud-based service. In the Control System Segment, the Company looks to transition from "pachinko" to "smart pachislot" as the main business driver, and build a stable development system by insourcing development frameworks for medal-less bodies and software development.

As for earnings, the Company expects increased net sales, growth for MG Services, and so forth to boost earnings. Nevertheless, it forecasts operating income will decline based on conservative estimates regarding impact from semiconductor shortages and surging raw material prices, in addition to proactive investments in areas such as the cloud and pachislot.

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Outlook

FY3/23 forecast

	FY3/22		FY3/23		YoY change	
	Result	Share	Forecast	Share		% change
Net sales	24,390		26,000		1,609	6.6%
Information System Segment	18,647	76.4%	19,500	75.0%	852	4.6%
Control System Segment	5,759	23.6%	6,500	25.0%	740	12.8%
Adjustment	-17	-	-	-	-	-
Gross profit	10,143	41.6%	10,400	40.0%	256	-
SG&A expenses	8,952	36.7%	9,550	36.7%	597	-
Operating income (loss)	1,191	4.9%	850	3.3%	-341	-28.6%
Information System Segment	2,171	11.6%	1,950	10.0%	-221	-10.2%
Control System Segment	537	9.3%	450	6.9%	-87	-16.3%
Adjustment	-1,518	-	-1,550	-	-31	-
Ordinary income (loss)	1,367	5.6%	950	3.7%	-417	-30.5%
Net income (loss) attributable to owners of the parent	1,228	5.0%	650	2.5%	-578	-47.1%

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

2. FISCO focus

Though there is a need to take a cautious view on impact from semiconductor shortages and rising raw material prices, FISCO also believes the Company's earnings forecasts are well within reach since pachinko halls' capital investments have gradually recovered due partly to the launch of popular machines with high utilization, and the introduction of smart gaming machines planned going forward will be a tailwind too. Points that warrant attention in particular are how smart gaming machines enhance the performance of pachislot machines, which has stalled, and how industry reorganization (polarization) centered on leading hall companies accelerates as the market recovers. What kind of effect the above has on the Company's performance will probably also be important information for gauging its future growth potential. In addition, it is worth keeping an eye on the Company's forward-looking initiatives such as cloud service sales expansion and pachislot development.

Industry environment

There are signs of market gaining vigor with the emergence of popular machine models and an eye to future deployment of smart gaming machines, but semiconductor shortages are a concern

Japan's pachinko industry has been experiencing a challenging environment over the past few years, reflecting the decline in the overall number of pachinko players, a trend toward playing games with low rental costs for balls, increases in Japan's consumption tax, and other factors. The self-regulatory action taken by the industry in 2015 (tightening restrictions on both pachinko and pachislot machines with strong gambling elements) left the whole industry in a slump in 2016 as it started to grapple with the problem of collecting and removing all pachinko machines that may perform differently from certified standards. Furthermore, promulgation of Implementation Rules for the Act on Control and Improvement of Amusement Business, etc. and Rules on Partial Revision of Rules Related to Gaming Machine Certification and Format Inspection (enforced on February 1, 2018; hereafter, "new regulations")* on September 4, 2017 fueled pessimistic views of the industry and uncertainty about the future. This disarray persisted for a while, and additional impact by COVID-19 (temporary hall closures and shorter operating hours) since the start of 2020 accelerated the harsh environment.

* The new regulations restricted the maximum number of output balls (as one example) and clarified standards for managed gaming machines.

In 2021, however, the market was enlivened by replacement demand for gaming machines, driven by progress in gradually replacing gaming machines with those meeting the new regulations ahead of the deadline at the end of January 2022, and the emergence of several popular gaming machine models with new amusement features (such as "play time"*) following revisions to the Technology Format Interpretation Standards adopted in January 2020, and in accordance with related Nikkoso internal stipulations. In addition, the gaming machine market and pachinko hall industry are approaching a new era, with attention focusing on the deployment of smart gaming machines going forward. As for near-term risks, renewed expansion of the COVID-19 pandemic, including due to the emergence of new variants, delivery delays from semiconductor shortages, and other negative impacts are a concern.

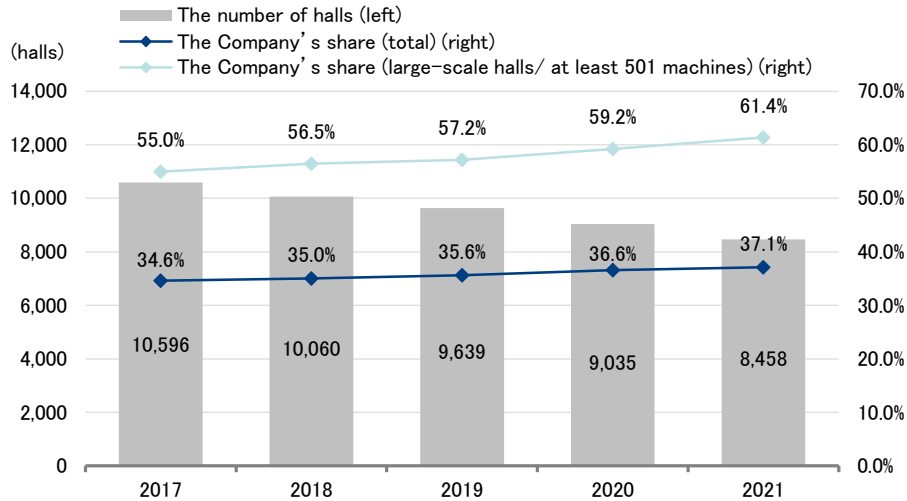
* "Play time" is a system (rescue measure) whereby the machine enters a shortened time mode (a function that efficiently rotates balls without reducing the number of balls up to a certain number of times) if the player does not have a big win in a specified number of rotations during normal play (low probability). With the recent industry regulations, new functions such as "play time" have been added, and the breadth of game features of game machines has expanded significantly.

According to surveys by the National Police Agency, the number of pachinko halls in Japan declined at an average annual rate of 3.9% from 2012 to 2021. In particular, in recent years there has been a noticeable decline in new hall openings due to the impact of the new regulations and other factors. At the end of December 2021, the number of halls was 8,458 (-577 YoY), and the Company share of hall computer customers rose to 37.1% continuing the trend to increase year by year. Its customer halls are often high-end, large pachinko halls that are the top performers in their respective local markets and exceed the market average in size*. The customer base hence is fairly resilient to economic fluctuations and possesses healthy investment resources. As the Company moves toward a new era with new smart gaming machines, we expect an excellent opportunity for it to expand business once investment appetites recover, mainly at large halls.

* The Company's share of the large-scale halls (at least 501 machines) market is even higher at 61.4%.

Industry environment

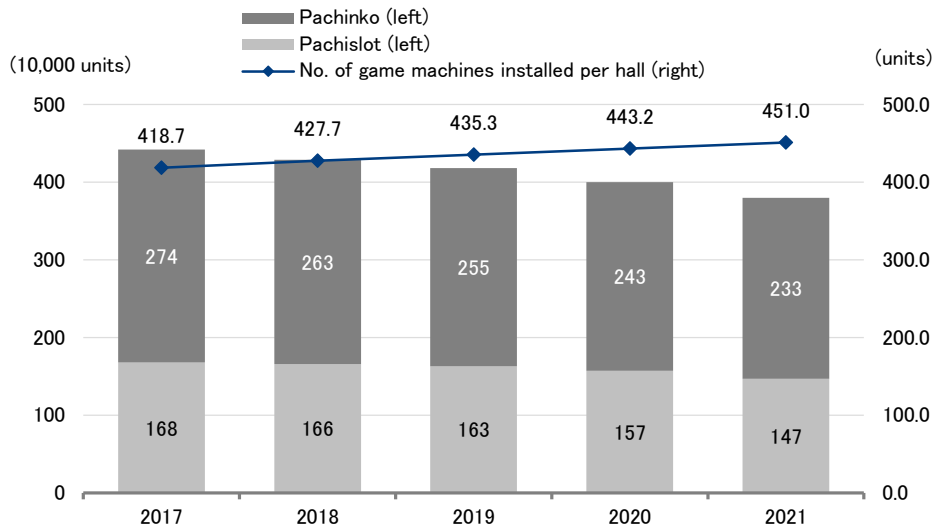
Trends in the number of halls and the Company's share of the hall computer market



Source: Safety Division, Community Security Bureau, National Police Agency
 Prepared by FISCO from the Current Status of Entertainment and Amusement Businesses, etc. and the Status of Measures for Crimes relating to Entertainment and Amusement Businesses, etc. 2021 and the Company's results briefing materials

Meanwhile, although the number of game machines installed and running in the market is on a downward trend (the decline in pachinko machines is particularly striking), the number of machines per hall is increasing, indicating that halls are becoming larger. As discussed above, larger pachinko halls that command economies of scale are a main segment, therefore this trend should benefit the Company with its ability to realize robust investment return through advanced functionality and added value.

Trends in the number of installed units in the gaming machine market

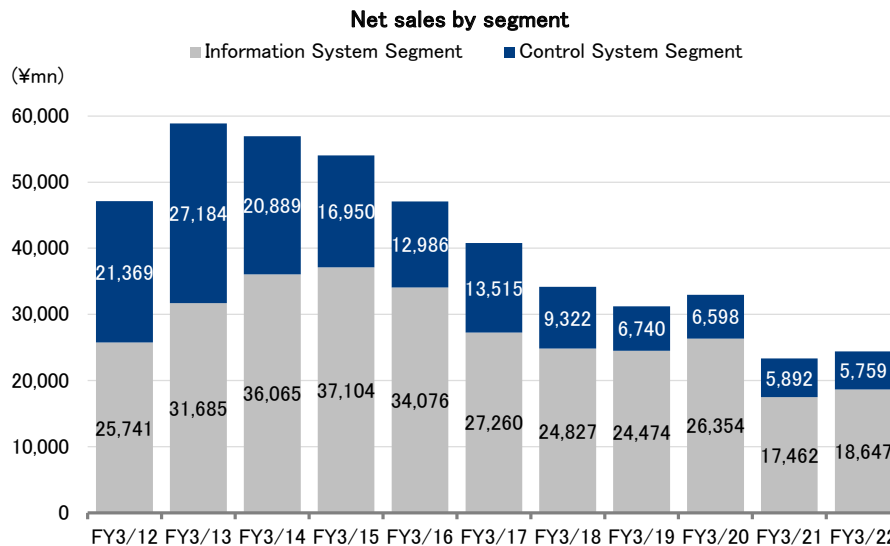


Source: Safety Division, Community Security Bureau, National Police Agency
 Prepared by FISCO from the Current Status of Entertainment and Amusement Businesses, etc. and the Status of Measures for Crimes relating to Entertainment and Amusement Businesses, etc. 2021

■ Performance over the past fiscal years

As the industry enters a period of transition, earnings have been on a downward curve, but the Company is establishing a foundation for sustainable growth eyeing the future

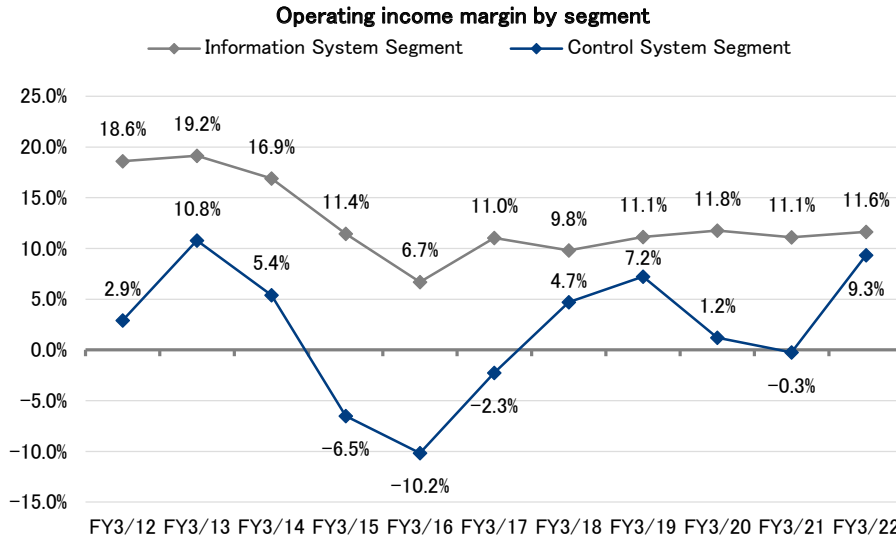
Looking back at past results, the Company's sales shrank YoY because of restrained consumer spending and the impact of the Great East Japan Earthquake in FY3/11. Its results rebounded afterwards, even though the pachinko industry continued to contract. This recovery was mainly led by the Information System Segment, which holds high market shares for its products. Net sales in this segment reached consecutive record highs from FY3/13 to FY3/15, supporting the Company's overall performance. However, net sales have been weak since FY3/16 due to the impacts of negative factors in the industry (self-regulatory action, collecting and removing of machines, and uncertainty related to new regulations), as well as the impacts of the COVID-19 pandemic and other factors since the start of 2020.



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

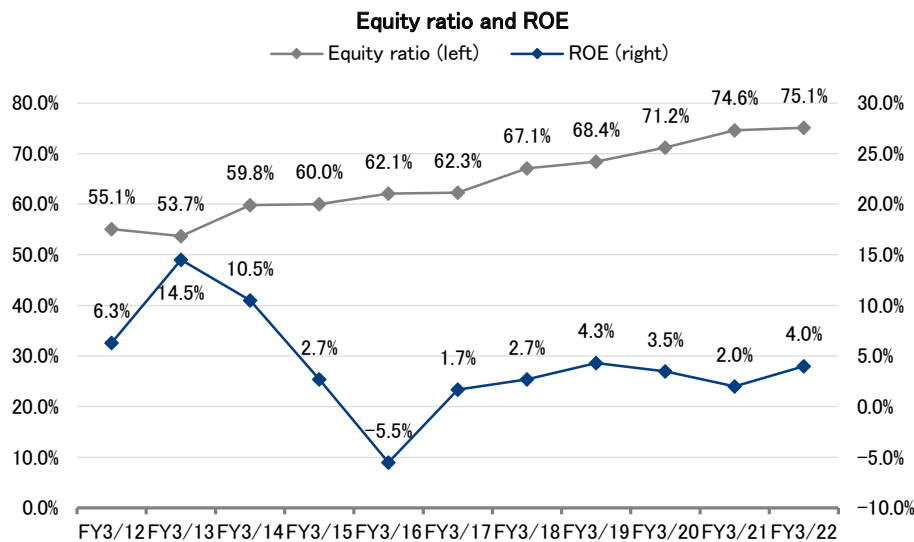
The Information System Segment has become the source of profits, and has maintained high profit margins as the Company's performance recovered. Reflecting increasing investment in R&D for next-generation products from FY3/14 to FY3/17, profit margins have declined, but considering the size of the investment, they are still high. However, although R&D for next-generation products has run its course for the meantime since FY3/18, profit margins have not completely returned to the previous high levels due to factors including the stagnation in net sales. Meanwhile, steady progress in the conversion to a recurring-revenue business model, including growth in MG Services, has been supporting income.

Performance over the past fiscal years



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

In terms of financial indicators, the Company's equity ratio, a measure of financial stability, has been rising, reflecting an accumulation of retained earnings and reaching a high level of 75.1% in FY3/22. The current ratio, which indicates the ability to make payments in the short term, was 284.1%, mainly due to large holdings of cash and deposits, as the Company's robust financial base is a strength not only for business continuity, but also as a source for powering future growth. ROE, a measure of capital efficiency, has been low since FY3/15 due to a deterioration of net income. The Company suffered losses in FY3/15 due to the bankruptcy of a manufacturer customer and in FY3/16 due to the devaluation of parts and materials for its pachislot machines as industry restrictions were placed on risky machines. Going forward, the Company will work on growing profits and improving ROE.



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

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■ Shareholder returns

Plans to pay a ¥40 annual dividend in FY3/23, expect scope for raising dividends alongside profit growth

Regarding the dividend, the Company has a fundamental policy of paying a stable dividend and implements a special dividend based on earnings. In FY3/22, it paid a ¥60 dividend per share for the full year (¥25 interim, ¥35 year-end), an increase of ¥20 YoY. Since profits were much higher than expected, the Company revised up the year-end dividend by ¥5 from its initial forecast. In FY3/23, it currently plans to pay a ¥40 dividend per share for the full year (¥10 interim, ¥30 year-end). However, there is also room to raise the dividend further depending on future profit growth.

Additionally, the Company resumed the shareholder benefit program, which seeks to enhance the investment appeal of its stock and promote medium- to long-term ownership, in FY3/22*. The benefit program gives QUO cards to shareholders with the value calibrated to the number of shares owned and the period of sustained ownership at the end of September each year.

* The Company temporarily eliminated the shareholder benefit program in FY3/21 due to sharply lower profits caused by the impact of the COVID-19 pandemic amid continued uncertainty in the business environment.



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